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Section of Environment, Energy and Resources

Special Committee on Environmental Disclosure Newsletter

Vol. 2, No. 1 November 2004

MESSAGE FROM THE CO-CHAIRS

Jeffrey A. Smith
Thomas M. McMahon

As the Special Committee on Environmental Disclosure begins its second year, we find we need to run very fast to keep up with developments. Investor and environmental groups have escalated demands for more detailed environmental disclosure. Transparency has become a watchword, in both substantive environmental performance and environmental management systems. The metrics remain elusive, however, and thus the picture continues to be volatile. The Government Accountability Office (GAO) issued a report calling for increased U.S. Securities and Exchange Commission (SEC) attention to environmental disclosure and increased coordination with the U.S. Environmental Protection Agency (EPA), and both agencies have agreed to do so. Finally, some major companies recently have broken ranks from their industry groups and are making unprecedented disclosures, especially regarding climate change.

Your committee has worked to find effective ways to keep Section of Environment, Energy, and Resources members informed about these developments, through programs, our newsletter, and our Web site and list serve, and through cooperation with other Section committees.

Programs

We have been extraordinarily fortunate to have worked with other Section committees and to have played a lead role in putting on three programs. We participated in a program on environmental disclosure at the 2004 Annual Conference on Environmental Law (Keystone Conference) in which the focus was U.S. practices and benchmarking and the growing tensions between voluntary and involuntary disclosure.

We presented a program at the ABA Annual Meeting, cosponsoring with the International Environmental Law Committee. The focus of this program was international, and it captured the voluntary and mandatory disclosure regimes that are rapidly proliferating in the European Union and elsewhere, featuring practical comments from Peter Wright, of Dow Chemical; the international negotiating experience of Chris Bell, of Sidley Austin; and a far-reaching overview of the global disclosure picture from Allen White, the founder of the Global Reporting Initiative.

Finally, we presented a program at the 12th Section Annual Meeting in San Antonio in

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Scott D. Deatherage, Editor

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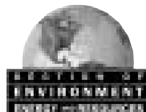

October, co-sponsoring with the In-House Counsel Committee; Ethics Committee; Sustainable Development, Ecosystems and Climate Change Committee; and Special Committee on Restructuring of the Electric Industry. This program used a hypothetical from the energy industry to examine ethical issues in the context of environmental disclosure, particularly regarding climate change.

In addition, we are considering organizing an annual Environmental Disclosure Symposium to bring together the various stakeholders, including corporations, the SEC, EPA, and a wide variety of NGOs and interest groups who are developing and publishing performance metrics and otherwise speaking out on environmental disclosure issues. We plan to seek cosponsorship as appropriate, and believe such a program would be financially self-sustaining.

This Newsletter

Scott Deatherage has given us another excellent Newsletter. It features an article by several senior U.S. EPA officials discussing EPA's recently adopted Environmental Management Systems (EMS) Strategy and its relationship to environmental disclosure. Next there is an article by a representative from AIG on the role environmental insurance can play in the management and disclosure of environmental liabilities. Scott Deatherage then points us to a recent Court of Appeals decision spotlighting the fact that standard Director and Officer (D&O) insurance policies exclude coverage for claims based on alleged inadequate disclosure of environmental liabilities. Finally, there is an article summarizing the GAO report and the related Congressionally-sponsored symposium.

Member Participation

We have a number of projects on the drawing board that need participation from our

members. If you would like to work on environmental disclosure issues, please contact Jeff or Tom.

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EPA'S NEW STRATEGY FOR DETERMINING THE ROLE OF EMSS IN REGULATORY PROGRAMS

George Wyeth and Jon Silberman

Introduction

On April 12, 2004, the U.S. States Environmental Protection Agency (EPA) released a new *Strategy for Determining the Role of Environmental Management Systems (EMSs) in Regulatory Programs* (*EMS Strategy*). EPA's EMS Web site contains a wide range of information and resources on EMSs for businesses, associations, the public, and government agencies. Links are provided to the new EMS Strategy and the EPA Position Statement on EMSs (May 15, 2002), discussed *infra*. See www.epa.gov/ems/. The *EMS Strategy* encourages carefully designed experimentation to determine whether EPA and the States, by considering EMSs in permits and regulations, can achieve better environmental results at less cost, improve compliance, target resources more effectively and enhance public involvement. This article describes EPA's new *EMS Strategy* and explains how it fits within the broader context of the agency's policy to promote the widespread use of EMSs across a range of organizations and settings.

EMSs are a practical tool, based on a Plan-Do-Check-Act cycle, providing a systematic approach to environmental management. They help organizations integrate environmental considerations into relevant decisions and practices with an emphasis on continually improving the system to enhance performance in both regulated and unregulated areas. EMSs elements normally include processes and procedures for developing, documenting, reporting and assessing a wide range of information on the firm's environmental policy, goals, and performance. The information can then be communicated to internal users as well as to a potentially wide range of external stakeholders, from regulators to investors to communities.

EMSs should be of considerable interest to the Special Committee on Environmental Disclosures, for a variety of reasons. The SEC rules implementing Section 302 of the Sarbanes-Oxley Act of 2002, for example, require companies to develop disclosure controls and procedures. The author of a recent ABA-published article on the rules recommends making such controls and procedures "an integral part of each system that management uses to regulate and guide its operations" with programs to "ensure the reliability and integrity of information," "compliance with policies, plans, procedures, laws and regulations," and progress in meeting "established operational objectives and goals." Mary Fedash, *The Bucks and the Books – A look at the new world of 'disclosure controls'*, Business Law Today, May/June 2003, at 31-35, www.abanet.org/buslaw/blt/2003-05-06/fedash.html. Where environmental concerns are involved, an EMS is exactly such a system.

EPA EMS Policy and Programs

Over the past decade, organizations of all types have adopted EMSs to help maintain regulatory

compliance, improve environmental performance in unregulated areas, and enhance efficiency and profitability. The *EPA Position Statement on EMS* (May 15, 2002) (f.n. 1, *supra*) expresses the agency's support for EMSs as a valuable tool for improving environmental performance and results. Additionally, pursuant to the *Position Statement,* EPA encourages organizations to share information on the performance of their EMSs with the public and government agencies.

EPA's chief way of encouraging the use of EMSs is voluntary, non-regulatory programs. For example, EPA has developed EMS sector templates, incorporated EMSs into environmental leadership and recognition programs, and implemented EMSs at its own facilities. Voluntary programs featuring EMSs include the National Environmental Performance Track (NEPT) environmental leadership program (www.epa.gov/performancetrack/index.htm), the Public Entity Environmental Management System Resource (PEER) program for local governments, the Design for the Environment (DfE) program (www.epa.gov/dfe/) and OPEI's Sector Strategies Program (www.epa.gov/sectors/).

EPA is also promoting EMS research through the Science to Achieve Results (STAR) grant program (es.epa.gov/ncer/grants/) and in appropriate enforcement settlements. Specifically, where EPA determines, taking into account a violator's size, characteristics and compliance obligations, that the root cause of a defendant's violations is the absence of a systematic approach to identifying, understanding and managing regulatory compliance, EPA may seek, as injunctive relief, an EMS with a compliance focus. This policy represents a situation-specific exercise of EPA's obligation, in all enforcement actions, to address the root causes of noncompliance to return violators to compliance and minimize the potential for repeat violations. To date, EPA has required defendants to develop and implement compliance-focused EMSs at 258 facilities nationwide. EPA's approach to EMSs in enforcement settlements is explained in EPA's Guidance on the Use of EMSs in Settlements as Injunctive Relief or Supplemental Environmental Projects. See www.epa.gov/compliance/resources/policies/incentives/ems/emssettlementguidance.pdf.

