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Opening Remarks of the Panelists

Editors

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OPENING REMARKS OF THE PANELISTS

On April 16, 1994, the Villanova Environmental Law Journal held its Fifth Annual Symposium on the topic of "Disclosures of Environmental Liability in SEC Filings, Financial Statements, and Debt Instruments." At the intersection of business and environmental law, the proper disclosure of environmental liabilities is an issue of increasing importance to management, corporate and environmental counsel, public accountants, and shareholders. Determining when a potential environmental liability must be disclosed is a complex task which is complicated by the varying standards of "materiality" under the federal securities laws and the lack of consensus on the appropriate standard.

The issues involved with this topic are important to many different interests. Therefore, the panelists for the symposium were chosen from several different areas and represented a wide variety of interests and experiences. The panelists were: Elizabeth Glass Geltman, Professor at the George Washington University National Law Center; Michael M. Meloy, Partner at the Philadelphia law firm of Manko, Gold & Katcher; Marcia E. Mulkey, EPA Regional Counsel, Region III; Amy A. Ripepi, C.P.A. at Arthur Andersen & Co.; Richard Y. Roberts, Commissioner of the United States Securities & Exchange Commission; Mark A. Stach, attorney at Ashland Oil.

The following remarks were given by the panelists at the start of the symposium and provide a general overview of the issues involved. Following these remarks are articles written by the panelists which examine these issues in more depth.

Professor Elizabeth Glass Geltman†

I have been charged with the undaunting task of trying to summarize for you all of the Federal Securities Laws and the Federal

† Ms. Geltman is an associate professor at the George Washington University, National Law Center and is of counsel to the Washington, D.C. office of Squire,
Environmental Laws in 10 minutes. So I can either talk very fast or give you a very brief description of what we are going to be talking about today.

Before I do that I would like to begin by just getting a feel for the audience. How many of you are environmental lawyers or come from an environmental perspective? Good. OK, how many of you are securities lawyers or come from a security perspective? Less. OK good.

What we would like to do today is start off with a brief discussion and overview. Each of our panelists will then go on and give you their general impressions of the field and then we will go into the discussions of the hypotheticals. I would like to open the floor up to discussion at the end of each panelist’s presentation, so you can ask them questions. During the hypothetical discussion I would encourage your participation so that we may get some lively debate.

To start off, one of the things that we want you to think about and the purpose of this panel is that after you examine all of the reporting obligations under the federal environmental statutes and the state environmental statutes, if you represent a public registrant you need to think also about your reporting obligations under the federal securities laws and also under your state securities laws in whatever state your client may be located.

Now how do these arise and what are the obligations? Well first of all, one of the things that is going to be governing any disclosure requirements are the anti-fraud provisions of the federal securities laws. The private anti-fraud provisions are §10(b) and Rule 10b-5 promulgated thereunder. The Securities and Exchange Commission (“SEC”) can also bring actions under §17(a) of the 1934 Act, but as most of you know there is no implied clause of action under 17(a). So most of the activities that you see in the anti-fraud provisions are under Rule 10b-5.

Now what are the elements for a Rule 10b-5 cause of action? In order to survive a motion for summary judgment, the plaintiff needs to demonstrate that the registrant knowingly used interstate commerce to fraudulently breach its fiduciary or its statutory duty by making a material misrepresentation or omission in connection with the sale of the security. The fraudulent misrepresentation or

Sanders & Dempsey. Prior to entering academia, Ms. Geitman worked for the Washington, D.C. offices of Fulbright & Jaworski and Hunton & Williams. She also clerked for the Honorable Paul Alpert of the Maryland Special Court of Appeals. Ms. Geitman received a Masters in Law from Georgetown University, her Juris Doctorate from the University of Baltimore School of Law, and her bachelor’s degree from Cornell University.
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omission of the registrant must cause damages which are related to the material misstatement or omission. The plaintiff must also show that he or she relied on the veracity of the registrant's statements. Although, with the Supreme Court's adoption of the fraud on the market theory this element has not been as difficult to prove as in the past.

Now, statutory duty. How does that arise? In most cases statutory duty is going to arise under Regulation S-K. Regulation S-K is the integrated disclosure requirement that the SEC promulgated and it requires that public registrants make certain statements whenever they do a public offering or, more significantly for our purposes, whenever they file their quarterly statements on the Form 10-Q or their annual statements on Form 10-K.

There are three principle provisions that require or are likely to require environmental disclosure under regulation S-K. The first one is Item 101 and specifically it's paragraph (c)(i)(vii) of Item 101 which is the description of business. This paragraph states: "The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material." In other words, in your description of business under item 101 you are going to need disclose any kind of capital expenditures which need to be made in order to meet environmental obligations. Of particular significance for Item 101 disclosure are the Clean Air Act amendments of 1990, which require mandated control technology upgrades.

