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DISCLOSURE OF ENVIRONMENTAL LIABILITY IN SEC
FILINGS, FINANCIAL STATEMENTS, AND DEBT
INSTRUMENTS: AN INTRODUCTION

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I. INTRODUCTION

Since the flowering of environmental activism of the 1960's and the first Earth Day in 1970, there has been an unprecedented explosion of environmental regulation. Environmental issues have increasingly come to share center stage with other critical concerns confronting our society. Changing awareness and perceptions regarding the interrelationship between varying types of activities and their impact on the ecosystem which we inhabit have fostered broad political support for increasingly stringent environmental regulations. Environmental programs and requirements now exist at federal, state and local levels which broadly affect individuals, businesses and government. These programs and requirements influence a wide array of disparate activities ranging from the selection of raw materials and the management of wastes to the provision of safe drinking water and the recycling of household trash.

As the reach of environmental regulation has expanded and the sensitivity to environmental concerns has increased, the costs of compliance have multiplied. Employing sophisticated pollution control equipment, maintaining detailed operational records, undertaking enhanced monitoring procedures and satisfying complex permitting requirements are common examples of the types of demands confronting the regulated community. The costs of compliance, at least in the first instance, have fallen most heavily on businesses and industry.

By way of example, the 1990 amendments to the federal Clean Air Act ("CAA") represent one of the most complex and ambitious pieces of legislation in history. While a variety of requirements are specifically included in the amendments, the precise impact on the members of the regulated community in many instances will not be known until regulations implementing various statutory provisions have been promulgated. This process is likely to stretch into the

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next century. The costs of compliance in satisfying the mandates of the amendments will be significant with estimates ranging into the hundreds of billions of dollars.

Separate and apart from the broad sweep of environmental regulatory programs designed to prospectively minimize the environmental impact of ongoing activities, a number of programs are also now in place to address environmental threats posed by past activities associated with more than a century of industrial activity. Undoubtedly the most familiar of these programs is the federal Superfund program developed under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA"). The Superfund program is designed to facilitate the cleanup of sites posing a threat to human health or the environment as a result of the release or potential release of hazardous substances. Waste disposal sites, landfills, recycling facilities, abandoned dumps, factories, lagoons, drum storage areas, and a host of other types of facilities qualify as potential Superfund sites.

While the Superfund program may be the best known of the environmental cleanup programs, it is by far not the only such program. Many states have similar programs to supplement cleanup efforts resulting under CERCLA. Facilities that store, treat or dispose of hazardous wastes or have done so in the past may be independently subject to cleanup requirements emanating under the Resource Conservation and Recovery Act. Contamination resulting from leaking underground storage tanks must be addressed under the federal underground storage tank program and a host of analogous state programs.

The costs associated with cleanup activities can be staggering, often reaching tens and hundreds of millions of dollars at specific locations. Indeed, one estimate of the costs associated with cleaning up the nation's known waste disposal sites over the next thirty years exceeds \$750 billion. These costs are being spread to individuals, businesses and governmental entities which in some instances may only have a remote connection with the activities that created the wastes.

As environmental cleanup and compliance costs have grown, they have had a profound influence on balance sheets, profits, cash flow, and even the very ability of certain businesses to compete. The financial implications of environmental cleanup and compliance costs thus have become an increasing concern to investors, lenders, and other individuals and entities with a stake in the financial health of a particular enterprise. In addition, environmental

considerations have become a significant aspect of many real estate and business transactions.

With the growing financial impact of environmental cleanup and regulatory programs, the Securities and Exchange Commission ("SEC") has increasingly scrutinized the way and the degree to which information regarding environmental liabilities and costs is being disclosed to potential investors by companies subject to the SEC's jurisdiction. Certified Public Accountants ("CPAs"), investment bankers, borrowers, attorneys, and corporate officers and managers are wrestling with the thorny issue of how and when environmental liabilities and costs should be reported.

Concerns are being raised over the apparent lack of disclosure by companies, publicly held and otherwise. A provocative article appearing in the *Wall Street Journal* in 1988 entitled "Can \$100 Billion Have 'No Material Effect' on Balance Sheets? Huge Toxic-Waste Cleanup Will Burden Many Firms, SEC Questions Disclosure" highlighted the gulf between the costs for environmental compliance and cleanup being projected and those that historically have been disclosed in financial materials made available to potential investors.

At the heart of the matter is the perception that the numbers simply do not add up. If the estimated costs of environmental cleanup and compliance are as significant as many believe, then presumably many of those costs should be reflected in the disclosure statements of publicly-held companies. However, this has not been the case. For example, in a 1993 report to the House Energy and Commerce Committee, the General Accounting Office found that leading insurance companies have rarely disclosed the amount of their exposure for environmental liabilities despite their claims that such liabilities could bankrupt the industry. The report recommended that the SEC take steps to require insurance companies routinely to disclose both the number and type of environmental claims and the estimated costs associated with those claims.

Whatever the reasons for this apparent lack of disclosure, the SEC, the investment community, and even the courts are sending strong signals that it is not a situation which should be allowed to continue. Moreover, disappointed investors and/or the SEC may seek in the future to hold accountants, lawyers, and other professionals responsible for inadequate disclosure of environmental liabilities, thereby placing additional burdens on the accounting and securities professions to perform due diligence concerning the scope and magnitude of environmental liabilities. This potentially

could place professionals with expertise in the securities and financial fields in the center of a vortex of liability involving highly technical issues concerning environmental compliance, contamination and cleanup requirements.

