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# ENVIRONMENTAL DISCLOSURE REQUIREMENTS UNDER THE FEDERAL SECURITIES LAWS

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## INTRODUCTION

During the past two decades, U.S. companies have spent billions of dollars as a result of increased enforcement of environmental regulations. One need not look far to find illustrations of where this money has been spent. Civil penalties in the millions of dollars have been sought and obtained in federal Clean Air Act and Resource Conservation and Recovery Act enforcement actions. The cost to remediate the average Superfund site has been estimated by the U.S. Environmental Protection Agency ("EPA") to be $25 million. People may debate the wisdom and efficacy of the current environmental regulatory scheme, but the tremendous impact it has had on the economy and corporate behavior cannot be denied.

U.S. capital markets have experienced unprecedented growth. In the early 1990s, Commissioner Richard Roberts of the U.S. Securities and Exchange Commission ("SEC") publicly cautioned reporting companies that the SEC would apply increased scrutiny to environmental disclosure contained in public filings. His comments specifically targeted the insurance, pulp and paper and electric utilities industries, among others. Although few SEC enforcement proceedings were reported in the wake of the Commissioner's pronouncements, the quality of environmental disclosure thereafter notably improved.

The manner in which financial performance and liabilities – including environmental liabilities – are reported to the investing public continues to gain in importance. Today, in the wake of corporate scandals and in an era of globalization and financial uncertainties, there is once again renewed interest on the part of the SEC and the EPA as well as various stakeholders in the scope and quality of environmental disclosure. Moreover, as global warming and climate change increasingly dominate public debate, the impacts of greenhouse gas emissions are prompting growing demands for disclosure of risks relating to climate change.

As we discuss in the following pages, public reporting companies must satisfy a host of SEC requirements regarding the recordation and disclosure of environmental loss contingencies. Principal among these provisions is Regulation S-K, the repository for the SEC's integrated disclosure requirements. In addition, the SEC has issued various staff accounting bulletins and other guidance documents which clarify and amplify the disclosure requirements under Regulation S-K. The following outline describes these requirements, as well as various

accounting standards and guidance documents and new proposals by a range of parties for enhancing environmental disclosure and financial reporting relating to environmental liabilities.

## 1. REGULATION S-K

### 1.1 Generally

Regulation S-K is the "repository" for the SEC's uniform disclosure requirements under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). See Adoption of Integrated Disclosure System, 47 Fed. Reg. 11380 (1982). Its provisions are specifically applicable to the content of the non-financial statement portions of (1) registration statements under the Securities Act, and (2) registration statements, annual or other periodic reports, going private transaction statements, tender offer statements, annual reports to security holders, proxy and information statements, and any other documents required to be filed under the Exchange Act. See 17 C.F.R. at 229.10(a). The Regulation incorporates the relevant interpretive releases under the Acts, as well as the forms under the Acts. See id. Three sections of the Regulation are directly relevant to the disclosure of environmental matters: Item 101, 17 C.F.R. 229.101; Item 103, 17 C.F.R. 229.103; and Item 303, 17 C.F.R. 229. 303.

### 1.2 Item 101, Description of Business

#### *1.2.1 Generally*

Item 101(c)(xii) requires the disclosure of the "material"[1] effects that compliance with Federal, State and local provisions . . . regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries." 17 C.F.R. 229.101(c)(xii). Disclosure of material estimated capital expenditures for

1. "Material" information is defined under the Securities Act and the Exchange Act as information "to which there is a substantial likelihood that a reasonable investor would attach importance in deciding to buy or sell the securities registered." 17 C.F.R. 240.12b-2 (Exchange Act); see 17 C.F.R. 230.405 (Securities Act). See also Staff Accounting Bulletin ("SAB") 99.

environmental control facilities is required for the remainder of the current fiscal year, its succeeding fiscal year, and "such further periods as the registrant may deem material." Id.

(a) Contingent Effects: Item 101(c)(xii) requires the disclosure of effects that environmental matters may have on the financial condition of the registrant. See id. This language requires the disclosure of contingent effects as well as those of which the company knows. In interpreting a precursor to the provision, the SEC emphasized the disclosure of "the possible future effects of environmental statutes and regulations, and proceedings thereunder, on the issuer. . . ." Compliance with Environmental Requirements, Securities Act Release No. 33-5386 [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 77,001, at 17,202 (Apr. 20, 1973).

(b) Foreign Environmental Provisions. The SEC has stated that "to the extent any foreign [environmental] provisions may have a material impact upon the company's financial condition or business such matters should be disclosed." Air Products and Chemicals, Inc., SEC No-Action Letter (June 11, 1973) (interpreting precursor to Item 101(c)(xii)).

(c) Small Offerings. The SEC has further imposed identical requirements on disclosures relating to small offerings. See Securities Act Release No. 6340.

### *1.2.2 Time Period Covered by Disclosures*

Item 101 requires the disclosure of material effects which will occur after the specified periods if the registrant deems such effects material. The SEC has emphasized that disclosure beyond the required period may be required where the disclosed costs do not adequately reflect the expenditures necessary to comply with the environmental requirements in question, or when material penalties for non-compliance are reasonably likely to be imposed. See In re United States Steel Corp., Exchange Act Release No. 16223 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 82,319, at 82,376 (SEC Admin. Proc. Sept. 27, 1979) (interpreting precursor to Item 101(c)(xii)). In such a situation, the SEC has warned that disclosure of effects for the additional periods may be required to prevent the mandatory disclosures from being misleading. See id.

### *1.2.3 Costs Associated with Non-Compliance*

Although by its terms Item 101(c)(xii) requires the disclosure of only those expenditures necessary to comply with environmental regulations, both the Second Circuit and the SEC have interpreted the provision to require the disclosure of expenditures resulting from non-compliance as well. For example, in Levine v. NL Industries, 926 F.2d 199 (2d Cir. 1991) the Second Circuit, though finding no material omission, acknowledged that "[d]isclosure of potential costs for violations of environmental laws, if material, is ordinarily required [by Item 101(c)(xii)]." 926 F.2d at 203. The SEC came to a similar conclusion in a 1980 administrative proceeding against Occidental Petroleum Corporation, where it stated that Occidental was required to disclose costs associated with "possible remedial activities necessary to compensate for previous non-compliance with environmental regulations. . . ." In re Occidental Petroleum Corp., Exchange Act Release No. 16950, 20 SEC Docket 567, 570 (July 15, 1980) (interpreting precursor to Item 101(c)(xii)).

### *1.2.4 Detail Required in Disclosure*

(a) Estimates. In interpreting the precursor to Item 101(c)(xii), the SEC has stated that the registrant may be required to set forth "the source of its estimates, the assumptions and methods used in reaching the estimates, and the extent of uncertainty that projected future costs may occur in order for the disclosure made not to be misleading." In re United States Steel, Fed. Sec. L. Rep. (CCH) para. 82,319, at 82,383.

(b) Segregation of Costs. Interpreting the same provision, the SEC has further stated that where expenditures are partly for environmental compliance, and partly for "the replacement, modification or addition of equipment or facilities," the costs of environmental compliance should be segregated to the extent there is a reasonable basis to do so. Securities Act Release No. 33-5386, Fed. Sec. L. Rep. (CCH) para. 79,342, at 83,030.

(c) In the same release, the SEC warned that such estimates "should not be calculated or stated on an annual basis when such [sic] would diminish the apparent materiality of the expenditures or result in non-disclosure." Id.

## 1.3 Item 102, Description of Property

Item 102 requires a brief description of the location and general character of "materially important physical properties of the registrant and its subsidiaries." 17 C.F.R. 229.102. The purpose of this provision is to inform investors as to the "suitability, adequacy, productive capacity and extent of utilization of the facilities by the registrant." Id. at Instruction 1. Neither the SEC nor the courts have addressed the issue of whether Item 102 specifically requires the disclosure of environmental matters.

## 1.4 Item 103, Legal Proceedings

### *1.4.1 Generally*

Item 103 requires the registrant to describe any material legal proceedings, pending or known to be contemplated, "to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject." 17 C.F.R. 229.103. The provision expressly excludes from its requirements "ordinary routine litigation incidental to the business. . . ." Id. Environmental litigation is not considered ordinary litigation under Instruction No. 5 to Item 103. See infra Section 1.4.2.

### *1.4.2 Instruction No. 5*

In particular, Instruction No. 5 to Item 103 states that an administrative or judicial proceeding arising under any legal provisions "that have been enacted or adopted regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment" are not ordinary routine litigation incidental to the business. The Instruction requires that such proceedings be disclosed if *any one* of the following three conditions exist with respect to them:

(A) Such proceeding is material to the business or financial condition of the registrant;

(B) Such proceeding involves primarily a claim for damages, or involves potential sanctions, capital expenditures, deferred charges or charges to income and the amount involved, exclusive of interest and costs, exceeds 10 percent of the

current assets of the registrant and its subsidiaries on a consolidated basis; or

(c) A governmental authority is a party to such proceeding and such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interests and costs, of less than $100,000; provided, however, that such proceedings which are similar in nature may be grouped and described generically. See 17 C.F.R. 229.103 at Instruction 5.

In order to determine whether a proceeding must be disclosed under Instruction 5(A), a registrant must employ the materiality test as articulated in Basic v. Levinson, 485 U.S. 224, 229-31 (1988) (specifically adopting the materiality test of TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), for Rule 10b-5, the general disclosure rule). Under Basic, a registrant must disclose any fact that the reasonable investor would view as significantly altering "the total mix of information made available." Id. at 231-32.[2]

Under Instructions 5(B) and 5(C), environmental proceedings meeting the threshold requirements set forth in either of those instructions must be disclosed even in the absence of materiality. See Mark A. Stach, *Disclosing Environmental Liability Under the Securities Laws*, 3-23 to 3-28 (1996).

### *1.4.3 Contemplated Proceedings*

Item 103 requires the disclosure of proceedings which are pending or "known to be contemplated by governmental authorities." 17 C.F.R. 229.103. In In re Occidental Petroleum Corp., the SEC found that a disclosure duty existed after the company's management was informed by the U.S. Attorney that a criminal action against the company for violations of environmental provisions "would be likely." Exchange Act Release No. 16950, 20 SEC Docket at 569. Item 103 does not require the disclosure of uncharged criminal conduct, however,

2. See also Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 516-17 (7th Cir. 1989), in which Judge Easterbrook, in dicta, defines materiality as depending "not only on the magnitude of its effect but also on its probability."

provided that such charges are not known to be contemplated. See United States v. Crop Growers, 954 F. Supp. 335, 347 (D.D.C. 1997) (finding no duty to disclose where registrants had no knowledge of any proceedings against them at the time of the filings).

(a) EPA Notice. In a Memorandum dated January 19, 2001, the EPA requested its Regional Offices and Headquarters enforcement personnel to distribute a "Notice of SEC Registrants' Duty to Disclose Environmental Legal Proceedings" (the "EPA Notice") to companies that are parties to formal EPA-initiated administrative enforcement actions unless the enforcement personnel bringing the action reasonably believe that Item 103 does not apply. The EPA Notice seeks to inform recipients that they are *potentially* subject to Item 103 and should themselves determine whether disclosure of the action is required. The EPA Notice system is based on the notion that increased scrutiny of corporate environmental information, particularly legal proceedings, by the public, shareholders, and investors will likely provide a deterrent to future non-compliance.

The EPA Notice must comply with the following guidelines:

- Recipients: Companies involved in an administrative legal proceeding taken in response to violation(s) of Federal, State or local provisions having the primary purpose of environmental protection should receive the EPA Notice, *provided that* the EPA has initiated the enforcement action and the EPA has the lead for prosecuting the case.
- Exemptions: The EPA Notice should *not* be distributed if: (1) the party to receive the EPA Notice is a Federal, State or local governmental entity or if (2) the case has been, or is expected to be, referred to the Department of Justice.
- Timing: The EPA Notice should be distributed no later than the initiation of any formal administrative action brought by EPA. For the purpose of these guidelines initiation is considered to be when a formal administrative complaint is filed, an administrative order is issued, or a letter demanding stipulated penalties is sent.

See Memorandum regarding Guidance on Distributing the "Notice of SEC Registrants' Duty to Disclose Environmental Legal Proceedings" in EPA Administrative Enforcement Actions from K. Lynch, Director of Planning and Policy Analysis, Eric Schaeffer, Director of Office of Regulatory Enforcement, to OECA Office Directors, Official Regional Counsel, Enforcement Division Directors and Enforcement Coordinators (dated Jan. 19, 2001).

(b) Prospective Effects. Though Item 103 does not specifically require predictions as to the effects of litigation, it is common practice to disclose whether management considers the litigation to be material.

### *1.4.4 "Proceedings" Broadly Defined*

The SEC has stated that for the purposes of the disclosure of environmental matters, "the meaning of an administrative proceeding has never been construed narrowly. . . ." In re United States Steel, Fed. Sec. L. Rep. (CCH) para. 82,319 at 82,383 (interpreting precursor to Item 103, Instruction 5).

(a) The Role of the Government. Item 103 requires the disclosure of proceedings which are "known to be contemplated by governmental authorities." 17 C.F.R. 229.103. The SEC has broadly interpreted environmental disclosure provisions as requiring the disclosure of "administrative proceedings which are initiated by the registrant, as well as those initiated by the government." In re United States Steel, Fed. Sec. L. Rep. (CCH) para. 82,319 at 82,383 (interpreting precursor to Item 103). The government need only be a party to such contemplated proceedings in order to trigger this disclosure requirement.

(b) Environmental Actions brought by a Foreign Government. The SEC staff has stated that the "[t]he reference in Instruction 5 to an administrative or judicial proceeding arising under 'local provisions' is sufficiently broad to require disclosure of environmental actions brought by a foreign government." See SEC Staff Telephone Interpretations Manual (Mar. 2007).

(c) Administrative Orders Not Following a Proceeding. The SEC has interpreted its environmental disclosure provisions as requiring the disclosure of "all administrative orders relating to environmental matters, whether or not those orders literally follow a 'proceeding.'" In re United States Steel, Fed. Sec. L. Rep. (CCH) para. 82,319 at 82,384 (interpreting precursor to 103). In so stating, the SEC gave as examples the situations where "a corporation directly consents to the entry of an order or where the order is the product of negotiation between the parties." Id.

(d) Notices of Violation. The SEC has stated that a company's receipt of a Notice of Violation in the form of a cease and desist order from the EPA "would constitute a sufficiently concrete indication of contemplated governmental legal action to require disclosure. . . ." Securities Act Release No. 5704, Fed. Sec. L. Rep. (CCH) para. 80,495 at 86,297 n.22 (interpreting precursor to Item 103); See also, In re United States Steel, Fed. Sec. L. Rep. (CCH) para. 82,319 at 82,383.

