

ENVIRONMENTAL FINANCIAL DISCLOSURES

PUBLIC DISCLOSURE OF ENVIRONMENTAL LIABILITIES AND THE POTENTIAL IMPACT OF GLOBAL WARMING

*By Michael David Lichtenstein**

The Securities Act of 1933¹ and the Securities Exchange Act of 1934² require publicly traded companies to disclose material financial and non-financial information to the public. As the United States' capital markets have grown during the past two decades, the United States Securities Exchange Commission (SEC) has applied increased scrutiny to the environmental disclosures contained in public filings. Activist groups, shareholders, and other actual or potential investors have also increased their awareness of disclosure obligations and companies' compliance (or lack of compliance) therewith.

ENVIRONMENTAL DISCLOSURES

In 1982, the SEC integrated all of its regulations regarding what information public companies must disclose in their public filings into one omnibus regulation: Regulation S-K.³ Sections 229.101⁴ (Item 101), 229.103⁵ (Item 103) and 229.303⁶ (Item 303) of Regulation S-K require environmental disclosure of material effects on a public company of (1) environmental compliance; (2) legal proceedings; and (3) overall financial condition. An effect is "material" if the omitted fact "would have assumed actual significance in the deliberations of the reasonable shareholder."⁷ This definition is often referred to as the "reasonable investor" standard.

Specifically, Item 101 requires companies to disclose the material effects of compliance with federal, state and local environmental provisions on capital expenditures, earnings and competitive position. Item 103 re-

* *Michael David Lichtenstein is a Member of Lowenstein Sandler PC where he is Co-Chair of the firm's Insurance Practice Group and a founding member of its Climate Change Practice Group. Mr. Lichtenstein represents business and industry in civil litigation involving a variety of issues and problems including environmental, insurance recovery, bankruptcy and commercial litigation. Mr. Lichtenstein can be reached by e-mail at mlichtenstein@lowenstein.com.*

1. 15 U.S.C. §§ 77 *et seq.*

2. 15 U.S.C. §§ 78a *et seq.*

3. Adoption of Integrated Disclosure System, 47 Fed. Reg. 11380 (1982).

4. 17 C.F.R. § 229.101.

5. 17 C.F.R. § 229.103.

6. 17 C.F.R. § 229.303.

7. *TSC Industries, Inc. v. Northway*, 426 U.S. 438, 449 (1976).

quires companies to describe material judicial or administrative proceedings arising from environmental regulations. Item 303 requires companies to identify known trends, commitments or uncertainties that may result in material changes to the companies' liquidity. This includes a discussion of information on any environmental matters that could materially affect the company's operations or finances now and into future years.

There is little debate that Regulation S-K has improved the quality of environmental reporting in the past twenty-five years. However, there is still a concern among investors and environmental groups that the disclosure requirements contain far too many loopholes permitting companies to omit details of environmental liabilities. The loopholes focus primarily on the interpretation of how much "certainty" is required before such an "effect" must be identified and disclosed and whether that effect can be properly "estimated" in financial terms.

For example, the Financial Accounting Standards Board (FASB) sets principles and standards for the accounting profession. The standards and principles are relied on by public companies and their auditors to determine when certain environmental liabilities must be publicly disclosed. FASB's Statement of Financial Accounting Standard No. 5 (FASB 5) establishes standards of financial accountings for loss contingencies. Under FASB 5, reporting of a loss contingency is required where available information "indicates that it is probable that an asset has been impaired or a liability has been incurred" and the "amount of the loss can be reasonably estimated."⁸

When a loss is "probable" is hardly a definitive concept, and has been the subject of great debate. For example, is a loss probable at the time of environmental contamination or at the time of governmental enforcement? Is receipt of a notice of potentially responsible party (PRP) status pursuant to federal environmental law sufficient to determine the probability of an environmental loss?⁹ Does a company have to disclose "likely" costs associated with its failure to comply with environmental laws?¹⁰

Reasonable estimation brings its own inherent uncertainties and room for maneuvering. There is remarkably little guidance on when an environmental liability is "capable" of reasonable estimation. FASB Interpretation No. 14, issued in 1976, entitled "Reasonable Estimation of the Amount of Loss," requires companies to place the estimated economic

8. FASB 5 at 5, ¶¶ 6, 8.

9. The SEC has determined that receipt of a notice of PRP status does not mandate reporting under Regulation S-K. *See* Securities Act Release No. 6835, 54 Fed. Reg. 22, 427, 430 n.30 (1989) (notice of PRP status alone does not provide a company with knowledge that it is the target of a government agency proceeding).