What about Regulatory Applications?

For a number of years, some have argued that EPA's regulatory programs should also take EMSs into account. The arguments for doing so are varied. Some feel that organizations that incur the cost of investing in an EMS deserve some regulatory advantage for doing so – both rewarding them and encouraging others to adopt EMSs. Others argue that EMSs offer better ways of achieving regulatory goals, so that where they are used highly prescriptive rules may be unnecessary and possibly even counterproductive. Regulators have sometimes speculated that if they can identify organizations with strong EMSs they can redirect their oversight efforts to others who are more likely to be sources of problems.

At the same time, others have expressed great discomfort with writing EMSs into regulatory programs – even in an optional way. Businesses fear losing control of their own management systems; they do not want the specifications of their EMSs written into rules or permits, and audited by government agencies. Environmental groups, to the extent they pay attention to the issue at all, tend to see it as illegitimate to offer regulatory flexibility in exchange for adopting an EMS; at the very least, they question whether the benefits justify the incentives being offered.

In response to all of these desires and concerns, EPA developed its new strategy – eschewing any broad program changes at this time but inviting states and others to work with EPA in experimenting on a limited basis.

Key Elements of the Strategy

Before discussing what is in the strategy, it is important to say what it does not do. As EPA's *EMS Position Statement* explains, EMSs do not replace the need for regulatory programs but can complement them or indicate streamlining opportunities. The *EMS Strategy*'s measured approach to experimentation in the regulatory context does not alter this position. Nor does EPA intend to mandate the use of EMSs in permits or rules. EPA's primary focus will be to work with interested parties to promote voluntary EMS adoption to determine the benefits and pitfalls of providing *options*, within the regulatory structure, for organizations that choose to adopt EMSs.

Projects conducted under the *EMS Strategy* will be based on a defined set of *Principles to Guide Actions and Decisions*, *EMS Policy Ideas to Test*, and *Design Considerations* to ensure a continued high level of health and environmental protection. The *Principles to Guide Actions and Decisions* elaborate upon those in the *EPA Position Statement*. First, EMSs should make "business sense." This is important because experience and research demonstrate that EMSs are most effective when adopted voluntarily by organizations which embrace them actively as furthering important business goals. Second, regulators should focus on performance because properly-designed EMSs promote positive environmental results but do not guarantee any specific level of performance or compliance. Third, organizations should measure and report their performance under an EMS. Public understanding and support is enhanced when EMSs provide for performance measurement, public input, and transparency. Fourth, EMSs should employ a comprehensive, multimedia approach to consider all environmental impacts under all media, regulated or not. Regulators, whose programs usually focus on narrower issues (in a single medium) need to bear this in mind. Lastly, any incentives provided to EMS users should be proportional to environmental performance and reward results over process. Performance, not process, is the bottom line for the firm and its stakeholders.

At the heart of the *Strategy* are its six key *Policy Ideas to Test*. This list is not exhaustive – other ideas are likely to emerge over time – but they are fundamental to our understanding or whether incorporating EMSs into rules or permits actually does improve compliance, performance, and public involvement efficiently for regulators and firms. The six *Ideas to Test* are:

1. Can EMSs, in tandem with performance standards, achieve better and more efficient regulatory/permitting environmental results than prescriptive operational controls?

2. Can the multimedia analysis that is the hallmark of an EMS support cross-media tradeoffs to achieve higher overall environmental performance and pollution prevention?

3. Under what conditions could regulators rely on EMSs in permits and rules to redirect regulatory oversight from lower to higher priority areas?

4. Can EMS elements improve performance and efficiency by substituting for overlapping administrative and information-gathering requirements in rules and permits?

5. Does incorporating an EMS into a permit yield better public involvement procedures and environmental results than traditional permit models?

6. Can regulated facilities use their EMSs to enhance the environmental performance of third parties such as suppliers, customers or environmental quality trading partners?

For each *Policy Idea to Test*, EPA provides 2-4 examples of possible experimental projects followed by questions and issues specific to that policy area (see Appendix A to the *Strategy*). These examples take many forms, such as providing performance based requirements in place of detailed work practice specifications, or reducing enforcement oversight where the facility audits itself through the EMS and reports results to the agency.

An example of particular interest to this committee related to the potential value of enhanced public involvement in the EMS implementation process. Suppose a facility with an established EMS decides it wants to engage external stakeholders more directly to ensure environmental performance of value to them. The facility identifies a mix of stakeholders and engages them in identifying aspects and impacts, determining impact significance, and selecting targets and objectives of value to the community. The experiment in this case could be to compare the targets self-selected previously by the facility with those identified with stakeholder involvement and analyze the actual environmental results achieved by each to determine whether and how the stakeholder involvement added value to the process.

We encourage readers to download the full *EMS Strategy* and read through Appendix 1 in its entirety as it presents many more project examples and readers often remark that it is the examples that "bring the document to life" for them.

Finally, the Strategy highlights important *Design Considerations* addressing fundamental issues likely to arise whenever experimenting with EMSs in rules and permits. The *Design Considerations* flag such important issues as identifying appropriate partners for conducting projects, ensuring high-quality EMSs, setting project goals, measuring and evaluating performance, linking EMSs with permits (including practical draftsmanship issues), involving the public, and analyzing and responding to project results. An example of a design consideration is the need to carefully distinguish, in the permit or rule, between EMS-related terms intended as enforceable commitments, serving as conditions for eligibility for benefits or alternative regulatory options, and meant as strictly voluntary aspirations. This practical consideration is critically important in project design given the challenges associated with incorporating EMSs, which are multimedia in nature, into permits or rules which tend to be media-specific.

Conclusion

Today's federal and state regulators are tasked with improving health and environmental protection at a time of static, if not shrinking, resources. The regulated community faces an increasingly complex array of legal, social and economic pressures requiring management approaches that are strategic and holistic. An array of stakeholders seek better tools and information to distinguish between top, average and poor performers for financial, consumer-based and oversight-related reasons. This context makes the search, under the *EMS Strategy,* for new insights into the appropriate role of government in promoting EMSs an important undertaking at this time.

Underlying much of the Strategy is the issue of trust. Most of the ideas to test reflect in some way a hypothesis that organizations with EMSs (and perhaps other indicators of strong environmental performance) can be trusted with greater flexibility and less oversight, and that this shifting of leadership will lead to better compliance, better environmental results, and better use of both public and private resources. To date, however, this remains a hypothesis: the aim of the strategy is to develop experience that shows whether the theory works in practice.

EPA hopes the results obtained through the *Strategy* will position the agency, within approximately 3 years, to consider the broader policy implications of providing EMS-based options in rules and permitting programs. If the outcomes support the hypothesis that EMSs can help organizations generate and disclose enhanced information that is more meaningful, reliable and transparent, EMSs may support a performance-based rationale for distinguishing between firms for purposes of regulation, finance, oversight and acknowledgment.

EPA encourages interested Section of Environment, Energy, and Resources members and other stakeholders to review the *EMS Strategy* and share viewpoints, reactions and suggestions with the Agency. EPA also welcomes proposals for projects that would help test the ideas that the *Strategy* presents.

George Wyeth, director of the Policy and Program Change Division in EPA's Office of Policy, Economics, and Innovation, led the workgroup which wrote the EPA EMS Strategy.