(e) Potentially Responsible Party Status. The SEC has stated that potentially responsible party ("PRP") status in Superfund litigation is not itself sufficient to require disclosure under Item 103. See Securities Act Release No. 6835, 54 Fed. Reg. 22427, 22430 n.30. The SEC explained that "PRP status alone does not provide knowledge that a governmental agency is contemplating a proceeding." Id. Nonetheless, stated the Commission, PRP status is a factor in determining whether proceedings are known to be contemplated, and "when coupled with other circumstances," may trigger Item 103's disclosure requirements. Id.

(f) Knowledge of Violation Alone. At least one court has held that a company's mere knowledge of the existence of a violation, and that suit was a possibility, did not give rise to a disclosure duty under Item 103. See Levine v. NL Indus., 717 F. Supp. 252, 255 (S.D.N.Y. 1989), aff'd, 926 F.2d 199 (2d Cir. 1991) (company's internal documents established that it knew of violation and that state environmental authorities could bring suit, but not that state was contemplating action). In affirming the district court's determination, the appellate court emphasized that, since the U.S. Department of Energy

("DOE") had agreed to indemnify the defendant for any loss its subsidiary would suffer as a result of violations of environmental law, any such violation was immaterial. See Levine, 926 F.2d at 203.

(g) Permit Proceedings. In Wielgos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989), the Seventh Circuit suggested that Item 103 may require the disclosure of the existence of pending permit applications. In holding that the company had disclosed "all that Item 103 requires," the court pointed out that the company had revealed that "it was building five nuclear reactors, which it could not operate without licenses from the NRC [(Nuclear Regulatory Commission)]." Id. at 517.

The SEC, however, has stated that "since clause (C) [of Instruction 5] concerns proceedings involving potential monetary sanctions, permit proceedings and requests for waivers or variances would not be disclosable pursuant to clause (C)." Securities Act Release No. 6383, Fed. Sec. L. Rep. (CCH) para. 72,328 at 63,004.

(h) Environmental Compliance Reports. The SEC has refused to require the listing of environmental compliance reports under Section 103, see Securities Act Release No. 5704, Fed. Sec. L. Rep. (CCH) para. 80,495 at 86,295, and has further refused to require the disclosure of governmental authorities from which such reports may be obtained. See Securities Act Release No. 6383, Fed. Sec. L. Rep. (CCH) para. 72,328 at 63,005.

### *1.4.5 "Sanctions" for the Purposes of Instructions 5(B) and (C)*

The SEC has construed broadly the meaning of "sanctions" for purposes of Instructions 5(B) and (C), and has stated on at least two occasions that "there are many ways a PRP may become subject to potential monetary sanctions. . . ." Thomas A. Cole, SEC No-Action Letter (Jan. 17, 1989); Securities Act Release No. 6835, 54 Fed. Reg. at 22430 n.30. As an illustration of the breadth of the definition, the SEC has stated that "triggering the stipulated penalty clause in a remedial agreement" qualifies as a sanction under this provision. Id.

The Commission has stated that costs incurred pursuant to a remedial agreement under Superfund, "entered into in the normal course of negotiations with the EPA, generally are not 'sanctions' within either Instruction 5(B) or (C) to Item 103." Securities Act Release No. 6835, 54 Fed. Reg. at 22430 n.30. The Commission has warned, however, that such remedial costs would constitute either charges to income or capital expenditures, and therefore may be relevant to whether disclosure is required by Instructions 5(A) or (B). Id.

(a) Aggregation of Sanctions. The SEC has stated that registrants are not required to aggregate potential monetary sanctions of similar proceedings when determining whether disclosure is required by Instruction 5(C). See Securities Act Release No. 6383, Fed. Sec. L. Rep. (CCH) para. 72,328 at 63,004. However, aggregation of sanctions in proceedings "which present in large degree the same issues" is required for purposes of Instruction 5 (A) and (B). 17 C.F.R. 229.103 at Instruction 5. See James G. Archer, Thomas M. McMahon & Maureen M. Crough, *SEC Reporting of Environmental Liabilities*, 20 ENVTL. L. REP. at 10106 (March 1990). In proceedings involving both monetary penalties and supplemental environmental projects ("SEPs"), the amount of the monetary penalties should be aggregated with the cost of the SEP for purposes of determining whether the $100,000 threshold has been met.

### *1.4.6 Detail Required in Disclosure*

Item 103 requires the disclosure of "the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought." 17 C.F.R. 229.103.

The Seventh Circuit has held that, although Item 103 requires disclosure of the name of the court or agency in which the proceedings are pending, the Item does not require the disclosure of the specific agency tribunal before which a proceeding is to be tried. See Wielgos, 892 F.2d at 517 (holding that omission of fact that permit proceeding was before ASLB rather than some other part of the NRC was not a violation of requirements of Item 103).

The court further stated that Item 103 did not require the company to disclose the "status of the pending case." Id.

## 1.5 Item 303, Management's Discussion and Analysis

### *1.5.1 Generally*

Item 303, titled Management's Discussion and Analysis ("MD&A"), requires that the registrant discuss historical financial results, as well as "known trends . . . events or uncertainties . . . that are reasonably likely" to have a material impact on liquidity, capital, sales, revenues or income.[3] 17 C.F.R. 229.303. The provision requires that the discussion focus specifically on events and uncertainties known to management that would cause other reported information to become misleading. 17 C.F.R. 229.303 at Instruction 3. The SEC has particularly emphasized the disclosure in the MD&A of matters relating to the registrant's prospects for the future. See id. at Instruction 3(A); Securities Act Release No. 6835, 54 Fed. Reg. 22428. At a 1994 meeting of the Organization Resources Counselors, then SEC Commissioner Richard Y. Roberts stated that he expected the SEC to intensify its review of the MD&A disclosures of environmentally sensitive companies. *Roberts Reviews Developments Surrounding Environmental Disclosure*, SEC TODAY, 94-35 (Feb. 24, 1994).

(a) Applicability to Disclosure of Environmental Matters. The SEC has stated that such a provision "would compel the disclosure of information concerning environmental compliance, impact, expenditures, plans or violations, not otherwise specifically required, of which the average prudent investor ought reasonably to be informed." Securities Act Release No. 5704, Fed. Sec. L. Rep. (CCH) para. 80,495 at 86,297 (interpreting precursor to Item 303 which required disclosure of "all material information necessary to make statements [in required filings] neither false nor misleading"). Moreover, in its 1989 interpretive release on MD&A, the SEC

3. The SEC has pointed out that the MD&A would also require the disclosure of the management's decision not to incur an expenditure if the effect thereof would be a material change in a growth trend. See Securities Act Release No. 6835, 54 Fed. Reg. at 22429.

used as an illustration of the provision's operation an example in which a Company was required to disclose its PRP status under CERCLA, and the effects thereof. See Securities Act Release No. 6835, 54 Fed. Reg. at 22429.

### *1.5.2 Disclosure of Contingent Events*

The MD&A may require the disclosure of contingent events and their prospective effects. In its 1989 interpretive release, the SEC put forth the following test for determining whether Item 303 requires disclosure of a particular contingent event:

(a) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(b) If management cannot make that determination, it must evaluate objectively the consequences of the event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur. Securities Act Release No. 6835, 54 Fed. Reg. at 22430.

Registrants should note that the SEC has expressly rejected the probability/magnitude balancing test for disclosure of contingent events approved in Basic v. Levinson, 485 U.S. 224, 238 (1986), as "inapposite to Item 303 disclosure." Securities Act Release No. 6835, 54 Fed. Reg. at 22430 n.27. That an event be reasonably likely to occur is therefore a threshold inquiry for requiring disclosure under Item 303, and cannot be compensated for by the event having great potential consequences.[4]

(c) Determination Must Be Objectively Reasonable. The SEC has stated that a registrant's determination as to whether to disclose a contingent event in the MD&A "must be objectively reasonable, viewed as of the time the determination is made." Id. at 22430. The Commission has further warned that if a material change in financial condition or results of operation

4. The SEC has given no indication that the Basic test is inapplicable to either Item 101 or Item 103.

occurs and was not discussed in prior MD&A disclosures, the SEC staff will inquire into the circumstances of the prior MD&A filings to determine whether the registrant failed to meet the requirements of Item 303. Id. at 22430 n.28.

(d) Joint and Several Liability. The SEC has also warned that for purposes of determining whether to disclose potential environmental liability in the MD&A, "aggregate potential cleanup costs must be considered in light of the joint and several liability to which a PRP is subject." Securities Act Release No. 6835, 54 Fed. Reg. at 22430.

### *1.5.3 Forward-Looking Information vs. "Known Uncertainties"*

The MD&A requires the disclosure of "known uncertainties." 17 C.F.R. 229.303(a)(1). On the other hand, the provision encourages but does not require the disclosure of "forward-looking information," and states that "[a]ny forward-looking information supplied is expressly covered by the safe harbor rule for projections." 17 C.F.R. 229.303 at Instruction 7. Both the Securities Act and the Exchange Act establish "safe harbors" for "forward-looking statements" made with a reasonable basis and in good faith. See Securities Act Release No. 6835, 54 Fed. Reg. at 22429 & n.22 (citing Rule 175(c) under the Securities Act, 17 C.F.R. 230.175(c); Rule 3b-6(c) under the Exchange Act, 17 C.F.R. 240.3b-6). The SEC attempted to resolve this apparent contradiction in its 1987 "Concept Release" on MD&A. The SEC stated that "required disclosure" is characterized by trends or uncertainties which are "currently known" and "reasonably expected to have material effects." Securities Act Release No. 6711, Fed. Sec. L. Rep. (CCH) para. 84,118, at 88,624 (Apr. 20, 1987). "In contrast," continued the Commission, "optional forward-looking disclosure involves anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty." Id. The distinction therefore appears to rest on the degree of predictability of the event at issue.

In 1995, Congress passed the Securities Litigation Reform Act of 1995 ("1995 Reform Act"). Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.). Through a new section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, the 1995 Reform Act

provides a legislative safe harbor for forward-looking statements and projections disclosed by corporate issuers. See generally Harvey L. Pitt & Karl A. Groskaufmanis, *The Recently Enacted Securities Litigation Reform Act Gives Public Companies a Safe Harbor for Some Predictive Statements*, NAT'L L. J., Jan. 15, 1996, at B4. The safe harbor provision shields material forward-looking statements that are identified as such and that are "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." Id.

### *1.5.4 Types of Contingencies Reportable Under MD&A*

(a) Effects of Proposed Regulation. Material effects of proposed environmental requirements would be reportable in the MD&A. As an example of information required to be disclosed, the 1989 MD&A interpretive release cites a situation where "regulations have been proposed [pursuant to recently enacted legislation] which, if promulgated, would require the expenditure of [material capital resources]." Securities Act Release No. 6835, 54 Fed. Reg. 22430; cf. Exchange Act Release No. 17390, Fed. Sec. L. Rep. (CCH) para. 82,712 at 83,890 (Dec. 18, 1980) (stating without specific reference to MD&A that SEC rules and regulations "require the disclosure of all material information relating to the impact of proposed . . . statutes, rules, [or] regulations").

(b) PRP Status. The MD&A interpretive release makes clear that PRP status may give rise to a contingency reportable in the MD&A. In illustrating the operation of the Item 303, the release cites a situation in which a registrant has been designated a PRP and material costs are reasonably likely. The release concludes that the MD&A requires disclosure of the effects of the PRP status in such situations. See Securities Act Release No. 6835, 54 Fed. Reg. at 22430.

At least one commentator has noted that, with regard to PRPs, the SEC has departed from the "traditional materiality analysis as espoused in Basic v. Levinson, 485 U.S. 224 (1988), instead promulgating an enhanced disclosure standard which requires MD&A disclosure . . . unless the registrant can determine that [PRP] status is not reasonably likely to have a

material effect." Elizabeth Glass Geltman, *Disclosure of Contingent Environmental Liabilities by Public Companies Under the Federal Securities Laws*, 16 HARV. ENVTL. L. REV. 129, 130 (1992).

### *1.5.5 Detail Required in MD&A*

Item 303 provides that the information provided in the MD&A "need only include that which is available to the registrant without undue effort or expense and which does not clearly appear in the registrant's financial statements." 17 C.F.R. 229.303 at Instruction 2; see Securities Act Release No. 6835, 54 Fed. Reg. at 22430 (stating that MD&A requires quantification of potential liability "to the extent reasonably practicable"). The SEC has indicated that such information need only be detailed "to the extent necessary to an understanding of the registrant's business as a whole." See Securities Act Release No. 6231, 20 SEC Docket 1059, 1072 (Sept. 2, 1980). However, Item 303(a) also indicates that if in the registrant's judgment a discussion of segment information or of other subdivisions of the registrant's business would be appropriate to an understanding of such business, the discussion should focus both on each relevant reportable segment or other subdivision as well on the registrant as a whole.

Notwithstanding the apparent laxity of these requirements, the SEC has required the registrant to state "the amount, or describe the nature or extent of the potential [environmental] liabilities" in its disclosures. In re Occidental Petroleum Corp., Exchange Act Release No. 16950, 20 SEC Docket 567, 571 (July 15, 1980) (discussing precursor to Item 303). The SEC has further advised that even where exact calculations of potential environmental liability are not possible, the effects of such liability should be "quantified to the extent reasonably practicable." Securities Act Release No. 6835, 54 Fed. Reg. at 22430; See *Remedies Act to Be Enforced on Case-by-Case Basis*, McLucas Says, 23 SEC. REG. L. REP. (BNA) 1557, 1558 (Oct. 25, 1991) ("Companies certainly ought to be able to produce a 'reasonable range' of the amount necessary to solve the problem.").

In In re Lee Pharmaceuticals, 66 SEC Docket at 2133-20 (Apr. 9, 1998), the SEC issued a cease and desist order to Lee Pharmaceuticals ("Lee"), a manufacturer of dental and cosmetic products, for materially understating its "environmental

responsibilities" in several annual filings. In 1988, the California Regional Water Quality Control Board ("Water Board") ordered Lee to further investigate soil and groundwater contamination that had been identified on Lee's property. In 1989 and 1990, Lee's consultant conducted additional sampling and furnished Lee with an estimate of $465,200 for investigation and cleanup costs. Lee's management, however, believed this estimate to be "unreliable" and disclosed in its 1991 10-K only that the company had identified "some potential contamination" and that the investigation was inconclusive. After further tests conducted in 1991 confirmed the contamination, the Water Board issued a "cleanup order" to Lee. Despite the Water Board's order and a $700,000 claim that Lee was pressing against its insurance carrier in connection with the order, Lee again stated in its 1992 10-K that it had no information about the estimated cleanup costs. In addition, during 1991, Lee was named by EPA as a PRP at the San Gabriel Superfund Site. In its 1992 10-K, Lee inaccurately stated that the contamination at the San Gabriel site "was sufficiently low that the EPA was not currently requiring a cleanup." The SEC found that Lee "materially understated its environmental responsibilities" by not disclosing that it was a PRP at the San Gabriel site or that it had received a cleanup order from the Water Board with respect to its own site. The SEC ruled that even though its response costs had not yet been determined, Lee had a duty to disclose a reasonable estimate of such costs.