The second area specified in Regulation S-K is Item 103 disclosure. This is disclosure concerning litigation. The litigation must be "material" before it must be disclosed. How do you know if something is material? Instruction 5 to Item 103 established certain objective thresholds for disclosing environmental proceedings. Under Regulation S-K, disclosure of environmental proceedings is required when (1) the proceeding is material to the business or financial condition of the company, (2) the proceeding or damage action involves a potential monetary loss exceeding 10 percent of current assets of the company, or (3) if the proceeding is brought by the government seeking monetary sanction, unless the company reasonably believes that the proceeding will result in fines of less than $100,000—a relatively low test.

The third area that has been problematic is what is called Item 303 or the Management Discussion and Analysis ("MD&A").

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MD&A has come into play particularly as the result of a 1989 SEC release which incidentally followed a 1988 Wall Street Journal article.

In the 1989 release, the SEC carved out a new standard of materiality under Item 303. The old standard was developed in Basic v. Levinson. This test asked the management to look at what the reasonable investor would want to know in terms of making investment decisions. The Basic test demanded that the registrant measure the probability of an event’s occurrence against the potential magnitude of liability. Thus, the registrant’s management must weigh all factors and consider whether the data was important to the “reasonable investor.”

Under this test you needed to give information that was neither overly optimistic nor overly pessimistic. Federal Securities laws were supposed to protect would-be buyers as well as would-be sellers. Under the analysis in the 1989 release there is a new duty to disclose when a trend, demand, commitment, event, or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant’s financial condition or results of confirmation.

This new test requires a two-step analysis. The first thing that management must do is determine whether the known trend is likely to come to fruition. Management must determine the likelihood that the trend is in fact going to come to fruition and look at whether it is objectively reasonable and what the consequences of that trend were likely to be—on the assumption that it would in fact come to fruition.

In other words, under the Basic test management has to evaluate the probability that the event would come to fruition and charge it against the magnitude of that liability. It is a balancing test. Under the new test erected under the 1989 release for Item 303, management is charged with the requirement to disclose information unless that event is not likely to have a material effect. So in other words, under the Item 303 test you are now having to disclose unless you can prove a negative. You must disclose, unless you can prove that it is not likely to have a material effect. The probability/magnitude test of Basic was done away with for the purposes of Item 303 disclosure, although it still remains for purposes of the remainder of Regulation S-K, including Items 101 and 103.

Under Regulation S-K for the purposes of environmental disclosure requirements there are two separate tests: one for when you are looking at capital expenditures under Item 101 or 103, and
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a second separate test that requires you to disclose unless you can determine that it is not reasonably likely to have a material effect under Item 303.

Now you will notice that there are certain conflicts inherent in the later test of materiality. Under Item 303 Management Discussion and Analysis, you have to disclose earlier or arguably earlier then you would under an Item 101 or 103 analysis. That means that if you should get a notice of potential litigation you are going to have two different standards that you need to evaluate. Something may not be material under the Basic test for purposes of Items 101 and 103 disclosure, but you need to disclose it under Item 303 because you don’t know when you discover the data that it is not likely to have a material effect.

Now let me run through very quickly why this is such a concern and what types of statutes are the ones that brought it to fruition. The principle environmental statute that the SEC has focused its attention on is the Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”). Because of the potential liabilities created under CERCLA, it has presented the greatest problems under Securities disclosure.

Superfund was enacted in 1980 in response to the tragedy at Love Canal. It is designed to clean up abandoned hazardous waste sights. The problem with Superfund for the purposes of disclosure regulations is that the liability that can be imposed is strict and joint and several as well as retroactive. That means that if a public registrant deposited a thimble full of hazardous waste in a dump site, a Superfund site that is five miles wide, completely full of hazardous waste and that registrant is a deep pocket. They conceivably could be held jointly and severally liable for the entire cost of the cleanup of that site even though they only contributed a thimble full of wastes.

Now that sounds like a horrible problem and it sounds like something that immediately we are going to need to disclose. The problem is this: although Superfund can impose joint and several liability, in most cases an individual Potentially Responsible Party (“PRP”) will not in fact be held jointly and severally liable but will instead be held liable for a portion of the cleanup costs. That means that although only one party may be sued, most of the time the party that is sued goes out and finds other PRPs and tries to make and hold them responsible. So although theoretically when you receive a notice that you are a potentially responsible party, in
the end you are not likely to be held responsible for the entire cost of cleanup. You are likely to be sharing the costs.

Who can be held liable under Superfund? Well, current owners and operators can be held liable regardless of whether or not they had contributed to the waste site. Past owners and operators that owned the property at the time the waste was disposed can be held liable. You will notice that intervening owners are not expressly to be held liable under Superfund. It is only current owners and past owners and past owners and operators that owned and operate at the time of disposal that are held liable under the language of the statute. Generators of hazardous substances who by contract agreement or otherwise arrange for the disposal or treatment of the hazardous substances may also be held liable. Finally, transporters who deliver hazardous substances to a site that is selected by them can also be held liable. You should note that transporters are only held liable if they selected the site. Somebody who just transported hazardous waste is not necessarily liable under Superfund.