Jon Silberman, a senior attorney in the U.S. EPA's Office of Enforcement and Compliance Assurance, played a leading role in developing the EMS Strategy*. The views expressed in this article are those of the authors and do not necessarily reflect those of EPA.*

THE COMMITTEE NEWSLETTER

If you have an interest in publishing an article in the Special Committee on Environmental Disclosure Newsletter, please contact Scott Deatherage at 1700 Pacific Ave., Suite 3300, Dallas, TX; (214) 969.1206, or at scott.deatherage@tklaw.com.

RECONCILING ENVIRONMENTAL DISCLOSURE WITH ENVIRONMENTAL EXPOSURE: A CASE FOR ENVIRONMENTAL RISK OVERSIGHT

Peter Gilbertson

In the face of highly publicized corporate accounting scandals and heightened vigilance on the part of shareholders, regulators, analysts and environmental groups, companies are facing far greater pressure concerning their approach to, and the substance of, their environmental disclosures. Understanding the background, evolution and available solutions for offsetting environmental uncertainty has become a priority today that can impact the way a company does business.

Publicly traded firms have historically employed many approaches to reporting environmental liabilities. With increasing scrutiny surrounding reporting and transparency, companies' efforts to present environmental matters in their most favorable light, while balancing long-standing U.S. Securities and Exchange Commission (SEC) rules and Financial Accounting Standards Board (FASB) interpretations with the new requirements presented by Sarbanes-Oxley have become more challenging.

With this evolution of reporting regulation comes an increased possibility of assessments, fines, penalties, sanctions and clean-up costs for boards and management teams of companies with inadequate environmental risk oversight, controls and reporting procedures. These costs may add up to millions of dollars, offsetting corporate income and reducing shareholder perception of firm value. Environmental insurance is one of the tools that can help manage the financial uncertainty associated with environmental liabilities.

The increasing use of environmental insurance, among other techniques, has expanded the number of companies that reference such

products in their disclosures to illustrate how they help insulate shareholders from the cost variability of environmental contamination, both known and unknown. Consider the following excerpt from an SEC filing:

> "…During 2002, we purchased an environmental insurance policy which covers the costs of remediation activities at the identified sites and remains in effect for 30 years. As a result, we will receive reimbursements from the insurance company within other current assets and other non-current assets in amounts equal to our environmental accrual…"

Protecting the Value of a Company: Problems and Solutions

This article presents available risk solutions in environmental insurance and illustrates methods that enable companies to report confidently in their 10-K filings that known and potential environmental exposures have been properly contained, managed and disclosed. For example, environmental insurance:

- Removes or mitigates uncertainty by specifically quantifying the liability;
- Assures shareholders that the reported liability will not change;
- Moderates adverse impact a company may face in disclosure of environmental liability; and
- Provides investors with confidence that environmental liabilities will not impose a drag on the value of securities.

The following list provides a brief overview of how environmental insurance products address issues of financial assurance and mitigating the uncertainty of environmental risk:

Cleanup Cost Cap (CCC): Provides coverage to cap environmental clean-up costs, mitigating the uncertainty inherent in forecasting pollution remediation costs. The Cleanup Cost Cap policy covers insureds for cost overruns associated with the clean up of known contamination, as well as optional coverage to cover costs associated with clean up of newfound contamination at the site.

Pollution Legal Liability (PLL): Provides protection against environmental risk, presenting flexible solutions to regulatory obligations, contract requirements, lender or landlord requirements, and board of director objectives. PLL can provide environmental insurance coverage for losses due to on- or off-site pollution conditions from an owned or operated property, when such conditions are pre-existing and unknown. Coverage for losses arising from future conditions created during the operation of the facility can also be purchased. Losses for pollution conditions may be triggered by government orders, third party claims or first-party discovery, any of which can be unpredictable and difficult to quantify. The PLL suite of products transfers environmental liabilities to the insurer, helping organizations achieve greater financial stability.

Environmental Protection Programs (EPP): are insurance programs that companies can use to manage their environmental liabilities. These policies combine traditional environmental insurance coverages, such as the Cleanup Cost Cap coverage or Pollution Legal Liability insurance, with discounted funding techniques for existing liabilities. The Environmental Protection Program is designed to meet the specific financial and risk management objectives of the client, and often involves "finite" policies with multi-year terms that incorporate elements of both self-funding and significant risk transfer.

Heightened Scrutiny and Regulatory Activity Brings Environmental Disclosure to the Forefront

Under the current long-standing SEC non-financial disclosure requirements, regulated

corporate entities must disclose both actual and contingent environmental liabilities within their 10-K filings. However many corporate entities underreport these liabilities, or have used the flexibility of certain rule interpretations as the basis for avoiding explicitly presenting the full scope of such liabilities in their filings. For example, the SEC reported in September 2003 that Management's Discussion and Analysis (MD&A) disclosure of environmental liabilities among Fortune 500 companies was "materially deficient in explanation or clarity."

Inadequate Disclosure Threatens Shareholder Perception of Value

Ongoing corporate scandals have had an enormous impact on the value of securities. Consequently, investor vigilance concerning the adequacy of corporate disclosure of environmental liabilities has been raised to new levels. Studies relating to overly aggressive accounting practices – resulting in disclosure of environmental liabilities that is often opaque – indicate that such vague reporting may have a negative impact upon shareholder value. Investors realize that poor disclosure or lack of disclosure of environmental liabilities undercuts risk analysis and can threaten shareholder value. The Environmental Fiduciary (The Rose Foundation for Communities & The Environment, Oakland, CA), (Aug. 2002), at 14.)

Until recently, trends indicated that the SEC had not arduously reviewed the environmental disclosure practices of regulated corporate entities. Corporate accounting scandals such as Enron and WorldCom have helped fuel the movement towards financial transparency and full disclosure across the board. Included within this movement has been a hard push by the United States Environmental Protection Agency (EPA) and Socially Responsible Investment (SRI) groups for meaningful environmental disclosure and stepped-up enforcement by the SEC.

Corporate management and boards must develop a solid foundation for environmental risk oversight, and have a strong understanding of the tools available to minimize risk. Environmental insurance programs may be utilized to better insulate shareholders from the cost variability of environmental liabilities.

Current SEC Environmental Disclosure Requirements

The laws and rules that govern the securities industry in the United States derive from the notion that all investors are entitled to information about potential investments prior to buying them. Accordingly, the SEC requires public companies to disclose material financial and non-financial information so that the public can make educated determinations about their investment decisions.

Environmental Disclosure Rules Initiated in the 1970s

As environmental issues became more significant for corporate America in the 1970s, the SEC recognized that special rules were necessary to address environmental disclosure. These rules took form as part of the10-K form for non-financial reporting under Regulation S-K, applying to any corporation that issues publicly traded equity or debt securities. Robert H. Feller, Environmental Disclosure and the Securities Laws, 22 B.C. ENVTL. AFF. L. REV. 225, Winter 1995.

Item 101: Material Environmental Disclosure

Item 101 requires that the applicant describe the general development of the business of the registrant, its subsidiaries and any predecessor(s) during the past five years. Title 17 Commodity and Securities Exchanges Code of Federal Regulation 229.101 (a). Under the Regulation, subsection c (xii) requires that registrants make appropriate disclosure "as to the *material* effects that compliance with

Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials in 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 CFR 229.101 (c)(xii).