### *1.5.6. SEC Proposal and Guidance Regarding Critical Accounting Estimates*

On May 10, 2002, the SEC proposed, but has not yet issued, a final rule concerning, new disclosure requirements in the MD&A relating to (a) critical accounting estimates and (b) the initial adoption of critical accounting policies that have a material impact on a company's financial condition or results of operations. See *Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies*, Securities Act Release No. 8098 (May 10, 2002), 67 Fed. Reg. 35620 (May 20, 2002). The proposal would also require disclosure of a detailed mathematical sensitivity analysis of critical assumptions underlying the estimates. Because many companies' environmental reserves typically are based on estimates, it is

possible - dependent on the final text of the rules - that the new MD&A requirement could require enhanced disclosure of critical environmental accounting estimates.

As proposed, every MD&A would include a separately captioned section regarding critical accounting policies and estimates. An "accounting estimate" means an approximation made by management of a financial statement element, item or account in the financial statements. An accounting estimate is "critical" and would require disclosure if (1) it requires the company to make assumptions about matters that are highly uncertain at the time of the estimate and (2) different estimates that the company reasonably could have used, or changes in the estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition or results of operations.

The SEC proposal would also require disclosure regarding the initial adoption of an accounting policy that has a material impact on a company's financial condition or results of operations that may occur when events or transactions affecting the company occur for the first time, or were previously immaterial in their effect but become material, or events or transactions occur that are clearly different in substance from previous ones.

The proposed rules will potentially apply to environmental estimates. Under the proposed rules, companies could be required to describe critical environmental accounting estimates in a separately-captioned section of their MD&A in any annual report, registration statement or proxy or information statement. Such companies would also need to indicate what the environmental estimate would be if different assumptions were used. Where the environmental contingency is so uncertain that an estimation cannot be made under FASB SFAS No. 5 (see description in Section 2.1 below) the proposed disclosure requirement would probably not apply since it can be said that no estimate is made at all in such a situation.

The SEC has published the proposed rules for comment. When the rules were first proposed, a member of the SEC staff stated that the SEC hoped to issue final rules in 2003, but no final rules have yet been issued.

In December 2003, the SEC provided interpretive guidance on critical accounting policy disclosure, stating that the MD&A

disclosure should present a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time. With respect to the latter, the SEC stated that a company should address the risk that its accounting estimates or assumptions may change. In addition, a company should analyze, to the extent material, such factors as how it arrived at an estimate, how accurate the estimate or assumption has been in the past, how much the estimate or assumption has changed in the past, and whether the estimate or assumption is reasonably likely to change in the future. See SEC Release No. 33-8350 (Dec. 19, 2003).

### *1.5.7 SEC Review of 2002 10-K Disclosure by Fortune 500 Companies*

In the SEC's February 2003 summary review of 2002 10-K disclosure by Fortune 500 companies, inadequate MD&A disclosure of environmental liabilities was among the items receiving SEC comment. The SEC noted that companies should improve disclosure required under FASB SFAS No. 5, SOP 96-1 and SAB 92 relating to the nature of loss contingencies, amounts accrued, estimates of the range of reasonably possible losses, significant assumptions underlying the accrual, and the cost of litigation. The SEC also noted that many companies had failed to adequately disclose items specifically required under SAB 92 relating to closure and post-closure costs and other site restoration expenses incurred upon the sale or abandonment of property.

## 1.6 Climate Change – Application of Regulation S-K to Evolving Regulatory Requirements

In light of growing empirical evidence of the warming of the climate system, the focus on climate change issues in recent years by governments, regulators, businesses and consumers is virtually unprecedented. This focus has led to the adoption of mandatory programs to limit greenhouse gas emissions in a number of countries and associated emission trading systems; regional, state and local initiatives in the U.S. to curb greenhouse gas emissions; and litigation seeking to require regulators to address the climate change issue or seeking injunctive relief (such as the reduction of greenhouse gas emissions and or the consideration of global warming in

environmental permitting decisions) and/or damages allegedly resulting from greenhouse gas emissions. See GLOBAL CLIMATE CHANGE AND U.S. LAW (Michael B. Gerrard ed., ABA Section of Environment, Energy & Resources, 2007). Although climate risk may be material for some businesses and subject to mandatory disclosure under Regulation S-K, the disclosure of risks associated with climate change has been inconsistent[5] and, to some extent, has been overshadowed by voluntary disclosure pursuant to guidelines issued by various groups of institutional investors and nonprofit organizations.[6] This Section 1.6 provides a brief summary of the evolving regulatory requirements relating to climate change and examines the possible application of Item 101, Item 103 and Item 303 of Regulation S-K to climate change issues.[7]

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5. Disclosure on climate change in similar industries can range from no disclosure at all to detailed disclosure of current and proposed climate change legislation and climate change litigation. See Ceres, *Climate Risk Disclosure by the S&P 500* (Jan. 2007), available at http://www.ceres.ort/pub/docs/CeresSP500.pdf (last visited Mar. 10, 2008); Michel Chan-Fischel, Friends of the Earth, *Fifth Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical and Utilities Companies* (2006).
6. See Section 5.5.2 herein for a discussion of such voluntary disclosure guidelines. One commentator has lamented that "the climate change disclosure market has been largely privatized, and that most of the best and most thorough reporting on climate change has been done outside disclosure mandated by the Securities Act and the Exchange Act, and through frameworks that the SEC did not participate in creating" and called for SEC guidance on climate change disclosure. See Jeffrey A. Smith, *Disclosure of Climate Change Risks and Opportunities,* THE REVIEW OF SECURITIES AND COMMODITIES REGULATION, Vol. 41, No. 1 (January 2, 2008), available at http://www.abanet.org/environ/committees/environdisclosures/highlights_docs/Disclosure_of_Climate_Change_Risks_1.08.pdf (last visited Mar. 10, 2008). A number of institutional investors and nonprofit organizations have called for SEC guidance or Congressional action to address climate change disclosure. See Section 5.5.2 herein for a summary of such institutional investor initiatives.
7. For a more detailed discussion of the possible application of Regulation S-K (as well as the Sarbanes-Oxley Act of 2002 and various accounting standards) in the climate change context, see Loyti Cheng & Heather Daly, *Is it Hot in Here? Practical Pointers for Climate Change Disclosure*, ENVTL. TRANSACTIONS AND BROWNFIELDS COMMITTEE NEWSL., Vol. 10 No. 1, at 13 (Feb. 2008) available at http://www.abanet.org/environ/committees/envtab/newsletter/feb08/ETAB_Feb08.pdf; GLOBAL CLIMATE CHANGE AND U.S. LAW, supra Section 1.6; *Smith*, supra note 6; Scott D. Deatherage, *Climate Change Disclosure: A Growing Issue for Publicly-Traded Companies*, ENVTL. DISCLOSURE COMMITTEE NEWSL., Vol. 5 No. 1 (January 2008), available at http://www.abanet.org/environ/committees/

### *1.6.1 Regulatory Requirements*

Regulatory requirements relating to climate change are evolving at international, federal, regional, state and local levels.

(a) The Kyoto Protocol. On the international level, the Kyoto Protocol to the United Nations Framework Convention on Climate Change, which entered into force in 2005, sets mandatory greenhouse gas emission limits for the more than 175 developed nations (including Canada, Russia, Mexico and the European Union) that ratified it. See United Nations Framework Convention on Climate Change, available at www.unfccc.int (last visited Feb. 15, 2008); See also, *Status of Ratification*, available at http://unfccc.int/kyoto_protocol/background/status_of_ratification/items/2613.php (last visited Feb. 15, 2008). In accordance with the Kyoto Protocol, in 2005 the European Union established a cap and trade system for greenhouse gas emissions, known as the European Union Greenhouse Gas Emissions Trading Scheme.[8] Efforts toward negotiating a post-Kyoto treaty have begun, most notably with the United Nations Climate Change Conference in Bali in December 2007, which was attended by ministers of 180 countries and resulted in the Bali Roadmap, an agreement that includes the Bali Action Plan, which charts the course for negotiations for a new treaty designed to address climate change. See BNA Environment Reporter, *Bali Delegates Agree on 'Road Map,' But 'Complex Negotiations' Lie Ahead* (Dec. 12, 2007).

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environdisclosures/newsletter/jan08/EnvDiscl_Jan08.pdf (last visited March 13, 2008).

8. There is currently no formal guidance addressing accounting for emission allowances. In 2005, the International Accounting Standards Board formally withdrew guidance on accounting for emission allowances (developed by the International Financial Reporting Interpretations Committee and known as IFRIC 3 Emission Rights) and began a project to draft a separate standard on accounting for pollution emission allowances relating to greenhouse gases. See Deloitte, *Accounting for Emissions Rights* (2007), available at www.deloitte.com/dtt/cda/doc/content/us_er_Accounting%20ForEmission%20Rights_0220_2007.pdf (last visited Mar. 2, 2008). Similarly, in the U.S., the FASB has begun a project to provide accounting guidance for emission allowance programs. See www.fasb.org/project/emissionalloances (last visited Mar. 2, 2008).

(b) U.S. Legislation and Proposals. The U.S. withdrew from Kyoto treaty negotiations in March 2001, when President Bush announced that the U.S. would not ratify the Kyoto Protocol due to concerns that compliance would have significant adverse economic effects. Since that time, a number of Congressional proposals to address climate change issues have stalled; however, it now appears likely that some form of federal legislation mandating a cap and trade system for greenhouse gas emissions will eventually pass. The leading bill relating to climate change issues in the Senate (the "Lieberman-Warner bill") includes directions to the SEC to promulgate climate change disclosure requirements. S. 2191, 110th Cong. § 9002 (2007). In the absence of federal legislation, a patchwork quilt of regional, state and local regulation of greenhouse gas emissions has developed in the U.S.[9] For example, Massachusetts, Wisconsin, Oregon and New Hampshire have all adopted rules capping or requiring reductions in total CO2 emissions from power plants. In addition, seven Northeastern states entered into a bipartisan accord (The Regional Greenhouse Gas Initiative, or "REGGIE") requiring reductions by 2019 in CO2 emissions from power plants within their boundaries to a level 10% below current emissions. REGGIE, which includes a market-based cap and trade program, takes effect in 2009. See *Northeast Governors Sign Landmark Global Warming Pollution Pact* (Dec. 20, 2005) available at http://environmentmaine.org/envmaine.asp?id2=21076 (last visited Mar. 21, 2007). In February 2007, the Governors of six Western states, a well as several Canadian provinces and Indian tribes, entered into the Western Climate Initiative to establish a regional greenhouse gas emission reduction goal and market-based strategies to achieve the reductions. See http://www.westernclimateinitiative.org/ (last visited Mar. 10, 2008). In addition, in November 2007 nine Midwestern governors and the Premier of Manitoba recently signed the Midwestern Regional Greenhouse Gas Reduction

9. For a comprehensive overview of regional, state and local climate change initiatives (as well as international regulatory requirements), see *Petition for Interpretive Guidance on Climate Risk Disclosure*, Appendix C, available at http://www.sec.gov/rules/petitions/2007/petn4-547.pdf (last visited Mar. 10, 2008).

Accord, which establishes greenhouse gas reduction targets and timeframes, develops a system to track and trade greenhouse gas credits and calls for incentives and funding for the development of low-carbon fuels in the area. See ***Ten Midwestern Leaders Sign Greenhouse Gas Reduction*** *Accord* (Nov. 15, 2007), available at http://www.wisgov.state.wi.us/journal_media_detail.asp?locid=19&prid=3027 (last visited Feb. 15, 2008). In addition, several states (including California, Hawaii and New Jersey) have set mandatory, economy-wide caps on greenhouse gas emissions. Most notably, the California Global Warming Solutions Act of 2006 establishes a mandatory greenhouse gas emissions cap based on 1990 emission levels, mandates the promulgation of regulations by 2011 to achieve the reductions, and requires reporting of greenhouse gas emissions by 2008. See *Gov. Schwarzenegger Signs Landmark Legislation to Reduce Greenhouse Gas Emissions* (Sept. 27, 2006) available at http://gov.ca.gov/index.php?/press-release/4111/ (last visited Feb. 15, 2008).

(c) Climate Change Litigation. On the litigation front, the climate change docket in the U.S. has become increasingly active in recent years. Many of the cases involve suits to compel environmental regulatory agencies to promulgate or strengthen regulations addressing greenhouse gas emissions. Most significantly, in 2007, in Massachusetts v. E.P.A., the U.S. Supreme Court held that CO2 is an air pollutant under the Clean Air Act for purposes of motor vehicle emissions. See 127 S. Ct. 1438 (2007). A number of cases have also been filed against major greenhouse gas emitting businesses unsuccessfully alleging public nuisance and seeking injunctive relief (such as reduction in greenhouse gas emissions) and/or monetary damages. See, e.g., Connecticut v. American Electric Power Co., 406 F. Supp. 2d (S.D.N.Y. 2005); California v. General Motors, No. C06-05755 MJJ (N.D. Cal. 2005). Another category of cases involves suits against private entities or governmental agencies seeking to compel them to account for the impact of climate change in environmental permitting actions. See, e.g., Northwest Envtl. Defense Ctr. v. Owens Corning, 434 F. Supp. 957 (D. Or. 2006); Steven D. Cook, *EPA Appeals Board Case Could Determine If Carbon Emissions Are Factor in Permits*, TOXICS LAW REP.(BNA), at

152-53 (Feb. 19, 2008). Finally, a number of climate change cases have been filed against private entities and their insurance carriers in the aftermath of Hurricane Katrina. See, e.g., Barasich v. Columbia Gulf Transmission Co., 467 F. Supp. 2d 676 (E.D. La. 2006) (dismissing lawsuits alleging that activities of oil and gas companies contributed to the destructive impact of Hurricanes Rita and Katrina for failure to state a claim); Comer v. Murphy Oil, No. 05-CV-436LG (S.D. Miss. 2005) (suit against a group of oil companies for contribution to global warming and intensity of Hurricane Katrina dismissed in 2007 for failure to state a claim).

Although to date no cases have been filed seeking disclosure under Regulation S-K of climate change issues, in September 2007, New York Attorney General Andrew Cuomo issued subpeonas under New York State security law to five energy companies seeking internal documents related to their analysis of climate change risks. In letters accompanying the subpoenas, Attorney General Cuomo expressed concern over the adequacy of climate change risk disclosures in the companies' 2006 Form 10-Ks given that all the companies were involved with plans to build new coal-fired power plants. The letters are available at http://www.oag.state.ny.us/press/2007/sep/sep17a_07.html (last visited Mar. 6, 2008).

