

# ENVIRONMENTAL LIABILITY

## ENVIRONMENTAL DISCLOSURES: WHAT RISKS LIE UNSEEN BENEATH THE SURFACE?

*By Steven Siros\* and Michael Strong\*\**

In the United States, it is no longer a question of if, but when federal climate change regulations will be promulgated. In fact, regardless of which political party wins in November 2008, federal climate change regulations are all but inevitable by the end of 2009. In the meantime, many states have already promulgated regulations mandating reductions of greenhouse gas (GHG) emissions. Not surprisingly, institutional investors and ratings agencies are closely scrutinizing companies' strategies with respect to preparation for, and compliance with, these regulations. As part of this scrutiny, these same investors and rating agencies are also closely examining companies' SEC disclosures with respect to these issues as well.

For example, in September 2007, a coalition of state pension plans and institutional investors, who together control over \$1.5 trillion in assets, joined with environmental groups and governmental entities to petition the SEC to issue guidance regarding disclosure of climate change issues.<sup>1</sup> This SEC petition was organized by the Coalition for Environmentally Responsible Economies (Ceres), a coalition of environmental and investor groups. In addition to this SEC petition, Ceres has directly requested information on climate change strategies from companies listed on the S&P 500.<sup>2</sup> As of the date of this article, although the SEC has yet to formally respond to Ceres' petition, at least five hundred "individual in-

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1. Ceres, et al., Request for Interpretive Guidance on Climate Risk Disclosure, File 4-547 (Sec. Exch. Comm'n, Sept. 18, 2007), available at <http://www.sec.gov/rules/petitions/2007/petn4-547.pdf>.

2. David Gardner & Associates, *Climate Risk Disclosure by the S&P 500* (Ceres 2007), available at <http://216.235.201.250/NETCOMMUNITY/Document.Doc?id=146>.

vestors” have submitted letters in support of the rulemaking,<sup>3</sup> and more than two hundred companies have provided information in response to Ceres’ information requests.<sup>4</sup>

At the same time, these same companies are facing increased shareholder scrutiny with respect to climate change issues. According to Ceres, twenty-four shareholder resolutions relating to climate change issues were filed during the 2006 proxy season.<sup>5</sup> During the 2007 and 2008 proxy seasons, the number of climate change-related shareholder resolutions more than doubled (forty-three and fifty-four, respectively).<sup>6</sup> Many of these resolutions garnered the support of more than twenty percent of the stockholders (which is fairly high for a shareholder resolution), while others were voluntarily withdrawn after the company agreed to make the requested disclosures.<sup>7</sup>

Some requests for information relating to climate change disclosures were somewhat more adversarial. In September 2007, five energy companies received subpoenas from the New York Attorney General seeking information as to whether these companies had properly disclosed their potential liabilities with respect to CO<sub>2</sub> emissions.<sup>8</sup> As of the date of this article, the New York Attorney General has not yet initiated an enforcement action against any of the subpoenaed companies.

Although an article discussing pending state and federal GHG regulations is likely to be outdated soon after it is written, several bills that are pending before Congress contain provisions that would require more disclosure of climate change risks.<sup>9</sup> For example, the version of the Lieberman-Warner Climate Security Act (which incidentally was the first climate-change bill to have passed out of committee) that passed out of subcommittee in November 2007 contained provisions that would obli-

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3. See SEC Petition for Rulemaking Webpage (comment section) for Ceres’ petition at <http://www.sec.gov/comments/4-547/4-547.shtml>.

4. Gardner & Associates, *supra* note 2.

5. Press Release, Investor Network on Climate Risk, 2006 Proxy Season Produces Positive Results on Climate Change (Jul. 14, 2006), available at <http://www.incr.com/NETCOMMUNITY/Page.aspx?pid=312&srcid=330>.

6. David Gardner & Associates, *Investor Progress on Climate Risks & Opportunities: Results Achieved Since the 2005 Investor Summit on Climate Risk at the United Nations*, available at <http://www.ceres.org/NETCOMMUNITY/Document.Doc?id=287>; Press Release, Ceres, Investors File Record Number of Global Warming Resolutions with U.S. Companies (Mar. 6, 2008), available at <http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=854&srcid=421>.

7. Gardner & Associates, *supra* note 6 at 6; see also 2006 Proxy Season Produces Positive Results on Climate Change, *supra* note 5.