A corporation's interpretation of the term "material" is essential in making a determination as to whether reporting is necessary. For example, in *TSC Industries, Inc. v. Northway* (*TSC*) (*TSC Industries, Inc. v. Northway*, 426 U.S. 438 (1976)), the Supreme Court held that the materiality standard has been held to apply only "if there is a substantial likelihood that a reasonable investor would have found the omitted information important or that the missing facts would have altered the 'total mix' of information available to the investor." This regulation and the court opinion leave room for interpretation to the registrant, allowing subjective judgment to play a large role in the determination of materiality. In recent SEC Staff Accounting Bulletin, the SEC asserts that an auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality. SEC Staff Accounting Bulletin: No. 99- Materiality, Exchange Release No. SAB 99 (Aug. 12, 1999).

The Supreme Court later held that the materiality standard as set forth in *TSC* similarly applies in the context of Rule 10b-5 (17 CFR 240.10b-5, Employment of manipulative and deceptive devices. The Rules states: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.) for disclosure. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

Item 103: Material Pending Legal Proceedings

Item 103 (17 CFR 229.103) under Regulation S-K requires that a registrant disclose any "material pending legal proceedings" to which the corporation or any of its subsidiaries is a party. Under instruction 5 to Item 103, a public company is required to describe a proceeding if:

1. The proceeding is material to the business or financial condition of the registrant;

2. The proceeding involves a claim in excess of 10 percent of the current consolidated assets of the registrant; or

3. The proceeding involves a governmental authority, unless the registrant reasonably believes that monetary sanctions, if imposed, will not exceed $100,000. The EPA has stated, "SEC registrants should note that the duty to disclose information related to these legal proceedings may exist before the actual initiation of a proceeding, so long as the registrant reasonably expects that the qualifying proceeding will be initiated." United States Environmental Protection Agency, Office of Enforcement and Compliance Assurance, Enforcement Alert Volume 4, Number 3 (Oct. 2001).

Item 303: Management's Discussion and Analysis of Financial Conditions

Item 303 (17 CFR 229.103) under Regulation S-K, Management's Discussion and Analysis (MD&A) of financial condition and results of operation, requires the registrant to prepare a narrative report discussing liquidity, capital resources and results of operations.

This item requires that the corporation provide both a historical analysis of its financial condition as well as a prospective analysis within the MD&A narrative. While environmental liability is not specifically mentioned within the context of Item 303, the SEC clearly states that environmental liabilities are applicable for reporting purposes. (Securities Act Release No. 6349 (Sept. 28, 1981)). In its interpretive bulletin, the SEC raised a hypothetical where a registrant had been properly designated a PRP (Potentially Responsible Party) by EPA with respect to the cleanup of hazardous waste at three sites.

In the hypothetical, the registrant was to determine the nature of its potential liability and the amount of remedial costs. The ability to obtain contribution from other PRP's was unclear, as was the extent of insurance coverage. The SEC that based upon the facts of the hypothetical, Item 103 reporting would not be required because PRP status alone does not constitute knowledge that a governmental agency is contemplating a proceeding. However, MD&A disclosure of the effects of the PRP status, quantified to the extent reasonably practicable, would be required. The SEC further stated that the availability of insurance coverage and potential sources of contribution from other PRPs may be factored into the determination of whether a material future effect is not reasonably likely to occur. *Id.*

Contingent Liabilities

The FASB Statement of Financial Accounting Standards No. 5 (FASB-5) (Accounting for Contingencies, Statement of Financial Account Standards No. 5 (Fin. Accounting Standards Bd. 1975)) governs disclosure of contingent liabilities in financial statements. FASB-5 applies to environmental liabilities in the same manner as it does to other contingent liabilities. Essentially, a company may incur a liability resulting from a past activity, which may not be paid until some time in the future. The premise of accounting for loss contingencies is founded on the concept that the estimated future costs of the event should be reflected in the financial statements covering the time of the loss. (Tracy Soehle, SEC Disclosure Requirements for Environmental Liability, TUL. ENVTL L. J. (Summer, 1995)).

Under FASB, estimated losses from loss contingencies must be charged to income on the balance sheet if it is probable that a liability has been incurred and it is reasonably estimated. (Larry Schnapf, excerpt from Environmental Liability: Managing Environmental Risks in Corporate, Real Estate and Brownfield Transactions, (Issue 18.2002), Juris Publishing.) The rule requires that companies recognize an estimated loss by a charge to income on their balance sheets when:

- Information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred as of the date of the financial statements; and

- The amount of loss can be reasonably estimated. (Accounting for Contingencies, Statement of Financial Account Standards No. 5 (Fin. Accounting Standards Bd. 1975)).

While both conditions must be met to trigger disclosure, Paragraph 8 of the FASB-5 leaves it up to the executive management of the reporting company to determine whether there is a reasonable possibility that a loss or additional loss may have been incurred.

In response to initial confusion voiced by registrant companies, FASB issued an interpretive bulletin (FIN 14) indicating that if a particular loss contingency fell within a range, the company should recognize the number within the range that represents the better estimate. When no amount within the range is a

better estimate than any other amount, the minimum amount should be accrued. (Reasonable Estimation of the Amount of a Loss, FASB Interpretation No. 14 (1976)). In addition,FASB states companies must also report the range itself. Under the FASB interpretation, corporations may be aggressive, reporting the range and accruing the minimum amount, while acting within the letter of the law. The size of the range can be substantial, reflecting the inherent uncertainty. Environmental insurance may enable registrants to ease shareholder concern by insuring over and above even the high end of the range. Certain environmental and Socially Responsible Investment (SRI) groups have petitioned the SEC for mandatory adoption of the American Society for Materials Testing (ASTM) standards for estimation and disclosure of environmental liabilities. If this petition is successful, companies will be required to report the "expected value," rather than the "known minimum" value. Such a shift would likely trigger a significant volume of new disclosure, and risk a correspondingly significant adverse shareholder reaction.

Obligation and Compliance

Both the SEC regulations and FASB clearly obligate management to disclose the corporation's environmental liabilities. Compliance with these regulations has been publicly characterized as inadequate. (U.S. EPA, Guidance on Distributing the Notice of SEC Registrants' Duty to Disclose Environmental Legal Proceedings in EPA Enforcement Actions, Mar. 2001 presentation to the American Bar Association Conference on Environmental Law.) The requirements, while clear on their face, leave room for interpretation by management. Additionally, FASB's own interpretation of its rule suggests the opportunity to use the low-end estimated liability in what might be a very wide range of values. The FASB analyses, coupled with the lack of SEC enforcement, have contributed to the underreporting trend.

Enforcement Trends: Applying Pressure to the SEC

EPA and grassroots environmental organizations, such as The Rose Foundation, which collectively represent several billion dollars in institutional assets, continue to apply pressure on the SEC to step up enforcement of environmental disclosure. While there has been very little enforcement activity in recent years, there is mounting evidence of the coupling of the interests of the environmentalist with those of investors seeking to protect their financial future. These forces appear likely to push the SEC to enforce regulations that are currently on the books, as well as to force the adoption of new ones.

In response to the EPA findings, the Office of Enforcement and Compliance Assurance finalized an Enforcement Alert. The notice informed publicly traded companies of their duty to disclose environmental legal proceedings pursuant to the SEC environmental disclosure regulations and potential fines and penalties for noncompliance. EPA also indicated its intention to monitor the disclosures made by parties to EPA enforcement actions as well as share the information with the SEC. (U.S. Environmental Protection Agency, Office of Enforcement and Compliance Assurance, Enforcement Alert, Vol. 4, No. 3 (Oct. 2001)).

