FOOLING INVESTORS & FOOLING THEMSELVES
HOW AGGRESSIVE CORPORATE ACCOUNTING & ASSET MANAGEMENT TACTICS CAN LEAD TO ENVIRONMENTAL ACCOUNTING FRAUD

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**PAST ROSE FOUNDATION PUBLICATIONS ON THIS TOPIC:**


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**ABOUT THE ROSE FOUNDATION**

The Rose Foundation for Communities and the Environment is a grantmaking public charity dedicated to nurturing positive intersections between the environment, the economy and communities. Through its Environmental Fiduciary Project, the Foundation advocates the prudent inclusion of environmental and social factors into investment portfolio management. ([www.rosefdn.org](http://www.rosefdn.org))
INTRODUCTION & EXECUTIVE SUMMARY

In order to accurately assess the value of their investments and to inform their portfolio management decisions, shareholders need to assess a company’s financial health. In recognition of this need, the U.S. Securities Exchange Commission (SEC) requires all registrants to publicly disclose financially material conditions to investors or prospective investors. Few would deny that major environmental risks and liabilities can impact a company’s profitability, competitive position and shareholder value. As financially significant conditions, major environmental risks and liabilities, such as environmental remediation and regulatory compliance; human health related costs, such as exposure to asbestos and toxic pollution; and forward looking costs, such as those related to global climate change would seem to meet the U.S. Supreme Court’s definition of materiality, and thus trigger SEC disclosure requirements.

Yet, despite the volume of data about the significance, and therefore the materiality of environmental costs, many companies do not provide detailed environmental liability information to shareholders. In much the same way that various off balance sheet arrangements and other financial manipulations were made infamous by Enron, Worldcom, Global Crossing and others, various devices currently are widely used by corporations to avoid quantification of environmental liabilities – in many cases artificially inflating the market’s assessment of a company’s shareholder value.

PAVED WITH GOOD INTENTIONS

It is only fair to recognize that much of what the Rose Foundation and other critics label as “non-disclosure” is motivated by the best of intentions. In order to manage the expectations

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1 17 CFR Section 228.101, 17 CFR Section 228.103, 17 CFR Section 228.303.
2 The costs associated with environmental liability and the opportunities associated with environmental performance, as well as the specific disclosure of information to shareholders regarding environmental risks and liabilities has been the subject of a number of recent reports produced by governmental, academic, business and non-governmental organizations including U.S. EPA, Price Waterhouse, World Resources Institute, CERES, Innovest, Tellus Institute, Friends of the Earth, Rose Foundation and numerous other sources. A number of these reports are available at www.rosefdn.org or www.foundationpartnership.org. Also see, on disclosure, Cynthia Williams, “The Securities and Exchange Commission and Corporate Social Transparency,” 112 Harv. L. Rev. 1258 (1999); Robert Repetto & D. Austin, “Coming Clean: Corporate Disclosure of Financially Significant Environmental Risks” (World Resources Inst. 2000); and Michelle Chan-Fishel, “After Enron: How Accounting and SEC Reform Can Promote Corporate Accountability While Restoring Public Confidence,” 32 ELR 10965, August 2002. And, on performance impacts, see Office of Cooperative Environmental Management, U.S. EPA, “Green Dividends? The Relationship Between Firms’ Environmental Performance and Financial Performance” (2000); Ralph Earle III, The Emerging Relationship Between Environmental Performance and Shareholder Wealth (2000); Stephen Garone, “The Link Between Corporate Citizenship and Financial Performance” (1999); Don Reed, CFA, “Green Shareholder Value, Hype or Hit?” (World Resources Inst. 1998). A few bibliographical websites have also been created to house academic research on this topic, including: http://www.figsnet.org, http://www.sristudies.org, and http://web.mit.edu/doncram/www/environmental/envir-fi
3 The Supreme Court has held that a fact is material if there is a substantial likelihood that it would be viewed by a reasonable investor as having significantly altered the total mix of information made available. See TSC Industries v. Northway, Inc., 426 U.S. 438, 96 S.Ct. 2162, 48 A.L. Ed. 2d 757 (1976).
of Wall Street analysts, assure shareholders of future profitability, avoid triggering potentially significant compliance costs or environmental torts, or to maintain their company’s competitive posture, management may feel that their fiduciary obligation to current shareholders prevents the disclosure of information that could trigger expensive consequences.

However, this rationalization fails the tests of both logic and the law. Legally, the Supreme Court’s mandate is clear – like beauty, materiality is in the eye of the beholder. If reasonable investors, such as those who have fueled our nation’s tremendous growth in socially responsible investing (SRI), believe that a company’s environmental performance and competitive posture are material considerations, then the company is obligated to try to supply that information. According to the SEC’s own published guidance, when in doubt, the balance should tip towards disclosure in financial reports and discussion in the Management’s Discussion & Analysis (MD&A) section of a company’s 10-K, unless management can objectively determine that each fact or circumstance that it wants to hide from shareholders is either not reasonably likely to occur or is unlikely to have a material effect on the registrant’s operations.