8. See, e.g., Felicity Barringer & Danny Hakim, *New York Subpoenas 5 Energy Companies*, N.Y. TIMES, Sept. 16, 2007, available at <http://www.nytimes.com/2007/09/16/nyregion/16greenhouse.html>.

9. E.g., Global Warming Pollution Reduction Act, S.309, 110th Cong. (2007) (requiring disclosure of financial exposure to global warming issues); Global Warming Pollution Reduction Act, S.309, 110th Cong. (2007) (requiring same disclosure from companies with market capitalization exceeding \$1 billion).

gate the SEC to promulgate regulations requiring disclosure of climate-related risks.<sup>10</sup> More specifically, the draft version of this bill makes clear the United States' commitment to reduce GHG emissions should be considered to be a material effect and global warming a known trend.<sup>11</sup>

All of the attention being paid to climate change disclosures shouldn't lull companies into a false sense of security as to the more traditional environmental disclosures. Since at least 2003, the SEC has frequently indicated that it believed that companies were not providing adequate disclosure with respect to environmental matters.<sup>12</sup> In the past eighteen months, the SEC made good on its threats by taking action against several companies and corporate executives engaged in improper environmental financial reporting. For example, on November 26, 2006, the SEC imposed a cease-and-desist order against Ashland, Inc. and its former Director of Environmental Remediation for materially understating its environmental reserves from 1999-2001.<sup>13</sup> The SEC concluded that Ashland's internal controls were inadequate and ordered Ashland to take steps to address these deficiencies.<sup>14</sup> In June 2007, the SEC settled pending civil charges against certain ConAgra executives relating to the improper reductions of the company's environmental reserves. ConAgra's former CFO agreed to pay over \$700,000 to settle those charges.<sup>15</sup> That same month, the former CFO of Safety-Kleen pled guilty to improperly reducing the company's environmental reserves.<sup>16</sup> Safety-Kleen's CFO was sentenced to seventy months in prison.<sup>17</sup>

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10. See America's Climate Security Act of 2007, S.2191, 110th Cong. § 9002 (2007). Although the SEC provision remains in the bill as listed on the government bill tracker site, [thomas.gov](http://thomas.gov), on May 20, 2007, Sen. Boxer (D-CA), chair of Senate Environment and Public Works Committee, offered new language in the form of an amendment that did not contain the SEC disclosure section. For a copy of the amendment, please see the language posted on the Environment and Public Works Committee website at [http://epw.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=aa57ba9-ee98-4204-882a-1de307ecdb4d](http://epw.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=aa57ba9-ee98-4204-882a-1de307ecdb4d).

11. *Id.* at §§ 2-3 (discussing findings, purposes of the Lieberman-Warner Act).

12. See, e.g., Sec. & Exch. Comm'n, Summary by the Division of Corporate Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Feb. 2003), available at <http://www.sec.gov/divisions/corpfin/fortune500rep.htm>.

13. See E. Lynn Grayson, *Recent SEC Enforcement of Environmental Financial Disclosure*, Jenner & Block Air Land and Water News (Jul. 26, 2007) (addressing contemporary SEC environmental reserves use and reporting enforcement), available at [http://www.jenner.com/files/tbl\\_s20Publications%5CRelatedDocumentsPDFs1252%5C1772%5CRecent\\_SEC\\_Enforcement\\_of\\_Environmental\\_Financial\\_Disclosure\\_0707.pdf](http://www.jenner.com/files/tbl_s20Publications%5CRelatedDocumentsPDFs1252%5C1772%5CRecent_SEC_Enforcement_of_Environmental_Financial_Disclosure_0707.pdf) (hereinafter "Recent SEC Enforcement Article").

14. *Id.*; *In re Ashland Inc. and William C. Olatin*, Exch. Act Release No. 54830, Accounting and Auditing Release No. 2518, Administrative Proceeding File No. 3-12487 (Nov. 29, 2006).

15. See Recent SEC Enforcement Article, *supra* note 13.

16. *Id.*

17. *Id.*; Press Release, U.S. Attorney S.D.N.Y., Former Safety-Kleen Chief Financial Officer Sentenced to 5 Years and 10 Months for \$267 Million Accounting Fraud (Nov. 8,

Moreover, as further discussed below, recent changes to environmental disclosure and accounting rules and regulations may require changes to be made with respect to the manner in which companies evaluate environmental liabilities. In light of these disclosure and accounting changes, coupled with the increased scrutiny being paid to companies' environmental and climate change disclosures by private and regulatory entities alike, companies would be well advised to re-evaluate their disclosures to ensure that they are accurately addressing their environmental and climate change liabilities and risks.