Strong Correlation Between Environmental Compliance and Profitability

The National Advisory Council for Environmental Policy and Technology formed the Environmental Capital Markets Committee to examine the nature of the relationship between a firm's environmental performance and its financial performance. In a summary report to EPA, the committee advised EPA to maintain dialogue with the SEC to promote changes in corporate disclosure that would give investors more relevant information about environmental performance. (Environmental Capital Markets

Committee. Green Dividends?: The Relationship Between Firms' Environmental Performance and Financial Performance, (May 2000).)

Utilizing market forces as a method to incent environmental compliance could be an attractive alternative to the current regulatory system. Potentially, the same level of pollution reduction can be met, while decreasing the cost of direct regulation. (Nicholas C. France, Corporate Environmental Disclosure: Opportunities to Harness Market Forces to Improve Corporate Environmental Performance, American Bar Association Conference on Environmental Law, Keystone, Colo., Mar. 8-11, 2001.) As an example, studies have shown a strong correlation between environmental stewardship and financial performance. It is reasonable to conclude that well managed environmental compliance is a proxy for solid management performance in general. This path of reasoning suggests that providing adequate information to investors allows them to select superior environmental performers and screen out poor ones, providing an incentive for companies to improve environmental performance. *Id.*

A Push for Tougher Guidelines to Estimate Environmental Liabilities

In September, The Rose Foundation, proposed in their revised petition to the SEC the use of standardized guidelines for estimating environmental liabilities. (The Rose Foundation proposed the use of ASTM 2001 Standards, which are designed to provide guidance to companies for the accurate estimation of environmental liability by utilizing four cost estimation methods. ASTM also call for materiality to be measured based upon the aggregate, instead of individual environmental liabilities.) In its report, the Rose Foundation argues that the cost of environmental liability is now more fully estimable due to advances in engineering, science and technology. The premise of the proposals offered by the Rose Foundation Report is that "without clearly articulated methods for estimating costs and liabilities and without full and accurate disclosure, significant underreporting and inaccurate reporting will continue. As a consequence, investors will not be able to accurately assess the value of the equities in their portfolios." (Letter to Mr. Jonathan G. Katz, Secretary to the U.S. Securities and Exchange Commission from Jill Ratner, President of the Rose Foundation for Communities and the Environment, Sept. 20, 2002.)

Supporting literature drafted by the Rose Foundation, *The Environmental Fiduciary*, illustrates how accurate corporate disclosure of environmental liabilities favorably impacts environmental performance, further illuminating the positive correlation between environmental disclosure and performance, and long-term financial stability.

Proposed SEC Rulemaking

In addition to recent regulations for Acceleration of Periodic Report Filing Dates and Management Certification of Disclosure (Sarbanes-Oxley Act), the SEC published proposed rulemaking for *Management's Discussion and Analysis about the Application of Critical Accounting Policies*, on May 10, 2002. This proposed rule would mandate extensive disclosure surrounding any accounting estimate that relies on assumptions about highly uncertain matters, or where there is a range of estimates, or where it is likely that such estimates could dramatically change period-to-period. Additional disclosures required include descriptions of the methodologies and assumptions used in the development of accounting estimates, and the sensitivity of financial results to changes in the assumptions used. This represents a significant departure from what has been required in the past. (Ernst & Young Actuarial Services, CFO Alert on SEC Developments, No. R0005, (Sept. 2002).)

Potential Adverse Effects of Improving Disclosure

Public and private companies alike need to consider the potential adverse consequences of reporting a significant increase in disclosed environmental liabilities. It could, for example, place a firm in violation of its debt covenants, constraining its ability to operate. Additionally, a substantial charge may prompt public shareholders to sell shares, causing a decline in share price. It is not unreasonable to assume that such a chain of events could lead to legal actions by shareholders against the firm and/or its directors and officers. Directors and officers of publicly held companies can now be personally liable if environmental conditions are not addressed or disclosed properly. Through the use and disclosure of environmental insurance, directors and officers can properly communicate to shareholders that environmental conditions have been proactively addressed

D&O Exposure: Exclusions for Pollution, Financial Restatements and Failure to Maintain Insurance

Directors and Officers are personally protected by Directors & Officers (D&O) insurance, which covers them for actions brought by shareholders alleging malfeasance. These Director's and Officer's policies contain exclusions, which may be triggered in the event that a securities claim is the result of environmental matters. Some of the exclusions that could result in a gap in protection are:

- Pollution Exclusion

  This exclusion obviates coverage for any claim against a Director or Officer, which has as its underlying cause the release or threatened release of pollutants.

- Failure to Maintain Insurance

  This exclusion could be triggered by a claim arising out of the failure of the company to investigate the advantages of commercially available coverage that might have protected it from a significant loss.

- Financial Restatements Exclusion

  This exclusion may negate coverage for claims arising out of the restatement of financial results, which might arise in the wake of releasing previously undisclosed environmental costs.

Environmental Risk Oversight as Part of the Solution

Neither the letter of the law nor the shareholder public will continue to permit certain companies to be as opaque or cryptic in their environmental disclosures as they might have been in the past. A solid approach to environmental risk oversight, and employment of techniques that improve how environmental risks are managed, reported and communicated to shareholders and other stakeholders will play an increasingly significant role in corporate governance. The ability to cap environmental costs through use of environmental insurance can provide assurances to shareholders that environmental risks are properly disclosed and contained.

Strong Economic Incentive and Competitive Advantage

It is critical that management and audit committee members move away from a *don't ask, don't tell* posture, and communicate to shareholders a clear strategy for addressing contaminated sites and facilities. Companies that take a proactive approach may be looked at favorably against peer companies who do not, in instances where competing firms are being evaluated on the risk of their liability

portfolios. Failure to do so not only risks a qualified audit opinion, unwanted scrutiny from regulators and environmental groups, but also may put a company at a disadvantage when accessing the capital markets.

As reported in the New York Times, May 2003

> …Institutional investors are looking for assessment of the triple bottom line – social, environmental and financial – not simply financial," and further that "failure to address pollution issues can make a company vulnerable to changing regulatory landscape, liability for damages and poor public image.

By utilizing environmental insurance products, companies can assure all stakeholders that known, unknown and future environmental exposures have been properly contained, managed and reported, adequately protecting the value of the company and the shareholder's investment.

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DIRECTORS AND OFFICERS MAY FACE UNINSURED LIABILITY FOR FAILURE TO DISCLOSE ENVIRONMENTAL LIABILITIES

Scott D. Deatherage

Officers and directors face a variety of risks of incurring personal liability. The large number of shareholder suits that are filed every year alleging failure of the officers and directors to disclose properly the financial condition of their companies coupled with the increased stringency of financial disclosure requirements imposed by the Sarbanes-Oxley Act, creates a heightened level of concern for officers and directors who oversee financial disclosure. To address these risks, companies typically purchase insurance policies (D & O policies), which typically contain exclusions for claims based on environmental matters. The scope of these exclusions, specifically the extent to which these exclusions can be read to address shareholder claims for alleged failure to disclose potential environmental risks and liabilities of the company to shareholders, is an increasingly important issue for directors and officers and their companies.

This question was the subject of recent opinions by the Fifth and Sixth Circuit Courts of Appeal. Although the two courts arguably reached differing conclusions as to whether environmentally-related exclusions apply to shareholder claims, read together against the backdrop of the state laws that each court applied and the specific language of two different exclusions involved in each case, the two opinions might provide a preliminary road map for evaluating these types of coverage issues.