10. Both the federal courts and the SEC have said "yes." *See, e.g., Levine v. NL Industries*, 926 F.2d 199, 203 (2d Cir. 1991) and *In re Occidental Petroleum Corp.*, Exchange Act Release No. 16950, 20 SEC Docket 567, 570 (1980).

loss within a given range. If no amount in the estimated range is more likely than another, then the company must disclose the lowest estimate, and merely note that a higher cost is possible. If a company is incapable of providing even a range, then its obligation to disclose the potential liability is in doubt.

To help answer these difficult questions, the American Institute of Certified Public Accountants (AICPA) has issued comprehensive guidance on the disclosure of environmental liabilities. However, the guidance still relies on terms like “probable” and “reasonably probable.” The AICPA also offers guidance on the cost elements that should be included when estimating environmental liabilities. However, these elements provide tremendous latitude in the ability to estimate and the dollar amount of any estimation.¹¹

In sum, while a public company has a clear obligation to disclose material environmental liabilities, there has been and remains a clear risk that these disclosure obligations offer major flexibility for public companies and may, therefore, allow dramatic underreporting. In July 2004, the United States Government Accountability Office (GAO) (formerly the Government Accounting Office) reached just that conclusion in a report to Congress entitled “Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information.” On the other hand, the SEC does pay some attention to the decisions that companies make, and will bring enforcement actions when companies fail to properly disclose. For example, in November 2006, the SEC issued an administrative cease-and-desist order against a Fortune 500 company in connection with misstatements of the company’s environmental reserves.¹²

CLIMATE CHANGE

What the International Policy Network called a “myth” in November 2004¹³ is now accepted fact in most corners of the scientific community and the world.¹⁴ In the United States, the impact of global warming includes sea level rise, coastal erosion, flooding, reduced agricultural output, water scarcity, alternate energy production and demand, and more severe weather conditions. All of these will likely have major impacts of the economy and United States companies that operate within it.¹⁵

11. See AICPA, *Statement of Position 96-1: Environmental Remediation Liabilities*.

12. *In the Matter of Ashland Inc. and William C. Olatin*, SEC Release No. 54830, (November 29, 2006).

13. *The impacts of climate change: An appraisal for the future*, INT’L POLICY NETWORK (Nov. 9, 2004).

14. IPCC (*Intergovernmental Panel on Climate Change*) *Fourth Assessment Report: Climate Change 2007* (Feb. 2007).

15. U.S. Environmental Protection Agency, <http://www.epa.gov/climatechange/index.html> (last visited May 7, 2008).

In December 2007, the government of Indonesia hosted the United Nations Climate Change Conference which included participants from 180 countries. The conference culminated in the adoption of the Bali Roadmap, consisting of a number of forward-looking tracks to worldwide greenhouse gas emissions reduction. A major component of the Roadmap is the Bali Action Plan. The Plan authorized the creation of an Ad Hoc Working Group on Long-term Cooperative Action. The Ad Hoc Working Group will hold quarterly meetings in 2008 to negotiate the terms of an agreement on climate change issues. The first meeting was held from March 31- April 4 in Bangkok, Thailand.

The issues to be addressed include, among others, measurable, reportable and verifiable national commitments to quantified greenhouse gas emissions limitations and reduction objectives. The Ad Hoc Working Group will present its work product in 2009, when all countries will be expected to sign a binding agreement. Because the United States committed to the Bali Roadmap, there will be tremendous pressure on the United States to participate in whatever agreement the Working Group presents; participation will require implementing legislation if none exists beforehand.