### *1.6.2 Materiality*

A threshold question under Item 101, 103 and 303 is whether current or future regulation of greenhouse gas emissions or the physical risks associated with climate change will have a material impact on the registrant. As noted in Section 1.2.1 above, a fact is material "if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." See SAB 99 (quoting TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976)). A recent petition seeking SEC guidance on climate change disclosure posits that the "steadily growing demand" from investors for information relating to climate risk is evidence that "reasonable investors" consider the risk of climate change as part of the "total mix" of information necessary to make investment decisions. See *Petition for Interpretive Guidance on Climate Risk Disclosure*, Appendix C,

available at http://www.sec.gov/rules/petitions/2007/petn4-547.pdf (last visited Mar. 10, 2008). Even if institutional investor interest in climate change is not evidence of its materiality, before concluding that the impact of climate change will not be material (or that the impact cannot be determined), commentators are urging that a registrant should carefully consider the potential impacts of physical risks and regulatory risks relating to climate change on the registrant. See *Cheng & Daly*, supra note 7; *Deatherage*, supra note 7. In order to do so, it may be necessary to assess the registrant's levels of greenhouse gas emissions – particularly in industrial sectors that are significant emitters of greenhouse gases.

### *1.6.3 Item 101*

Item 101 requires registrants to disclose the material effects of costs to comply with environmental laws and regulations. In particular, Item 101(c)(xii) requires a registrant to disclose material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and the succeeding year, as well as any further periods that the registrant deems material. For registrants in industrial sectors that have high greenhouse gas emissions (e.g., coal-burning utilities and aluminum smelters), Item 101 will require careful consideration of regulatory developments relating to climate change (e.g., mandatory cap and trade programs and reporting of greenhouse gas emissions), as well as the disclosure of material contingent capital plans. See *Smith,* supra note 6, at 3. In addition, multinational companies with facilities both in the U.S. and in Canada and/or Europe must consider whether disclosure under Item 101 is required with respect to capital expenditures undertaken as an alternative to purchasing emission credits in the European Union Greenhouse Gas Emissions Trading Scheme or other greenhouse gas emissions trading programs. See id. (citing 1973 SEC No-Action Letter clarifying that "to the extent any foreign environmental provisions may have a material impact upon the company's financial condition or business, such matters should be disclosed").

### *1.6.4 Item 103*

Instruction 5(A) of Item 103 requires disclosure of material legal proceedings that are pending or known to be contemplated to which the registrant is a party or of which the registrant's property is subject.[10] As noted in Section 1.6.1 above, the climate change litigation docket has grown. Item 103 requires registrants that are parties to the proceedings to disclose any such legal proceedings that may result in material liabilities and costs (e.g., material costs associated with the installation of pollution control facilities to reduce CO2 emissions or the purchase of emission offset credits). However, non-defendant companies should also consider disclosure of legal proceedings to the extent any precedent established will be controlling and likely to result in material legal or regulatory consequences. As a result, "disclosure of climate change litigation, both by the parties involved and by those potentially affected by the outcomes, has been the most robust and detailed of all SEC-mandated climate disclosure to date." See *Smith*, supra note 6 at 4.

### *1.6.5 Item 303*

Item 303 requires registrants to disclose known trends, events or uncertainties that are reasonably likely to have a material impact on liquidity, capital, sales, revenues or income. Specifically, the registrant must (i) assume that the trend, event or uncertainty will occur, unless the registrant concludes that it is not reasonably likely to occur, and (ii) disclose the trend, event or uncertainty, unless the

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10. In addition to the requirement pursuant to Instruction 5(A) of Item 103 to disclose legal proceedings that are material to the business or financial condition of a registrant, Instructions 5(B) and (C) require disclosure, respectively, of (i) legal proceedings involving claims for damages or costs in excess of 10% of consolidated assets and (ii) legal proceedings to which a governmental authority is a party and which involve monetary sanctions, unless such sanctions are reasonably expected to be less than $100,000. At least one commentator has posited that, although suits by state attorney generals against private emitters of greenhouse gases to date have sought only injunctive relief (e.g., reduction of greenhouse gas emissions), future climate change suits by state attorney generals (which are governmental authorities) could seek relief that potentially could be considered "sanctions" within the meaning of Instruction (C) of Item 103. See, e.g., GLOBAL CLIMATE CHANGE AND U.S. LAW, supra Section 1.6, at p.462.

registrant can determine that it is not reasonably likely to have a material effect on the registrant's financial condition or results of operations. In light of an emerging consensus on the science of climate change, the likely ultimate passage of federal climate change legislation and the regional, state and local initiatives mandating reductions in greenhouse gas emissions, it would be difficult to conclude under the first inquiry that regulation of climate change is a trend, event or uncertainty that is not reasonably likely to occur. Thus, disclosure will be necessary under Item 303 unless a registrant can determine that climate change impact and regulation is not reasonably likely to have a material effect on the registrant. See, e.g., GLOBAL CLIMATE CHANGE AND U.S. LAW, supra Section 1.6, at 466.

## 2. FINANCIAL STATEMENTS AND ACCOUNTING REQUIREMENTS

Accounting standards, which are used by the SEC for reviewing financial filings, may also dictate disclosure of environmental matters. Former Commissioner Richard Roberts emphasized this point: "[e]nvironmental matters may also have financial implications for issuers that must be reflected under generally accepted accounting principles. . . ." Commissioner Roberts Discusses Environmental Disclosure, 1507 Fed. Sec. L. Rep. (CCH) at 7. In recent years, the SEC has shown increased willingness to police financial disclosure relating to environmental matters. See SEC v. James Charles Blue, Litigation Release No. 19969 (Jan. 17, 2007) (SEC alleged that senior executives of a subsidiary of ConAgra Foods Inc. engaged in improper accounting practices, including reducing legal and environmental reserves to offset losses in other areas and to boost earnings during 2000 and 2001, and thereby caused ConAgra to make false and misleading statements in its periodic filings); In Re Ashland Inc. & William C. Olasin, Exchange Act Release No. 54830 (Nov. 29, 2006) (SEC issued a cease and desist order against Ashland after an Ashland executive reduced cost estimates from 1999 to 2001 for environmental remediation obligations without any reasonable basis, leading to a reduction in Ashland's environmental reserves and an increase in its net income); SEC v. Safety-Kleen Corp., Litigation Release No. 18555, Jan. 28, 2004 (SEC announced a final judgment against former senior executives of Safety Kleen who materially overstated Safety-Kleen's revenue and earnings from at least

November 1998 to March 2000 by, among other things, creating fictitious income by arbitrarily reducing several environmental remediation reserve accounts without analysis to support the reductions); SEC v. Buntrock, Litigation Release No. 17435, Mar. 26, 2002 (in which the SEC alleged that senior executives of Waste Management inflated environmental reserves in connection with acquisitions and charged unrelated environmental expenses to such reserves, thereby understating current liability expenses).

### 2.1 FASB SFAS No. 5

The primary accounting standard applicable to environmental disclosure in financial statements is Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* ("SFAS No. 5"), which deals with accounting for contingencies. SFAS No. 5 provides that loss contingencies must be disclosed if: (1) available information indicates that it is probable that "an asset has been impaired or a liability has been incurred at the date of the financial statements" and (2) the amount of the loss can be reasonably estimated. SFAS No. 5 at para. 8. If both these conditions are met, the Statement requires that the loss be disclosed as a charge to income. Id.

Paragraph 10 provides that even when both of the conditions for accrual in paragraph 8 are not met, disclosure of the loss contingency shall nonetheless be required where there is "at least a reasonable possibility" that the loss has been incurred. This is true even if "information may not indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements." SFAS No. 5 at para. 10, n.6. This disclosure is required to state the nature of the contingency, and give an estimate of the possible loss or range of loss, or state that an estimate cannot be made. Id. The registrant is further required to record the most likely amount within the range if one can be determined. *Remedies to be Enforced on Case-by-Case Basis, McLucas Says*, 23 SEC. REG. &. L. REP. (BNA) at 1559; cf. SEC Commissioner Roberts, *Update on Environmental Disclosure*, delivered before the Colorado Bar Association on September 28, 1991, cited in Ronald M. Loeb & Kevin A. Frankel, *Disclosing Environmental Matters* 10 (manuscript Nov. 28, 1991) ("If management determines that the amount of the liability is likely to fall within a range and no amount within that range can be determined to be the better estimate, the registrant is required to

record the minimum amount of the range."). See also FIN 14, *Reasonable Estimation of the Amount of a Loss*, cited in SAB 92.[11]

(a) Immaterial Items. SFAS No. 5 provides that it "need not be applied to immaterial items." The FASB has not provided further guidance with respect to the materiality threshold for purposes of SFAS No. 5. However, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, provides that information is material when "[t]he magnitude of an omission or misstatement of [such information], in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

(b) Recording of Contribution, Indemnity, and Insurance. Former Commissioner Roberts stated with respect to financial reporting that "the recognition and measurement of the liability must be evaluated separately from the consideration of any expected insurance recoveries." Remarks of Richard Y. Roberts, Commissioner of the SEC, *Update on Environmental Disclosure*, delivered before the Colorado Bar Association on September 28, 1991 cited in Loeb & Frankel, Disclosing Environmental Matters 10. "[S]eparate display of a claim for indemnification or contribution will lead to a more rigorous consideration of the

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11. On March 15, 2005, the FASB rejected a proposal by the Rose Foundation for Communities and the Environment to require present value estimation for environmental liabilities under SFAS No. 5 and to consider whether environmental liabilities should be aggregated for purposes of determining materiality. The FASB reasoned that environmental liabilities should not have special measurement attributes separate from other contingent liabilities and that the issue could be addressed in an anticipated future project reconsidering generally the accounting treatment of contingent liabilities. See *Environmental Liabilities Project Rejected; FASB Staff Studying Broader Work* in BNA SEC. REG. & LAW REP., Vol. 37, No. 11, Mar. 14, 2005. At a September 2007 meeting, the FASB voted to add to its agenda a project comprehensively to reconsider the accounting for contingencies, as currently provided for in SFAS No. 5, which would, among other things, attempt to eliminate inconsistencies in measurements required by SFAS No. 5 and SFAS No. 141(R) (discussed in Section 2.5 below) and could result in the adoption of "fair value" measurement (discussed in Section 2.6 below) for all contingent liabilities. See *Minutes of the September 6, 2007 Board Meeting—Accounting for Contingencies,* Sept. 18, 2007, available at http://fasb.org/board_meeting_minutes/09-06-07_contingencies.pdf.

uncertainties affecting realization of that claim." Remarks of Richard Y. Roberts, Commissioner of the SEC, *Environmental Liability Disclosure Update*, delivered at the New Jersey Institute for Continuing Legal Education on May 5, 1995. Statement of Position 96-1 of the American Institute of Certified Public Accountants ("AICPA") concurs: "The staff believes that separate presentation of the gross liability and related claim for recovery in the balance sheet most fairly presents the potential consequences of the contingent claim on the company's resources and is the preferable method of display." Statement of Position 96-1, *Environmental Remediation Liabilities* at 56 (Oct. 10, 1996). See infra Section 2.2.

## 2.2 SOP 96-1

In October 1996, the AICPA published Statement of Position 96-1, *Environmental Remediation Liabilities* ("SOP 96-1"). In issuing SOP 96-1, the AICPA sought to improve and make more uniform the manner in which existing authoritative accounting literature is applied with regard to measuring and disclosing environmental remediation liabilities. The statement expressly excludes from its purview accounting guidance for costs associated with operational pollution control technology, site restoration triggered by the cessation of operations or voluntary site remediation not resulting from a third-party claim or litigation. Further, the guidance does not address the recognition of liabilities of insurance companies with respect to unpaid claims or asset impairment.

The statement is organized in chapters: chapters 1 through 4 provide a narrative of major federal legislation addressing pollution control and remediation; chapters 5 through 7 address the recognition, measurement and disclosure of a registrants' remediation liabilities. Despite its great length, SOP 96-1 offers few new insights, but serves as a useful compendium of existing legislative authority and guidance. An instructive passage, set forth in Appendix B, is an illustrative case study analyzing appropriate accounting treatment for various stages of an environmental investigation and remediation.

### *2.2.1 EPA Environmental Accounting Project*

In 1992, the EPA created an Environmental Accounting Project to "encourage and motivate business to understand the full

spectrum of their environmental costs, and integrate these costs into decision-making." The EPA has partnered with the Tellus Institute, a non-profit environmental research and consulting organization, to maintain and further develop tools and documentation on environmental accounting. In April 1992, the EPA's Pollution Prevention Program launched the Environmental Management Accounting international website (www.emawebsite.org, last visited Mar. 21, 2007; down for maintenance as of March 7, 2008). The website is a comprehensive source for articles, research and education regarding environmental accounting. In addition, the International Federation of Accountants released a guideline in August 2005 on environmental management accounting. See http://www.ifac.org/Store/Details.tmpl?SID=1123595939318284 (last visited Feb.28, 2007).

### *2.2.2 Governmental Accounting Standards Board–Pollution Remediation Obligations*

On December 1, 2006, the Governmental Accounting Standards Board ("GASB"), an organization which establishes accounting standards for state and local governments, issued Statement No. 49*, Accounting and Financial Reporting for Pollution Remediation Obligations*, which provides guidance to state and local governments regarding how and when to measure and report the costs associated with pollution cleanup obligations. See http://www.gasb.org/news/nr120106.html (last visited Mar. 2, 2008).

## 2.3 SAB 92

In 1993, the SEC published *Staff Accounting Bulletin No. 92*, Topic 5-Y, *Accounting and Disclosures Relating to Loss Contingencies* ("SAB 92"). SAB 92 is an interpretation of generally accepted accounting principles ("GAAP") with regard to contingent environmental liabilities, and "was intended to promote the timely recognition of contingent losses and to address the diversity in practice with respect to the accounting for and disclosure of contingent liabilities." Under SAB 92, contingent environmental losses must be accrued by a charge to income if it is probable that a liability has been incurred and if the amount of the liability can be estimated. The Emerging Issues Task Force of FASB determined that

environmental liabilities should be evaluated independently of potential claims for recovery. Potential losses from environmental claims should only be reduced by potential recoveries that are probable.

SAB 92 is organized in a series of questions and interpretative responses, summarized as follows:

(1) Offsetting losses and recoveries should be represented on the balance sheet separately rather than netted because this "most fairly represents the potential consequences of the contingent claim on the company's resources." SAB 92 at 4.

(2) With respect to joint and several liabilities for a contaminated site, if there is a reasonable method of apportioning the costs, and it is probable that the other PRPs will contribute, then the registrant need only recognize the estimate of its portion of the liability. A note on the uncertainties relating to contributions by other PRPs may be necessary.

