

Environmental Disclosure Committee Newsletter

Vol. 5, No. 1

January 2008

MESSAGE FROM THE CHAIR

C. Gregory Rogers

In our last issue, the former chair of the Environmental Disclosure Committee, Jeff Smith, spoke of two different objectives that drive environmental disclosure. “One is broad-based and far-reaching—to create a language for stakeholder communication; the other is more mundane and rooted in regulation—to do exactly what is required under U.S. Securities and Exchange Commission regulations under federal and state law, including regulations governing environmental accounting practices.” As you read through the articles in this issue, edited by our returning Newsletter Vice Chair Scott Deatherage, I encourage you to consider these two objectives and how they relate to the following questions:

- What environmental information is material to investors?
- Is voluntary disclosure intended to influence investment decisions? If not, what is the purpose? If so, why is such information not contained in regulatory filings?
- Are growing investor demands for voluntary disclosure intended to improve investment decisions, change corporate behavior with regard to the environment, or both?
- What legal standards govern voluntary environmental disclosure? Is regulation needed?
- Do the dual objectives of environmental disclosure require separate communication channels or can both objectives be met through

the regulatory disclosure process?

- Will increased voluntary disclosure eventually render regulatory disclosure moot?
- Will efforts to make voluntary disclosure mandatory, if successful, eliminate the need for voluntary disclosure?

In coming years, these issues, among others, seem likely to drive new legislation, regulations, and litigation, as well as broad-based and far-reaching changes in corporate disclosure practices. Undoubtedly, the membership of our committee will be in the center of the action.

As your new chair, I thank you for your participation in the committee and welcome your comments on how we can better meet your professional needs in this exciting and fast-changing area.

ABA Section of Environment, Energy, and Resources

26th Annual Water Law Conference

Feb. 21-22, 2008
San Diego, California

37th Annual Conference on Environmental Law

March 13-16, 2008
Keystone, Colorado

Plan to Attend!

**Environmental Disclosure
Committee Newsletter
Vol. 5, No. 1, January 2008
Scott D. Deatherage, Editor**

In this issue:

Message from the Chair
C. Gregory Rogers 1

Accounting and Disclosure Update
C. Gregory Rogers 2

Climate Change Disclosure: A Growing
Issue for Publicly-Traded Companies
Scott D. Deatherage 8

Greenwash
*Thomas P. Lyon and
John W. Maxwell*..... 20

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ACCOUNTING AND DISCLOSURE UPDATE

C. Gregory Rogers

This article presents an update on recent developments relating to environmental accounting and disclosure. The headline stories for 2007 include the continuing wholesale revision of accounting principles, the emergence of Securities and Exchange Commission (SEC) interest in the environmental area, and a rising focus on climate risk disclosure in SEC filings.

As recently reported by CFO Magazine, everything you thought you knew about accounting is about to change. “Most publicly traded companies may now be in compliance with Sarbox, but the push for transparency that it set in motion is rippling out in all directions, and there is scarcely any aspect of corporate accounting—from overarching principles to specific standards—that isn’t ripe for reconsideration. ‘I’ve been a student of financial reporting for 25 years,” says Greg Jonas, managing director of Moody’s Investors Service, “and I’ve never seen a time when so many big-ticket financial-reporting issues were in play.”” Michelle Leder, *Rewriting the Rules: Everything you thought you knew about accounting is about to change. Is there any reason to smile?*, CFO MAGAZINE, Oct. 01, 2007, <http://www.cfo.com/article.cfm/9861756/c9891771?f=singlepage>.

These changes will directly affect the recognition and measurement of liabilities associated with environmental cleanups, natural resource damages, asset retirement obligations, toxic tort claims, regulatory fines and penalties, and carbon emission allowances. Perhaps most significantly, the notion of “contingent liability” is being redefined in a manner that will have significant and unexpected consequences for companies, accountants, and lawyers.

In addition to the ongoing sea change in accounting standards, the SEC is showing interest in environmental issues. After decades of inactivity, three SEC enforcement actions in the past 12 months have featured or involved manipulation of environmental reserves. The public release of SEC comment letters also shows that the agency is paying greater attention

to environmental disclosures (or the lack thereof) in SEC filings. At the same time, institutional investor groups are pressing the SEC to demand more disclosure on climate-related risks affecting U.S. public corporations.

Asset Retirement Obligations

The past year saw some notable developments in the implementation of Financial Accounting Standards Board (FASB) Statement 143 and Interpretation No. 47 (FIN 47), including the public release of several SEC comment letters and a \$700 million adjustment by a major oil and gas company.

Comment letters from the SEC Division of Corporate Finance released during 2007 raised several questions about how public companies in the telecommunications, chemical, mining, oil and gas, and energy industries are reporting asset retirement obligations (AROs). Following are examples of comments and questions raised by the SEC:

- Explain and disclose the specific legal obligations associated with your manufacturing, distribution, and marketing facilities and how you concluded the economic useful lives were indeterminate in light of the assigned service lives.
- We note your statement that you believe that you do not have any material asset retirement obligations or environmental remediation liabilities related to leased manufacturing facilities. You also state that due to your lack of experience with facility closures and the related asset retirements, you are unable to estimate an asset retirement obligation. It appears to us that these two statements contradict each other.
- Expand your disclosures to include a description of your asset retirement obligations that fall within the scope of Statement 143. Are you trying to convey that the fair value of your asset retirement obligations cannot be reasonably estimated "... because the timing of any ultimate obligation is indefinite." If so, please clarify and revise to provide the disclosures required by paragraph 22 of Statement 143.
- We note your disclosure indicating that certain assets have indeterminate lives which limits your ability to determine the associated asset retirement obligation. Please explain the nature of these assets and the consideration given for other estimates used for these same assets such as your determination of their estimated useful lives. Additionally, please explain why you believe that you have considered all information to reasonably estimate the timing of the settlement of your asset retirement obligations. Please describe to us the limiting factors which prohibit you from further recognizing an asset retirement obligation, if that is your belief.
- Please expand your disclosure to address how you account for asset retirement obligations that cannot be reasonably estimated. Additionally explain that is the case, if true, and the reasons it cannot be reasonably estimated. Refer to paragraph 22 of Statement 143.
- Given that under FIN 47 you are required to disclose the reasons why you can not estimate the fair value of an asset retirement obligation, please describe to us in a comprehensive manner why you can not reasonably estimate the fair value of each of your asset retirement obligations given your experience in your industry. Be sure to include as part of this discussion a description of the data that you feel is necessary, that you presently do not have, in order to record the cost of your obligation.
- You indicate that you have unrecorded legal obligations to remove poles and asbestos. Describe these obligations and tell us why you are unable to estimate them. What information is not currently available? Explain to us why this information is necessary. Tell us when and under what circumstances this information will or may become available. Describe how you applied the guidance of Statement 143 and FIN 47 to these obligations.

These SEC comments indicate that the widespread practice of not recognizing conditional AROs due to indeterminate settlement dates may not be sustainable. Notably, Chevron, which previously has claimed that it

could not estimate AROs for its refining, marketing, transportation, and chemical assets due to indeterminate retirement dates, recently announced an estimated \$700 million in nonrecurring net charges in the third quarter of 2007 for “asset impairments, environmental remediation provisions, income tax adjustments, asset retirement obligations, and severance provisions.” The company has not yet provided detailed disclosures on the nature of these charges. Chevron Corporation Form 8-K dated Oct. 9, 2007, <http://www.sec.gov/Archives/edgar/data/93410/000095013407021068/f34376exv99w1.htm>.

Fair Value Measurement

FASB Statement 157, which provides standards for the application of fair value measurement (see C. Gregory Rogers, *Fair Value Measurement of Environmental Liabilities*, ABA Environmental Disclosure Committee Newsletter, Vol. 3, No. 1, Oct. 2005) was set to become effective Nov. 15, 2007. Fair value measurement is currently required for AROs under Statement 143 and FIN 47 and environmental indemnities under FASB Interpretation No. 45 (FIN 45). Soon, it will also be required for environmental loss contingencies assumed in a merger or acquisition (see discussion under “Business Combinations” below).