In the absence of current federal legislation, the states have moved to fill the vacuum of climate change regulation. State action has been of two types - state legislation and regional initiatives. A good example of state legislation is the New Jersey Global Warming Response Act (Act).¹⁶ Signed into law on July 6, 2007, the Act establishes greenhouse gas emission reduction requirements in New Jersey to 1990 levels by 2020 and by eighty percent of 2006 levels by 2050. The Regional Greenhouse Gas Initiative (RGGI) is a good example of a regional initiative.¹⁷ RGGI is a cooperative effort by ten Northeast and Mid-Atlantic states to design and operate a regional cap-and-trade program covering carbon dioxide (CO₂) emissions from power plants in the region. Participating states include Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island, and Vermont. The initial auction of emissions credits is scheduled for as early as the fall of 2008.

While there are several competing bills in Congress, the bill with the greatest traction is sponsored by Senators Joe Lieberman and John Warner (S. 2191).¹⁸ The Lieberman-Warner Climate Security Act of 2007 (Lieberman-Warner Bill, or Bill), which reported out of the Senate Environment and Publics Works Committee on December 5, 2007, applies to

16. New Jersey Global Warming Response Act, N.J. STAT. ANN. § 26:2C-37 *et seq.*

17. The other regional initiatives are the Western Regional Climate Action Initiative (WCI), which includes Washington, Oregon, Arizona, New Mexico, California, Utah, and British Columbia, and the Midwestern Greenhouse Gas Reduction Accord (MGA), which includes Minnesota, Wisconsin, Illinois, Indiana, Iowa, Michigan, Kansas, Ohio, South Dakota, and Manitoba.

18. Other bills include Lieberman-McCain (S.280), Bingamen-Specter (S.1766), Feinstein-Carper (S.317) and Olver-Gilchrest (H.R. 620).

coal-burning power plants and industries, natural-gas processing plants and importers, petroleum- or coal-based fuel producers and importers, and facilities that produce or import (for sale) greenhouse gases such as sulfur hexafluoride or perfluorocarbons. The Bill establishes an economy-wide cap covering over eighty-seven percent of United States greenhouse gas emitters, with a goal of reducing greenhouse gas emissions “substantially enough between 2007 and 2050 to avert catastrophic impacts of global climate change.” The Bill proposes to regulate emissions of CO₂, methane, NO₂, sulfur hexafluoride, perfluorocarbons and hydrofluorocarbons, and sets emission reduction objectives for greenhouse gas emissions in 2012 to 2005 levels (5.775 billion tons CO₂ equivalents¹⁹) and in 2050 to 1.732 billion tons CO₂ equivalents (a seventy percent reduction from 2005). To achieve these results, the Bill establishes a national cap-and-trade system of emissions “allowances.”

CLIMATE CHANGE AND THE SEC

The SEC has neither taken a position on climate change risks nor issued an interpretive statement guiding public companies on how to address their disclosure obligations on the risks of climate change to the economics of their business. The issue, however, is front and center with public companies and their investors.

For example, on March 19, 2007, a group of major investors and public companies asked the SEC to clarify what information companies should be disclosing about the financial impact climate change may have on their businesses. The group included Alcoa, Inc., BP America, DuPont, and numerous pension funds and state treasurers including the California Public Employees Retirement System (CalPERS), the largest United States public pension fund.

The ambiguity surrounding the disclosure of environmental liabilities is even greater when deciding whether and what to disclose concerning the actual and potential impact of climate change. A quick look at Regulation S-K's Items 101, 103 and 303 makes the point.

Item 101 (Capital Expense & Loss)

The more certain the world becomes about the tangible impact of global warming, the greater the possibility that the anticipated impact on cost and loss must be disclosed. The most obvious example of this is asset impairment and actual anticipated losses due to severe weather and the resulting coastal erosion and flooding. These losses can come in the form of physical damage (think property damage in Hurricane Katrina) or asset impairment (think decreased value of investments in other companies with exposure to global warming risks).