#### OVERVIEW OF SEC DISCLOSURE OBLIGATIONS – ENVIRONMENTAL MATTERS

A detailed discussion of the rules, regulations and guidance with respect to the estimation and disclosure of environmental liabilities is well beyond the scope of this article. However, a brief overview of these rules, regulations and guidance, including recent modifications, follows.

##### 1. *SEC Disclosure Obligations*

The statutory basis for companies' SEC disclosure requirements with respect to environmental liabilities can be found in Regulation S-K, and more specifically, Items 101, 103, and 303 of that regulation.<sup>18</sup> These reporting obligations can be briefly summarized as follows:

###### a. Description of the Business – S-K Item 101

Companies are required to disclose material effects that compliance with environmental laws that have been enacted or adopted will have on earnings, competitive position, and capital expenditures.<sup>19</sup> Materiality is defined for these purposes as to whether the environmental liability will impact the company's financial position.<sup>20</sup> Typically, Item 101 has led to the disclosure of costs associated with compliance with applicable environmental laws such as the installation of an emission control device or the costs associated with soil or groundwater remediation.<sup>21</sup>

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2007) (discussing sentence), available at <http://newyork.fbi.gov/dojpressrel/pressrel07/accountingfraud110807.htm>.

18. 17 CFR §§ 229.101, 229.103, 229.303 (discussing disclosure requirements).

19. 17 C.F.R. § 229.101(c) (xii).

20. The United States Supreme Court has interpreted "materiality" to mean that companies should disclose information if there is a "substantial likelihood that a reasonable investor would have found the omitted information important or that the missing facts would have altered the 'total mix' of information available to the investor." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

21. In determining materiality, the non-binding ASTM Standard Guide for Disclosure of Environmental Liabilities (E-2173-01) states that "disclosure should be made when an entity believes its environmental liability for an individual circumstance or its environmental liability in the aggregate is material." Standard for purchase at <http://www.astm.org/Standards/E2173.htm>. Of course, this is contrary to a June 1993 General Accounting Office (GAO) report titled *Environmental Liability: Property and Casualty Insurer Disclosure of Environmental Liabilities*, which interpreted the applicable SEC regulations as

SEC Staff Accounting Bulletin 92 (SAB 92) provides specific examples of the types of environmental losses that should be disclosed (if material): (1) recurring costs associated with managing toxic substances; (2) capital expenditures allocated to monitor hazardous substances or pollutants; (3) expenditures mandated by a court or administrative agency for contaminated sites; and (4) other nonrecurring cleanup expenses that can reasonably be anticipated but are not yet required to be incurred by the relevant government agency.<sup>22</sup> Thus, even state legislation that requires a company to report—without mandatory reductions—greenhouse gas emissions could qualify under the second prong of SAB 92 as a loss contingency that must be disclosed, if material. The same logic would equally apply to the early years contemplated by Lieberman-Warner, where companies create a “baseline” for future greenhouse gas emission reductions.<sup>23</sup>

b. Legal Proceedings – S-K Item 103

Companies are required to disclose pending material legal proceedings, other than routine litigation incidental to the business, to which the company is a party. Any enforcement proceeding initiated by the government is deemed to be material unless the company reasonably believes that the proceeding will result in fines of less than \$100,000.<sup>24</sup> U.S. EPA has begun to share information relating to enforcement proceedings directly with the SEC and a recent U.S. EPA enforcement database (ECHO) provides the SEC with a useful tool to evaluate companies’ compliance with Item 103.<sup>25</sup>

c. Known Trends and Uncertainties – S-K Item 303

Referred to as Management’s Discussion and Analysis of Financial Condition and Results of Operation (MD&A), companies are required to disclose any known trends, demands, commitments, events or uncertainties that are reasonably likely to have a material effect on a company’s financial condition.<sup>26</sup> SEC guidance on MD&A focuses on two lines of inquiry: (1) is the known trend, commitment, event, or uncertainty likely to occur; and (2) if the company cannot make that determination, the company must evaluate the known trend, commitment, event or uncertainty as if it would occur, unless the company concludes that the known trend, commitment, event or uncertainty is not reasonably likely to have a

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requiring materiality to be evaluated in terms of individual claims. GAO/RCED-93-108 (Washington, D.C. Jun. 2, 1993), *available at* <http://archive.gao.gov/t2pbat5/149533.pdf>.

