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Disclosing Environmental Liabilities in the Wake Of Sarbanes-Oxley

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Although the Securities and Exchange Commission (SEC) has required disclosure of environmental costs and liabilities for at least 20 years, recent legal and political developments have prompted public companies to devote greater attention to environmental disclosure. In particular, the much-discussed Sarbanes-Oxley Act of 2002, new rules the SEC has promulgated, new ASTM standards for disclosing and estimating environmental liabilities, and increased public scrutiny of corporate governance and disclosure issues, have induced companies to reexamine their procedures for quantifying and disclosing potential environmental liabilities. This article revisits existing SEC requirements for environmental disclosures, and examines how their interpretation and implementation are changing after Sarbanes-Oxley.

Sarbanes-Oxley – The Congressional Response to Calls for Corporate Accountability

Sarbanes-Oxley requires certifications from the highest corporate officers as to the accuracy of each substantive SEC filing by public companies. It also requires CEOs and CFOs to certify that they personally reviewed their companies' controls and procedures to identify, quantify and disclose material changes in financial conditions and results of company operations, including expectations of future performance. CEOs and CFOs must certify, for example, that: (1) they are responsible for establishing and maintaining a system of disclosure controls and procedures that is designed to ensure that information required to be disclosed in SEC filings is recorded and reported in a timely manner; and (2) they have evaluated the effectiveness of these controls within the 90-days preceding the report and provided any conclusions with respect to that evaluation in the report. To implement these requirements, the SEC has adopted new regulations which direct public companies, for example, to adopt and maintain controls and procedures to ensure adequate and timely financial disclosures.

Sarbanes-Oxley also required promulgation of new federal standards of conduct for attorneys "appearing and practicing before the SEC." These new standards, issued in January 2003 and codified at 17 CFR Part 205, apply broadly, including to any attorney advising a public company whether or not to disclose issues to the SEC. The standards include requirements for "up the ladder" reporting of material violations of securities regulations, "whistleblower" protections, and SEC enforcement sanctions.

SEC Requirements for Disclosure of Environmental Liabilities: A New Approach to Old Rules?

Sarbanes-Oxley's focus on disclosure controls and procedures, and its new standards of personal accountability for senior executives and counsel, are causing public companies to reevaluate their procedures for estimating and disclosing environmental compliance costs and liabilities. The duty to disclose generally pertains only to those costs and liabilities that are "material." The SEC has explicitly warned companies that there is no *quantitative* threshold for materiality, stating that the test is whether the information would alter a reasonable investor's view of the company. At least with respect to enforcement actions, SEC guidance indicates that the materiality threshold may be lower for environmental than for other matters.

At present, the specific SEC rules governing disclosure of environmental costs and liabilities are, briefly, as follows:

– *Item 101 of Regulation S-K* requires a company to disclose *material* effects of compliance with environmental laws that have been "enacted or adopted."

– *Item 103 of Regulation S-K* requires a description of "any *material* pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party." Environmental litigation is categorically not "ordinary" or "routine." Item 103 also requires disclosure of any enforcement proceedings that reasonably may be expected to result in sanctions of $100,000 or more, *regardless of whether the company considers it material*. In evaluating the materiality of Superfund claims, companies should review carefully Staff Accounting Bulletin No. 92 (SAB No. 92), which provides specific guidance on whether and how to account for offsetting contributions from insurers and from other "potentially responsible parties" or "PRPs."

– *Item 303 of Regulation S-K*, entitled Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A), contains a general requirement to disclose "any known trends, demands, commitments, events or uncertainties" that are reasonably likely to have a *material* effect on a company's "financial condition or results of operation." Item 303 requires companies to assess the likely *future* consequences, for example, of impending new environmental costs or liabilities. Specifically, disclosure is required if management cannot determine that (i) the trend or event is not reasonably likely to occur; and (ii) such trend or event is not reasonably likely to be material.

While these reporting rules have been in place for years, the passage of Sarbanes-Oxley and its new implementing regulations are altering the context for the rules' interpretation. Companies now are on notice that they should be able to point to an established protocol for identifying, tracking, quantifying, and assessing the materiality of environmental matters. In addition, environmental activists and "socially responsible" investment funds are surveying the MD&A sections of companies' annual reports, and they are publishing

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differences they find in the extent to which companies disclose, for example, the potential effects that climate change legislation and regulations may have on future operating results.