The Sixth Circuit, applying Ohio law, held that an asbestos exclusion was not clear enough to exclude claims based on financial disclosure of company liability for asbestos claims. The court reasoned that the asbestos issues were too removed causally from the alleged financial misrepresentation. The Fifth Circuit applied Texas law and held that a broad pollution exclusion did not cover the alleged failure of the officers and directors to disclose potential environmental liabilities known to the officers and directors. The apparent divergence in the opinions resulted in part from the differences in the language used in each exclusion. The pollution exclusion construed by the Fifth Circuit used terms such as "directly or indirectly" and specifically referred to claims alleging damages to the company or its securities holders. The asbestos exclusion, construed by the Sixth Circuit, did not. The Sixth Circuit opinion may suggest some protection may be afforded under

D & O policies for suits alleging improper disclosure regarding asbestos litigation under the wording of the particular policy. The Fifth Circuit case illustrates a risk to officers and directors and their companies that they may not be effectively insured from liability under D & O policies from shareholder litigation alleging improper or insufficient environmental disclosure.

In the Sixth Circuit case, *Owens Corning v. National Union Fire Insurance Co. of Pittsburgh, PA.*, No. 97-3367, 1998 WL 774109 (6th Cir. Oct. 13, 1998), the court concluded that the asbestos exclusion in the D & O policy obtained to protect the officers and directors of Owens-Corning and the company itself did not exclude coverage for shareholder derivative claims for misrepresentation of or failure to disclose the potential liability of the company for asbestos-related claims. The underlying claim in the *Owens Corning* case involved shareholder assertions that the officers and directors failed to disclose adequately and misrepresented the potential liability of the company for asbestos litigation. The alleged misrepresentations focused on notes in the financial statement on contingent asbestos litigation liabilities. The class action lawsuit was settled for almost $10,000,000. *Id.* at *2.

The court's analysis focused on whether the exclusion, which clearly excluded claims for liabilities directly caused by asbestos exposure, was broad enough also to preclude claims for misrepresentation of or failure to disclose the liability for those claims. The district court had ruled that the claims relating to financial disclosure of asbestos liability were excluded from coverage under the National Union D & O policy.

The Sixth Circuit did not agree. The court analyzed the exclusion under Ohio law, which the court held provided for a narrow construction of insurance policy exclusions. The court interpreted Ohio law to require that the exclusion be "specific, clear, and exact." This turned out to be a very strict test, as applied by the Sixth Circuit. The critical question was whether the claims for inaccurate financial disclosure of asbestos liability were "based upon, arising out of, or related to" asbestos, use of asbestos or asbestos products liability claims. *Id.* at 4. The court's opinion defined these three terms.

First, the court concluded that the class action suit was not "based upon" the use of asbestos or any product liability issue, but was a claim regarding financial disclosure. *Id.* Second, as for "arising out of" products liability for asbestos products, the court reviewed Ohio law and concluded that there must be a direct causal relationship between the initial event and the damages claimed. In the context of a claim based on financial disclosure, the court determined that the asbestos use or injury were too distant from the alleged wrongdoing for the financial disclosure claim to be deemed to arise out of the asbestos activity of the company. The court ruled that it was the misrepresentations – and not the asbestos products – that were the cause of the harm the plaintiffs alleged. *Id.* at *4-5. Third and finally, the court ruled that the claims did not "relate to" asbestos matters. Since the business of Owens Corning primarily involved asbestos, if all shareholder derivative claims related to asbestos were excluded, the court reasoned then that the policy would effectively exclude all shareholder claims. The court believed this result would be inconsistent with the intent of the policy. *Id.* at *5.

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), the Fifth Circuit ruled that a director and officer insurance policy effectively excluded claims filed by shareholders against directors and officers alleging they failed to disclose environmental liabilities in filings with the Securities and Exchange Commission and in press releases. In this case, the company and its directors and officers sought to reverse a declaratory

judgment issued by the federal district court that the pollution exclusion in the company's D & O insurance policy excluded any claims filed by shareholders against the directors and officers alleging that the stock price of the company had fallen when previously undisclosed environmental liabilities of the company became known to the public.

In the underlying lawsuits, the plaintiff shareholders alleged U.S. Liquids had acquired other waste management businesses without regard to their environmental liabilities and without disclosing the environmental practices or liabilities of these companies to shareholders. *Id.* at *3-4. An FBI investigation of operations of one of the acquired companies discovered what the government alleged was the knowing discharge of hazardous wastes into a city sewage system and the knowing illegal transport and disposal of hazardous waste. This investigation led to an expensive cleanup and the closure of one of the acquired company's waste management facilities. *Id.* at *5. The shareholder plaintiffs alleged the directors and officers actively concealed the illegal activities of the acquired company from the shareholders and the public. When this information became known to the public, the price per share of U.S. Liquids fell $10.75. Trading of the company's stock was halted for six days and analysts downgraded the rating of the stock. *Id.*

In interpreting the pollution exclusion under Texas law, the Fifth Circuit noted that it applied to any loss in connection with a claim "alleging, arising out of, based upon, attributable to, or in any way involving, directly or indirectly" pollution matters. *Id.* at *2-3. The exclusion specifically stated "including but not limited to a Claim alleging damage to the Company or its securities holders." *Id.* at *3. In particular, the court cited Texas case law holding that the exclusion in an insurance policy "need only bear an incidental relationship to the described conduct for the exclusion to apply." *Id.* at *8.

The court applied a "but for" test, and concluded that "but for" the underlying illegal activities related to pollution, there would be no shareholder claims against the officers and directors. *Id.* at *17.

Taken together, the *Owens Corning* and *U.S. Liquids* cases highlight the importance to officers and directors of understanding their obligations to review and disclose environmental liabilities of the public companies they manage. Not only are companies and their officers and directors potentially exposed to claims for failure to make proper environmental disclosure, but if the D & O policies contain broadly-worded pollution exclusions, particularly in jurisdictions in which such exclusions are loosely construed, the officers and directors, and any company that is obligated to indemnify its officers and directors, may be exposed to an uninsured risk. If coverage is not included in the policy, is ambiguous, or is otherwise a concern, the company may want to consider evaluating additional insurance or endorsements to existing policies to protect the officers and directors in the event a claim is asserted relating to environmental disclosure.

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GAO ISSUES REPORT ON ADEQUACY OF ENVIRONMENTAL DISCLOSURE IN SEC FILINGS AT A SYMPOSIUM SPONSORED BY SENATORS CORZINE, LIEBERMAN AND MCCAIN

Lesley C. Foxhall, Thomas M. McMahon and Jeffrey A. Smith

On July 15, 2004, the Government Accountability Office (the new name of the General Accounting Office, GAO) released a report entitled *Environmental Disclosure – SEC Should Explore Ways to Improve Tracking and Transparency of Information* (available at www.gao.gov/new.items/d04808.pdf). The report was released during a well-attended congressional symposium entitled, "Coming Clean: Corporate Disclosure of Environmental Issues in Financial Statements," held in Washington, D.C.. The event was sponsored by Sen. Jon S. Corzine (D-NJ) and other members of Congress, including Sen. John McCain (R-AZ) and Sen. Joseph Lieberman (D-CT), among others. The symposium featured remarks from: John Stephenson of GAO; SEC Commissioner Roel Campos; Steven Shimberg, EPA; Dale McCormick, Treasurer, State of Maine; corporate governance expert Nell Minow; and Steve Lydenberg, Chief Investment Officer, Domini Social Investments. Sen. Corzine and Rep. Donald M. Payne (D-NJ) made opening remarks, and Michelle Chan-Fishel from Friends of the Earth (FoE), moderated the program. The report and the symposium remarks are each summarized below.