22. Staff Accounting Bulletin No. 92, S.E.C. Release No. SAB - 92, 54 SEC Docket 635, 1993 WL 194317 (Jun. 8, 1993) (*see answer to Question 6*); 17 C.F.R. Part 211; 58 Fed Reg. 32844.

23. S.2191 at §§ 1103-1105.

24. 17 C.F.R. § 229.103, Instr. 5C.

25. *Available at* <http://www.epa-echo.gov/echo/index.html>.

26. 17 C.F.R. § 229.301, Instr. 1.

material effect on the company's financial position.<sup>27</sup> As further discussed below, the potential impact of climate change regulations may be precisely the type of issue that would need to be discussed in an MD&A.

## 2. *Proper Treatment of Environmental Liabilities on Company Balance Sheets*

In addition to these SEC disclosure obligations, companies are required to ensure that environmental liabilities are properly reflected on their balance sheets. To that end, the Financial Accounting Standards Board (FASB) has developed standards to guide companies with respect to financial statement disclosures of contingent environmental liabilities. FASB Standard Number 5 (SFAS 5) requires that all loss contingencies be accrued (reflected on a company's balance sheets) if it is (1) "probable" that the liability will be incurred and (2) the amount of loss can "reasonably" be estimated.<sup>28</sup>

After SFAS 5, some companies "struggled" with whether contingent environmental losses were probable or could reasonably be estimated, and in light of the confusion brought about by this "struggle," some companies elected not to accrue liabilities for these contingent losses.<sup>29</sup> In an attempt to alleviate this confusion, subsequent guidance followed. The American Institute of Certified Public Accountants issued Statement of Position 96-1 (SOP 96-1), which established a two-part test to determine whether a loss was "probable." According to SOP 96-1, a loss is probable if: (1) litigation has commenced, a claim has been asserted, or commencement of either is probable; and (2) the outcome of the litigation or claim would be unfavorable.<sup>30</sup> FASB's Financial Interpretation Number 14 (FIN 14) provided guidance with respect to whether the liability could be "reasonably estimated."<sup>31</sup> According to FIN 14, a loss is "reasonably estimable" when a range of possible losses can be established. If a particular loss falls within that range, a company must recognize the better number within that range, or, if no amount within the range is a better estimate than any other amount, the minimum amount should be accrued.<sup>32</sup> If a loss contingency is only possible (rather than probable), or if the loss cannot be reasonably estimated, then the loss contingency need not be accrued but the nature of the loss contingency should be disclosed in a footnote to the financial statement.<sup>33</sup>

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27. Sec. Act. Release No. 6835, 54 Fed. Reg. 22, 427, 22, 240 (May 24, 1989).

28. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5 (Mar. 1975), available at <http://www.fasb.org/pdf/fas5.pdf>.

29. Marie Leone, *The Greening of GAAP: Are Corporations Being Forthright about Their Environmental Liabilities?*, [www.cfo.com/article.cfm/3124349](http://www.cfo.com/article.cfm/3124349).

30. American Institute of Certified Public Accountants, Statement of Position 96-1: Environmental Remediation Liabilities, 183 J. OF ACCOUNTANCY 3, at 96 (March 1997).

31. Financial Accounting Standards Board, FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, at FIN 14-1 (Sept. 1976).

32. *Id.* at FIN 14-2, 14-3.

33. *Id.* (discussing what must be accounted for—rather than merely disclosed—under SFAS 5).

Companies need also to be cognizant of SFAS 143, titled Accounting for Asset Retirement Obligations, and its subsequent interpretation, Financial Interpretation No. 47 (FIN 47), Accounting for Conditional Asset Retirement Obligations.<sup>34</sup> SFAS 143/FIN 47 were intended to fill a perceived gap in financial reporting requirements relating to asset retirement obligations (AROs) and conditional asset retirement obligations (CAROs). Per SFAS 143/FIN 47, the fair market value of environmental liabilities associated with an asset or operation must be accounted for if (1) they are the result of the “normal operation” of the asset and (2) if the legal obligation is associated with the retirement [retirement includes sale, abandonment, recycling, or other disposal] of the related asset.<sup>35</sup> For example, in New Jersey, although there may not be an immediate obligation to remediate an owned contaminated parcel of property, upon the sale of that property, the contamination would need to be addressed under the Industrial Site Redevelopment Act.<sup>36</sup> Another example might be the removal of asbestos when a building is demolished or renovated. These are typically the kinds of obligations that would need to be reflected on a company’s balance sheets per SFAS 143/FIN 47, although they probably need not be accrued per SFAS 5. These obligations, if material, may also need to be disclosed per Item 101. In addition, the process by which companies evaluate their SFAS 143/FIN47 obligations may reveal issues that are appropriate for discussion in a company’s MD&A.<sup>37</sup>