19. A CO₂ equivalent has the same global climate change impact as one metric ton of CO₂.

Item 103 (Legal)

Here is an area where the impact of global warming should affect the nature of public disclosures. It is clear that a lawsuit against a public company, alleging damages relating to global warming, must be disclosed. However, what is a company to tell investors about lawsuits that do not involve them specifically, but potentially lead to devastating economic impacts?

In the last several years, numerous high profile lawsuits have been filed to either prevent the continued emissions of greenhouse gases or to seek damages for the results of those emissions. For example, in *Connecticut v. American Electric Power*,²⁰ a combination of states and land trusts sued large emitters of carbon dioxide in an effort to prevent the continuing impact of the emissions on several Northeastern states. In *Comer v. National Mutual Insurance Company*,²¹ individual victims of Hurricane Katrina, relying on a nuisance theory, sued oil companies, chemical companies and refineries alleging that greenhouse gas emissions from these facilities increased the damage caused by Hurricane Katrina. Neither of these cases has resulted in any liability to any company.

Of course, these cases involve only a specific number of companies. However, what may make the existence of this litigation material, and therefore subject to disclosure, is the far-reaching impact that a successful result by a plaintiff might have on the multitude of companies that are not defendants. Imagine the potential financial impact if the plaintiffs succeed in obtaining damages from companies because their greenhouse gas emissions are found to be material contributors to Katrina. Imagine the impact if northeastern states can shut down, or otherwise control the operations of power plants in the Midwest?

It is far from clear that these potential impacts are sufficiently related to any company not specifically involved as a defendant to require disclosure. However, using the reasonable investor standard as the touchstone for disclosure obligations, can a company with major greenhouse gas emissions legitimately say that its investors would not find this information “material” to their decisions to buy and sell company stocks or bonds? Speaking candidly, how many investors even know that a nuisance

20. 406 F. Supp. 2d 265 (S.D.N.Y. 2005).

21. 2006 WL 1066645 (S.D. Miss. Feb. 23, 2006). This putative class action was filed by Mississippi residents whose property was damaged by Hurricane Katrina, against three classes of defendants (1) an insurance defendant class alleged to have denied coverage for the damage; (2) a mortgage lending class alleged to have failed to obtain appropriate insurance coverage; and (3) a chemical manufacturing and oil company defendant class alleged to have contributed to global warming, thereby increasing plaintiffs' damages. In February 2006, the district court found the claims against the insurer and mortgage lender defendants did not merit class treatment, but allowed plaintiffs to file an amended complaint clarifying their claims against the chemical and refining defendants. In August 2007, the trial court dismissed plaintiffs' remaining claims, for lack of standing and because they were non-justiciable pursuant to the political question doctrine. An appeal to the Fifth Circuit is pending.

theory has the potential to have such a wide-ranging economic impact? How many investors know that it is even possible that the company in which they are investing may be held liable for the economic consequences of emissions in another part of the country or the world?

Item 303 (Trends)

Item 303 requires, in part, the disclosure of (1) known trends or any known demands, commitments, events or uncertainties that will result or that are reasonably likely to result in the company's liquidity increasing or decreasing; (2) material commitments for capital expenditures; (3) known material trends, favorable or unfavorable, in the company's capital resources; and (4) known trends or uncertainties that have or are reasonably expected to have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.²²

It is hard to imagine a global trend that may have a greater impact on a company's liquidity, capital expenditures, sales, and revenue than global warming. At the international level, it has been at least a decade since the vast majority of the world made global warming and the reduction of greenhouse gases a world priority. This trend has continued in the most recent round of talks that will lead to even more restrictive greenhouse gas (GHG) emission standards. At the federal level in the United States, the clear trend is toward a national standard of GHG emission reductions that will undoubtedly require the expenditure of billions of dollars for compliance. The states have already taken measures to require GHG emission reductions on a very aggressive timetable, with the first of these due to require the purchase of emission allowances as early as June 2008.