(3) Liabilities should be estimated based on present facts and existing technology, while also considering all other available information, including future circumstances such as the effects of inflation. If management is able to determine that the amount of a liability is likely to fall within a range, and no amount within that range can be determined to be the better estimate, the registrant should recognize the minimum amount of the range.

(4) If registrants discount estimates of liabilities, the rate used to discount the expected payments should be the rate that will produce an amount at which the environmental liability could be settled in an arm's length transaction; if that rate cannot be determined, a rate no greater than the risk-free rate should be used.

(5) Detailed disclosures regarding material environmental loss contingencies must be furnished in the notes to financial statements to prevent those financial statements from being misleading.

(6) With respect to disclosures regarding loss contingencies outside of financial statements, Items 101, 103, and 303 of Regulation S-K provide guidance.

(7) Site restoration costs or other environmental exit costs should be disclosed in the notes to financial statements.

(8) During the life of an asset, it is permissible to accrue costs that will be incurred after the useful life of the asset provided the costs are reasonably estimable.

## 2.4 FASB SFAS No. 143

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 143*, Accounting for Asset Retirement Obligations* ("SFAS No. 143"). SFAS No. 143, which became effective for fiscal years beginning after June 15, 2002, affects the way companies recognize and measure legal retirement obligations resulting from the acquisition, construction or normal operation of tangible, long-lived assets (such as utility plants, mines, landfills, and transformers). SFAS No. 143 requires companies to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred if a reasonable estimate of fair value can be determined. Thus, a company that has a legal obligation to perform decontamination activities when a facility (or a portion of a facility) ceases to operate would have an asset retirement obligation that must be recognized as a liability and measured for fair value. The costs associated with the recognition of the asset retirement obligation are capitalized and depreciated over the expected life of the asset.

There is some uncertainty regarding the extent to which clean-up obligations are subject to SFAS No. 143. Remediation obligations resulting from normal, "proper" operations (e.g., disposal of telephone poles or other contaminated equipment or fixtures) are subject to SFAS No. 143. SFAS No. 143, however, does not apply to legal obligations resulting from the "improper" operation of an asset, such as an oil spill, which instead would be subject to SOP 96-1. It is debatable whether all spills result from "improper" operations (and thus would be subject to SOP 96-1) or whether some spills result from the "proper" operation of an asset (and thus would be subject to SFAS No. 143).[12]

SFAS No. 143 does not apply to asset retirement obligations that are "immaterial." The FASB has not provided further guidance with respect to this materiality threshold.

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12. For a panel discussion that considered what constitutes "normal" operations in the context of FAS 143, see ABA Special Committee on Environmental Disclosure, Vol. 3, No. 2, available at http://www.abanet.org/environ/committees/environdisclosures/newsletter/archives.shtml (last visited Mar. 22, 2007).

### *2.4.1 FIN 47*

On March 30, 2005, the FASB published an interpretation ("FIN 47") clarifying the standards governing asset retirement. See FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143*, available at http://www.fasb.org/pdf/fin%2047.pdf (last visited Mar. 2, 2008). FIN 47 clarifies that a legal obligation to perform an asset retirement activity that is conditional on a future event is within the scope of SFAS No. 143. Accordingly, FIN 47 requires companies to recognize and report future environmental liabilities upon the retirement of a related asset. The ability of a company indefinitely to defer settlement of the obligation or the ability of a company to sell the asset prior to its retirement would not relieve the company of recognizing the obligation.

FIN 47 includes several illustrative examples, including the purchase of a building containing asbestos-containing materials, for which regulations are in place requiring special handling and disposal of the asbestos upon renovation or demolition. According to the example, the asset retirement obligation occurs when the company purchases the building. The ability of the company to abandon the factory does not relieve the company of the obligation as "no building will last forever." Similarly, the ability of the company to sell the factory does not relieve the company of its obligation, as the sale would transfer the obligation to another entity and that transfer would affect the selling price. Therefore, the company should recognize the asset retirement obligation upon acquisition of the factory, assuming that the fair value of the special handling and/or disposal is reasonably estimable.

FIN 47 indicates that the fair value of an asset retirement obligation can be reasonably estimated if (1) the purchase price of an asset reflects the fair value of the obligation (e.g., a negotiated purchase price reduction, or the use of indemnities or insurance to transfer environmental risk), (2) there is an active market for the transfer of the obligation, or (3) there is sufficient information to calculate the expected present value of the liability (if necessary, using a probabilistic weighted average of possible outcomes).

FIN 47 does not require immediate recognition of a liability if a fair value determination cannot be made. In such a situation, FIN 47 requires the financial statement to describe the obligation,

explain that the liability has not been recognized, and provide the reason why the fair value is not presently reasonably estimable.

FIN 47 expressly requires companies to identify all asset retirement obligations and directs affected companies to take a one-time cumulative accounting charge to net income to true up their books. FIN 47, which became effective no later than December 15, 2005 (for fiscal year companies) and December 31, 2005 (for calendar year companies), has been the subject of significant criticism from industry. Some commentators have speculated that FIN 47 creates an incentive for companies to sell-off properties that face large asset retirement obligations.

It has been noted that the effect of FIN 47 on financial statement disclosure has varied - even among companies in the same industry - with some companies recording significant charges as a result of asset retirement obligations[13] and others stating that their obligations are not estimable or material.[14] Recent SEC Comment Letters indicate that the SEC has been requiring companies to provide additional disclosure regarding their analysis of asset retirement obligations in light of FIN 47, in particular where companies have indicated that such obligations are not estimable. See, e.g.,

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13. For example for fiscal year ended December 31, 2005, Ford Motor Co. took a $251 million charge for conditional asset retirement obligations associated with asbestos abatement and PCB removal. See Ford Motor Co. Form 10-K/A, filed on November 14, 2006, available at http://sec.gov/Archives/edgar/data/37996/000114036106016171/form10-ka.htm. ConocoPhilips increased asset retirement obligation liabilities by $417 million in its reporting for fiscal year ended December 31, 2005. See ConocoPhilips Form 10-K, filed on February 2, 2006, available at http://sec.gov/Archives/edgar/data/1163165/000110465906012015/a06-2522_110k.htm. See also Chevron Corporation Form 8-K, dated October 9, 2007 (announcing an estimated $700 million in nonrecurring net charges for, inter alia, asset retirement obligations and environmental remediation provisions), available at http://sec.gov/Archives/edgar/data/93410/000095013407021068/f34376exv99w1.htm.

14. See C. Gregory Rogers, *If Your Head Is in the Sand, Your Assets Are Expose*d (Brownfield News, June 2006), available at http://www.advancedenvironmentaldimensions.com/documents/Head%20in%20the%20Sand.pdf; *FIN 47 Poses Hard Questions for Estimating Future Environmental Liabilities*, Goodwin Proctor (Apr. 24, 2007), available at http://www.eli.org/pdf/alerts/Goodwin_Procter_04-24-07.pdf ; *The Impact of FIN 47 (So Far)*, Controllers' Leadership Roundtable (Mar. 2006), available at http://www.advancedenvironmentaldimensions.com/documents/Controller's%20Leadership%20Roundtable.pdf.

SEC Comment Letter, *Autocam Corp.* (Nov. 29, 2006), SEC Comment Letter, *Alon USA Energy, Inc.* (Sept. 25, 2007).

### *2.4.2 FSP FAS 143-1*

In June 2005, the FASB issued a Staff Position under SFAS No. 143 to provide guidance on the accounting impact of electronic equipment waste disposal obligations under Directive 2002/96/EC on Waste Electrical and Electronic Equipment (the "WEEE"), adopted by the European Union in January 2003, which effectively obligates a commercial user to incur costs associated with the retirement of a specified asset that qualifies as "historical" waste equipment (i.e., products on the market on or prior to August 13, 2005). FAS 143-1 clarifies that a commercial user should apply the provisions of SFAS No. 143 to the obligation associated with historical waste and that the ability or intent of the commercial user to replace the asset and transfer the obligation does not relieve the user of its present duty or responsibility to settle the obligation. See FASB Staff Position No. FAS 143-1*, Accounting for Electronic Equipment Waste Obligations* (June 8, 2005).[15]

## 2.5 FASB SFAS No. 141(R)

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141, *Business Combinations* (revised 2007) ("SFAS No. 141(R)"), which changes the requirements for how an acquirer in a business combination recognizes in its financial statements the assets acquired, the liabilities assumed, and any noncontrolling interest in the target.[16] SFAS No. 141(R) applies to all transactions in which an acquirer obtains control of a businesses,

15. A related directive, Directive on the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment 2002/95/EC[1] (commonly referred to as "RoHS"), which was adopted in February 2003 by the European Union and took effect on July 1, 2006, restricts the use of certain hazardous materials in the manufacture of various types of electronic and electrical equipment.
16. The revision of SFAS No. 141 was part of a joint project of the FASB and the IASB, the objective of which was to develop a single standard of accounting for business combinations. For its part, the IASB issued a revised IFRS 3. The joint project is another example of the movement toward a convergence of global accounting standards. See supra Section 2.7.

including combinations achieved without the transfer of consideration. SFAS No. 141(R) does not apply to the formation of a joint venture; an asset purchase where the assets do not constitute a "business"; a business combination between entities under common control; or transactions in which the acquirer is a not for profit organization.

SFAS No. 141(R) requires an acquirer to measure and recognize the assets acquired and the liabilities assumed at their fair value as of the acquisition date, with limited exceptions, and changes the requirements for recognizing assets acquired and liabilities assumed arising from contingencies. Previously, SFAS No. 141 permitted deferred recognition of preacquisition contingencies until the recognition criteria for SFAS No. 5 were met. See supra Section 2.1. Under SFAS No. 141(R), an acquirer must recognize at fair value assets acquired and liabilities assumed arising from *contractual* contingencies (e.g., environmental covenants and indemnities) as of the acquisition date. All *noncontractual* contingencies (e.g., environmental obligations arising under statutory or common law) are measured at their fair values as of the acquisition date only if it is more likely than not that such noncontractual contingencies meet the definition of an asset or a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements* (Dec. 1985).[17] If that criterion is not met at the acquisition date, the acquirer instead accounts for the noncontractual contingencies in accordance with SFAS No. 5 and other applicable GAAP.

Under SFAS No. 141(R), an acquirer must continue to report an asset or a liability arising from a contingency recognized as of the acquisition date at its acquisition-date fair value absent new information about the possible outcome of the contingency. When new information is obtained, the acquirer must measure the liability at the higher of its acquisition-date fair value or the amount that would be recognized if applying SFAS No. 5, and must measure the asset at the lower of its acquisition-date fair value or the best estimate of its future settlement amount.

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17. Concepts Statement No. 6 provides that assets are "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" and that liabilities are "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

As a result, acquirers may have to record contingent environmental liabilities that were not previously accounted for by sellers under SFAS No. 5. Even if previously accounted for by sellers pursuant to SFAS No. 5 (which permits recognition of a liability at the low end of a range when no amount within the range can be determined to be the better estimate), it is possible that acquirers may have to record higher estimates based on the fair value measurement required by SFAS No. 141(R).

SFAS No. 141(R) becomes effective for transactions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

### 2.6 Fair Value Measurements

In September of 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("SFAS No. 157"), which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. The Statement is intended to create greater consistency and comparability in fair value measurements and to foster expanded disclosures about fair value measurements. SFAS No. 157 applies to a broad array of FASB pronouncements that utilize "fair value" as a measurement, including asset retirement obligations in accordance with FAS 143, business combinations in accordance with SFAS No. 141(R), and indemnity obligations in accordance with FASB Interpretation No. 45.[18] SFAS No. 157 defines fair value generally as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 establishes a fair value analysis hierarchy that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to data that is not observable by market participants and reflects the reporting entity's own assumptions based on the best information available to it, which might include its own data. Under the standard, fair value

18. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, clarifies that "a guarantor is required to recognize, at the inception of the guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee."

measurements would be separately disclosed by level within the fair value hierarchy. In addition, whereas under SFAS No. 5, liabilities may be recognized at the low end of a range of estimates if no number within the range is a better estimate, under a fair value analysis, probabilities of various outcomes must be weighed and factored to arrive at the point within the range that is most representative of fair value under the circumstances. As a result, fair value estimates may often be higher than estimates that result from the application of SFAS No. 5.

The FASB's initial exposure draft on fair value measurement permitted companies to avoid valuation approaches that companies deemed to pose "undue cost and effort." A number of public commentators criticized this exception because in some cases the best valuation technique might also be the most costly. Public commentators were concerned that the "undue cost and effort" clause would simply lead to companies abandoning estimation attempts when they become overly burdensome. In a January 2006 meeting, the FASB agreed to remove the exception relating to the "undue cost and effort" criterion. See Statement of Financial Accounting Standards No. 157*, Fair Value Measurements* (September 2006) available at fasb.org/pdf/fas157.pdf (last visited Mar. 22, 2007).

On February 12, 2008, the FASB issued Staff Position FAS 157-2, *Effective Date of FASB Statement No. 157* ("FAS 157-2"), which defers, in part, the effective date of SFAS No. 157, originally set for November 15, 2007, to allow for more time to resolve implementation issues that preparers and others were experiencing in relation to fair value measurements of certain nonfinancial assets and nonfinancial liabilities whose fair value measurements often rely on unobservable inputs. The deferral applies to nonfinancial assets and nonfinancial liabilities (such as environmental indemnities and asset retirement obligations), except for items that are recognized or disclosed at fair value in an entity's financial statements on a recurring basis (at least annually). In addition, the deferral does not apply to entities that have issued interim or annual financial statements reflecting the application of the measurement and disclosure provisions of SFAS No. 157 prior to the issuance of FAS 157-2. Those entities must continue to apply all of the provisions of SFAS No. 157.

## 2.7 Foreign Private Issuers and Convergence of Global Accounting Standards

Foreign private issuers may prepare financial statements in accordance with either GAAP or another comprehensive body of accounting standards (such as International Accounting Standards ("IAS")). Until recently, a foreign private issuer that used accounting standards other than GAAP was required to provide an audited reconciliation to GAAP. However, in December 2007, the SEC adopted amendments that, subject to certain conditions, permit foreign private issuers to file financial statements prepared in accordance with International Financial Accounting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB") without reconciliation to GAAP. See SEC Release No. 33-8879 (Dec. 21, 2008). IFRS are currently required or permitted to be used in more than 100 countries. The amendments are part of recent moves by the SEC and other standard setting bodies toward a convergence of accounting standards into one global standard and reflects the increasing use of IFRS outside the U.S. In recognition of the latter, the SEC recently issued a concept release seeking input regarding the nature and extent of the public's interest in giving U.S. issuers the option to file with the SEC financial statements prepared in accordance with IFRS as published by the IASB. See SEC Release No. 33-8831 (September 13, 2007). In another move toward the adoption of a global standard, the Canadian Accounting Standards Board recently confirmed that IFRS will replace Canada's current GAAP as the required standards for listed companies and other profit-oriented enterprises that are responsible to large or diverse groups of stakeholders.[19] The official changeover date is for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. See *Canadian Accounting Standards Board Confirms Changeover Date to IFRS* (Feb. 13, 2008), available at http://www.acsbcanada.org/download.cfm?ci_id=43289&la_id=1&reid=0 (last visited Mar. 3, 2008).