The Report

The report concluded that "little is known about the extent to which companies are disclosing environmental information in their filings with the SEC." Accordingly, "the adequacy of SEC efforts to enforce compliance with environmental disclosure requirements cannot be determined without better information on the extent of environmental disclosure." On the basis of the record before GAO, "one cannot determine whether a low level of disclosure means that a company does not have existing or potential environmental liabilities … or is not adequately complying with disclosure requirements."

The report also found:

- "Stakeholders [mainly investor and environmental groups, and the reporting corporations themselves] disagree about how well the SEC has defined environmental disclosure requirements." Certain investor organizations "maintained that the requirements allow too much flexibility and are too narrow in scope to capture important environmental information." Other stakeholders stated "that companies need flexibility to accommodate their individual circumstances."

- The SEC does not systematically track environmental issues and thus does not have the information needed to analyze the frequency of problems, identify trends, or identify areas in which additional guidance would be warranted.

- GAO identified four enforcement cases related to inadequate environmental disclosure since 1977.

- The SEC and EPA have made "sporadic" efforts to coordinate on improving environmental disclosure.

- GAO reviewed 27 previous studies and papers dealing with the adequacy of environmental disclosure and found all to have "severe" to "strong" methodological limitations.

- Concern about the adequacy of disclosure relating to climate change issues was evidently one of the prime

reasons for the GAO inquiry. In a section dealing primarily with electric utility companies, the report states that the SEC's Division of Corporate Finance takes the position that "…disclosures about the impact of potential greenhouse gas controls are not necessarily required at this time… [although] there may be circumstances in which a company … must disclose it in the filing." The report went on to note that 19 of 20 utility companies surveyed had made greenhouse gas disclosures in their filings, but "the amount and type of information disclosed varied widely."

- A panel of experts made suggestions for improving environmental disclosure in three broad categories: modifying disclosure requirements; increasing oversight and enforcement; and adopting non-regulatory *(e.g.*, voluntary) approaches.

Based on the foregoing, the report makes three recommendations. First, that the SEC track the information arising from its reviews of company filings. Second, that the SEC explore the creation of a database of SEC letters commenting on companies' filings and company responses that would be accessible to the public. Finally, that the SEC and EPA improve coordination to ensure that the SEC takes better advantage of EPA data that may be relevant to environmental disclosure. (As discussed below, the SEC and EPA generally agreed with the recommendations.)

The Symposium

John Stephenson, Director of the Natural Resources and Environment Division, GAO

Stephenson summarized the scope, methodology, conclusions and recommendations of the report. He explained that it is the response to a request from Senators Jeffords (I-VT), Lieberman (D-CT), and Corzine that GAO determine: (1) key stakeholders' views on how well the SEC has defined the requirements for environmental disclosure, (2) the extent to which companies are disclosing environmental information in their filings with the SEC, (3) the adequacy of the SEC's efforts to monitor and enforce compliance with the disclosure requirements, and (4) what actions experts suggest for increasing and improving environmental disclosure.

With respect to the first objective (determining stakeholders' views on how well the SEC has defined the requirements for environmental disclosure), GAO interviewed investor organizations, financial services institutions, environmental groups and consultants, business associations, credit rating agencies and public accounting firms. Not surprisingly, GAO found that key stakeholders disagree on how well the SEC has defined the requirements for environmental disclosure. This finding mirrors the debate in the marketplace and among commentators that has intensified over the past five years.

As to the second objective (obtaining information on the extent to which companies are disclosing environmental information in their filings with the SEC), GAO noted it is "extremely challenging" to assess the adequacy of environmental disclosure. GAO did review 27 studies conducted from 1995 to 2003 that attempted to assess disclosure. While most of the studies concluded that environmental disclosure was inadequate, all had strong to severe methodological limitations, according to GAO. Stephenson noted that 12 of these studies did not meet GAO standards and were therefore not considered. The 15 remaining studies also contained strong limitations and produced "mixed results."

To supplement its review of these existing studies, GAO also examined disclosures

relating to impacts of potential controls on greenhouse gas emissions made by 20 U.S. electric utilities with relatively high emissions of carbon dioxide. According to Stephenson, 19 of these 20 utilities made disclosures regarding greenhouse gas controls in SEC filings. Stephenson noted, however, that the amount and type of information disclosed varied significantly. He also suggested that the failure to make disclosures about the impact of potential greenhouse controls is not "illegal," because such controls do not appear imminent at the federal level through ratification of the Kyoto Protocol or legislation.

With respect to the third objective (SEC oversight and enforcement), Stephenson noted that without better information on the extent of environmental disclosure and the results of SEC's reviews of companies' filings, the adequacy of the SEC's efforts to monitor and enforce compliance with environmental disclosure requirements cannot be determined. According to Stephenson, the SEC questioned the usefulness of EPA data because it is facility specific and the SEC could not readily identify the parent *(i.e.*, reporting) company.

With regard to the fourth objective of the report (determining what actions experts suggest for increasing and improving environmental disclosure), GAO surveyed thirty experts who use disclosure information, including representatives of the accounting and auditing profession, environmental consultants and attorneys, investment and financial services, the insurance industry, environmental interest groups, public employee pension funds, and credit rating agencies. Stephenson observed that the experts' suggestions primarily fell into three categories: (1) modifying the disclosure requirements and improving guidance for reporting entities, (2) stepping up SEC's monitoring and enforcement of existing requirements, and (3) adopting nonregulatory approaches to improving disclosure.

According to Stephenson, GAO has concluded that it needs more information to determine whether the disclosure of environmental information in financial statements is inadequate. GAO, as Stephenson put it, has "just scratched the surface" of this issue.

Commissioner Roel Campos, SEC

SEC Commissioner Roel Campos declared that the SEC is "very happy" that this study was conducted by the GAO and that the SEC is "concerned" about the adequacy of disclosure concerning environmental risks. He also indicated that "GAO has our ear" on this issue.

Campos agreed that there are many different views on what information should be disclosed. By way of background, Campos noted that the SEC regulations require companies to disclose "material" facts. According to Campos, the definition of "materiality" is inherently elusive. He also made the point that the SEC's actions are circumscribed by the provisions of the securities statutes and that the SEC must evaluate environmental disclosures within that context. An article in the July 16, 2004 issue of the *Wall Street Journal* covering the symposium reported that Campos stated that the SEC "hasn't seen any evidence of" environmental liabilities being hidden from investors, which "statutorily it must have in order to justify tightening the regulations." This version of one of Campos' remarks seems to understate the SEC's willingness to look for new solutions, as reflected in the totality of the SEC's reactions to the report.

For example, in response to Stephenson's comments, Campos noted that the SEC is already working to implement the recommendations in the GAO report. According to Campos, the SEC has started to track its reviews of company filings so that trends can be identified. He said it will also post its comment letters and company responses on a publicly accessible Web site.

He also noted that SEC agrees that it needs to cooperate with EPA to better take advantage of EPA data relevant to environmental disclosure. According to Campos, the SEC would like to "formalize" such cooperation. Campos noted that the SEC welcomes new data and studies relating to environmental issues, stating that the SEC is dependent on "external sources" for information relating to the adequacy of companies' environmental disclosures.

During the question-and-answer session, a representative from the Rose Foundation for Communities and the Environment asked what steps the SEC would take to investigate the problems identified by the experts that were interviewed by GAO. The questioner noted, for instance, that the GAO report indicates that a high percentage of experts questioned the adequacy of current SEC guidance in the area of environmental disclosure. Stephenson suggested that the experts' opinions were basically reflective of the organizations they represented. Accordingly, Stephenson said that he "wouldn't take too much stock" in the percentages of experts who questioned the adequacy of the SEC guidelines. Campos noted that the GAO report demonstrated the polarity of expert opinion on this issue, but he suggested that the SEC would work with GAO to address these concerns.