One thing that I do want to emphasize is that Item 303 Management and Discussion Analysis disclosure requirements apply not just to Superfund liabilities but to any environmental liabilities. So if your client should receive notice of an environmental problem, as an environmental attorney, you need to think about your obligations to disclose not only under the environmental statutes, but also under the litigation provision as well as MD&A.

What other areas are important? Well, the Resource Conservation and Recovery Act ("RCRA") regulates the generation and transportation, treatment, storage, and disposal of solid and hazardous wastes. RCRA regulates not just the transport, storage, and disposal and the permitting process, it also includes regulation of underground storage tanks. It is probably the second area where you will find most of the problems in terms of environmental disclosure requirements under the federal securities laws.

A third area that is a principle problem for securities disclosure is the Clean Air Act, which was enacted in 1970 but was amended most recently in 1990. The Clean Air Act establishes standards and requirements for ambient air, air emissions, and asbestos. The problem under the Clean Air Act is that it does have statutorily mandated control technology upgrades that need to come into compliance under various provisions by certain statutory timetables. These are tremendously expensive. Because the deadlines for these upgrades are statutory mandated, there are many registrants that
have accounted for these liabilities but don’t really know in fact how much these technology upgrades are going to cost because EPA has not implemented the statutes through regulations. So you have a lot of situations where registrants are on notice that they need to upgrade their technology, but they don’t know what that technology is because EPA has not yet told them and that presents accounting and disclosure problems.

Now obviously there are many other federal statutes that are important. The Clean Water Act regulates disposal into the waters of the United States. TSCA, the Toxic Substance Control Act, mandates registration of toxic substances with EPA, such as PCBs. There are many PCB contaminated facilities. FIFRA, the Federal Insecticide and Pesticide Regulation Act, can also be a problem for companies that have large amounts of pesticides. OSHA, the Occupational Safety and Health Act, is another area where you are seeing a lot of SEC disclosure activity. Given that I am done my ten minutes, I am going to let each panelist make a brief presentation and we will get back to any questions that you have on other environmental matters later on.

Richard Y. Roberts, Esquire†

I am sure that everyone here is aware of the basic federal securities law disclosure requirements concerning environmental liabilities so I will not spend much time discussing them. These requirements are found in the general securities anti-fraud provisions of the Securities Act § 17(a), Exchange Act § 10(b), and Exchange Act Rule 10b-5. They are also found in the specific line item disclosure provisions of Items 101, 103, and 303 of Regulation S-K. Of course, the accounting literature describes the appropriate accounting treatment for potential environmental liabilities.

† Mr. Roberts was nominated to the SEC by President Bush and confirmed by the Senate on September 27, 1990. Prior to his nomination, Mr. Roberts was in private practice with the Washington, D.C. office of the law firm of Miller, Hamilton, Snider, Odom & Bridgeman, an Alabama law firm. Prior to that, he was administrative assistant and legislative director for Senator Richard Shelby (D., Ala.) from 1987-1990. From 1983-1987, Mr. Roberts practiced privately with the Alabama law firms of Pappanastos, Samford & Roberts and Perry, Russel & Roberts. From 1979-1982, Mr. Roberts was administrative assistant and legislative director for then-Congressman Shelby. Mr. Roberts received a Master of Laws in taxation from the George Washington University National Law Center in 1981. He is a 1976 graduate of the University of Alabama School of Law, and a 1973 graduate of Auburn University.

The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners, or the staff of the Commission.
There apparently does not exist the same familiarity with the accounting requirements as with the disclosure requirements, or at least the spotty accounting practices in the environmental liability area would lead one to that conclusion. Generally accepted accounting principles ("GAAP"), specifically Statement of Financial Accounting Standards No. 5, entitled Accounting for Contingencies ("SFAS 5"), require that an estimated loss can be reasonably estimated. In addition to SFAS 5, FASB Interpretation No. 14, entitled Reasonable Estimation of the Amount of a Loss ("FIN 14"), states that if the estimated amount of loss is within a range of amounts, and some amount within the range appears to be a better estimate than any other, then that amount should be accrued. FIN 14 adds that when no amount within the range is a better estimate than any other amount, then the minimum amount is unlikely to be zero. Any amount or range of loss in excess of the amount recognized that is reasonably possible should be disclosed in a footnote, or management should state that this amount cannot be estimated. As additional information becomes available, changes in estimates of the liability should be reported in the period that those changes occur in accordance with Accounting Principles Board Opinion No. 20 ("APB 20"), entitled Accounting Changes (Opinion 20).

While most registrants are now indicating that the amount accrued represents the amount that is probable of occurrence and reasonably estimable, some registrants are failing to disclose the additional reasonably possible loss that could occur, as required by SFAS 5. Please attempt to become more familiar with these accounting requirements.