Fair value measurement presents difficult challenges when applied to assets and liabilities that are thinly traded or, as in the case of environmental remediation liabilities and AROs, have no market with which to gauge their value. Many accountants and financial executives recognize that companies are not prepared for implementation of fair value measurement. Arguing that internal accounting teams, valuation experts, and external auditors need more time to grasp the many aspects of the standard, the Institute of Management Accountants and Financial Executives International recently petitioned the FASB to postpone the effective date of Statement 157, to give companies a one-year break. In denying the request for a blanket extension of the fair value rule at its Oct. 17, 2007 meeting, the FASB questioned whether companies lack the resources to comply in a timely manner, and suggested that instead of delaying implementation, corporate

managers were in fact hoping to avoid implementation altogether by re-opening the rulemaking. Sarah Johnson, *Ready or Not, Here Comes Fair Value: The Financial Accounting Standards Board votes thumbs-down on a one-year breather for companies to comply with FAS 157*, CFO.com, Oct. 17, 2007, <http://www.cfo.com/article.cfm/9985407?f=alerts>. However, at its Nov. 14, 2007 board meeting, the FASB agreed to a one-year deferral for the implementation of Statement 157 for nonfinancial assets and liabilities, such as environmental indemnities and AROs. The FASB will issue an exposure draft for comment in the near future on this partial deferral. “FASB Rejects Deferral of Statement 157 for Financial Assets and Liabilities: Partial Deferral Granted for Nonfinancial Assets and Nonfinancial Liabilities,” FASB News Release, Nov. 14, 2007, <http://www.fasb.org/news/nr111407.shtml>.

Business Combinations

The FASB is preparing to issue a revision of Statement 141 (business combinations) that will dramatically change existing standards for recognizing and measuring contingent liabilities, including environmental liabilities, assumed by the surviving entity in a business acquisition or merger. When issued, Statement 141-R will replace the long-standing recognition criteria under Statement 5 (i.e., probable and reasonably estimable). Instead, acquirers in a business combination will be required to recognize, without regard to the probability of loss:

1. All loss contingencies arising from contractual obligations (e.g., environmental remediation covenants and indemnifications) at the acquisition date; and
2. Loss contingencies that do not arise from contractual obligations (e.g., environmental obligations arising under statute or common law) if it is more likely than not that the contingency meets the definition of a liability (i.e., a present obligation arising from a past event, the settlement of which is reasonably expected to result in an outflow of resources) at the acquisition date.

These criteria are likely to trigger recognition of many environmental liabilities that would not be recognized

under current standards. For example, the following types of environmental loss contingencies when assumed by an acquirer seemingly would be subject to recognition under Statement 141-R, whereas they would not be subject to recognition under Statement 5:

- *Environmental indemnity.* The entity provided an environmental indemnity to the buyer of an industrial facility ten years ago. As of the acquisition date, the buyer has not made a claim on the indemnity and a claim is not considered probable. Nonetheless, the environmental indemnity constitutes a loss contingency arising from a contractual obligation. Note that environmental indemnities also may be subject to FASB Interpretation No. 45.
- *Stipulated Penalties.* The entity has violated terms of an EPA consent decree and is subject to stipulated penalties. Although enforcement of the penalties is not considered probable, the past violations constitute a loss contingency arising from a contractual obligation.
- *Disputed toxic tort lawsuit.* The entity disputes liability in a pending toxic tort lawsuit because it does not believe that its emissions caused any harm. The pending claim more likely than not meets the definition of a liability. The start of legal proceedings obliges the entity to stand ready to perform as the court directs and hence the entity has a present obligation arising from a past event—the start of legal proceedings.
- *Contaminated land—legislation substantively enacted.* An entity in the oil industry causes contamination, but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates previously had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. As of the acquisition date, the government, however, has enacted new legislation that will require contamination, including prior contamination, to be cleaned up. The circumstances more likely than not meet the definition of a liability. The past event is the enactment of legislation, which creates a present obligation to clean up the entity's

contamination.

- *Contaminated land and constructive obligation.* An entity in the oil industry causes contamination and operates in a country in which there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honoring this published policy. The circumstances more likely than not meet the definition of a liability. The past event is the contamination of the land, which gives rise to a present constructive obligation.

Instead of using the measurement techniques under Statement 5 (as set forth in FASB Interpretation No. 14) (i.e., use the most likely value or the low end of the range of estimates if there is no most likely value), contingencies that meet the recognition criteria in Statement 141-R must be measured at fair value. Many, perhaps all, contingent environmental liabilities that are not considered “reasonably estimable” under Statement 5 and FIN 14 can be estimated using fair value measurement. Thus, the new recognition and measurement standards under Statement 141-R, taken together, can be expected to significantly increase both the number and magnitude of reported environmental liabilities assumed in M&A transactions.

In addition, the new business combination standard will require significantly more information in the footnotes to the financial statements. Statement 141-R is expected to include the following disclosure provisions for contingencies:

1. The acquirer should disclose the nature of each acquired contingency, the amount recognized as of the acquisition date, if any, and an estimate of the range of outcomes (undiscounted) or a statement that an estimate of the range cannot be made.
2. After the business combination, the acquirer should disclose changes in the amounts recognized, changes in the range of outcomes (undiscounted) for both recognized and unrecognized contingencies, and the reasons for the changes.
3. Those disclosure requirements apply even if the acquirer believes that making them might

provide information that might adversely affect its ability to settle or litigate a legal claim. An acquirer would, however, be permitted to provide aggregate disclosures for contingencies that are similar in nature. See FASB's Web page on Business Combinations: Applying the Acquisition Method—Joint Project of the IASB and FASB, http://www.fasb.org/project/bc_acquisition_method.shtml.

Contingent Liabilities

In March 2005, the FASB rejected a request by the Rose Foundation to reconsider the accounting and reporting for contingent environmental liabilities. At that time, the FASB said that it did not desire to reconsider Statement 5, solely in the context of environmental liabilities. The FASB hinted that a more comprehensive project was in the works.

At its Sept. 6, 2007 meeting, the FASB voted to add a comprehensive project to revise Statement 5. According to the FASB, reconsideration of Statement 5 is necessary because the existing recognition criteria for contingent liabilities (i.e., probable and reasonably estimable) result in delayed recognition of liabilities. The FASB also believes that the disclosure criteria in Statement 5 are inadequate or ineffective. The Statement 5 project will include research about a possible interim solution for disclosures and an overall long-term reconsideration of the recognition and measurement of contingencies. Research includes the possible convergence with the International Accounting Standards Board (IASB) on the long-term phase of the project. The IASB is already well underway with an overhaul of its Statement 5-equivalent standard. See <http://www.iasb.org/Current+Projects/IASB+Projects/Liabilities/Liabilities.htm>.

This development can be expected to have a significant future impact on the recognition and measurement of environmental remediation, toxic tort, and product-related liabilities, as well as other types of contingent liabilities. It seems likely that the FASB will fashion the revisions to Statement 5 after the new standards for contingencies contained in Statement 141-R (see "Business Combinations" above). Thus, companies

would account for their existing contingencies under a revised Statement 5 in the same manner as they will be required to account for new contingencies assumed in a business acquisition or merger under Statement 141-R.

Emission Allowances

At its Feb. 21, 2007 board meeting, the FASB approved a project to provide comprehensive accounting guidance for participants in emission allowance programs. The project will provide guidance on accounting for emission allowances and related liabilities. More information on this project is available on the FASB's Web site at http://72.3.243.42/project/emission_allowances.shtml.

Internal Control: Restatements and SEC Enforcement

In March 2007, General Motors restated its 2004 and 2005 financial statements to increase its accrued liabilities for environmental operation and maintenance costs for certain environmental sites. Pre-tax earnings were decreased, through an increase to cost of sales, by \$1.4 million (\$0.9 million after tax) and \$4.9 million (\$3.2 million after tax) in 2005 and 2004, respectively, and retained earnings at Jan. 1, 2004 was decreased by \$32.2 million. General Motors 2006 10-K, <http://www.sec.gov/Archives/edgar/data/40730/000095012407001502/k11916e10vk.htm>.)

In the past 12 months, the SEC has concluded three enforcement actions against corporate executives accused of illegal environmental financial reporting. The three matters are:

1. The November 2006 imposition of a cease-and-desist order on Ashland, Inc. and its former Environmental Remediation director for improperly reducing the company's estimated remediation reserves.
2. The June 2007 settlement of civil charges against ConAgra executives that alleged the improper reduction of environmental reserve estimates in order to offset losses; and
3. The June 2007 entry of a guilty plea by Safety-Kleen's former CFO, Paul Humphreys, who was accused of improperly reducing

environmental remediation reserve account estimates to overstate earnings.

These recent actions, which follow decades of seeming indifference to environmental matters, suggest that the SEC may have a new-found appetite for policing fraud and internal control weaknesses relating to environmental accounting and disclosure.