19. Private companies (non-publicly accountable enterprises) and not-for-profit organizations are not required, but are permitted, to adopt IFRS in 2011.

### 2.8 Restating Financial Information

An obligation to restate financial information disclosed to the SEC may arise if information was not disclosed in accordance with Regulation S-K or any applicable accounting standard. For example, in connection with due diligence undertaken in the acquisition of Millennium Chemicals Inc. (Millennium), it was discovered that errors had been made in recording estimated liabilities for future environmental remediation costs associated with Millennium's existing obligations, primarily related to a single site. In 2005, the board of Millennium determined to correct the errors by increasing its recorded liabilities for environmental remediation by $59 million in a restated Form 10-K including restated financial statements for the years ended December 31, 2001 through 2003. More recently, General Motors, as part of a restatement of its consolidated financial statements and financial information for 2002 through the third quarter of 2006, recorded adjustments to its earnings and retained earnings for 2004 and 2005 to reflect properly obligations for ongoing environmental operation and maintenance costs for certain of its sites. See General Motors Corp. Annual Report for Fiscal Year Ended December 31, 2006 on Form 10-K, available at http://sec.gov/Archives/edgar/data/40730/000095012407001502/k11916e10vk.htm (last visited Mar. 3, 2008).

## 3. THE IMPACT OF THE SARBANES-OXLEY ACT AND CEO/CFO CERTIFICATION ON ENVIRONMENTAL DISCLOSURES

Although the 2002 Sarbanes-Oxley Act did not expressly address environmental disclosure requirements, it may have resulted in increased or at least more timely and accurate environmental disclosure based on the mandated internal controls and procedures to ensure accuracy of disclosure and senior management certification as to the material accuracy of disclosure and financial statements. The Sarbanes-Oxley Act requires that CEO's and CFO's make certain certifications with their company's periodic and annual reports filed with the SEC, under Sections 906 and 302, respectively. The Section 906 certification must state that any periodic report containing financial statements *fully complies* with the requirements of Section 13(a) or 15(d) of the Exchange Act and that information contained in the periodic report *fairly presents*, in all material respects, the financial condition and results of operations of the issuer. The certification as to the compliance of the

periodic report with the requirements of Section 13(a) or 15(d) of the Exchange Act is not qualified as to materiality.

Section 302 and rules promulgated by the SEC pursuant to the Sarbanes-Oxley Act require the CEO and the CFO to make certain certifications in each annual and quarterly report. In general, the CEO and CFO (or persons performing similar functions) are required to certify that:

- he or she has *reviewed* the report being filed;
- *based on his or her knowledge*, the report *does not contain any untrue statement of a material fact* or omit to state a material fact;
- *based on his or her knowledge*, the financial statements, and other financial information included in the report, *fairly present* in all material respects the financial condition, results of operations and cash flows of the company;
- he or she is responsible for establishing and maintaining *disclosure controls and procedures* and *internal control over financial reporting* for the company and having such disclosure and internal control systems periodically evaluated;
- the disclosure controls and procedures ensure that material information relating to the company is made known to them by others with sufficient speed to allow "timely" decisions regarding disclosure; and
- the internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

The SEC expressly required that public companies adopt and maintain controls and procedures to ensure adequate and timely SEC disclosures. In In Re Ashland Inc. & William C. Olasin, Ashland Inc.'s Director of Environmental Remediation, William Olasin, reduced the cost estimates from 1999 to 2001 for remediating environmental contamination at dozens of chemical and refinery sites for which Ashland had responsibility. Ashland used those estimates to determine its environmental reserves, which Ashland disclosed in the periodic reports that it filed with the SEC. Securities Exchange Act of 1934, Release No. 54830 (Nov. 29, 2006). Olasin had no reasonable basis for reducing these cost estimates, which had been developed by a team of Ashland

engineers, an outside consultant, and a computer program. The SEC issued a cease and desist order against Ashland after it concluded that Ashland's process for setting its environmental reserve did not establish adequate guidelines for, or require documentation or review of, adjustments to environmental cost estimates, and therefore, its system of internal accounting was insufficient.

The new SEC rules may encourage companies to re-examine their environmental reporting systems because senior management must now certify that (1) the environmental disclosures comply with periodic and annual disclosure requirements and (2) any environmental liabilities are appropriately reflected in the financial statements in accordance with GAAP. The potential criminal penalties for a false certification under Section 906 (a $5 million fine and up to 20 years imprisonment for a willful violation) should provide a strong incentive to ensure that there is a well-documented system to ensure the accuracy of environmental disclosures and appropriate consideration and accounting treatment of potential environmental liabilities.

The Sarbanes-Oxley Act also directed the SEC to adopt minimum federal standards of conduct for attorneys who appear and practice before the SEC, including attorneys involved in preparing SEC disclosure. 15 U.S.C. § 7245. These rules impose a duty on both outside and in-house counsel to report material violations of securities law that come to be known by counsel "up-the-ladder" to the chief legal officer, chief executive officer, audit committee or board. See SEC Release No. 33-8185. Such up-the-ladder reporting would require reporting of any material misstatements in the disclosure of environmental liabilities.

## 4. SHAREHOLDER LAWSUITS AND PETITIONS ALLEGING MATERIAL ENVIRONMENTAL NONDISCLOSURE

### 4.1 Shareholder Lawsuits

In Grossman v. Waste Management, Inc., shareholders brought a class action, alleging that various problems defendant had encountered with environmental authorities should have been disclosed under Rule 10b-5, especially in light of the fact that Waste Management had explicitly touted its environmental record. See 589 F. Supp. 395, 409-410 (N.D. Ill. 1984). For instance, in the company's 1981 annual report, Waste Management stated that it "set the standards for the entire industry" for environmental excellences and that the growth of the company largely resulted from "environmentally sound handling

of a broad range of materials." Id. at 410. The district court denied the defendant's motion for summary judgment, holding that a question of fact remained as to whether the prospectuses and reports upon which plaintiffs relied had disclosed all material information regarding environmental issues. See id. at 409-412; see also United Paperworkers Int'l v. Int'l Paper Co., 985 F.2d 1190 (2nd Cir. 1993) (company issued misleading statements regarding its environmental record). But see Anderson v. Abbott Lab., 140 F. Supp. 2d 894 (finding that in the absence of explicit favorable claims regarding, or in reference to, its environmental record or regulatory issues, Abbott did not have to disclose potential FDA violations).

More recently, six securities class action lawsuits were filed (and thereafter consolidated) against United States Liquids, Inc. See In re United States Liquids Securities Litigation, Case No. H-99-2785, 2002 U.S. Dist. LEXIS (S.D. Tex. June 12, 2002). The plaintiffs alleged that the company failed to disclose that the EPA and the FBI were investigating illegal disposal of PCBs into the Detroit sewer system from one of the company's most profitable facilities. After the EPA issued heavy fines and ordered a temporary shutdown of the facility, the company's stock price dropped by 50%. In August of 2004, the company filed a petition for bankruptcy and is now defunct. The plaintiffs' claims against company were extinguished in the bankruptcy proceeding and the claims against three officers of the company were settled in May of 2006, with the defendants agreeing to pay $600,000 to a settlement fund.

### 4.2 Shareholder Petitions

Since the late 1990's, investors, environmental organizations, public interest groups and unions have alleged frequent noncompliance with environmental disclosure requirements and called for stricter SEC enforcement of such requirements.[20] These

20. The Corporate Sunshine Working Group, similar non-profit groups, accounting organizations, governmental agencies and legal scholars have published a number of reports concluding that many companies are failing adequately to disclose environmental liabilities in their SEC reports. See, e.g., Michael F. Crusto, *Endangered Green Reports: Cumulative Materiality in Corporate Environmental Disclosure After Sarbanes-Oxley*, 42 HARV. J. ON LEGIS. 483; Robert Repetto, *Silence is Golden, Leaden and Copper, Disclosure of Material Environmental Information in the Hard Rock Mining Industry*, YALE SCH. OF FORESTRY & ENVTL. STUD., Report No.1 (2004); *Duty To Disclose: The Failure of Food Companies To*

groups have filed a number of petitions with the SEC requesting the agency to investigate alleged environmental disclosure violations by individual companies. See, e.g., Petition of two institutional investors relating to Dow Chemical (dated August 10, 2004) (alleging that the company made misleading statements during an annual shareholder meeting and omitted material information from SEC filings relating to the 1984 Bhopal, India explosion, dioxin contamination in Midland, Michigan and the chemical defoliant Agent Orange); Petition by nine institutional investors relating to Abbott Laboratories (dated June 28, 2001) (alleging that the company failed to disclose recent scientific findings relating to chemicals associated with the production of polyvinyl chloride plastic); Petition by Friends of the Earth relating to Scotts Company (dated March 7, 2001) (alleging that the company failed to disclose trends in UK environmental regulations which the group contended were potentially material to the company's peat extraction business); Petition by two shareholders relating to Crown Central Petroleum (dated August 25, 1999) (alleging that the company failed to disclose environmental penalty proceedings); Petition by United Steel Workers of America relating to Phelps Dodge (dated November 5, 1998) (alleging that the company failed to adequately disclose environmental liabilities and cleanup costs associated with a contaminated site); and Petition by Friends of the Earth, the Sierra Club and Citizen Action relating to Viacom (dated February of 1997) (alleging that the company had inadequately disclosed its Superfund liabilities). Most of these petitions are available at www.corporatesunshine.org (last visited Mar. 2, 2008).

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*Disclose Risks of Genetically Engineered Crops To Shareholders* (U.S. PIRG, 2004); *Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical, and Utilities Companies* (Friends of the Earth, 2006, 2004, 2003 & 2002); *The Environmental Fiduciary: The Case for Incorporating Environmental Factors into Investment Management Policies* (The Rose Foundation, 2002); *Corporate Environmental Disclosure: Opportunities To Harness Market Forces To Improve Corporate Environmental Performance*, citing 1998 EPA study on compliance with SEC environmental disclosure requirements (EPA, 2001); *Environmental Disclosure of Companies Involved in Initial Public Offerings* (Freedman & Stagliano, 1996); *Environmental Liability: Property and Casualty Disclosure of Environmental Liabilities* (GAO, 1993); *Accounting for Environmental Compliance: Crossroads of GAAP, Engineering and Government-Second Survey of Corporate America's Accounting for Environmental Costs* (PriceWaterhouse, 1992).

## 5. OTHER INITIATIVES TO ENHANCE ENVIRONMENTAL DISCLOSURE

### 5.1 Non-Material Environmental Matters

#### *5.1.1 NRDC v. SEC*

Natural Resources Defense Council v. SEC, 389 F. Supp. 689 (D.D.C. 1974), involved an action by an environmental group under 15 U.S.C. § 77g and the National Environmental Policy Act, 42 U.S.C. §§ 4321 et seq., to compel the SEC to require disclosures of certain environmental matters not having a material financial impact. See 389 F. Supp. at 694 (listing proposals rejected by SEC, which rejections plaintiffs contested). The district court held that the SEC had violated the procedural provisions of the Administrative Procedure Act, 5 U.S.C. §§ 551 et seq., in its rulemaking decisions on environmental disclosure. See id. at 701. The court ordered the SEC to reconsider its rules accordingly, and specifically directed the Commission to consider the possibility that "ethical investors" may have an interest in environmental information which does not necessarily have a material financial impact, and that this interest may require the disclosure of such information. See id.; see also Roeder v. Alpha Indus., Inc., 814 F.2d 22, 25 (1st Cir. 1987) (assessing materiality of company's omission of bribes to contractors, court points out that management's willingness to engage in unlawful activity and its decision to place the corporation at risk by doing so "may be critically important factors to investors").

### 5.2 SEC Rejection of Requirement

The SEC has refused to require the disclosure of non-material environmental information. For example, in rulemaking proceedings intended to respond to the NRDC opinion, the SEC rejected each of five proposals regarding the disclosure of non-material environmental information. See Securities Act Release No. 5627, Fed. Sec. L. Rep. (CCH) para. 80,310, at 85,706, 85,717-19 (Oct. 14, 1975) (rejecting proposals which would require comprehensive disclosure of environmental effects of corporate activities, disclosure of all pending environmental litigation, disclosure of general corporate environmental policy, and disclosure of all capital expenditures for

environmental purposes); Securities Act Release No. 5704, Fed. Sec. L. Rep. (CCH) para. 80,495, at 86,295 (rejecting proposal which would require listing of environmental compliance reports).

The SEC has, however, indicated that the disclosure of a company's environmental policy will be required if either of two conditions exist. First, if the corporation voluntarily chooses to make disclosures concerning its environmental policy, it must make such additional disclosures concerning its policy as are necessary to prevent the voluntary disclosures from being misleading. See In re United States Steel, Fed. Sec. L. Rep. (CCH) para. 82,319, at 82,384. Furthermore, if a corporation has an environmental policy which is "reasonably likely" to result in "substantial" financial penalties for non-compliance, it may be necessary to disclose the likelihood and extent of such penalties to prevent the required disclosures concerning the company's business from being misleading. See id.

### 5.3 The "Valdez Principles"

Shareholders have successfully compelled the disclosure of non-material environmental matters through proxy statements. Rule 14a-8 under the Exchange Act requires that a registrant include valid "proposal[s] for action" from shareholders in its proxy statement. 17 C.F.R. 240.14a-8(a). Using this provision, shareholders interested in monitoring their corporation's environmental compliance have submitted proposals that the corporation become a signatory to the "Valdez Principles." The Valdez Principles, developed by the Coalition for Environmentally Responsible Economies, require the registrant to implement a broad range of measures designed to protect the environment, and further require periodic assessment and public disclosure of the success of those measures. These proposals have generally withstood challenges under Rule 14a-8(c), which provides bases on which proposals may be properly excluded from proxy statements by registrants. See also United Paperworkers Int'l v. Int'l Paper Co., 985 F.2d 1190 (2d Cir. 1993) (affirming that International Paper Company violated Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 promulgated thereunder in issuing misleading statements regarding the company's environmental record in a proxy statement which recommended the rejection of a shareholder proposal to adopt the Valdez Principles).