Particular attention should also be paid in the environmental liability disclosure area to the Management, Discussion, and Analysis ("MD&A") item of Regulation S-K, Item 303, and to Staff Accounting Bulletin No. 92 ("SAB 92"). SAB 92, which was issued in June 1993 sets forth the Commission staff's interpretation regarding contingent liabilities, including environmental liabilities. The guidance expressed in SAB 92 is intended to promote timely recognition of contingent losses and to address the diversity in practice with respect to the accounting and disclosures in this area. Hopefully, publication of SAB 92 will improve this practice.

As a general matter, SAB 92 presents the view of Commission staff regarding: (1) the manner in which a contingent and any related asset representing claims for recovery should be displayed in the financial statements ("offsetting"); (2) the appropriate discount rate to be used for recognition of a contingent liability presented at
its present value to reflect the time value of money ("discounting"); and (3) the disclosures that are likely to be of particular significance to investors in their assessment of these contingencies. SAB 92 stresses that a discussion connecting MD&A disclosure with the presentation of environmental liabilities in the financial statements is often appropriate. The most controversial aspect of SAB 92 apparently is the view of Commission staff that contingent liabilities should be displayed on the face of the balance sheet separately from amounts of claims for recovery from insurance carriers or third parties. I do encourage the members of this audience to become familiar with the guidance set forth in SAB 92.

I also wish today to discuss the anticipated Commission approach in the liability disclosure area for the near future. Concerns with the environment have captured the public's attention in recent times, and environmental awareness is probably at an all time high. This public interest in environmental matters has brought increased pressure to bear on the Commission to ensure that publicly-held companies are disclosing in a fair, full, and timely manner present and potential environmental costs of an economically material nature. This pressure is not expected to abate in the near future.

The Commission's response to this pressure to date has been to more closely coordinate with the EPA and to scrutinize carefully the environmental related disclosures in the documents filed with the Commission pursuant to the requirements of the Securities Act and the Exchange Act. When appropriate, the staff of the Commission has requested amended disclosures from registrants as a part of the filing review process.

In terms of what may be anticipated from the Commission for the reasonably foreseeable future in this area, I would expect to see continued scrutiny of registrant filings. In fact, I would anticipate that the filing review process will even intensify with respect to environmentally sensitive companies. I imagine that a great deal of the filing review focus will be directed on determining whether MD&A disclosures are being updated in a timely and appropriate fashion. An environmentally related MD&A enforcement case is always a possibility. The Commission's 1992 MD&A action against Caterpillar, reaffirmed by the 1994 MD&A enforcement action against Shared Medical Systems, should have delivered the message that the Commission considers MD&A disclosures to be a very serious matter. The members of this audience should be careful to treat MD&A disclosure as a very serious matter as well.
Moreover, I anticipate that the staff of the Commission will closely scrutinize registrant disclosures of contingent liabilities during their review of the filings for the foreseeable future. The staff will probably focus particular attention on registrant compliance with all aspects of SAB 92. The staff apparently is very concerned about the extent of explanation registrants provide with respect to environmental liabilities. The staff is further expected to concentrate on the application of the offsetting and discounting provisions of SAB 92. Since the offsetting provision of SAB 92 is effective for most 1994 filings, the staff monitoring in this area should pick up steam throughout the remainder of this year and may even intensify next year. I wish to emphasize again that the Commission expects the accounting and disclosure practices in the contingent liability area, particularly in the environmental liability area, to improve considerably with the issuance of SAB 92.

The Commission’s environmental disclosure focus has more than likely indirectly improved environmental compliance overall by publicly-held companies. While I view this as a positive development, as a result of this compliance progress, some have called for the Commission to become directly involved in environmental compliance by utilizing even more aggressively the broad regulatory authority provided under the federal securities laws. My guess is that the Commission will resist such a change in regulatory direction and will stick to a disclosure approach instead.

I have become very comfortable with the traditional Commission disclosure role. I will continue to emphasize this approach and intend to continue to press for vigilant oversight efforts to ensure that publicly-held companies are disclosing fully, fairly, and in a timely manner the present and potential environmental costs of an economically material nature. My view is that the Commission owes this to the investing public.

Marcia E. Mulkey, Esquire†

I believe that this topic is particularly interesting and important for EPA because this area, this area of public disclosure in the

† Ms. Mulkey has been EPA Regional Counsel for Region III since 1988. Prior to that she was the Chief of the Air and Toxics branch at the EPA for Region III from 1985-1988. From 1980-1985, Ms. Mulkey was an attorney with the Pesticides/Toxic Substances Division in the EPA office of General Counsel in Washington, D.C. She also served as an attorney in the Office of Executive Legal Director at the United States Nuclear Regulatory Commission from 1976-1980. Ms. Mulkey graduated from Harvard Law School in 1976. She received her master's degree in 1968, and her bachelor's degree in 1967 from the University of Georgia.
investing public financing context provides a rich opportunity for enhancing support for the mission of EPA and the purposes of the environmental laws. It allows for a form of partnership between the environmental regulators and implementors, the implementors of the securities laws and the investing public.