The New ASTM Standards: More Accurate Disclosure or Just More Disclosure?

In March, 2002, the American Society of Testing and Materials (ASTM) adopted two new standards for estimating and disclosing environmental liabilities. A pending rulemaking petition by a coalition of charitable foundations and "socially responsible" investment funds has urged the SEC to adopt these standards as regulations. According to the petitioners, adoption of the ASTM standards would remedy two current sources of underreporting of environmental liabilities: (1) claims that environmental costs are not readily estimable due to associated uncertainties; and (2) evaluation of the materiality of environmental costs and liabilities on an individual, as opposed to an aggregate, basis.

The ASTM estimation standard (ASTM E 2137) is intended to provide uniform methods for estimating economic expenses, accrued liabilities, and loss contingencies arising from environmental matters. The standard describes four cost estimation methods and how and when to use each. The four approaches, presented by ASTM in order from "most preferred" to "least preferred," are: (1) *"Expected Value" Approach*, which calculates the probability-weighted average of costs over the range of all possible outcomes; (2) *"Most Likely Value" Approach*, which represents the cost of the scenario believed to be most likely to occur; (3) *"Range of Values" Approach*, which develops a range of values without probabilities, where probabilities for various outcomes cannot be determined; and (4) *"Known Minimum Value" Approach*, which identifies only those costs that are reasonably certain to be incurred.

In essence, the ASTM estimation standard proposes a hierarchy of approaches based upon the quality and quantity of data available. The standard explicitly provides for quantification of a potential loss even if the magnitude and probability of the outcome are difficult to predict. If adopted, therefore, the ASTM standard may change current accounting standards, including the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 5, which requires recognition of a potential loss only if it is both "probable" and "reasonably estimable."

The ASTM disclosure standard (ASTM E 2173), which is intended to apply to MD&A, would require companies to consider the financial impact of all environmental liabilities. The standard provides, "Disclosure should be made when an entity believes its environmental liability for an individual circumstance *or its environmental liability in the aggregate* is material." Whenever a company's environmental liabilities in aggregate are material, ASTM E 2173 would impose certain minimum disclosure requirements, including: (1) the number of sites for which the company has been named as a PRP and the number of claims, suits, actions, demands, requests for payment, notices, or cases that have been presented to the company; (2) an estimate of the company's environmental liabilities and a description of the approach used to estimate those liabilities; (3) the cost estimation methodology employed by the company for accrued liabilities; (4) a characterization of any

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material loss contingencies; and (5) the nature and terms of cost-sharing arrangements with other PRPs.

The ASTM disclosure standard could increase dramatically the scope and detail of a public company's environmental disclosures. The standard's mandates of an "all in" aggregate trigger for materiality, disclosure of cost-sharing agreements, and specification of estimation methodology diverge substantially from existing SEC disclosure requirements.

Conclusion

Sarbanes-Oxley and the SEC's implementing regulations require public companies to adopt, implement, and certify to the existence of internal procedures adequate to identify and accurately disclose material changes in financial conditions and results of company operations, including expectations of future performance. These new rules apply equally to material environmental costs and liabilities.

The specific steps that a company should take to ensure that it has adequate internal procedures to estimate and disclose environmental costs and liabilities may vary significantly depending on the size of the company, the nature of its business, the scope and complexity of its environmental compliance responsibilities, and its financial condition.

In developing a process that fits its specific needs, however, companies should consider: (1) delegating specific responsibility for identifying and documenting emerging trends in environmental regulation or enforcement that may have a material financial impact on the company's operations; (2) establishing a method for evaluating potential environmental liabilities in threatened or pending enforcement and litigation matters, including those involving state and federal "Superfund" sites; and (3) involving senior management in evaluating information concerning potential compliance, enforcement, clean-up, and other environmental costs and liabilities. Development of an appropriate process will require substantial prior input from, and communication among, environmental professionals, legal counsel, and business unit managers to identify potential costs and liabilities, determine the extent to which they can be estimated, summarize the results, and obtain peer review of information for inclusion in a formal disclosure.

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