The rules applicable to estimating environmental contingencies related to new acquisitions are also changing. FASB recently issued a revised Business Combination Standard, SFAS 141R, which modifies existing standards for estimating contingent liabilities acquired or assumed as part of a business acquisition or merger.<sup>38</sup> SFAS 141R will be effective for transactions which close on or after a buyer’s first reporting period after December 15, 2008.<sup>39</sup> Environment loss contingencies that may not have been required to be booked using SFAS 5 criteria may now need to be booked based on FAS 141R “fair value” principles. Basically, buyers

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34. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 143 (June 2001), *available at* <http://www.fasb.org/pdf/fas143.pdf>; Financial Accounting Standards Board, FASB Interpretation No. 47, at FIN 47-1 (March 2005).

35. SFAS 143 at ¶¶ A10-A13; Financial Interpretation 47 at FIN 47-4 - 47-5.

36. N.J. STAT. ANN. § 13:1K-6 *et seq.*

37. Compliance with SFAS 143/FIN 47 has been a focus of recent SEC comment letters released in 2006 and 2007. *See e.g.*, Sept. 18, 2007 Letter from SEC to ALLETE, Inc., *available at* <http://www.sec.gov/Archives/edgar/data/66756/000000000007060977/file name1.pdf>. As a result, many companies have reexamined their SFAS 143/FIN 47 disclosures. For example, in the third quarter of 2007, Chevron estimated \$700 million in nonrecurring net charges in the third quarter of 2007 for, among other things, asset retirement obligations, after having previously claimed that it could not estimate its asset retirement obligations because it was unable to determine when these assets would be retired. *See* Chevron Corp. form 8-K for 3Q 2007 (filed Oct. 9, 2007), *available at* <http://www.sec.gov/Archives/edgar/data/93410/000095013407021068/f34376e8vk.htm>.

38. *Available at* <http://www.fasb.org/pdf/fas141r.pdf>.

39. *Id.* at vi.

will now be required to recognize and disclose (if material), the “fair value” of:

- (1) All contractual contingencies (such as an environmental indemnity agreement); and
- (2) Any non-contractual contingency (such as contribution to a site-cleanup where no demand has yet been made) if it is more likely than not that the contingency represents a liability.<sup>40</sup>

Contingent environmental liabilities that might not have been considered reasonably estimable under SFAS 5 may now be able to be estimated using a FAS 141R’s fair value measurement.<sup>41</sup> In a fair value measurement, any uncertainty about whether the liability will materialize is factored into the amount that will be recognized, rather than being a prerequisite as to whether the liability must be recognized in the first instance under SFAS 5.<sup>42</sup>

### 3. *Sarbanes-Oxley*

Of course, any discussion of environmental disclosures would be incomplete if it omitted the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley has resulted in heightened scrutiny with respect to all corporate disclosures, which obviously includes environmental disclosures. Sarbanes-Oxley has increased public accountability—backed by civil and criminal penalties—for corporate officers and directors for any errors, omissions, or misstatements in a company’s disclosures. For example, Section 302 requires CEOs and CFOs to certify that the company’s disclosures and financial statements fairly present the financial condition of the company.<sup>43</sup> This same section requires CEOs and CFOs to certify that the company has an internal management system consisting of disclosure controls and procedures to ensure that the information that is required to be disclosed is appropriately gathered and communicated to management.<sup>44</sup> To the extent that company’s environmental liabilities are not accurately reflected in its disclosures and financial statements, CEOs and CFOs may be subject to criminal liability.<sup>45</sup>

In addition, Sarbanes-Oxley requires supplemental 8-K disclosures as to material environmental events within four days of the event.<sup>46</sup> Typical events that could trigger this supplemental disclosure obligation could include the sale of a contaminated property which triggers a remediation

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40. *Id.* at 8.

41. *Id.* at 164.

42. *Id.* at 150 (requiring measurement at fair value).

43. 15 U.S.C. § 7241(a).

44. 15 U.S.C. §§ 7241(a)(4)-(5), 7262.