Governmental Remediation Liabilities

In November 2006 the Governmental Accounting Standards Board (GASB) issued a new standard that will require state and local governments to provide the public with better information about the financial impact of environmental cleanup obligations. Statement 49, which takes effect for periods beginning after June 15, 2007, requires a government entity to report a liability for pollution remediation obligations if it knows a site is polluted and any of the following recognition triggers occur:

1. Pollution poses an imminent danger to the public or environment and a government has little or no discretion to avoid fixing the problem.
2. A government has violated a pollution prevention-related permit.
3. A regulator has identified (or evidence indicates it will identify) a government as responsible (or potentially responsible) for cleaning up pollution, or for paying all or some of the cost of the cleanup.
4. A government is named (or evidence indicates that it will be named) in a lawsuit to compel it to address the pollution.
5. A government begins or legally obligates itself to begin cleanup or post-cleanup activities (limited to amounts the government is legally required to complete).

Under Statement 49, liabilities must be estimated at current value—the amount that would be paid if all equipment, services included in the estimate were acquired during the current period (rather than their present value) using an expected cash flow (probabilistic weighted-average) measurement technique. Unlike fair value measurement, only in

situations where the government intends to hire another party to perform the work should the estimate incorporate profit and risk premiums expected to be charged by an outside party.

Climate Risk Disclosure

On Sept. 18, 2007, a broad coalition of investors, state officials with regulatory and fiscal management responsibilities, and environmental groups filed a petition asking the SEC to require publicly-traded companies to assess and fully disclose their financial risks from climate change. Petition for Interpretive Guidance on Climate Risk Disclosure, <http://www.sec.gov/rules/petitions/2007/petn4-547.pdf>. The petition—which claims widespread deficiencies in reporting of climate risks and liabilities under Statement 5 and Items 101, 103, and 303 of Regulation S—requests that the SEC issue an interpretive release clarifying that material climate-related information must be included in corporate disclosures under existing law.

C. Gregory Rogers, J.D., CPA, is president and founder of Advanced Environmental Dimensions, LLC, a management consulting and education firm specializing in environmental financial reporting and related business strategies. He is also “of counsel” with a Dallas law firm focusing on environmental legal matters, where he advises public and non-public companies on the purchase, sale, financing, and redevelopment of contaminated real estate. Mr. Rogers is on the editorial board for Brownfield News and is the author of “Financial Reporting of Environmental Liabilities and Risks after Sarbanes-Oxley” (Wiley 2005).

BACK ISSUES

Back issues of this newsletter can be viewed on the Environmental Disclosure Committee Web page at <http://www.abanet.org/enviro/committees/envirodisclosures/newsletter/archives.shtml>.

CLIMATE CHANGE DISCLOSURE: A GROWING ISSUE FOR PUBLICLY-TRADED COMPANIES

Scott D. Deatherage

Introduction

Climate change disclosure, or climate risk disclosure, has increasingly become an important issue for publicly-traded companies when preparing financial disclosures for public stock or public debt offerings or their periodic reports submitted to the Securities and Exchange Commission (SEC). After the U.S. Supreme Court decision in *Massachusetts v. EPA* (549 U.S. 1438 (2007)), the regulation of greenhouse gases (GHGs) under the current Clean Air Act appears inevitable. Even without federal regulation, the states are adopting GHG restrictions on their own making GHG regulation a reality in many regions of the United States. As a result, the importance of evaluating what climate change disclosures may be appropriate has only increased. Recent actions by the New York attorney general and a petition filed with the SEC requesting that an interpretive release clarifying that material climate-related information must be included in corporate disclosures under existing law, may draw even greater attention by public companies as they evaluate to what extent climate risk should be included in their public disclosures.

First and foremost, to understand how financial disclosure obligations may involve climate change risk, one must review the mandatory disclosure requirements promulgated by the SEC under the traditional securities laws and the many requirements of the Sarbanes-Oxley Act (Sarbanes-Oxley). Second, it is critical to appreciate disclosure pressures that extend beyond the mandated requirements of the SEC and Sarbanes-Oxley. The pressure for “voluntary” disclosure arises from initiatives and protocols developed by non-governmental organizations (NGO), who seek to create enough awareness among the public and institutional investors to compel companies to disclose environmental risk and impacts, and as a result to change their behavior to avoid future negative disclosure. While the efficacy of such activities may

vary, NGO pressure on public companies and their investors and lenders are becoming more difficult to ignore.

Because climate change disclosure involves issue of strategic importance to the company, the management and board of directors of public companies should be involved in the setting of policies and procedures for determining what will be disclosed. In doing so, it is key for management and the directors of companies to evaluate the many interconnected and interrelated entities and interest groups that may affect their economic success. As these entities and interests groups demand ever more information on environmental and corporate social responsibility and specifically demand disclosure regarding climate change, how companies manage climate change disclosure demands may become increasingly important in managing shareholder and public stakeholder expectations.

For some companies with operations in states or countries where climate change regulation is in effect or is in the process of being implemented, climate risk may present material financial effects on the company that may require discussion in their public disclosures. For other companies, any disclosure at this stage will be forward-looking, focusing on potential future risks. Even for these companies, the stage is rapidly changing, as U.S. states have or are preparing to impose restrictions on GHG emissions. Care must be taken in deciding what to disclose—too little disclosure may not provide a full picture to investors; too much disclosure, particularly of inchoate or never-realized financial effects, may not provide realistic information to investors.

December 2007 involved significant developments in climate change regulation. After the U.S. Supreme Court handed down the *Massachusetts v. EPA* decision earlier in the year, concluding that GHG emissions can be regulated under the federal Clean Air Act, December proved full a month for international and domestic developments.

Internationally, the Bali, Indonesia, climate change talks to begin development of a successor treaty to the

Kyoto Protocol took place. Based upon the European Union position, it appears that a successor treaty will be negotiated, with or without U.S. participation. Developing countries would appear to gain enough in the process to commit to a post-Kyoto agreement. The United States is still pressing for reductions in the major developing countries such as China, India, and Brazil. December was the month of significant developments in the climate change arena.

On Dec. 21, 2007 Congress included in the Omnibus Spending bill a requirement that the U.S. Environmental Protection Agency (EPA) create an economy-wide GHG reporting system and registry. President Bush has signed this spending bill, making the requirement law. Under this provision, a proposed regulation is due nine months from December 2007, and a final regulation is due eighteen months from December 2007. The details of this system will be developed by EPA unless additional legislation is passed in the next nine months. How EPA under the current administration will handle this mandate is not clear, particularly with respect to which types of sources will be required to submit reports, what de minimis level of emissions will be set, and what other exemptions will be provided. In any event, a federal GHG reporting requirement will go into effect within two years.

On Dec. 5, 2007, the Senate Committee on Environment and Public Works voted the first climate change bill, co-sponsored by Sen. Joe Lieberman and John Warner called the Climate Security Act, out of committee. The committee vote on Senate bill 2191 was 11-8, with all Democrats, the two Independents, and one Republican voting for the bill, and the other eight Republicans voting against the bill. Numerous amendments to the bill were debated in the Committee. Fourteen were adopted and many more were voted down. The bill requires cuts in carbon dioxide and other greenhouse gases from electric utilities, fuel production and importation, and certain other sources of GHGs, accounting for an estimated 75 percent of U.S GHG emissions.

The bill would cap GHGs at the 2005 emission level starting in 2012 and gradually reduce them by

15 percent to 1990 levels by 2020, with a long-term reduction of GHG emissions of 65 percent reduction in 1990 levels by 2050.

The bill would address all six GHGs through a cap and trade system with two categories. The first group consists of carbon dioxide, methane, nitrous oxide, sulfur, hexafluoride, and perfluorocarbons and the second group consists of hydrofluorocarbons.

The types of operations that would be regulated would include those that

- Use more than 5,000 tons of coal annually;
- Process or import natural gas;
- Produce or import petroleum or coal-based liquid or gaseous fuel that when combusted will emit a Group I GHG;
- Produce for sale or distribution or import more than 10,000 tons of carbon dioxide equivalents (“CO₂e”) of chemicals that are Group I GHGs, assuming no capture or permanent sequestration of the emissions;
- Emit as a by-product of HCFC production more than 10,000 tons of CO₂e of HFCs.