In fact, it could be strongly argued that disclosure of even non-financial environmental or health and safety performance and liability information is required if such information would be viewed as material by a “reasonable investor” unless management can conclusively demonstrate that environmental liability, performance and health information – regardless of precise quantifiability – do not have material effects on profitability and shareholder value. Since SRI investors collectively have amply demonstrated a keen interest in corporate environmental performance and because environmental performance has been widely demonstrated to be at least potentially quite material, management must either supply the information or regard one of the fastest growing classes of investors in the United States as “unreasonable.”

Protecting shareholders by withholding information that could well effect their buy/sell/hold decisions also fails any test of logic this side of Alice in Wonderland’s looking glass. Environmental performance and liability information is frequently well quantified and highly material. In fact, some investors have come to regard corporate environmental performance as an extremely quantifiable proxy for the overall quality of corporate management. And here is where the logic and the law merge. Denying shareholders information about expensive environmental liabilities – even if the precise costs of those liabilities may be difficult to predict – violates both the law and common sense. The intention to protect the company and its current shareholders may be sincere, but the effect may be to penalize those same shareholders.

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4 According to the Social Investment Forum, more than one out of every nine dollars under professional management today is involved in socially responsible investing, and environmental screens are among the most popular and universally employed. SIF, “2003 Report on Socially Responsible Investing Trends in the United States.”


6 In fact, given the wide acceptance of industry programs such as DuPont’s Six Sigma and the recommendations of the industry-led Global Environmental Management Initiative, this rebuttal of the relevance and materiality of environmental, health and safety factors is getting harder and harder to credibly make.

7 For example, see Goodman, Kron & Liddle, “The Environmental Fiduciary” (2002), bibliography, p. 69 – 71, available at www.rosefdn.org, listing approximately 40 major, peer reviewed studies documenting correlations between environmental performance, profitability and shareholder value.
shareholders by preventing them from learning about their company’s environmental liabilities until after the loss, the leak, the spill, the lawsuit or other catastrophic event that triggers both public disclosure and an immediate negative market backlash.

There is a legal term for intentionally providing shareholders with a false sense of security about their company’s finances – fraud.

Our research indicates the wide deployment by corporations of a set of general strategies to avoid assessing, quantifying or disclosing environmental liabilities for investors. This paper describes the strategies and tactics that underlie poor, and in many cases even fraudulent, disclosures to investors. We offer public policy recommendations to ensure better assessment and disclosure of financially material environmental liabilities.

**How Companies Fool Themselves (or “Don’t Ask / Don’t Tell”)**

Our research identifies how publicly registered companies commonly employ five overarching strategies to hide environmental bad news. Although often with a seemingly appropriate rationale, these strategies have the effect of avoiding or delaying assessment of environmental liabilities, or avoiding or delaying sharing internal assessments with shareholders:

- **Delay the quantification of liabilities** for years, or in some cases, decades.
- **Avoid meaningful qualitative disclosure** of liabilities that cannot yet be accurately quantified.
- **Hide the big issues in the footnotes** to make investors go on a treasure hunt to piece together a complete picture out of scattered cross-references.
- **Piecemeal the liability analysis** to assess the materiality of environmental liabilities one by one, rather than in the aggregate.
- **Employ artificial time horizons** to prevent the recognition of future costs.

Specific examples of how companies employ these strategies are outlined in the “Fooling Investors” Chapter.

Collectively, these strategies to avoid estimation and disclosure of liabilities reflect a pervasive “don’t ask / don’t tell” approach to environmental liabilities – an approach which is sometimes fostered by current legal rules, regulatory interpretations and corporate culture. In the absence of an enforceable mechanism to require quantification and disclosure of a liability, the assumption of many corporate managers and their counsel is that it is best to say as little as possible – to conserve resources consumed by the process of estimation, to defer ultimate cleanup expenditures, and to avoid drawing attention to environmental issues that could potentially invite new litigation. But delaying or denying the accounting for expensive environmental liabilities can be just an exercise in delaying the inevitable.

In the case of existing contamination, no amount of creative accounting can undo the contamination and put the toxic genie back in the bottle. Once it has occurred, contamination is not a contingency, it is a fact. In the case of future liability stemming from macroeconomic conditions such as global climate change, denial is a strikingly shortsighted business strategy.
As the Earth warms, even the ostrich will get sunburned (and perhaps more painfully than its forward looking peers). In both cases, by failing to acknowledge the problem and plan for the appropriate cleanup, mitigation or business model changes, management is only fooling themselves by thinking that problems only exist if they are acknowledged.

**How Companies Fool Investors**

Our review indicates that these general strategies are implemented through a set of informal and formal accounting and asset management tactics. Some of these tactics are fully permissible under existing accounting rules, some result from aggressively interpreting ambiguities in the law, and still others appear unlawful under any reasonable interpretation of existing laws and rules. In this paper, we identify seven specific tactics – apparently in widespread use today – that major U.S. companies employ to keep expensive environmental liabilities off their books and away from shareholder scrutiny.