When I say implementors of the securities laws, I of course envision the government and it is really all governments. There are national securities laws but also state.

Before I tell you my one antidote which I thought would build a colorful way of explaining how I stumbled upon learning a little bit about this, it is probably worthwhile mentioning that I see an increased opportunity and an increased likelihood of even more coordination between the Securities Exchange Commission and the Environmental Protection Agency as our databases become easier to use, more reliable, and easier to share. I envision an era not too far away when we on our desk may be able to pull up information and 10-Ks and other things, and SEC lawyers and other reviewers may on their desk be able to pull up a compliance history of companies. We are not there yet, I don't mean to imply that we are but the sharing of information has a great capacity in the future for the sharing of information among governmental entities with an interest in these matters.

Now on with the story, I first discovered a little bit about environmental disclosure issues in the early years when I was at EPA and defending a very large attack by several chemical companies on the constitutionality of FIFRA. FIFRA has a rather arcane provision which provides for a mechanism by which pesticides may be marketed by companies that did not originally develop them by relying on the health and safety data developed by the original company and offering to compensate for those data.

So we were coping with a massive fact trial over this provision of FIFRA. At least one of these large pesticide companies was asserting rather boldly in pleadings and other filings in those court cases that this provision of FIFRA would destroy its business and I understand that if a company was asserting that its business was going to be devastated that it probably had a duty to reveal that to its investor. So I asked through official channels for a copy of the 10-K of this particular company and we counted every filing we could find by that company and the disclosure was not at hand concern-

The views expressed by Ms. Mulkey are her own and do not necessarily represent those of the Environmental Protection Agency.
ing the potential devastating effect of FIFRA on the company’s business.

I like to believe that when we asked in our request for admissions a request to admit that no such disclosures had been made in any of the company’s public statements that at least sent a little bit of nervous shock waves. This case taught me a lot about the opportunity to think across our two statutory schemes.

At that time I remember being rather dismayed at the materiality standard because it seemed to me there were so many things that the investing public ought to know. As a citizen I felt like they ought to know things which didn’t seem to meet that materiality test. So, in anticipation of this seminar among other things, I learned about some movement to a more per se approach to describe materiality. I was frankly quite pleased to see the $100,000 penalty test written in I suspect because it would be difficult for a large company to be required to have revealed only $100,000 in penalties under the old tests.

Of course there is injunctive relief required by law which has never been known to be the subject of litigation. To put it another way, the cost of complying with various regulatory requirements. Also, it is important to remember that there is not only the remediation cost estimate but the natural resources damages provisions, which in certain fact patterns may dwarf the remediation costs. I think that is more likely to occur under OPA than under CERCLA, but there are some circumstances in which natural resource damages may be a very substantial component of the cost.

And finally, just in the interest of thought process, I will ask in the context of the per se requirement about the $100,000 penalty test, why not citizen suits? Why limit the disclosure to matters brought by government? I can understand that there probably was a debate about this that there probably was a decision that maybe there is more likelihood of frivolous initiations in this context. It is all speculation on my part, but I think there is a general feeling that private attorneys general are a very important part of the overall environmental enforcement game. So perhaps in the evolving approach to this matter at the Commission there might be some popular revisiting of that question and in any event I think it might be a productive one for informing our discussion.

So I will end on that note, not so much because that is the single issue that I think most burning, but it allows us to broaden our discussion beyond what the law now is.
Amy A. Ripepi, CPA†

You've heard discussion of the securities regulations as they apply to S-K, the accountant where the financial statements comes in has to be concerned with Regulation S-X. In addition to that we accountants have our own body of professional pronouncements that we are required to apply in executing our duties. In your material you have gotten a handout that I prepared that basically walks through at a very high level, the accounting requirements. Those accounting requirements come primarily from the private sector. The accounting profession has been a self-regulated profession for many decades, just about since its inception, and we have private standard-setting bodies that annunciate rules that we are required to follow whenever we issue an opinion that states that the financial statements that you read are fairly presented in accordance with Generally Accepted Accounting Principles. Now Generally Accepted Accounting Principles means those pronouncements issued by these private standard-setting bodies of which the Financial Accounting Standards Board ("FASB") is one, but it also means that we need to apply general practice as it has evolved throughout the decades, general practice by virtue of analogy to comparable situations that are articulated in detail into the accounting literature. So although the accounting literature can't possibly hope to specifically address every transaction that investment bankers and others can dream up, we do have a body of literature from which to work and hopefully arrive at an appropriate answer.

Accounting like much else, however, is evolutionary and as we get more experience with things, that is as particular issues become problematic, we need to address those. Because as with a matter of law, many things are open to interpretation. So what we find in practice is that different companies and different accountants reach different judgments about things that are purportedly grey and therefore we end up with diversity in practice.

As we talk to users of financial statements we find that what they don't like to see is noncomparability in information. If companies account for or disclose things one way and the competitors do

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it another way, it makes it very hard for the investing community to understand what the company is all about and to evaluate their investment decisions appropriately.