On Dec. 21, 2007, Congress moved forward with the foundation of any future GHG regulatory system by including in the Omnibus Spending bill a requirement that EPA promulgate an economy-wide greenhouse gas reporting regulation and create a GHG registry. President Bush has signed this spending bill, making this obligation law. A proposed regulation is due nine months from December 2007, and a final regulation eighteen months from December 2007. The details of this system will be developed by EPA unless additional legislation is passed in the next nine months further defining the parameters of the reporting requirements and registry. Absent such legislation, how EPA will handle this mandate under the current administration is not clear, particularly with respect to which industries and sources will be required to submit reports, what de minimis level of emissions will be set, and what other exemptions will be provided. In any event, it would appear that a GHG reporting requirement will go into effect in less than two years.

A More Expansive View of “Regulation”

In developing strategies for disclosure, corporate management and directors should appreciate that the concept of “regulation” has evolved in the latter part of the twentieth century and the beginning of the twenty-first century. The source of activity that attempts to constrain corporate behavior continues to evolve into much broader sources of impact on the corporation than what was understood twenty years ago.

Traditionally “Regulation” has involved legislation and regulations promulgated by regulatory agencies, such as EPA, the U.S. Occupational and Health Administration (OSHA), and other federal and state agencies that promulgate environmental, health, and safety regulations. With respect to financial disclosure, the SEC has developed regulations pursuant to various securities laws and, more recently, Sarbanes-Oxley.

In the beginning of the twenty-first century, financial institutions, banks, investors, particularly pensions funds and other institutional investors, consumers, and NGOs, assert more influence on company policy and behavior to such a degree that “Regulation” must be understood to extend now to the influence of various economic, political, governmental, and citizen groups and entities on corporate decisions and strategy. Various public and private entities may in certain circumstances exert significant pressure on companies to alter their behavior and decision making. In terms of environmental disclosure, environmental NGOs have become increasingly sophisticated and successful in exerting pressure on the marketplace and the investment community to require additional financial disclosure or other “voluntary reporting,” particularly by larger, publicly-held multi-national corporations.

“Regulation” is no longer limited to direct governmental restrictions on corporate action, but now is in fact broader, involving more entities and organizations, all of which may influence a “regulated” company. As a result of the interrelationships between these entities and organizations, the influence of one entity or organization may have a cascading effect throughout the system of interconnected investors, financial entities, consumers, and NGOs. The best example of this is the growing concern about global warming and

climate change where NGOs have been able to foster a certain amount of voluntary action by public companies to address the issue and to disclose the effects of climate change and future potential regulation on the company. The disclosure demands reflect an adaptation by both NGOs and the corporations whose behavior NGOs are attempting to change.

Publicly-traded companies should consider how they may be affected by such a system of governmental and non-governmental entities and market influences, and attempt to develop strategies for addressing the many-fold attempts to drive their behavior. Because of the interrelationships of various stakeholders in the financial and economic marketplace, it is more effective to link environmental disclosure with environmental risk management and regulatory compliance: disclosure decisions should not be made in isolation from or without adequate information about the management of risks that may require disclosure.

As discussed above, the traditional concepts of regulatory activity or regulation have involved a legislative body passing legislation and subsequently a governmental agency enacting regulations to regulate a particular activity. Traditional legislation has been applied to climate change issues through California legislation and its participation with several western states in the Western States Climate Initiative (WSCCI), the northeastern states Regional Greenhouse Gas Initiative (RGGI), and, more recently, the nine Midwestern states entry into the Midwestern Regional Greenhouse Gas Reduction Accord. Now, almost half the U.S. states are participating in a multi-state compact designed to limit GHG emissions from industrial sources and power plants. Various other states are acting as observers and may join one or more of these multi-state compacts. Thus, even without federal legislation, GHG emissions limitations will be in force in a significant part of the country, in some of the most populous states, with a significant portion of the overall U.S. economy.

Some companies operating in these states may face significant financial effects on their business as a result of reductions in GHG emissions. The effects of climate change concerns have already affected TXU and its

failed attempt to permit eleven coal-fired power plants in Texas. In perhaps the first of its kind in the United States, ConocoPhillips has been forced to pay \$10 million to offset new GHG emissions from expansion of an oil refinery in California. <http://ag.ca.gov/newsalerts/release.php?id=1466&year=2007&month=9>. In another apparent first in this country, an air emissions permit has been denied for a coal-fired power plant on the basis of GHG emissions by the Kansas Department of Health and Environment. <http://www.washingtonpost.com/wp-dyn/content/article/2007/10/18/AR2007101802452.html>. The agency stated that the GHG emissions of the proposed plant threatened public health and the environment.

Congress has been very active in the climate arena in 2007. More than nine bills have been filed in the House and Senate. Most recently, Sens. Lieberman and Warner have sponsored a bill that purportedly will serve as the basis for negotiation of a climate change bill that will be offered for a vote in the Senate. It is clear that with a Democratic majority, climate change legislation is top priority of the Congress, and likely that legislation will be proposed in the coming years.

International negotiations are continuing in Bali, Indonesia, as the United Nations attempts to develop a climate change treaty to follow the Kyoto Protocol. Tremendous international pressure has and will come to bear on the United States to seriously participate in the next GHG reduction treaty and take action to accomplish the goals of that treaty by reducing U.S. GHG emissions.

These rapidly developing regulations or the enforcement of existing regulations and statutes to address or limit GHG emissions present a significant issue to many companies who have significant GHG emissions. Thus, it is important to evaluate these issues in the process of preparing financial disclosures, particularly now as we head into the annual 10K season for many companies.

Beyond such regulatory programs, voluntary industry standards have played a role either in establishing non-governmental standards for industry, which are designed to fill a void left by existing government regulation, or as an attempt to stave off further

regulation as being unnecessary, or both. “Voluntary reductions” certainly have been touted with respect to climate change by the current presidential administration as a means to avoid new regulation. However, all signs point toward probable U.S. participation in some form of an international treaty designed to reduce greenhouse emissions after the 2012 expiration of the Kyoto Protocol and domestic legislation at the state and federal level to limit GHG emissions.

Financial Disclosure and Publicly-Traded Companies

Based on the potential material effect that existing and developing regulatory programs, publicly-traded companies who are materially affected currently or may be in the future by such regulations, should develop an appropriate strategy for climate risk disclosure. In doing so, public companies may have to manage disclosure in more than one form—ranging from SEC regulation to broader protocols for voluntary disclosure. Many larger companies have chosen to participate in these voluntary environmental, sustainability, or climate change disclosure programs. For these companies, disclosure takes on a broader process than simply attempting to comply with SEC regulations alone.

SEC regulations involve several provisions that mandate disclosure surrounding environmental issues that implicate climate change issues, from new regulations imposing reductions in GHG emissions to litigation filed by plaintiffs seeking damages for allegedly caused by a company’s GHG emissions. For some companies, these regulations or litigation could have a potential material effect on financial costs, profits, and liabilities. A brief review of the specific SEC regulations is helpful in understanding the potential impact climate change disclosure issues may have on the content of a company’s disclosure statements.

SEC Regulation S-K, Item 101

S-K 101 requires companies to disclose material effects that compliance with environmental laws will have on earnings, competitive position, and capital expenditures. 17 C.F.R. § 229.101. Specifically, the

rule requires disclosure of estimated material capital expenditures for environmental control facilities for the current fiscal year, the next fiscal year, and further periods, if material. *Id.* § 229.101(c)(1)(xii). Here, climate change issues are implicated as those doing business in the European Union (EU) for example may be required to expend additional capital to reduce GHG emissions from their facilities in EU countries. As states impose restrictions, such as California and the WSCI, RGGI, and the new Midwest Regional Greenhouse Gas Reduction Accord, companies with operations in these states must evaluate the extent to which disclosure for regulatory compliance is necessary to meet the demands of these jurisdictions.

SEC Rule S-K 103

S-K 103 requires that companies disclose legal proceedings, including those related to environmental and health issues. *Id.* § 229.103. Environmentally-related proceedings include pending or known to be contemplated claims, including administrative or judicial proceedings, even if initiated by the company itself. These proceedings must be material before they must be disclosed. The materiality issue has been specifically addressed for governmental proceedings. If a government agency is a party to the proceeding and monetary sanctions could reach \$100,000 or more, whether or not otherwise material to the company, the company must disclose these proceedings. *Id.* § 229.103, Instructions, Item 5.