45. 18 U.S.C. § 1350(c) (setting out criminal penalties).

46. 15 U.S.C. § 78m(l) (Section 13(l) in the Securities and Exchange Act of 1934, created by Sarbanes-Oxley § 409); *See also* Press Release, Sec. & Exch. Comm’n, SEC Adopts Rules on Provisions of Sarbanes-Oxley (Jan. 15, 2003) (SEC description of four day 8-K disclosure), available at <http://www.sec.gov/news/press/2003-6.htm>.

obligation (i.e., in New Jersey) or the receipt of new information that has a material effect on the company such as receipt of a Special Notice Letter from U.S. EPA.

#### GREENHOUSE GAS DISCLOSURE OBLIGATIONS

So what does all this mean in the context of climate change disclosures? Following the Supreme Court's decision in *Massachusetts v. EPA* and as discussed at the beginning of this article, federal regulation of GHGs is inevitable and state regulation has already occurred. Companies are under increasing pressure to disclose the effects that climate change and its associated regulations will have on a company's financial position.<sup>47</sup> For companies with operations in states or countries where climate change regulations will have a material effect, the disclosure requirements are more straightforward. For companies with operations in states where climate change regulations have not yet been finalized, an evaluation of a company's disclosure obligations will be more forward-looking, focusing instead on the likely impacts of future regulations.

For example, S-K Item 101 requires companies to disclose material effects of compliance with existing environmental laws. For companies with operations in the European Union or in a Regional Greenhouse Gas Initiative (RGGI) state,<sup>48</sup> it may be necessary to disclose the amount of capital expenditures that will be required either to reduce GHG emissions or purchase sufficient emissions credits to meet these regulatory obligations. These regulatory compliance costs are real and can be substantial. For example, in Texas, TXU failed in its attempt to permit eleven coal-fired power plants in part due to the GHG emissions associated with these plants, requiring it to modify its plans by proceeding to permit only two of these coal-fired power plants.<sup>49</sup> The Kansas Department of Health and Environment recently denied a permit for a coal-fired power plant on the basis of its GHG emissions, and an attempt by the Kansas legislature to overturn that permit denial was unsuccessful.<sup>50</sup> In 2007, Conoco

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47. The focus of this article is on legally required disclosures. However, many companies are facing pressure for voluntary "climate change" disclosures from non-governmental organizations and institutional investors. See e.g., Jenner & Block Climate and Clean Technology Law Practice, Climate Change: Current and Emerging Legal Issues (Jun. 2007) (available upon request at [www.jenner.com](http://www.jenner.com)).

48. Full RGGI members include Connecticut, Delaware, Maine, Maryland, New Hampshire, New Jersey, New York and Vermont. Observers states include District of Columbia, Massachusetts, Pennsylvania and Rhode Island.

49. Jasmina Keleman, *TXU's Emissions U-Turn Shocks Power Industry*, MarketWatch (Feb. 26, 2007), available at <http://www.marketwatch.com/news/story/txu-reversal-coal-plant-emissions-shocks/story.aspx?guid=%7BCBF10ED6-CA64-4533-A7E8-CC903D8E243B%7D> (decision to go from eleven to three).

50. Press Release, Kan. Dept. of Health and Env't, KDHE Denies Sunflower Electric Air Quality Permit (Oct. 18, 2007) (KDHE decision), available at [http://www.kdheks.gov/news/web\\_archives/2007/10182007a.htm](http://www.kdheks.gov/news/web_archives/2007/10182007a.htm); Elizabeth Souder, *TXU's Plan for Central Texas Plants Approved*, Dallas Morning News (Jun. 14, 2007), available at <http://www.dallasnews.com/sharedcontent/dws/dn/latestnews/stories/061407dnbusoakgrove.44d2228e.html>.

Phillips was forced to pay \$10 million to off-set GHG emissions at an oil refinery in California.<sup>51</sup>

Item 103 requires companies to disclose material legal proceedings (or government proceedings seeking monetary sanctions in excess of \$100,000). Although most of the nuisance actions that were filed in 2006 and 2007 have been unsuccessful,<sup>52</sup> the fact remains that if (or when) a nuisance action is successful, the damage awards could be substantial.<sup>53</sup> Moreover, if the New York Attorney General elects to act on the recently issued subpoenas to the electric utilities, it is likely that such litigation would need to be disclosed in light of the \$100,000 threshold for government actions.