## 5.4 The "Pure Profit" Report

On the other hand, corporations were able to exclude shareholders proposals for corporate reports assessing the environmental issues raised in a report published by the World Resources Institute in March 2000, entitled *Pure Profit: The Financial Implications of Environmental Performance* (the "Pure Profit Report"). The Pure Profit Report examined 13 leading companies in the pulp and paper industry and concluded that pending environmental issues will have material financial impacts and that financial exposures vary considerably between the companies. In a companion report published in October 2000, *Coming Clean: Corporate Disclosure of Financially Significant Environmental Risks*, the authors examined the 1998 and 1999 public disclosure of the 13 companies and concluded that few of the companies disclosed any details about the financial risks or potential impacts arising from "known environmental uncertainties." The shareholder proposals, which were part of an organized shareholder campaign in connection with the reports, sought information on liability projection methodology and an assessment of other major environmental risks. Corporations, however, have successfully excluded such proposals from proxy materials pursuant to (i) Rule 14a-8(i)(3) and Rule 14a-8(i)(6) because the proposal is vague, indefinite and misleading; (ii) Rule 14a-8(i) (7) because it deals with a matter relating to the company's ordinary business operations; and (iii) Rule 14a-8(i)(10) because it has been substantially implemented. See Willamette Indus., Inc. 2001 SEC No-Act. Lexis 439 (Mar. 30, 2001), Mead Corp., 2001 SEC No-Act. Lexis 181 (Jan. 31, 2001), Potlatch Corp. 2001 SEC No-Act. Lexis 216 (Feb. 13, 2001).

## 5.5 Global Warming and Climate Change Initiatives

### *5.5.1 Shareholder Campaigns*

Companies in the automobile, utility, oil & gas and manufacturing sectors have for some time been subject to shareholder campaigns aimed at improving disclosure (and reduction) of greenhouse gas emissions due to concerns over global warming. Recent years have seen a surge in the number of global warming shareholder resolutions filed. 31 shareholder global warming resolutions were filed in the 2003 proxy season, followed by 28 resolutions in 2004, and 33 resolutions in 2005. See

http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=421&srcid=552 (last visited Mar. 6, 2008). In 2006, the number decreased to 24, but 43 resolutions were filed in 2007, including the first filing of resolutions requesting that companies set specific greenhouse gas emissions targets. See *Investors Achieve Record Results in 2007 in Spurring Corporate Action on Climate Change*, available at http://www.incr.com/NETCOMMUNITY/Page.aspx?pid=227&srcid=227. A record high 54 resolutions have been filed to date in 2008. See *Investors Press Companies for More Global Warming Information*, available at http://www.bloomberg.com/apps/news?pid=email_en&refer=energy&sid=aDm9tFyG0FzE (last visited Mar. 10, 2008). The scope of the companies targeted by such campaigns has grown as well, and companies in the financial, insurance, property management, home building, airline, forestry and retail sectors have been subject to proposed resolutions calling for disclosure of their plans for dealing with the risks posed by climate change. See No-Act, WSB File No. 0221200622, Wachovia Corp. (Feb. 10, 2006) (CCH). See also *Power Companies and Wall Street Firms Begin To Assess Climate Risks*, available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=519&srcid=421 (last visited Mar. 6, 2008); *2007 ISS Social Issues Service Background Report J2*, available at http://www.riskmetrics.com/pdf/ISS%202007%20Global%20Warming%20Background%20Report.pdf (last visited Mar. 3, 2008).[21]

Support for shareholder climate change resolutions is also on the rise.[22] From 2006 to 2007, the number of climate change

21. The Free Enterprise Action Fund has filed several shareholder proposals aimed at curbing the lobbying activities of companies that support global warming regulations by seeking increased disclosures on the costs of corporate climate policies. See http://www.freeenterpriseactionfund.com/advocacy.html (last visited Mar. 3, 2008); *Group Wants Disclosure of Future Carbon Regulation Impacts*, BNA Environmental Due Diligence Guide Report (Nov. 15, 2007). Companies targeted by the Free Enterprise Action Fund include General Electric Co., Proctor & Gamble Co., Caterpillar, Inc., DuPont, Lehman Brothers and Goldman Sachs.

22. Although institutional investors have assumed a leading role in requesting increased disclosure of the financial impact of climate change, mutual funds have not supported the issue. According to a 2007 report, all 28 of the investment management companies responsible for the nation's 100 largest mutual funds abstained or opposed all shareholder resolutions in 2006 that sought increased corporate disclosure on the financial risks and opportunities posed by climate change. See *U.S. Mutual Funds Critical Missing Link in Supporting Climate Change Shareholder Resolutions*, available at http://www.ceres.org/

resolutions receiving more than 30% support rose from one to five, including a resolution at Allegheny Energy that won a record 39.5% support. See *Executives and the Environment: Looking Back at Proxy Season 2007*, available at http://www.socialfunds.com/news/article.cgi/2337.html (last visited Mar. 3, 2008). In several instances, the resolutions have resulted in increased disclosure of climate change impacts and, consequently, the withdrawal of the resolutions. For example, in 2005, a number of utility companies, including Cinergy Corp., Southern Company and TXU, agreed to disclose risks related to potential future constraints on carbon dioxide and other emissions. See *Southern Company, TXU Agree To Report To Shareholders On Preparedness For Green-house Gas Limits; Reliant Energy To Expand 10k Disclosure On Issue*, available at http://www.ceres.org/news/news_item.php?nid=48 (last visited Mar. 13, 2005). In 2006, Great Plains Energy Inc., Alliant Energy, WPS Resources and MGE Energy also agreed to disclose risks related to potential future constraints on carbon dioxide and other GHG emissions. See *Four Electric Power Companies in Midwest Agree to Disclose Climate Risks*, available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=547&srcid=421 (last visited Mar. 3, 2008); see also "2006 Proxy Season Produces Positive Results on Climate Change" available at http://www.incr.com/NETCOMMUNITY/Page.aspx?pid=312&srcid=33 (last visited Mar. 3, 2008). In 2007, a total of 15 resolutions were withdrawn by proponents after companies responded positively to their requests. See *Investors Achieve Record Results in 2007 in Spurring Corporate Action on Climate Change*, available at http://www.incr.com/NETCOMMUNITY/Page.aspx?pid=227&srcid=227. As of early March 2008, shareholders have withdrawn 14 resolutions after companies agreed to disclose potential impacts from emerging climate regulations and strategies for greenhouse gas emission reductions. See *Investors File Record Number of Global Warming Resolutions with U.S. Companies*, available at

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NETCOMMUNITY/Document.Doc?id=270 (last visited Mar. 3, 2008). In fact, most of the investment management companies associated with the largest mutual funds have proxy voting policies that require them to abstain on all environmental resolutions. See *Ceres Study Shows That Nation's 100 Largest Mutual Funds Sitting on Sidelines on Climate Change Issue*, available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=549&srcid=421 (last visited Mar. 1, 2008)).

http://www.incr.com/NETCOMMUNITY/Page.aspx?pid=854&srcid=198 (last visited Mar. 6, 2008). Companies that have complied with climate change resolutions (resulting in their withdrawal) include Ford Motor Co., General Motors Co., Anadarko Petroleum, The Home Depot, Lowes, Chubb, Costco, D.R. Horton, Toll Brothers, Toronto-Dominion, Simon Property Group, Hartford Insurance, Prudential Financial, Inc., Allegheny Energy, Alliant Energy, Southern, and Dominion Resources.

As mentioned above, in the past, a number of companies have been successful in arguing that such resolutions should be excluded from proxy statements under Rule 14a-8(i)(7) as such matters relate to the ordinary business operations of a company. See No-Act., WSB File No. 0221200622, Wachovia Corp. (Feb. 10, 2006) (CCH); No-Act., WSB File No. 0122200824, Arch Coal, Inc. (Jan. 17, 2008) (CCH). However, in some cases, the SEC has refused to issue a No-Action Letter based on this argument. See No. Act., WSB File No. 0205200726, General Electric Co. (Jan. 31, 2007) (CCH); No-Act., WSB File No. 012820810, KB Home (Jan. 23, 2008) (CCH). In March 2005, the SEC declined to allow ExxonMobil Corp. to omit from its proxy materials shareholder proposals dealing with global warming and other environmental topics. The SEC declined no-action relief requested by ExxonMobil Corp. to omit proposals that (1) the board make available to its shareholders the research data relevant to the company's position on the science of climate change; (2) the company prepare a report on the potential environmental damage that would result from drilling for oil and gas in protected areas and the implications of a policy refraining from drilling in those areas; and (3) the company prepare a report on how it will meet the GHG reduction targets for countries where it operates that have adopted the Kyoto Protocol. See BNA SEC. REG. & L. REP., Vol. 37, No. 14, Apr. 4, 2005. ExxonMobil subsequently issued a report setting forth the data behind the company's skepticism on climate science and explaining how the company intends to comply with the Kyoto Protocol's greenhouse gas emissions limits. See *Resolution Withdrawals Signal Success in Shareowner Advocacy Early in 2006 Proxy Season*, available at

http://www.socialfunds.com/news/article.cgi/article1945.html (last visited Mar. 28, 2007).[23]

In June 2005, the Corporate Finance Division of the SEC issued Staff Legal Bulletin No. 14C (the "Bulletin") to provide greater guidance as to when a resolution calling for a company to address environmental risks is excludable under Rule 14a-8(i)(7). The Bulletin cites Securities Exchange Act Release No. 40018, which states that a proposal relating to ordinary business might not be excludable under Rule 14a-8(i) (7) if the proposal addressed a "sufficiently significant social policy [issue] . . .because the proposals would transcend the day-to-day business matters . . . ."[24] The determination, as interpreted by the Bulletin, appears to turn on whether the risk addressed is internal or external to the Company:

> "To the extent that a proposal and supporting statement focus on the company engaging in an internal assessment of the risks or liabilities that the company faces as a result of its operations that may adversely affect the environment or the public's health, we concur with the company's view that there is a basis for it to exclude the proposal under rule 14a-8(i)(7) as relating to an evaluation of risk. To the extent that a proposal and supporting statement focus on the company minimizing or eliminating operations that may adversely affect the environment or the public's health, we do not concur with the company's view that there is a basis for it to exclude the proposal under rule 14a-8(i)(7)." Staff Legal Bulletin No. 14C (CF) (June 28, 2005), available at http://sec.gov/interps/legal/cfslb14c.htm (last visited Mar. 24, 2007).

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23. ExxonMobil Corp. has been the target of more recent shareholder resolutions relating to climate change. For example, in 2007, a shareholder resolution requesting specific greenhouse gas emissions reductions received 31% support. However, a separate 2007 resolution seeking increased spending on renewable energy technology was granted no-action relief by the SEC under Rule 14a-8(i)(10) after the company argued that the proposal had already been substantially implemented. See *$900 Billion of Institutional Investors Pressure ExxonMobil on Global Warming*, available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=448&srcid=421 (last visited Mar. 3, 2008); No-Act., WSB File No. 0402200703, Exxon Mobil Corp. (Mar. 23, 2007) (CCH).
24. "The general underlying policy of this exclusion is consistent with the policy of most state corporate laws: to confine the resolution of ordinary business problems to management and the board of directors . . . ." 98 CCH Dec., FSLR ¶86,018, Amendments to Proposals, Exchange Act Release No. 40018, Rules on Shareholder (May 21, 1998).

Thus, a shareholder proposed resolution calling for a company to disclose its policy with respect to environmental risks it faces may not be excludable under Rule 14a-8(i)(7) if the proposal could be viewed as addressing external, rather than internal, risks.

### *5.5.2 Institutional Investor Initiatives*

(a) Institutional Investor Guidelines for Voluntary Climate Disclosure. In the absence of clear and uniform standards for disclosure of climate change risks, institutional investors have developed voluntary disclosure frameworks intended to enhance the availability of information related to the risks that companies face from climate change and the regulation of greenhouse gas emissions.

The Carbon Disclosure Project ("CDP"), which is currently comprised of 385 institutional investors with assets of more than $57 trillion, has issued information requests on greenhouse gas emissions to large global companies for the past 6 years. Companies are encouraged to report their emissions data using the Greenhouse Gas Protocol, a standardized emissions reporting system developed by the World Resources Institute. The most recent information request, issued in February 2008 to over 3,000 companies, seeks disclosure of the companies' exposure to financial risks from climate change and steps they are taking to evaluate and address that risk. The companies' responses to the information requests issued by the CDP and related reports are available at http://www.cdproject.net/cdp5reports.asp (last visited Mar. 10, 2008).

The Global Reporting Initiative ("GRI"), a multinational group of stakeholders that includes institutional investors, has been developing and refining a sustainability disclosure framework since 1999. The sustainability disclosure framework includes reporting on greenhouse gas emissions and climate change risks. The "G3 Guidelines," the latest version of GRI's reporting framework, is available at http://www.globalreporting.org/ReportingFramework/G3Online/ (last visited Mar. 10, 2008).

In October 2006, 14 leading institutional investors and other organizations, including the California Public Employees Retirement System ("CalPERS"), the largest institutional

investor in the U.S., released the Global Framework for Climate Risk Disclosure to provide specific guidance to companies regarding the information they provide to investors on the financial risks posed by climate change. See *Leading Investors Worldwide Release Global Framework for Climate Risk Disclosure*" available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=457&srcid=421 (last visited Mar. 3, 2008).[25] Investors that adopt the Global Framework for Climate Risk Disclosure pledge to use the disclosure framework in engagements with companies and to encourage them to use existing climate change-related reporting mechanisms including the frameworks put forth by the Global Reporting Initiative and the Carbon Disclosure Project.

In January 2007, the World Economic Forum formed an international partnership of seven organizations called the Climate Disclosure Standards Board ("CDSB") to establish a globally accepted framework for climate risk disclosure by corporations. Founding members of CDSB include the California Climate Action Registry, Carbon Disclosure Project, Ceres, The Climate Group, International Emissions Trading Association, World Economic Forum Global Greenhouse Gas Register and the World Resources Institute.

In February 2008, the three major U.S. banks signed the Carbon Principles, which set forth guidelines to help lenders assess the risk of greenhouse gas regulation and manage climate change risks. See *The Carbon Principles*, available at http://www.jpmorganchase.com/cm/BlobServer?blobtable=Document&blobcol=urlblob&blobkey=name&blobheader=application/pdf&blobnocache=true&blobwhere=jpmc/community/Carbon_Principles_Diligence_Final.pdf (last visited Mar. 3, 2008). The three fundamental principles are energy efficiency, renewable and low carbon energy technologies, and conventional and advanced generation. The Carbon Principles also include an "Enhanced Diligence Process" that assesses

25. The framework is available at http://www.ceres.org/pub/publication.php?pid=225 (last visited Mar. 24, 2007) and consists of four elements of disclosure: (1) total historical, current, and projected greenhouse gas emissions; (2) strategic analysis of climate risk and emissions management; (3) assessment of physical risks of climate change; and (4) analysis of risk related to the regulation of greenhouse gas emissions.

the risks associated with financing carbon-intensive power plants, especially coal-fired power plants, by accounting for the risks of future regulation and litigation.