Climate change litigation against individual companies may be limited in the United States currently, but such litigation has been filed. Some plaintiffs attorneys have pledged to obtain civil damage awards for climate change litigation that exceeds what was obtained in the tobacco litigation. Lawyers Preparing for Explosion of Climate-related Work, *The Dallas Morning News*, June 25, 2007. Any climate change cases filed against publicly-traded companies would have to be disclosed under S-K 103. To the extent the New York attorney general proceeds with litigation against electric utility companies claiming that these companies failed to disclose climate risk, these cases would likely have to be disclosed under this rule. It is necessary to keep in mind the low threshold for cases brought by government agencies.

SEC Rule S-K 303

S-K 303 requires that companies disclose, in the Management Discussion and Analysis (MD&A) section, “known trends, events or uncertainties” that may have a material effect on the company’s financial condition. 17 C.F.R. § 229.303. A 1989 SEC Interpretive Release emphasized that this applies to environmental trends and uncertainties such as anticipated new regulations and Superfund liabilities. Securities Act Release No. 33-6835 (May 18, 1989). This is the SEC regulation that may present the most immediate concern for publicly-traded entities. In late 2006 and in 2007, climate change issues and the potential for GHG greenhouse gas regulation in the United States have changed dramatically. As discussed above, twenty-two states have entered into multi-state compacts to develop regional GHG reduction programs. The Supreme Court in *Massachusetts v. EPA* concluded that GHGs are air pollutants and may, if not shall, be regulated under the Clean Air Act. Nine or more climate change bills have been filed in Congress, three of which would require the SEC to take action to impose more specific climate risk disclosure on public companies.

With the New York attorney general’s investigation into the alleged failure to disclose the potential effects of climate change regulation on their financial condition and the petition filed by a large number of state pension fund managers among other parties to require the SEC to issue guidance on climate risk disclosure, ever greater pressure is mounting on firms to disclose trends and uncertainties under Item 303 relating to climate change and GHG emission regulation. After these important developments in 2006 and 2007, firms should carefully consider the degree to which discussion of these trends and uncertainties should be included in their public securities filings.

Accounting Rules

The next level of concern for public (as well as privately-held companies) involves disclosure required by the Generally Accepted Accounting Principles (GAAP). In the environmental and safety context, the most important of these historically has been Financial Accounting Standard No. 5, Accounting for Loss

Contingencies (FAS 5). FAS 5 would typically cover lawsuits and other claims for damages and superfund liabilities. A more recent accounting standard, Financial Accounting Standard No. 143, Accounting for Asset Retirement Obligations (FAS 143), and the follow on interpretation, Financial Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations (FIN 47), apply to legal obligations that arise at the time of retirement of an asset. Since most climate change legislation includes a cap-and-trade program, GHG emission allowances or credit will need to be accounted for in the coming years. The Financial Accounting Standards Board (FASB) is currently engaged in a project to provide comprehensive accounting guidance for participants in emission allowance programs. The project will provide guidance on accounting for emission allowances and related liabilities. [http://72.3.243.42/project/emission_ allowances.shtml](http://72.3.243.42/project/emission_allowances.shtml).

Sarbanes-Oxley Act

Finally, Sarbanes-Oxley raises issues for public companies in the environmental disclosure context. Most prominent of these are Sections 302 and 906 that require CEOs and CFOs to certify that the financial statements fairly present the financial status of the company, and Sections 302 and 404 that require certain certifications that the internal controls established by the company are adequate to ensure the accuracy of financial statements. In addition, Section 404 requires that the independent financial auditor review and attest to the adequacy of the company's internal controls. Consideration should be given as to disclosures being made by companies to meet these requirements. Are climate risks being considered by CEOs and CFOs when they make certifications? Do the internal financial controls address climate risk issues? At what point would it be appropriate to include climate risks, such as new capital costs or liability risks, in the Sarbanes-Oxley compliance programs?

SEC Enforcement

The importance of these internal controls as they relate to environmental reserves and disclosure was

demonstrated in a recent SEC enforcement case against Ashland Inc. (Ashland) and an environmental manager for alleged failure to properly record and report environmental financial liabilities. *In re Ashland Inc. and William C. Olatin*, File No. 3-12487 (Nov. 29, 2006). This case indicates the expectations of the SEC for corporate environmental disclosure and the necessary internal controls required for accurate disclosure. As a result of its factual and legal findings, the SEC ordered Ashland to take several steps, including better documentation of all adjustments to its environmental remediation estimates and the reasons for each adjustment to form a complete audit trail for environmental estimates. They also required that Ashland retain PricewaterhouseCoopers (PWC) to review its policies, procedures and internal controls relating to environment reserves, and its procedures to address internal complaints; and to submit the reports to Ashland's audit committee and the SEC. Finally, the SEC required that Ashland's audit committee or full board of directors review and adopt PWC recommendations, or to develop and adopt alternative policies or procedures that are reviewed and approved by PWC.

The SEC placed the ultimate responsibility for reviewing and approving internal controls over environmental disclosure on the audit committee or the full board of directors, apparently placing the expectation of ultimate authority and responsibility for implementing adequate financial internal controls to monitor and report environmental disclosure on the board of directors. It is important to note that this case was decided on the law as it existed before the passage of Sarbanes-Oxley. The SEC expectations may be higher under Sarbanes-Oxley.

The importance of climate change disclosure should not be overlooked. Consideration should be given by the Audit Committee and, if it exists, the Environmental Committee of public companies to disclosure requirements as they apply to climate change and GHG emission regulations, and the impact these issues may have on a company and their current and future financial conditions.

Voluntary Standards and Institutional/ Socially Responsible Investors

Beyond SEC regulations, accounting standards, and Sarbanes-Oxley, a plethora of protocols have emerged for “voluntary reporting” of environmental matters. These protocols have been developed by NGOs attempting to influence corporate behavior. These voluntary disclosure protocols include disclosure of information regarding environmental, sustainability, corporate social responsibility, and, more recently, climate change.

These voluntary standards have evolved as a result of growing concern about corporate impacts on the environment and public health, but also at least in part as a result of the difficulty in achieving results through the more traditional regulatory system. As NGOs in the United States have found a Congress and White House over the last ten or more years that were generally unfriendly to environmental regulation, the NGO’s have adapted and shifted their efforts to other means of exerting influence. One such approach has been in the area of institutional investing, particularly state pension funds. Finding like minded people in decision-making roles in public pension funds, the NGOs have developed socially responsible investing groups and protocols, and utilized the power of the media and the Internet to launch public campaigns to convince companies to disclose their activities that affect the environment.

Sustainability and corporate social responsibility have been the watchwords for several years. Many public corporations began issuing sustainability reports as a result of this pressure. Shareholder initiatives that involve environmental matters began to be proposed at a greater frequency. Most recently, climate change has become the focus of socially responsible investors. Protocols for disclosing a company’s “carbon footprint” and what they are doing about their GHG emissions have emerged.

The NGO pressure has similarly reached the financial sector. Publicly funded and private banks have adopted lending principles such as the “Equator Principles” to provide environmental criteria to be used when making loans. <http://www.equator-principles.com/>.

Pressure has also been placed on investment firms, many of whom have retreated from investing in certain industries. For example, one investment firm has withheld investments in coal projects as a result of global warming concerns associated with the burning of coal.

More recently chemical manufacturers and oil companies have been facing numerous shareholder initiatives filed by socially responsible investors to protest products or practices they consider to be public health or environmental threats. These resolutions urge management to change corporate policies to reduce the activities that the NGOs assert are harming the natural world or people.

No greater demand has been voiced by NGOs in the last five years than that public companies disclose the effect climate change and GHG regulation will have on their companies. In the voluntary disclosure area, climate change disclosure is the central focus of many of the organizations developing voluntary corporate environmental disclosure. For example, the Global Reporting Initiative, the Carbon Disclosure Project, and Global Framework for Climate Risk Disclosure focus on climate change reporting. Care must be taken in considering engaging in any of these programs, as the motivations and goals of the disclosure requirements or protocol may go well beyond true “financial” disclosure and instead address more “regulatory” disclosure. For example, one would not expect to disclose a company’s GHG emission levels company-wide or by facilities in a financial report, but may do so in the context of a climate change regulatory program. In fact, measuring and reporting one’s GHG emissions would be a fundamental aspect of such a regulatory system.

Voluntary Standards Evolving into Legal Requirements?

The demand for voluntary disclosure sprung from NGOs, and in recent years, has extended to state pension funds, where state officials in charge of these funds with substantial investments in publicly-traded companies have joined the call for voluntary disclosure. Recently, this voluntary call has evolved into a more pressing legal or mandatory demand. This has evolved

into a potential enforcement action by the New York attorney general and a petition filed with the SEC seeking a rule that would specifically require statements on climate risk, and even bills in Congress that would require disclosure of climate risk. A substantial group of shareholders are demanding greater climate risk disclosure.