So therefore the FASB established a group of accountant both for the private sector as well as from the corporate sector to try and address these emerging issues as they come about. The due process is very different, the issues tend to be very narrow, they tend to be big problems where there is diversity in practice and that group, the Emerging Issues Task Force, comes up with guidance that we as practitioners then need to follow. It becomes a part of the body, the accounting literature that we need to incorporate as we prepare and audit financial statements.

In addition to this the private sector standard-setting process which applies to all companies, private and public, any set of financial statements that are prepared, we also have those rules promulgated by the Securities Exchange Commission. Now the SEC has the legal right to mandate accounting standards and on occasion they have done so where they believe that the accounting literature either wasn’t sufficiently addressing something or wasn’t appropriately addressing something. By and large, however, they have deferred to the private sector. What they have done in their staff accounting bulletins (SAB 92 being one that Commissioner Roberts referred to earlier) is they have interpreted the accounting literature where they believe that there is diversity in practice and they want a particular view to be followed. They will promulgate that view in writing in an SAB. That is basically the accounting framework within which we operate.

So we get to the area of environmental remediation and I want to focus on the word remediation because there are a lot of costs out there that accountants would need to be worried about. There are costs of compliance, costs of prevention, costs of monitoring, costs of purporting, and of course costs of cleaning up. Liabilities within an accountant’s context are more than just legal liabilities, it is any future sacrifice of assets, and therefore my focus is going to be on environmental liabilities-specifically those related to remediating or cleaning up matters that have occurred in the past.

The basic accounting questions in dealing with environmental remediation matters are three. When do you report a liability? How much do you record? What do you say about it? Financial statements are not only the strict balance sheet income statement and statement of cash flows that you may have seen, there have also been notes to the financial statements which are deemed to be an
integral part of financial statements. And if any of you ever choose to invest in a company, I would strongly recommend that you focus on more than just the numbers on the pages that are labelled balance sheet income statement and statement of cash flows. The notes truly have a wealth of information that can be very important in understanding the raw data that you see on the tables.

In terms of when to record a liability, Commissioner Roberts earlier referred to Phase 5 Accounting for Contingencies. This has been around for a long time. This is well before even I became an accountant: 1975 to be precise. That is why in answer to the comment about what's new, I would argue that Statement 5 is actually quite old. I'm old, it's older than me, it must be old. As it was released accountants found Statement 5 difficult to interpret and so within 18 months after its release an interpretation of Statement 5, Interpretation 14, was released. It is also quite old.

Those pronouncements, although not specifically addressing environmental remediation contingencies, talk about lost contingencies. Lost contingencies are any sort of matter that will result in a cost to the company based on a past event, and I would argue that environmental remediation generally involves past events that will result in costs to companies. For that reason, Statement 5 and Interpretation 14 are quite applicable even though you will never find the word environmental anywhere in the documents.

Accountants have lived with the broad, general, somewhat vague rules in Statements 5 and Interpretation 14 for some time and we generally know how to work with the terminology and basically the terms used in Statement 5 are that the liability is to be recorded when the lost contingency is probable of occurring and can be reasonably estimated. You must meet both of these two tests. Probability and reasonable estimation of the amounts. Interpretation 14 went on to say that if the reasonable estimation of the amount results in a range of costs, in other words, you don't have a single point estimate for the amount of your loss but you do have a range, you are first to look to the best estimate within that range. But if there is no best estimate within that range, every number within that range has an equal probability of occurring. Then you are permitted to accrue the minimum amount in that range and that is what Interpretation 14 says. The fact that you have a range is not an excuse for not reporting a liability. And that again has been a longstanding pronouncement within the accounting profession. Statements 5 and 14 also go on to articulate disclosure requirements.
Now I would argue, as I think many would, that we really haven’t seen those sort of disclosures traditionally for environmental remediation contingencies. Hence the Wall Street Journal article: if it is going to cost us a 100 billion dollars why isn’t that talked about in financial statements.

All of that leads us to the SEC’s SAB 92 which reinforced what has been in the literature for some time and also went on to amplify certain particular specific areas where there isn’t any accounting guidance per se.

Now what the Emerging Issues Task Force had done in 1993 was address an issue relative to recovery of amounts from third parties verses the amount that you are going to have to pay and also the issue of whether or not the accrual could be recorded on a discounted basis. We accountants tend to look at things more in gross terms rather than in economic terms, although my background is that I am an economist by training. One of the things I find most fascinating is the fact that economics and accounting do not parallel each other and this is one arena where they don’t. The economic cost of the company by virtue of these liabilities being paid out over 30, 40, 50, 60, 80, 100 years, that is a different number than if I just took those numbers, added them up, and put them on the balance sheet today.

So the accountants have long wrestled with the issue of discounting in a multitude of areas, not just this area, and the general practice is to record things on a gross basis. Not to say that it is prohibited, but just that’s the general practice that has evolved over the decades. Well what the Task Force attempted to address was the question of whether or not you could record these sorts of liabilities on the discounted basis, and if you could, what criteria you need to meet before you were able to discount.