If the purpose of Item 303 is to help investors understand the relationship between past financial results and future results, a fair and open discussion of known trends is essential. In the area of climate change, that will require the disclosure of the possible regulatory and legal obligations that may face the company in the near and distant future, and an estimate of the potential economic impact that such regulations will have on future financial performance.

It is a fair question to ask whether an energy producer in one of the ten RGGI states can fail to disclose the possible implications of compliance. Virtually all companies must acknowledge the likelihood that some form of major federal regulation of GHG emissions is on the horizon. How can a company fail to acknowledge the likelihood that the price of electricity will surely go up, as the cost of producing electricity goes up? These concerns may also be disclosed under Items 103 and 303.

22. 17 C.F.R. § 229.303 (2007).

THE FUTURE OF DISCLOSURE REGULATION

Even if the SEC fails to act now, the pressure on public companies to make accurate disclosures of the impact of climate change and climate change regulation is great. For example, in September 2007, New York State Attorney General Andrew Cuomo began an investigation into whether certain utility companies should have disclosed whether plans to construct new coal-fired power plants carried financial risks from compliance with future climate change legislation. The focus of the investigation was whether the companies had provided enough information to investors about the potential financial liability of GHG emissions.²³

The Lieberman-Warner Bill requires the SEC to promulgate regulations that require public companies to inform investors of material risks relating to pollution emissions, and the economic impact of global warming.²⁴ The Bill also requires the SEC to issue an interpretive release providing that the United States' commitment to reduce global warming pollution is a "material effect" and that global warming constitutes a "known trend."²⁵

In September 2007, a broad coalition of investors, state officials and environmental groups filed a petition asking the SEC to require public companies to assess and fully disclose their fiscal risks from climate change and to closely scrutinize the adequacy of their climate disclosures under existing law.²⁶ The lead sponsor was Ceres, a national network²⁷ of investors, environmental organizations and other public interest groups working with companies and investors to address sustainability challenges such as global climate change. Ceres companies come in a range of sizes—multinationals to small operations—and a range of sectors involving financial services, manufacturers, electric power, retailers and technology companies. Members include American Airlines, Bank of America, Coca-Cola Company, Ford Motor Company, General Mills, Nike, Sunoco, Inc. and Time Warner.

Congress does not appear satisfied to wait until a bill is passed to require the SEC to act. In response to the September 2007 Ceres petition to the SEC, Senators Chris Dodd and Jack Reed sent a December 6, 2007 letter to the SEC urging the agency to provide guidance on climate change disclosures. The Senators were concerned that the public was not being provided with enough information about climate change: "We believe the SEC should issue definitive guidance in the form of an interpre-

23. Felicity Barringer & Danny Hakim, *New York Subpoenas 5 Energy Companies*, N.Y. TIMES, Sept. 16, 2007, available at http://www.nytimes.com/2007/09/16/nyregion/16greenhouse.html?_r=1&oref=slogin.

24. Lieberman-Warner Climate Security Act 2007, Section 9002 (Corporate Environmental Disclosure of Climate Change Risks). A copy of the bill can be found on Senator Lieberman's web site: <http://lieberman.senate.gov>.

25. *Id.*

26. A copy of the Petition can be found on the Ceres web site: <http://www.ceres.org>.

27. A complete list of Ceres companies can be found on the Ceres web site.

tive release to ensure greater consistency and completeness in disclosure of material information related to climate change and current and probable future governmental regulation of greenhouse gas emissions; provide information for registrants on whether and how to disclose such matters; and ensure that investors have access to material climate change information.”²⁸

CONCLUSION

Climate change disclosure issues are on the rise. Companies must be careful to evaluate all of the implications of climate change on the present and future performance of their business. Congress is increasing pressure on the SEC to carefully evaluate and review environmental and climate change disclosures. Perhaps more significantly, shareholders and other investors are, too.

28. The full text of the letter may be found on Senator Dodd’s web site: <http://dodd.senate.gov>.