The attorney general of New York, Andrew M. Cuomo, in September of 2007 opened an investigation of five major utility companies regarding whether their plans to build coal-fired power plants pose undisclosed financial risks that should be disclosed to investors. The investigation is based on the same New York securities law used by former New York attorney general and now governor of New York, Elliot Spitzer. The attorney general sent subpoenas to AES Corporation, Dominion, Dynegy, Peabody Energy, and Xcel Energy.

Only a week after the New York attorney general's announcement of an investigation into the climate risk disclosures of five major utilities that operate coal-fired power plants, a group of states and NGOs announced the filing of a petition with the SEC to promulgate a rule that would provide specific climate risk disclosures. The petition asserted that (1) "recent scientific, legal, and regulatory developments make it unavoidably clear that the risks and opportunities many corporations face in connection with climate change fall squarely within the category of material information that is required to be analyzed and disclosed in many corporate filings," and (2) that "corporate disclosures of the risks and opportunities created by climate change lag behind these developments, and investors are left with little or in some cases no useful information about corporate exposure to these risks." Petition for Interpretive Guidance on Climate Risk Disclosure, <http://www.sec.gov/rules/petitions/2007/petn4-547.pdf>. The petition requests an interpretive release clarifying that material climate-related information must be included in corporate disclosures under existing law, may draw even greater attention by public companies as they evaluate to what extent climate risk should be included in their public disclosures.

Congressional activity in 2007 after the Democratic takeover of Congress and the growing development at

the state level and international pressure on the United States to join in serious negotiations of a post-Kyoto Protocol treaty and adopt its own climate change legislation that curbs GHG emissions has led to numerous bills that provide various approaches to GHG emission reductions. What has not received as much discussion are the provisions in several of these bills would require the SEC to promulgate specific regulations that impose climate risk disclosures.

Three bills filed in the Senate would require the SEC to promulgate regulations requiring specific disclosure of climate risk. As stated above, on Dec. 5, 2007, the Senate Committee on Environment and Public Works voted the first climate change bill, co-sponsored by Sen. Joe Lieberman and John Warner, called the Climate Security Act, out of committee. The Climate Change Security Act, Senate bill 2191, contains a provision requiring the SEC issue an interpretive release clarifying that under Items 101 and 303 of Regulation S-K that (1) the commitments of the United States to reduce emissions of global warming pollution under the United Nations Framework Convention on Climate Change, done at New York on May 9, 1992, are considered to be a material effect; and (2) global warming constitutes a known trend. The legislation would require the SEC to promulgate a regulation in accordance with Section 13 of the Securities Exchange Act of 1934 within two years of enactment of the climate change legislation becoming law directing each issuer of securities to inform securities investors of the risks relating to (1) the financial exposure of the issuer because of the net global warming pollution emissions of the issuer, and (2) the potential economic impacts of global warming on the interests of the issuer. In addition to promulgating this rule, the legislation would require the SEC to enter into an agreement with the FASB, or another appropriate organization that establishes voluntary standards, to develop a uniform format for disclosing to securities investors information on the risks described in the provision requiring SEC promulgation of the rule governing climate risk.

Two other bills offered in the Senate would require similar actions by the SEC. Senate Bill 309, sponsored by Bernard Sanders, Patrick Leahy, and several other senators, and Senate Bill 485, sponsored by John Kerry, Olympia Snow, and Edward Kennedy, provide

provisions that would require the SEC to issue an interpretive release and later promulgate regulations imposing specific climate change disclosure requirements on publicly-traded entities.

Recently, Congressional hearings were held to discuss climate change disclosure. Several experts testified about the need for increased disclosure under the SEC regulations, and the need for the SEC to issue interpretive guidance for public companies to direct them in how to address climate change in their SEC filings. <http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=285>.

Finally, in a recent report, Kiplinger.com reports that the SEC, under pressure from the large institutional investors and state officials through the petition for an interpretive release, will issue guidance as early as 2008 clarifying that certain types of climate-related information is “material,” and must be included in corporate filings under existing securities laws and regulations. http://www.kiplinger.com/business_resource/forecast/archive/SEC_Wants_More_Information_on_Climate_Risks_071113.html. The accuracy of this report is not clear at this time.

Considering the growing demand for climate change disclosure and actions to investigate and compel such disclosure, corporations should take care in evaluating what should be disclosed with respect to climate change issues and the potential impact of GHG emission limitations on their financial performance.

Officer and Director Liability

Environmental and Climate Risk Management

One of the growing concerns derived from the evolving mandatory financial disclosure obligations and voluntary disclosure demands are the roles and responsibilities, and thereby potential personal liability, of officers and directors for overseeing these issues. Clearly, the individual responsibilities and liabilities of the CEO and the CFO have been increased by Sarbanes-Oxley. Other developments over the last couple of years have contributed further to the potentially greater responsibility for officers and

directors to manage the risks encountered and to ensure adequate disclosure is made of the appropriate information regarding such risks.

The case law regarding director liability and responsibility has been hinting at greater responsibility in the Delaware courts, long a reliable protector of directors. For example in the *Caremark* case (*In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996)), the Delaware court held that directors owe a fiduciary duty of care to the company they serve. To fulfill his or her duty of care, a director must make a good faith effort to be informed and to exercise appropriate judgment.

The duty of care includes a duty to supervise the company, including maintaining procedures to monitor compliance with law. Directors do not have a duty to “ferret out” wrongdoing in the absence of a red flag; however, where there are facts or circumstances which would create suspicions in the mind of an “ordinarily prudent director,” directors have an affirmative duty to make reasonable inquiries and, if appropriate, to take action.

To ensure that they are receiving adequate information upon which to base their judgment, directors must be satisfied that adequate reporting procedures are in place and being followed. As the *Caremark* court noted, “relevant and timely information is an essential predicate for satisfaction of the board’s supervisory and monitoring role.” Furthermore, though directors are generally entitled to rely on reports of management, directors should critically review those reports (not just accept them blindly) and should ask questions as necessary to become fully informed and to satisfy their concerns.

The *Caremark* decision has taken on particular importance in light of an expert panel report regarding the explosion at the BP Texas City refinery in March 2005. The expert panel led by Howard Baker (the “Baker Report”) concluded that the company had not properly maintained safety policies and procedures, which led to the explosion. The import for this discussion is that the Baker Report called on directors to participate in overseeing the company’s safety planning and practices. The Baker Report and the

Caremark case together suggest that a corporate director should exercise enough due diligence to understand health and safety issues relating to the operations of the company and to ensure that adequate information is being supplied to him or her to carry out the director's duty of care. In other words, there must be sufficient gathering and boiling down of information and presentation of that information so it is readily understandable by the director. The key to such a process is appropriate information flow and adequate metrics being provided to the directors.

These developments may be raising the bar for directors as expectations for overseeing environmental and safety practices of their company are converging with growing expectations after the passage of Sarbanes-Oxley that directors increase their oversight of financial disclosure and the internal controls in place to ensure fraud and inaccuracies are avoided in gathering, processing, and reporting corporate financial information.

The recent SEC order against Ashland discussed above was an enforcement case involving corporate environmental financial disclosure and internal controls. The decision by the SEC indicates the agency expects the audit committee, if not the full board, to exercise oversight of the internal controls used to gather and report environmental costs and liabilities and to properly report them to the public through securities filings.

In light of such responsibilities, personal liability may arise for directors. A significant slide in the stock price of a company after an environmental liability becomes public knowledge could result in a shareholder suit against directors. When this occurs, a question exists as to whether officers and directors are covered by director and officer (D&O) insurance. A troubling appellate court decision has been issued on this topic. The U.S. Court of Appeals for the Fifth Circuit, in *National Union Fire Insurance Co. Pittsburgh, P.A. v. U.S. Liquids, Inc.* (2004 U.S. App. LEXIS 2694 (5th Cir. Feb. 17, 2004)), ruled that the pollution exclusion in a D&O insurance policy effectively excluded claims filed by shareholders against directors and officers alleging they failed to disclose

environmental liabilities in filings with the SEC and in press releases. As a result of this case, directors and officers need to not only evaluate their potential risk of being sued, but also whether they would be covered by corporate D&O insurance policies. If environmental exclusions apply to shareholder suits, the company may be able to purchase additional coverage so that directors are not left without recourse for defense costs and protection against an adverse judgment.