So they clarified what you can discount and the criteria is quite narrow and then the SEC went on to indicate in their view what the appropriate discount rate was for purposes of discounting the liability that meets these relatively stringent criteria.

That kind of encompasses the body of accounting literature that we have and the last point that I would like to touch on is the auditing side of things. Accountants account for things and then auditors audit them, and I do both. I am both an audit partner as well as an accountant. So when I sign a set of financial statements, there is a report that maybe you look at and maybe you don’t, that means a lot to me and hopefully it means something to my client.
because that is what they pay me to do and that articulates my opinion with respect to financial statements.

An auditor's opinion is fairly standard. There are professional requirements that we follow in deciding how our report ought to read. And you will find in the last paragraph of our report which will go on to say that the information "fairly presents" the financial condition, the results of operation, and cash flows of the indicated company for the indicated period. Fairly presents. Not accurate to a nickel or accurate to a penny, fairly presents, and it encompasses the entire body of information.

Now, if I conclude that the financial statements do not fairly present, I have some options. If I say they fairly present that is what is commonly referred to as a clean opinion. But I have other options in my recording bag of tricks. I can issue what some refer to as a qualified opinion which means that I add an extra paragraph alerting a reader to a particular matter that I think has financial significance. Typically it is going to be a contingency of some sort that might materially change the financial picture that you see in the company absent the information that has already been reported. It is called a qualified opinion. I can issue an adverse opinion. Adverse is exactly what it sounds like: financial statements do not fairly present result of operations, etc., in accordance with Generally Accepted Accounting Principles.

Now that is a very bad report card and most companies do not like to receive an adverse opinion. The SEC for one will not accept that. The auditor and the company must come to some terms so that no adverse opinion will be rendered. There is also what is called a disclaimer of opinion. There are situations in which the matters at hand are so pervasive that an auditor simply is unable to reach a conclusion. They can't conclude that they are right and they can't conclude that they are wrong. They disclaim. That is also a relatively unusual circumstance not accepted by the SEC, but it is a possibility within our bag of tricks.

So as an auditor goes through the process of auditing the financial statements and trying to reach a conclusion, they need to consider obviously what's reported, what's not reported, and then this host of contingencies that may be out there. They look at the risk of the company based on the nature of its industry, the kinds of internal controls it has, the kinds of reporting procedures it has, the integrity of management. They go through and they evaluate the judgments and estimates that were made, particularly in this area since so many judgment estimates were required. In addition,
we look at the advice, the professional opinions of specialists in other areas. We can’t possibly know everything there is to know about everything. Therefore, we must rely on the professional judgments of attorneys, environmental engineers, actuaries, and others who are more qualified to render views in particular areas. We take the body of evidence that has been presented to us and independently verify it and therefore the auditor has to be involved not only with the internal accountants of the company but with professionals within the company, the legal department and the environmental departments as well as the outside specialist the company uses in helping it assess what its options are, what its problems are, what its courses of actions are, what its obligations are, and so forth.

Mark A. Stach†

I will begin with a rhetorical question. What are the four worst words that a corporate attorney can say to his or her management during the time it registers securities for sale of the public? “We are being reviewed.” It introduces an element of delay into the process. This delay can be critical to the sale of securities. There is a certain window in the marketplace that you are trying to hit when the interest rates or other conditions are most favorable to the issuers. You miss the window, the company suffers.

How do you mitigate against the effects of the review? First, one way is to properly disclose your environmental liabilities. It is not an easy task, and what you think is proper the regulators might not think it is proper. Nonetheless, I think it is imperative that you take every effort to try to do this and then by doing so you limit the number of comments that the SEC has on your registration statement and the comments relating to environmental liabilities are the most difficult to deal with, thus the most time consuming and the most likely to cause you to miss your window in the marketplace.

Having said that I see that there is a definite benefit to undertaking disclosure of your environmental liabilities; however, there is

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also cost in this regard. The first cost, I think the easiest cost to deal with, is literally hundreds of hours that it takes to do this. You have accountants, you have attorneys, you have administrative personnel. They are company wide, a large public company like the one I work for, they go company wide to every location, to every site gathering information, they are analyzing the information, they are evaluating it and finally you are formulating your disclosures. This is a time consuming process, it costs the company money and man hours. I think, like I said earlier, this is the easiest cost to deal with. I think it has become recognized by the management of companies that this is just a cost of a business.

A not-so-easy cost to deal with is the possibility that you are disclosing privileged information. You get a site specific estimate of liability at a site, you put that in your securities filings, the judgments of counsel that were used to come up with that estimate are subject to disclosure. Not just that number but everything that underlies the number. This is information that the other PRPs at the site are going to find of great value. Either those people who you are trying to impose liability on or those people who are trying to pose liability on you.