II. PRACTICAL CONSIDERATIONS RELATING TO ENVIRONMENTAL DISCLOSURE

Assuming that environmental liabilities and compliance costs are being routinely underdisclosed, there are a variety of factors that may be contributing to this phenomena. A number of those factors are identified below.

First, the scope of environmental regulatory programs and environmental liability is continually shifting and generally expanding. Businesses may face large expenditures simply to remain in compliance with changing environmental regulatory requirements. The complex and stringent requirements imposed by the 1990 amendments to the federal Clean Air Act are illustrative of this consideration.

Second, deciphering what is necessary to achieve compliance may be difficult in certain circumstances. Many environmental regulatory requirements are quite complex and difficult to interpret, particularly in the context of the tremendous diversity of activities that they are designed to cover. The manner in which these issues are resolved can often have significant financial impacts on the members of the regulated community which are subject to such requirements.

Third, information concerning past waste disposal practices may be incomplete or lacking entirely. Accordingly, companies may face significant liabilities and yet be entirely unaware of the lurking danger to their financial well-being until receiving a notice from the U.S. Environmental Protection Agency ("EPA") or a state environmental regulatory agency.

Fourth, identifying with precision the magnitude of environmental contamination and associated cleanup needs is often extremely difficult if not impossible to accomplish. Contamination is frequently located in subsurface areas where it can only be characterized through extensive testing. Many types of contamination are not detectable except through sophisticated analytical methods. The way in which contamination migrates from source areas can be influenced by a wide variety of factors, some of which may not be recognized at all or well understood.

Fifth, uniform cleanup standards are often poorly defined or non-existent. In some instances, cleanup standards may be articulated in terms of general aspirations which may be neither technically nor economically feasible to achieve. Because cleanup standards typically establish the stopping points for remediation activities, where such standards do not exist or are not well defined, the ability to predict with precision the costs associated with cleanup is impaired.

Sixth, obtaining insurance coverage for environmental contamination caused by past activities is fraught with uncertainties. Insurance policies contain varying provisions which can influence the availability of coverage. Moreover, courts in different jurisdictions have reached contradictory results in interpreting identical provisions thereby making the availability of coverage somewhat dependent on jurisdiction.

Seventh, environmental compliance and cleanup costs may have varying effects on profits, cash flow and net worth. For example, mandatory environmental expenditures may severely impact the cash flow of a company over a short period of time without necessarily having the same degree of impact on the overall net worth of the company. Determining how to describe these disparate impacts thus may be difficult and hinder disclosure.

Eighth, where a business has failed to comply with environmental regulations, civil penalties and/or criminal sanctions generally may be imposed. Penalties can often be extremely large, with many of the environmental statutes authorizing civil penalties of up to \$25,000 per day per violation. Such liability may accrue in addition to cleanup and compliance costs.

Ninth, environmental liabilities are often extremely hard to extinguish. For example, under the Superfund liability scheme, a person who owned a site at the time wastes were disposed thereon can be held liable for cleanup costs even if he or she no longer owns the site or was even aware of the disposal activities at the time of ownership. Superfund liability has also been found to pass through to successor companies and corporations. Accordingly, a company may have acquired or retained an environmental liability in circumstances where other types of liability may have been extinguished.

Tenth, those responsible for preparing disclosure statements may have little familiarity with the intricacies of the environmental field. The technical and legal complexity of many environmental issues may tend to impede disclosure of environmental matters in

comparison with issues that are more commonly confronted in the financial arena.

Finally, environmental issues are still relatively new. In some instances in the past, they may have simply been overlooked. This should not be a factor in the future, however, given the heightened environmental awareness that many in the financial community are showing.

These considerations do not excuse the failure to disclose environmental liabilities in circumstances where disclosure is warranted and required. However, they may make disclosure more difficult in many instances and they may increase the risk that whatever is disclosed will later turn out to be inaccurate. At a minimum, matters of environmental disclosure are likely to require the use of a team approach involving accountants, securities attorneys, environmental consultants, and environmental attorneys to ensure that appropriate information is provided.

III. CONCLUSIONS AND OBSERVATIONS

In the articles that follow, the issues and ramifications of environmental disclosure are closely analyzed. The evolution of the SEC's position regarding environmental disclosure is described and critiqued. The response of the accounting profession to issues of environmental compliance and cleanup costs is summarized and the implications of compliance with the sweeping and historic amendments to the Clean Air Act in 1990 are assessed in the context of disclosure requirements.

The issues raised in these articles are of critical importance to the many businesses that find themselves at the intersection of financial disclosure and environmental requirements. The marriage of these requirements may not be a happy one but is likely to be one of long duration. It is also a marriage that will generate issues of enormous difficulty and complexity — issues that may require the cooperation of professionals from a variety of different fields to resolve in any meaningful fashion.

Those businesses which fail to pay close attention to the issues of environmental disclosure may find themselves held accountable by the SEC, lenders, those with whom they engage in transactions, and/or disappointed investors. At the same time, recognition must be given to the many intrinsic difficulties associated with accurately evaluating environmental liabilities and compliance obligations. Ultimately, it may be left to the courts to sort out whether environ-

mental disclosure responsibilities are being satisfied in an appropriate manner.