Practical Approach to Climate Change Disclosure

Raising these potential risks to companies and their corporate leaders should not cause flight from positions of leadership in companies with environmental risks, particularly companies where the potential environmental and safety risks may yet be undiscovered or may prove remote. Rather, climate change disclosure issues and the degree to which mandatory and voluntary disclosure is necessary or advisable should encourage corporate leadership to develop strategies from which policies and procedures emerge to address these management and corporate risks.

In facing these issues head on, some practical issues the board of directors and management should consider include the following:

Develop a Realistic View of Potential Risks: The potential significant risks that may be faced by some companies with substantial GHG emissions or "carbon footprint" as regulations are being considered, proposed and then adopted at the state, federal, and international level are difficult to ignore. Companies should consider the conclusions of scientific academies so that the peer-reviewed science on climate change and human contribution to that change are understood. Tracking of climate change regulation in the jurisdictions in which the entities conduct their business and where significant emission sources owned or operated by the entity are located is critical to understanding what disclosure may be appropriate. Developing a risk analysis for the company based on potential regulatory impacts on the company then may be appropriate.

Determine What Risks Should Be Disclosed:

Fully evaluate potential risks and determine which of these risks rise to the level that some mention of the risk should be included in financial disclosures. This may vary from industry to industry. The developments in the jurisdiction are important. For example, companies with natural gas-fired boilers in California and certain Western states may be regulated, while they may not be regulated in the Northeastern states implementing RGGI. Utilities in both regions may find it necessary to discuss the potential risks, and perhaps, in somewhat more detail. As regulations are promulgated, and specific emissions limitations become clear, then the company may then need to disclose any liabilities or capital costs that may be incurred, and any offset credits that may need to be purchased.

Beyond Costs and Liabilities, Assets May Need to Be Described in the Form of Carbon

Allowances: In addition to liabilities, if a cap-and-trade system goes into effect, to the extent greenhouse gas emission allowances are provided without charge to regulated GHG emitters, then real financial value will be received in the form of these allowances, which can be sold and will develop a market price. The value of these allowances, however obtained, may require some form of disclosure under GAAP, and perhaps under SEC regulations. The need to purchase additional offsets may require disclosure as a liability.

Understand What Your Competitors Are Doing:

Review the disclosures by other industry members to understand the statements being made in the market place by competitors. Observing competitors who may increase disclosure regarding climate change regulation may serve to some extent as to the developing expectations of shareholders for climate risk discussion in public filings. On the other hand, care should be taken in taking too much comfort that limited disclosure among participants in a particular industry may demonstrate shareholder expectations or meet legal requirements. As the New York attorney general investigation shows, regulators or shareholders may bring actions alleging collective inadequate disclosure may not provide any form of defense.

Understand What Other Industries Have Done in Similar Situations:

Consider other industries and

what disclosures were made initially and over time with the development of regulations and filing of tort suits. How companies addressed disclosure in the early days of the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) may provide some assistance or guidance to companies evaluating disclosure under developing climate change regulation.

Understand the Migration from General to Specific in Disclosures as Regulations and Other Issues Develop:

Where regulation is only being developed and where lawsuits are only a potential, a more general disclosure in the MD&A may be all that is required. As regulations are promulgated or decisions by California, the WSCI, and RGGI, or developments in Congress come about, companies may need to consider disclosing more specific information about potential effects on the company. Where litigation is filed, then, depending on the materiality of matter, specific disclosure of that lawsuit or lawsuits may be prudent. The likelihood of loss may factor into disclosure as there may be significant legal and scientific barriers to plaintiffs succeeding in such suits. Since the likelihood of success may be remote in climate change lawsuits, but the potential losses may be fairly significant, care should be taken in evaluating what disclosure is required if such lawsuits are filed against a company. Consideration should also be given to the potential effect of lawsuits filed against EPA or other governmental entities attempting to force climate change regulation under existing statutes.

Goldilocks Approach: The goal is to disclose realistic potential risks without stating more than would be appropriate. Seek the “Goldilocks Approach,” that is, just the right amount of disclosure: attempt to disclose enough, but not to overstate the risk. Overstatement of the risk may mislead investors as much as understatement.

Understand the Relationship between Mandatory and Voluntary Disclosure:

Be prepared to deal with NGO pressure to disclose information beyond what is mandated by SEC regulations, GAAP, and Sarbanes-Oxley. Such pressure can arise quite quickly and consideration of particular issues at an early stage may allow the company the ability to deflect concern from

regulators, investors, and other parties who may have an impact on a company. Financial disclosure is not the same as general information that some NGOs are demanding about the amount of GHGs are being emitted for example. If the company is not subject to any exiting laws (such as EU or U.S. state laws) that require such disclosure, the company would have to decide whether it wants to participate in voluntary programs in which disclosure of climate risk or GHG emissions is part of the disclosure protocol. Moreover, understand the differences in terms of environmental financial disclosure and environmental disclosure of emissions and other information. For example, NGOs often fail to understand the difference, and the voluntary disclosure protocols frequently require disclosure of the amount of emissions and other environmental data that is likely not appropriate for environmental financial disclosures.

Manage Risk Internally: If not yet established, companies should develop appropriate systems to identify, measure, and report information relating to environmental, health, and safety costs, risks, and liabilities to management and the board of directors. As with other environmental issues, companies should establish appropriate policies and procedures for information flow through the organization to management and the board on climate change issues. Directors should consider what steps they can take to assure themselves the appropriate systems and controls are in place and that necessary and accurate information is flowing to them for review with respect to climate change risk and related disclosure.

Develop Policies and Systems to Involve and Inform Management and Directors in Climate Risk Issues: Environmental management and disclosure as practiced by many companies have often failed to properly involve and inform management and the board of directors. In the case of climate risk and GHG emissions, it is perhaps even more critical to develop systems that provide the appropriate information flow to management and the board and involve them in developing policies to govern both how the company manages these risks and determines how mandatory disclosure is made and the extent to which the company participates in any voluntary disclosure protocols.

Review D&O Insurance Coverage: As climate change issues will involve management and director participation and potential personal liability, it is critical to evaluate director and officer insurance coverage to insure that directors and officers are covered for shareholder claims or state or federal government claims arising from allegations that climate change risks or potential liabilities were not properly disclosed.

Conclusion

Environmental disclosure and risk management are inextricably intertwined, and no more relevant instance may exist over the coming years than in disclosure of climate risk. In evaluating the best approach to meeting Sarbanes-Oxley and SEC requirements for climate risk, disclosure and risk management should be managed together in the context of corporate strategy, and interrelated systems should be developed for environmental management and internal controls for environmental financial disclosure generally. Depending on the industry, climate change should either now be a significant part of this program, or should be in the very near future.

Voluntary disclosure should be carefully considered in light of the information generated by the environmental management and environmental disclosure systems to ensure the accuracy of statements made to the public in any environmental or corporate social responsibility report. Management and directors of public companies should develop a practical, proactive approach to evaluate climate-related issues and formulate strategies for responding to the myriad pressures and influences that can arise from the interconnected economic, political, and social entities and organizations that may affect business enterprises in the twenty-first century. Based on current scientific studies and current political and legal realities, climate change issues are unlikely to go away, and will likely only become more significant to many publicly-traded companies.

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GREENWASH

**Thomas P. Lyon
John W. Maxwell**

Environmental issues have been on the corporate radar screen for years. Thousands of firms participate in the Environmental Protection Agency's partnership programs, and many more participate in industry-led environmental programs such as the Council of Great Lakes Industries or the American Chemistry Council's "Responsible Care" program.

Despite these efforts, large portions of the public continue to view business as an enemy of the environment. Furthermore, although there are many reasons why companies should want to publicize their environmentally-friendly actions, firms are often surprisingly hesitant to do so, or to issue detailed environmental reports.

One important reason companies hesitate to spotlight their environmental good deeds is for fear those deeds will be dismissed as "greenwash" by non-governmental organizations (NGOs). Often these NGOs attempt to punish companies they view as greenwashers by embarrassing them in the media, and encouraging consumers to boycott them. At the 2002 Earth Summit in Johannesburg, a group of NGOs held a Greenwash "Academy Awards" to criticize companies that falsely promote themselves as environmentally responsible and to "recognize these companies for what they are: hypocrites." Winner for Best Greenwash was "BP for their Beyond Petroleum rebranding campaign." Among the other awards, South African electricity firm Eskom was Runner up for Best Picture "for being a key member of Business Action for Sustainable Development while generating electricity from coal and nukes." Monsanto was Runner Up for the Lifetime Achievement Award for its "tireless promotion of Roundup Ready GM crops as a solution to world hunger."