I read just the other day where a commentator said that by disclosing this number you almost make it a self-fulfilling prophecy. I think there is a lot of merit to that contention. You have to realize that there are long-term costs associated with any disclosure, not just environmental disclosure, that is what makes it the most challenging area. It is an area in which I think that corporate counsel is uniquely positioned to see both the cost and the benefits. On one hand you are the person that your management is looking to to get the deal done, get the securities registered, get them ready for sale of the public. You receive pressures in that regard and you want to get the environmental liabilities disclosed to the satisfaction of the regulators so that you can do that. On the other hand, the corporate counsel is also uniquely positioned in terms of seeing these costs, and evaluating the long term costs associated with certain disclosures. It makes, like I said a challenging area. I think it is an interesting area and everything I've seen to date indicates it will only become more important in the future.
Michael M. Meloy†

I want to pick up on a couple of threads that were mentioned already. There has been a rapid evolution in the area of SEC disclosure over the last five years. I think it is going to continue and I think much of it is driven by some of the cost estimates that are floating around as to how much it is going to cost to clean up waste sites around this country. For example, there is a University of Tennessee study that put the estimate of cleanup costs over the next 30 years as somewhere around $750 billion.

Now if you take those estimates and you give them any credence and you look at the kind of disclosure that is showing up in publicly traded companies, the numbers don’t match up. There are some questions being raised to say, well, shouldn’t the numbers be a little closer? What is going on here? Is there a lot of under disclosure? These types of concerns are driving many of the disclosure issues. I would also submit that while environmental disclosure for publicly traded companies is something that may be a relatively new issue, environmental disclosure in other areas has been around for some time. I point to what has happened over the last ten years or so in the context of real estate transactions, business transactions, loans, even the auditing function that accountants serve in signing off on the books of a company. In those settings, environmental issues often become very important. Trying to assign dollar figures to the liabilities and costs of compliance can be a very significant factor in whether a real estate transaction is going to go forward, whether you are going to be able to get a loan from a bank, and so forth.

So the process of evaluating environmental liabilities is something that a lot of companies have been through but perhaps in other contexts. In those other contexts, there are tools that have been developed to try to deal with evaluating liabilities and compliance costs. Many of you may be familiar with what is called the Phase 1 auditing process. In most real estate transactions, before a buyer is going to take title to a piece of property, there is an investi-

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gation to try to flag whether or not there are significant potential environmental problems.

The process of trying to collect this information and the tools that have been developed are tools that can also be used in the context of signing off on the books for an accounting audit or evaluating disclosure issues in the context of an SEC filing.

Now, with that said, I want to point out just a couple of factors that make evaluating environmental liabilities in many situations very difficult. First of all, environmental contamination and the associated clean-up costs may be difficult to try to get your arms around. Environmental contamination very often is something that you can't see. Generally, you need to go out and do elaborate tests in order to figure out whether contamination is there or not. These kind of tests may involve putting in ground water monitoring wells. You may also have to take soil samples. Trying to figure out where the contamination is to begin with, let alone figuring out what you need to do with it once you determine where it is can be a very time consuming and expensive process.

Once the contamination has been characterized, then the next question is what needs to be done to clean it up? There are a whole array of different environmental technologies that can be used for remediation. They vary in cost. There also is an ongoing problem with trying to figure out how much is enough, how clean is clean. There has been historically a lack of well defined clean-up levels so that even if you know what the problem is, trying to figure out what steps are necessary to address the problem may be a very complicated and difficult task.

Another factor in this area is that environmental regulations don't stay static. They change and it very often takes time to figure out exactly how the changes apply to a particular set of operations or a company. In the Clean Air Act context, companies may know that there are areas which are going to be subject to regulation. But the regulations themselves haven't been drafted yet. Trying to figure out the costs associated with complying with those regulations that don't yet exist is something that is a fairly daunting problem.

Recognizing that these factors exist and acknowledging that environmental liabilities and compliance costs may in many instances be very difficult to quantify should not, in and of itself, be an excuse not to try to disclose what is necessary. However, you should be aware that there are costs associated by trying to quantify
the costs and trying to quantify the liabilities, and that the process may take a long time to carry out.

The last point I want to make is that because you have the confluence of technically difficult issues in the environmental area and complex rules for disclosure, very often you need to adopt a team approach to try to deal with the big issues. This team may include accountants, securities lawyers, environmental lawyers, and environmental consultants. However, typically nobody wants to take responsibility for the decisions; it is like a hand grenade, with the pin pulled, and it is tossed from one person to the next. The environmental lawyers say “Well I have a consultant here who is telling me a certain set of numbers,” and the consultant says “Yes, but I am basing them on assumptions that you gave me,” and the accountants are saying “Well are those the right assumptions?” and “What do these numbers really mean?” The securities attorneys are saying “Well how does this relate to the rules that I am supposed to apply in disclosure?”

The whole area of disclosure of environmental liabilities implicates a very difficult set of issues. I think that the only way that those issues can be handled in practice is if you can assemble teams that can work together to try to sort through various components to those issues.