Steve Shimberg, Office of Enforcement and Compliance Assurance, EPA

According to Steve Shimberg, Associate Administrator of EPA's Office of Enforcement and Compliance Assurance, EPA "thinks the GAO report makes good recommendations." Shimberg noted that, in EPA's view, companies' disclosure of environmental risk improves their compliance with environmental laws and regulations.

Shimberg said that EPA is working to figure out how to share its data more effectively with the SEC, and that EPA and SEC representatives will be meeting in the near future to discuss this issue. During the question-and-answer session, though, Shimberg noted that much EPA data is site-specific, and would need to be aggregated and compiled at the corporate level in order to provide meaningful information for investors. He suggested that data at the level of the corporation could be collected, but he did not say that EPA would undertake this task.

Dale McCormick, Treasurer, State of Maine

Dale McCormick, Treasurer for the State of Maine, offered an institutional investor perspective. She indicated that the corporate scandals in the past few years have been a "wake up" call, but noted that institutional investors, because of their size, cannot simply disinvest in companies with potential environmental liabilities.

McCormick declared that institutional investors need to know at what point, and to what degree, companies in their portfolios are impacted by climate change-related risk. She said that companies need to assess and disclose climate change risk "as empirically as possible." McCormick focused on the regulatory risk arising from climate change, contending that many companies, particularly power companies, will need to make capital expenditures to lower their carbon dioxide emissions.

While McCormick acknowledged that many companies are beginning to disclose risk relating to climate change, she said that most companies fail to elaborate on or analyze that risk. She claimed, for example, that American Electric Power notes in its financial statements that climate change is a risk, but it fails to provide any further information about that risk.

She focused on a statement in the GAO report suggesting that "disclosures about the impact of potential greenhouse controls are not necessarily required at this time … because

controls do not appear imminent at the federal level through ratification of the Kyoto Protocol or legislation." According to McCormick, this assertion reflects "short-term thinking" that needs to be changed.

According to McCormick, institutional investors need help from SEC in the area of climate change disclosure. McCormick said that SEC needs to clarify that the Management's Discussion and Analysis should include "pithy information" relating to climate change risk. She also called on institutional investors to push companies to disclose more information about this risk. She warned that institutional investors "will not go away."

Nell Minow, Editor, The Corporate Library

Nell Minow, editor of The Corporate Library, an independent corporate governance research firm, noted that companies feel they are required by their fiduciary duties to their shareholders to externalize their costs to the extent feasible. According to Minow, this desire to externalize is reflected in companies' inadequate discussion of environmental issues in their financial statements.

Minow noted that inadequate environmental disclosure results in micro- and macro-effects. With respect to micro-effects, she noted that the lack of disclosure can lead an investor to incorrectly assess a particular company's risk. On this issue, Minow recommended that the audience read *Fooling Investors & Fooling Themselves: How Aggressive Corporate Accounting & Asset Management Tactics Can Lead to Environmental Accounting Fraud* (available at www.rosefdn.org/fooling.pdf), a report prepared by the Rose Foundation for Communities and the Environment that was also released at the symposium. With respect to macro-effects, Minow indicated that inadequate environmental disclosure prevents the public from having a global balance sheet.

Steve Lyndenberg, Chief Investment Officer, Domini Social Investments

Steven Lyndenberg, the chief investment officer at Domini Social Investments, suggested that reporting socially responsible corporate information should be mandatory. He indicated that other countries have already made progress in this area. Lyndenberg noted, for instance, that the United Kingdom is about to pass a revision to the Model Company Act, which will require companies to report material environmental information. Additionally, corporate boards are being directed to develop skills to assess environmental risk. He also noted that, in France, legislation was passed in 2001 that required publicly-owned companies to disclose socially-responsible and environmental information relating to 40 different indicators, and that compliance is at about 69 percent. Lyndberg predicted that such reporting increasingly will be required by other countries as well.

Friends of the Earth

Copies of FoE's latest report on corporate environmental disclosure: "Third Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemical, and Utilities Companies" (available at www.foe.org/camps/intl/corpacct/wallstreet/secsurvey2004.pdf) were made available to the audience.

Lesley C. Foxhall is an associate with Sidley Austin Brown & Wood; Thomas M. McMahon is co-chair of the Special Committee on Environmental Disclosure and a retired partner of Sidley & Austin; and Jeffrey A. Smith is co-chair of the Special Committee on Environmental Disclosure and a partner with Cravath, Swaine & Moore. The views expressed do not necessarily reflect those of the authors' firms.

INFORMATION ABOUT HOW TO JOIN THE COMMITTEE

If you have any interest in the subject of environmental disclosure, please join the Special Committee on Environmental Disclosure. The only prerequisites are that you be a member of the ABA and of the Seciotn of Environment, Energy, and Reosurces (you do not have to be a lawyer). To join, you may go to the following Web page: www.abanet.org./environ/committees/signup.html.If you have any problems, or if you have any questions about the Special Committee, please contact our membership vice chair: Fern Fleischer Daves, Environmental Counsel, ITT Industries by phone at (914) 641-2148 or e-mail at Fern.Daves@itt.com.

THE COMMITTEE'S WEB SITE AND LIST SERVE

The Special Committee on Environmental Disclosure's Web site has a goal of providing both a place for "where to start your research" links and materials to update and explain the background and current developments in environmental disclosure responsibilities. We now have the Primer, a modified and updated "PowerPoint" and a new Links page up on the site. The Links page in particular provides a brief explanation of just what to expect to find at each of the sources/sites provided.

Please send us suggestions on additional sources for information on environmental disclosure responsibilities and for tracking this developing field. We'll review them and merge them into the current structure. Similarly, suggestions on material which should be available on the site are greatly appreciated.

The list serve, addressable by sending e-mail to ENVIRON-ENVIRON_ DISCLOSURES@MAIL.ABANET.ORG, is open to members of the Special Committee on Environmental Disclosure, who are interested in engaging in discussion of the problems and issues involved in disclosure and reporting. This list serve is not open to the general public. Section members can join the Special Committee on Environmental Disclosure using the sign-up page at www.abanet.org/environ/committees/signup.html on the Section Web site or by sending a request to the Section's staff.

John Tatum, the Technology vice chair, can be reached via www.tatum.com or at 4931 Ranch Lane, Bloomfield Hills, MI 48302

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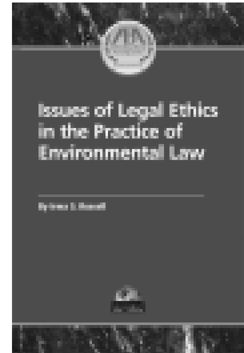
Issues of Legal Ethics in the Practice of Environmental Law by Irma S. Russell



This new book is an essential guide for every environmental lawyer on representing industrial clients, government agencies, individuals, and public interest groups. It focuses primarily on the rules of ethics that raise significant concerns for the environmental practitioner. A proactive approach to ethics helps lawyers avoid problems by making reasoned decisions before ethical problems arise in urgent or complicated context. This book helps you anticipate and analyze these difficult ethics issues. This book also examines the American Bar Association's Model Rules of Professional Conduct (Model Rules), judicial decisions, formal and informal ABA Opinions, and opinions of state boards of professional responsibility. Contents Include:

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