Item 303 requires disclosures of known trends, events or uncertainties that may have a material effect. This is probably the SEC regulation that poses the most challenge for publicly traded companies. As noted above, federal GHG regulations are inevitable. Moreover, states are developing and implementing GHG regulations that are not just limited to large power generators. The Department of the Interior just listed the polar bear as a threatened species.<sup>54</sup> Although this listing may not have an immediate effect on most companies, companies would be well served to evaluate the impact of this listing on their operations. For example, will oil and gas exploration in Alaska be derailed even more than it already is as a result of this listing?<sup>55</sup> Governmental projects are increasingly being delayed or challenged under the National Environmental Policy Act (NEPA) for having failed to consider projects' impact on GHG emissions.<sup>56</sup> In addition to these compliance issues, many companies may be directly affected by climate change, such as insurance companies (increased threats posed by extreme storms), companies affiliated with tour-

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51. Steve Geissinger, Brown, *ConocoPhillips Agree on Historic Offset Plan*, OAKLAND TRIB. (Sept. 12, 2007).

52. See, e.g., *California v. Gen. Motors*, 2007 WL 2726871 (N.D. Cal. Sept. 17, 2007) (dismissed on the grounds that this was a non-justiciable matter); *Comer v. Murphy Oil, Inc.*, Case No. 1:05-CV-436 (S.D. Miss. Aug. 30, 2007).

53. It is probable that any litigation filed by non-governmental plaintiffs would seek substantial damages "that could reach the same level as in the tobacco and asbestos cases, and if anything they could be higher," while an enforcement action by a governmental entity would likely seek damages in excess of \$100,000. James Kanter, *Fighting Climate Change, One Lawsuit at a Time*, INT'L HERALD TRIB., Aug. 15, 2007; see also Edward F. Malone and Michael Strong, *Registering Emissions under Lieberman-Warner Bill - Liability Risks and Solutions*, Emerging Issues in Environmental Law & Climate Change (LexisNexis, April 2008), at 14-17 (describing magnitude of litigation and enforcement risks).

54. News Release, U.S. Dept. of the Interior, Secretary Kempthorne Announces Decision to Protect Polar Bears under Endangered Species Act (May 14, 2008), available at [http://www.doi.gov/news/06\\_News\\_Releases/061227.html](http://www.doi.gov/news/06_News_Releases/061227.html).

55. On May 22, 2008, Alaska announced it was planning to challenge the listing, bearing that it would negatively impact oil and gas development in Alaska. See <http://www.abcnews.go.com/Technology/Global%20Warming/wirestory?id=4907790>.

56. See, e.g., *Montana Envtl. Info. Ctr. v. Johanns*, Civ. No. 07-1311 (D.D.C., filed July 23, 2007) (NEPA challenge United States Department of Agriculture approval of power plant for failure to consider effects of the GHG emissions).

ism (lack of snow at ski resorts) or agriculture-related companies (climate suitable for different crops). A discussion of the risks posed by these climate change-related issues may be appropriate as part of a company's MD&A.

#### RE-EVALUATION OF ENVIRONMENTAL DISCLOSURES

In light of the heightened scrutiny being paid to companies' environmental and climate change disclosures, coupled with the recent SEC enforcement activities, companies would be well served to re-evaluate the manner in which environmental risks and liabilities (including climate change risks and liabilities) are reflected in companies' environmental disclosures and financial statements. In many cases, once a disclosure decision is made with respect to a particular environmental liability, companies do not adequately re-evaluate, (1) for matters that have been disclosed, whether disclosure continues to be necessary or should be modified; and (2) for matters that have not been disclosed, whether disclosure is required. Here are some important factors for companies to consider when re-evaluating these issues:

1. *Corporate Sustainability Reports/Participation in Voluntary Greenhouse Gas Initiatives*

Many companies prepare and disseminate detailed sustainability reports and/or participate in voluntary GHG emission reduction programs such as U.S. EPA's Climate Leaders or the Chicago Climate Exchange. Often, in the course of preparing these reports or participating in these programs, companies will proudly publicize the specific steps that are being taken to proactively comply with environmental laws or minimize carbon footprints without evaluating the statements, and if necessary, conforming the statements with companies' environmental disclosures. It is important to strive for consistency between what is being stated in these public proclamations and what is being discussed in the MD&A. For example, if a company's sustainability reports discusses the specific steps that the company is taking to be well positioned to respond to and comply with future climate change regulations, the company's MD&A should likely continue a similar discussion.