What is Greenwash?

Before we can discuss effectively the phenomenon of corporate greenwash, we need a clear notion of what

the term actually means. It turns out to be surprisingly hard to pin down the meaning of the term based on its popular usage. NGOs often use the term “greenwash” in such a broad way that no oil company that promotes its own environmental improvements could possibly avoid the label. Webster’s New Millennium Dictionary of English defines greenwash as “The practice of promoting environmentally friendly programs to deflect attention from an organization’s environmentally unfriendly or less savory activities.” The Concise Oxford English Dictionary (10th Edition) defines it as: “Disinformation disseminated by an organization so as to present an environmentally responsible public image; a public image of environmental responsibility promulgated by or for an organization etc. but perceived as being unfounded or intentionally misleading.” Both these definitions emphasize the idea that the public has limited information about corporate environmental performance, and that corporations therefore can manipulate the dissemination of information to mislead the public.

The focus on greenwash is striking insofar as it targets corporations that report some good deeds, rather than companies that report nothing at all. It may be that activist groups are offended by the apparent hypocrisy of firms that trumpet small successes while failing to own up to their significant shortcomings. Perhaps these groups fear that environmentally-malignant firms will capture market share fraudulently, thereby exacerbating environmental problems rather than alleviating them. Alternatively, it is possible that companies that enhance their public visibility by promoting their successes become easier targets for activist groups with limited budgets, much as Nike and Starbucks are easier to attack than companies that are not household names. In this paper, we do not attempt to assess the underlying motives of the activists who focus on greenwash; rather, we offer an analysis of the consequences that may follow when activists take this approach.

Using the term “disinformation” to define greenwash implies that companies employ deliberately false messages. When examined carefully, however, corporate greenwashing does not seem to fit this definition. Instead, the typical concerns raised by NGOs are that companies present positive information

out of context in a way that could be misleading to individuals who lack background information about the company’s full portfolio of activities. Consider the following example, taken from *Don’t Be Fooled: The Ten Worst Greenwashers of 2003*:

“Royal Caribbean points to its advanced wastewater treatment systems as a sign of environmental progressiveness, yet they are installed on just 3 of the company’s 26 cruise ships. The advanced systems are only found on its Alaskan fleet, which due to Alaskan law are subject to the strictest environmental standards in the industry. Royal Caribbean deems them unnecessary on cruise ships that travel other routes.”

Thus, we will define greenwash as the selective disclosure of positive information about a company’s environmental or social performance, without full disclosure of negative information on these dimensions. Note that this is not the same as having a poor record of environmental performance. A firm can have a poor record without presenting any positive information about itself, in which case it would not be accused of greenwashing. On the other hand, it can have a good record while simultaneously promoting its positive actions publicly and failing to discuss its (few) negative environmental impacts, in which case it would be accused of greenwashing. Note also that greenwash is not the same as simply failing to report negative information; greenwash involves the additional step of selectively choosing to report positive information.

Key Results

In a recent paper, (Lyon and Maxwell 2007) we undertook a detailed analysis of corporate incentives for environmental disclosure, and how they are affected when NGOs may investigate and penalize companies for greenwashing, e.g., by launching a boycott or undertaking a negative information campaign. Here we discuss our key findings.

Who Greenwashes?

We find that the types of firms most likely to engage in partial disclosure are those with an intermediate probability of producing positive environmental and

social outcomes. Firms viewed as poor environmental stewards might as well fully disclose: they gain a lot from trumpeting a success, and lose little by withholding information about a failure (since they are already expected to fail); thus, there is little value in risking public backlash by refusing to disclose their failures. At the other extreme, firms seen as environmental leaders do not need to disclose anything: they gain little by disclosing information about successes (since they are already expected to succeed), and lose a lot by disclosing a failure; thus, there is little value in risking public backlash by disclosing a success while hiding failures. However, for firms with moderate reputations, partial disclosure is attractive: disclosing a success can produce a significant improvement in public perception, and withholding information about a failure can prevent a significant negative public perception; thus, they are willing to risk public backlash by disclosing only partially.

Environmental Reputation and Disclosures

We also find that when there is a decline in a firm's likelihood of producing environmental successes, it tends to increase its disclosures. As the foregoing paragraph argued, firms with strong environmental reputations have little need to disclose, while those with poor reputations have little to lose by disclosing. Our analysis shows that when a firm's environmental reputation falls, it never has incentives to decrease its environmental disclosures, and in many cases it will increase them.

A natural experiment for testing this hypothesis was provided when the Exxon Valdez struck a reef in Prince William Sound, Alaska, on March 24, 1989. The 11 million gallon spill caused oil company stakeholders, including citizens and shareholders, to re-evaluate the environmental risk of oil company operations. As one might expect, the incident also had a strong negative impact on the company's finances: within a year of the accident, Exxon had already spent over \$2 billion to clean up the spill. Accounting research has found that on average major oil companies more than doubled their environmental disclosures in the wake of the Valdez accident. This

increase in disclosures was virtually required for Exxon, which had to describe the event to shareholders. The interesting finding was that other major firms in the industry also increased their disclosures.

Lessons for NGOs

We find that an increased threat of NGO audits does not necessarily motivate firms to become more open and transparent. There is a real possibility that the fear of public backlash for greenwash will cause firms to "clam up" rather than become more forthcoming. In particular, such a response is likely from socially-responsible firms with a high probability of successful projects who are not fully informed about the environmental impacts of their actions. In an environmental context, one might characterize such firms as "poorly informed firms in clean industries." Because they are in clean industries, such firms tend to receive the benefit of the doubt if they make no disclosures. Yet because they are not well informed about the impacts of their actions, they are likely to lack the information needed to provide full disclosure, and hence they may well fear an NGO audit. For firms such as this, activist pressures designed to increase disclosure may backfire and produce exactly the opposite of the intended results.

The threat of NGO audits is more likely to increase disclosures from "well informed firms in dirty industries." Because they are in dirty industries, these firms tend to be viewed with skepticism if they make no disclosures. And because they are well informed, they are likely to be in a position to fully disclose. Hence, activist pressures are best focused on firms of this type. Fortunately, this description fits quite well with the types of firms typically singled out for scrutiny and outrage by activists, such as large firms in the oil and chemical industries.

The Role of Environmental Management Systems

As mentioned above, the threat of NGO auditing is more likely to induce a firm to become more open and transparent if the firm operates in an industry that is

likely to have socially or environmentally damaging impacts, and if the firm is relatively well informed about its environmental or social impacts. In turn, a firm is more likely to be well-informed about its environmental impacts if it has adopted an environmental management system (EMS). An EMS is a set of management processes and procedures that allows an organization to integrate environmental issues into day-to-day decisions. Of course, a necessary component of an EMS is a reliable system for measuring a firm's environmental impacts. Thus, whether NGO auditing is likely to increase disclosures depends on the presence of EMSs within the audited firms. Furthermore, the complementarity between EMSs and NGO auditing of greenwash points to a benefit from public policies that mandate the adoption of EMSs.

Our results suggest that public policy pressures may be justified to induce a broad cross-section of firms to adopt EMSs. Interestingly, Coglianesi and Nash (2001, p. 15) find that there has been "an explosion of programs in the United States that offer financial and regulatory incentives to firms that implement EMSs." These programs are being implemented at both the federal and state levels. Whether these programs are likely to achieve their objectives is unclear. Coglianesi and Nash (2001, p. 16) point out that "[a]ll of these policy initiatives are premised on the assumption that EMSs make a difference in environmental performance. Yet this question merits research and evidence rather than untested optimism."

Our results point to a rationale for encouraging firms to adopt EMSs which is independent of whether EMSs affect actual environmental performance. We do not presume that an EMS makes any difference in environmental performance, but instead simply assume an EMS improves the firm's internal information about its environmental performance. In this capacity, an EMS operates as a complement to NGO auditing of environmental disclosure and greenwash. An EMS increases the likelihood that management is well informed about its environmental liabilities. Thus, where a firm has adopted an EMS but discloses nothing about its environmental performance, the market infers that the firm is failing to disclose some negative information, and thus downgrades its rating of

the company's value. In turn, this means that an NGO's threat to punish greenwash is more likely to drive the firm with an EMS to disclose fully rather than to not disclose at all.

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