(b) Institutional Investor Meetings on Climate Change. There have been several climate risk meetings organized by institutional investors. The Institutional Investor Summit on Climate Risk ("Summit"), organized by CERES and the United Nations, first convened in 2003, when asset managers representing over $1 trillion in assets, including treasurers of 9 states (including New York and California) and managers of the nation's two largest union pension funds, issued a 10-point call for increased disclosure of the financial impact of potential regulation resulting from global warming. The 10-point call for action includes petitioning the SEC for enforcement of environmental risk disclosure requirements, filing and supporting global warming shareholder resolutions, and forming an Investor Network on Climate Risk to follow through on their plans. See www.incr.com (last visited on Mar. 22, 2007). A similar action plan was announced at the second Summit in 2005, where investors managing more than $3 trillion of assets announced that they will require investment managers overseeing their funds to set forth their strategies for assessing financial risks associated with climate change. See *U.S. & European Investors Tackle Climate Change Risks and Opportunities at the UN*, available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=469&srcid=42 (last visited Mar. 3, 2008). At the most recent Summit in February 2008, Ceres released a report outlining progress toward the objectives of the 2005 action plan, including successful shareholder resolutions, development of a Global Framework for Climate Risk Disclosure and engagement with Congress and the SEC. See *Investor Progress on Climate Risks & Opportunities*, available at http://www.ceres.org/NETCOMMUNITY/Document.Doc?id=287 (last visited on Mar. 3, 2008). In addition, investors managing more than $1.75 trillion in assets announced a third climate change action plan with objectives as in previous plans. See *U.S. and European Investors Tackle Climate Change Risks and Opportunities*, available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=838&srcid=421 (last visited Mar. 3, 2008).

(c) Institutional Investor Initiatives Requesting SEC Guidance/Regulation. In April 2004, 13 public pension fund leaders, including eight state treasurers and comptrollers, four labor pension fund leaders, and the New York City Comptroller, called on the SEC to require companies to disclose the financial risks of global warming. The group, collectively managing assets of nearly $800 billion, concluded that global warming poses material financial risk to many of their portfolio companies and that the SEC should require that those risks be disclosed. See *Thirteen Pension Leaders Call on SEC Chairman to Require Global Warming Risks in Corporate Disclosure*, available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=584&srcid=421 (last visited Mar. 3, 2008).

In a June 2006 letter to SEC Chairman Christopher Cox, 28 institutional investors wrote that climate change poses material financial risks to many of their portfolio companies and that those risks should be disclosed as a matter of routine corporate financial reporting to the SEC. The letter called on the SEC to enforce existing disclosure requirements on material risks that are underreported, such as climate change; strengthen current disclosure requirements by providing interpretive guidance on the materiality of risks posed by climate change; and require companies to include in their proxy statements shareholder proposals asking companies to report on financial risks due to climate change. The full text of the letter is available at http://www.incr.com/NETCOMMUNITY/Document.Doc?id=48 (last visited Mar. 3, 2008).

In March 2007, a large group of investors, asset managers and companies, representing $4 trillion under management, called on Congress to address their concerns regarding the risks of climate change. Among the key action requests was a call for the SEC to clarify what companies should disclose to investors on climate change in their regular financial reporting. See *Investors Managing $4 Trillion Call on Congress to Tackle Global Climate Change* available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=451&srcid=421 (last visited Mar. 3, 2008).

In September 2007, a group of 22 state officials, environmental groups and institutional investors submitted a petition to the SEC seeking interpretive guidance on the scope of climate risk reporting in corporate disclosures under existing law. See *Petition for Interpretive Guidance on Climate Risk Disclosure*, available at http://www.sec.gov/rules/petitions/2007/petn4-547.pdf (last visited Mar. 3, 2008).[26] The petition outlines three categories of risks of climate change that should be assessed and, if material, disclosed:

(i) physical risks from climate change;

(ii) financial risks associated with present or probable regulation of greenhouse gas emissions; and

(iii) legal proceedings related to climate change.

Representatives of the group that submitted the petition testified before the Senate Subcommittee on Securities, Insurance and Investment ("Subcommittee") about alleged inconsistency in the SEC's application of Rule 14a-8(i)(7) and the need for a uniform, general set of disclosure guidelines for climate change disclosure. See *Senate Subcommittee Witnesses Urge SEC To Issue Guidance on Climate Change Disclosure*, SEC Today Online, Vol. 2007-214 (Nov. 6, 2007); See *Smith*, supra Note 6. Following the testimony, Senator Christopher Dodd, the Chairman of the Senate Committee on Banking, Housing and Urban Affairs, and Senator Jack Reed, the Chairman of the Subcommittee, sent a letter to the SEC urging the Commission to issue interpretive guidance on climate change risk disclosure. The letter is available at http://www.abanet.org/environ/committees/environdisclosures/highlights_docs/FinalCoxletteronclimaterisjdisclosureassent.pdf (last visited Mar. 6, 2008).

26. The Free Enterprise Action Fund has also submitted a rulemaking petition asking the SEC to issue interpretive guidance requiring corporations to disclose the business risks posed by regulation of greenhouse gas emissions. See *Fund Petitions SEC to Require Disclosure on Risks of Climate Change Regulations*, SEC Today Online, Vol. 2007-211 (Nov. 1, 2007).

(d) Institutional Investor Initiatives Aimed at Large Public Companies. Institutional investors have on numerous occasions sent letters to large public companies seeking disclosure of the financial impact of climate change. For example, in November 2003, 95 institutional investors with assets of over $10 trillion wrote to the 500 largest publicly traded companies seeking disclosure of information concerning their greenhouse gas emissions. See *Third Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical, and Utilities Companies* (prepared by Friends of the Earth and dated July 2004).

In July 2005, 15 institutional investors and a number of state controllers sent letters to 43 of the 50 largest investor-owned greenhouse gas emitters in the electric utility industry seeking increased disclosure of the financial impact of climate change. See *Institutional Investors Call on Power Sector To Focus Attention To Financial Risks from Climate Change* available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=562&srcid=421 (last visited Mar. 3, 2008).

In December 2005, 20 leading investors, collectively controlling $800 billion in assets, co-signed letters requesting the 30 largest publicly-held insurance companies in North America to disclose their financial exposure from climate change and the steps they are taking to reduce those financial impacts. The investors made this request in light of back-to-back severe hurricane seasons in the U.S. (including the devastating effects of Hurricane Katrina). The investors requested that the climate reports be completed and shared with shareholders by August 2006. See *Institutional Investors Urge Insurance Companies To Boost Response To Financial Risks and Opportunities from Climate Change*, available at http://www.ceres.org/NETCOMMUNITY/Page.aspx?pid=466&srcid=421 (last visited Mar. 24, 2007).

### 5.6 The Rose Petition

On August 21, 2002, the Rose Foundation for Communities and the Environment submitted a rulemaking petition to the SEC (the

"Rose Petition").[27] The Rose Petition requests that the SEC adopt new rules requiring enhanced environmental disclosures based on the American Society for Testing and Materials ("ASTM") 2001 Standards (the "ASTM Standards"), which were adopted by the ASTM in March 2002. See *ASTM 2001 Standard Guide for Disclosure of Environmental Liabilities* (E 2173) and *ASTM 2001 Standard Guide for Estimating Monetary Costs and Liability for Environmental Matters* (E 2137). The Rose Petition proposes that the SEC promulgate new rules that directly reference the ASTM Standards with the important modification that all of the precatory language of the ASTM Standards be changed to mandatory language. For example the proposed rule would read: "Disclosure *shall* be made when an entity believes its environmental liability for an individual circumstance or its environmental liability in the aggregate is material" as opposed to disclosure *should* be made as provided by the ASTM Standards.

According to the Rose Petition, disclosure consistent with the ASTM Standards will provide investors with standardized and improved information critical to their evaluation of the financial risk associated with a company's environmental liabilities. The proposed rules would require corporations to estimate the costs and liabilities of environmental matters using four known cost estimation methods, which include:

- "expected value"
- "most likely value"
- "range of values"
- "known minimum value"

The Rose Petition argues that the proposed rules would minimize the circumstances in which disclosure can be avoided based on claims of uncertainty.

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27. The Rose Foundation for Communities and the Environment is a 501(c)(3) non-profit public interest organization dedicated to advancing positive intersections between the environment, the economy and communities. 25 other charitable foundations and 7 investment companies joined the petition. A revised petition was submitted on September 9, 2002. Except for altering the text of the petition to refer to ASTM 2001 by reference (rather than including the text), it is identical to the original petition in all material aspects. The Rose Petition is available at http://www.sec.gov/rules/petitions/petn4-463.htm (last visited Mar. 13, 2008).

In addition, the proposed rules would require companies to consider the financial impact of all environmental liabilities insofar as they instruct companies to disclose when a company believes its environmental liability for an *individual* circumstance *or its environmental liability in the aggregate* is material. According to the Rose Petition, this would close one of the biggest loopholes in reporting today: piecemeal accounting of environmental liabilities. Finally, the proposed rules would create more detailed minimum requirements concerning the content of a company's environmental disclosures.

The petitioners claim that the existing SEC rules and enforcement policies are inadequate to compel disclosure of information sufficient for investors to make informed choices based on companies' records of environmental compliance. The Rose Petition cites an EPA study from 1998 that found that 74 percent of companies failed to report in their Form 10-Ks cases in which environmentally related legal proceedings could result in monetary sanctions over $100,000. The EPA study also found that only 26 percent of civil and administrative proceedings involving penalties were correctly disclosed in companies' Form10-Ks. Moreover, only 16 percent of proceedings involving court-ordered Supplemental Environmental Projects ("SEPs") and only 4 percent of RCRA corrective action proceedings were correctly disclosed. The Rose Petition also cites a 1993 General Accounting Office ("GAO") report which found that disclosure of Superfund cleanup liabilities by insurance companies was very poor and put investors at risk.

To date, the SEC has not taken any action with respect to the Rose Petition.

In July 2004, the Rose Foundation published a report detailing accounting strategies employed by corporations to limit disclosure of environmental risks and liabilities. After examining how companies account for environmental liabilities and subsequently disclose (or not disclose) those liabilities, the authors conclude that the SEC should implement the recommendations found in the 2002 Rose Petition. Sanford Lewis & Tim Little, *Fooling Investors and Fooling Themselves: How Aggressive Accounting Leads to Environmental Accounting Fraud*, available at http://www.corporatesunshine.org/symp04/foolinvestors.pdf. (last visited Mar. 2, 2008).

### 5.7 California State Treasurer Initiative

In February 2004, California State Treasurer Phil Angelides launched an initiative calling on CalPERS and the California State Teachers' Retirement System to (1) use their financial clout in pressing the SEC to strengthen environmental disclosure rules, (2) target private investment in environmental technologies, and (3) invest in stocks of environmentally responsible companies. In April 2004, CalPERS recommended that the SEC begin public hearings within six months on the reporting of environmental risks by public companies. See *The Green Wave Initiative*, available at http://www.treasurer.ca.gov/greenwave (last visited Mar. 2, 2008).

To date, the SEC has not responded to CalPERS's request.

### 5.8 The EPA Disclosure Initiative

In 2001, the EPA announced an environmental disclosure initiative to encourage greater compliance with SEC disclosure requirements. To accomplish this objective, the EPA created an online database, Enforcement and Compliance History Online ("ECHO"), which identifies companies' environmental compliance history, formal enforcement actions and related penalties on a facility-specific basis. The EPA also notifies affected companies that SEC disclosure obligations may apply to pending enforcement actions. *Enforcement and Compliance History Online* , available at http://www.epa.gov/echo/index.html. See also William J. Walsh, et. al., *New Initiatives To Encourage Disclosure of Environmental Costs and Liabilities*, 34 ENVTL. REP. BNA 217 (Jan. 24, 2003).

### 5.9 GAO Review

In July 2004, the GAO released a report reviewing the effectiveness of the SEC's environmental reporting requirements, the level of compliance with such requirements and the level of disclosure directed at shareholders. The GAO report concluded that key stakeholders disagree on whether environmental disclosure requirements provide too much flexibility or are too narrow in scope; it is difficult to determine whether varying levels of disclosure within industries reflect different risks faced by companies or differences in the extent to which companies are disclosing risks; the adequacy of the SEC's efforts to monitor and enforce compliance with environmental disclosure requirements cannot be determined; and the

SEC should take steps to improve the tracking and transparency of its reviews of filings and to improve its coordination with the EPA. In response to the report, the SEC started tracking its reviews of company filings to identify trends in environmental disclosures. The SEC also agreed to make comment letters and company responses available on its website. *Environmental Disclosure, SEC Should Explore Ways To Improve Tracking and Transparency of Information*, United States Government Accountability Office, GAO-04-808 (July 2004), available at http://www.gao.gov/new.items/d04808.pdf (last visited Mar. 2, 2008).

## 6. DISCLOSURE OF ENVIRONMENTAL LIABILITY IN TENDER OFFERS

Courts have also acknowledged that registrants may be liable for material omissions of environmental liability in documents relating to a tender offer. For example, in Grumman Corp. v. LTV Corp., 527 F. Supp. 86 (E.D.N.Y. 1981), the court held that the defendant company's failure to disclose between $185 million and $240 million in future costs for environmental compliance in its Schedule 14D was an omission of a material fact. See id. at 103. The court subsequently held that the plaintiffs were entitled to a preliminary injunction under Section 14(e) of the Exchange Act, 15 U.S.C. § 78n(e) (antifraud provision applicable to tender offers), enjoining the defendant corporation from proceeding in the tender offer. Id. at 106; See also Crouse-Hinds Co. v. Internorth, Inc., 518 F. Supp. 416, 473 (N.D.N.Y. 1981) (holding that no material omission existed, but acknowledging that Section 14(e) requires the company to avoid misstating or omitting material facts regarding environmental liabilities).[28]

28. The Court in Crouse-Hinds stated that the SEC's requirements relating specifically to environmental disclosure, contained in Securities Act Release No. 5704, were inapposite to materials involved in a tender offer. See 518 F. Supp. at 474. However, this statement was made before the amendments to Regulation S-K making it the repository for the SEC's uniform disclosure requirements. The current version of Regulation S-K is by its own terms applicable to "any document required to be filed under the Exchange Act, to the extent provided in the forms and rules under such Act." 17 C.F.R. 229.10.

(a) Disclosures Regarding the Target.

In Koppers Co. v. American Express Co., 689 F. Supp. 1371 (W.D. Pa. 1988), the court refused to interpret the tender offer provisions as requiring the offeror to provide environmental information about the target. See id. at 1406.

## NOTES