2. *Potential Liability for Directors and Officers*

To the extent companies are reluctant to re-evaluate their environmental disclosures for fear that the investigation may result in more disclosures being required, it is important to note that in addition to potential criminal liability for CEOs and CFOs under Sarbanes-Oxley, officers and directors can face personal liability for failure to properly account for environmental liabilities.<sup>57</sup> One of the seminal cases on this issue is *In re*

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57. See *supra* note 13.

*Caremark International Inc. Derivative Litigation*, which established that in order to fulfill his fiduciary duty of due care to the organization, a director must make a good faith effort to be informed and exercise appropriate judgment.<sup>58</sup> A failure to properly perform this obligation could result in personal liability for directors (and officers) of a corporation.

In addition, a slide in stock price following disclosure of an environmental liability will often result in shareholder suits against the directors (and officers) of a company. In an effort to protect officers and directors from such personal liability, companies will often purchase what are referred to as D&O policies. However, these policies typically contain pollution exclusions and there are some conflicting court decisions concerning whether these pollution exclusions apply to shareholder claims relating to the improper disclosure or accounting for environmental risks and liabilities.<sup>59</sup> In the course of revisiting environmental disclosures, companies may be well served to re-evaluate the pollution exclusion provisions in their D&O policies and if necessary, re-negotiate these exclusions with the insurance company.

### 3. *Don't Provide Free Discovery or a Roadmap for a Lawsuit*

In evaluating whether to expand or modify existing environmental disclosures, companies should exercise care so as to not to disclose so much information that opposing counsel or the regulatory authorities are provided a roadmap as to a company's strategy for responding to and/or addressing a particular environmental liability. For example, a company may be obligated to disclose its potentially responsible party (PRP) status at a site despite the fact that liability has not yet been established. Care should be taken to ensure that (1) the contingent status of that environmental liability is clearly communicated in the environmental disclosure, and (2) the company does not disclose too much of the legal strategy it intends to deploy in defending the allegations of PRP status.

### 4. *Evaluate What Your Competitors Are Doing*

Companies' environmental disclosures will be evaluated and judged, at least in part, based on environmental disclosures by similarly situated companies. For example, if an electric utility's MD&A contains an extensive discussion of climate change risks, a failure by another electric utility to address climate change will likely be viewed with some skepticism. Although this is an obvious example, companies would be well served to

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58. 698 A.2d 959 (Del. Ch. 1996).

59. See *Owens Corning v. National Union Fire Insurance Co.*, 1998 WL 774109 (6th Cir. 1998) (holding that asbestos exclusion in D&O policy did not exclude insurance coverage for shareholder suit premised on failure to disclose asbestos claims). But see *National Union Fire Insurance Co. v. U.S. Liquids*, 2004 U.S. App. LEXIS 2694 (5th Cir. 2004, Feb. 17, 2004) (holding that D&O policy excluded shareholder claims premised on failure to properly disclose environmental liabilities in SEC filing.).

review competitors' environmental disclosures as part of any re-evaluation of the adequacy of their own environmental disclosures.

5. *Company's Internal Estimation for Contingent Asset Retirement Obligations*

As a follow-up to evaluating what your competitors are doing, companies should also ensure that adequate care has been used in determining estimates for CAROs, and more specifically, the manner in which a company complies with FAS 143/FIN 47. A comparison of various companies' CAROs clearly demonstrates that similarly situated companies have taken very divergent approaches with respect to compliance with SFAS 143/FIN47. For example a survey by the Corporate Executive Board's Accounting Practice Exchange noted vastly divergent reported financial impacts for CAROs, with similarly situated companies reporting estimates ranging from "immaterial" to in excess of \$200 million.<sup>60</sup> Based on recent SEC comment letters, it appears that companies' compliance with SFAS 143/FIN 47 will be an area that will be the focus of future SEC scrutiny.<sup>61</sup>

The scrutiny that is being paid to companies' environmental and climate change disclosures is unlikely to diminish in the foreseeable future. As such, the time may be right for companies to re-evaluate the adequacy of their environmental disclosures, rather than waiting for the inevitable Ceres information request, or worse, receipt of a subpoena from a state attorney general. The consequences of failing to properly account for and disclose environmental liabilities can be significant. However, for companies with complete and robust environmental and climate change disclosures, the investor community and rating agencies may ultimately wind up rewarding those companies.

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60. Corporate Executive Board Executive Briefing of The Impact of FIN 47 (March 2006).

61. *See supra* note 37.