- **Idling/mothballing contaminated facilities** to avoid environmental assessments that would be triggered by sale or full closure. Examples include many of the 21,000 Brownfields sites known to exist in 231 U.S. cities.
- **“No Look” agreements** to avoid assessment of environmental conditions during the sale of a contaminated, but still operational, facility. Examples include a controversial sale of the Tosco refinery in California that is now the subject of litigation.
- **Blaming non-disclosure on the government** because governmental decisions regarding the eventual levels of cleanup (and therefore the associated costs) have not yet been made. Examples include massive mercury contamination of Onondaga Lake in New York State, that could cost Honeywell as much as $1.4 billion if the company’s proposed lower cost approach to remediation is rejected by New York State officials. Our rough estimate is based on the dredging costs at other sites.
- **Passing the buck** by selling an end of life asset to another company. Examples include the sale of old oil wells in the Gulf of Mexico to small, undercapitalized companies.
- **Hiding insurance disclosures from investors** to keep internal projections about environmental remediation costs away from shareholders. Examples include Enpro Industries, facing at least 188,000 asbestos claims.
- **Avoiding disclosure of worker health impacts** to prevent disclosure of liabilities related to products such as asbestos. Examples include asbestos liabilities at Halliburton, Dow, and Kaiser Aluminum.
- **Denial of emerging hazards** such as global warming. Examples contrast companies wrestling with disclosures such as Shell and Ford with companies refusing to estimate potential impact such as TXU and General Motors.

**Towards Transparency: Policy and Regulatory Recommendations**

Fooling Investors & Fooling Themselves ends with a set of recommendations for action by the SEC, the Financial Standards Accounting Board (FASB) and the Public Company Accounting Oversight Board (PCAOB). Some recommendations call for immediate action under existing authority – for example, adoption by the SEC of new standards to guide environmental
disclosure. These standards,⁸ supported by institutional investors collectively representing over $1 trillion, call for:

- **Expected value probability analysis** to prevent companies from only accruing and reporting the low end of a potentially broad range of environmental remediation costs.
- **Aggregating environmental liabilities** before determining materiality to prevent individual liabilities from being swept under the rug one by one.

Among other recommendations for immediate SEC action are:

- **Allow shareholder resolutions** seeking better disclosure of particular environmental financial risks and liabilities. Many of these resolutions are currently being dismissed as “ordinary business,” closing one of the few avenues that shareholders can use to ask management tough questions about the extent of corporate environmental liabilities.

Regardless of any short-term responses by the SEC, long-term investors such as pension funds and foundations are urged to be more vigilant and to continue to demand that the SEC clarify and enforce its environmental disclosure regulations. Particular attention should be paid to red flags such as:

- **Artificially short time horizons** that may limit disclosure of known or suspected liabilities.
- “**No Look**” clauses that intentionally forestall investigation of known contamination.
- **Exposure to macroeconomic liabilities** such as global warming.
- **Lack of adequate environmental liability insurance** (especially for extractive or other high-risk industries).

Other recommendations call for a more long term response, such as:

- **SEC creation of a blue ribbon panel** to review broad questions related to environmental and social disclosure.
- **FASB analysis of inconsistencies and shortcomings** in current environmental accounting guidance.
- **PCAOB guidance holding audit committees** and independent auditors responsible for ensuring the consideration of financially material environmental conditions in corporate financial data collection and reporting.
- **Increased investor community pressure** asking portfolio companies tough questions about the projected costs of environmental liabilities.

As with past Rose Foundation publications, we view *Fooling Investors & Fooling Themselves* as a contribution to the continuing dialogue about the relationships between shareholder value, a sustainable economy, and corporate environmental and social performance. Our hope is to spark fresh dialogue and encourage creative thinking, not to articulate the last word. We value your feedback and opinions in response. Please reach us at rosefdn@earthlink.net.

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⁸ For details, see Rose Foundation Petition to the SEC, (SEC File # 4-463), available at [www.rosefdn.org](http://www.rosefdn.org).
This chapter provides an overview of five general strategies that companies may use to hide environmental bad news. Although often with a seemingly appropriate rationale, these strategies have the effect of avoiding or delaying assessment of environmental liabilities, or avoiding or delaying sharing internal assessments with shareholders. Specific examples of how companies employ these strategies are outlined in the following chapter, “Fooling Investors.”

Collectively, these strategies to avoid estimation and disclosure of liabilities reflect a pervasive “don’t ask / don’t tell” approach to environmental liabilities – an approach which is sometimes fostered by current legal rules, regulatory interpretations and corporate culture. In the absence of an enforceable mechanism to require quantification and disclosure of a liability, the assumption of many corporate managers and their counsel is that it is best to say as little as possible – to conserve resources consumed by the process of estimation, to defer ultimate clean up expenditures, and to avoid drawing attention to environmental issues that could potentially invite new litigation. But delaying or denying the accounting for expensive environmental liabilities is really just an exercise in delaying the inevitable.

In the case of existing contamination, no amount of creative accounting can undo the contamination and put the toxic genie back in the bottle. Once it has occurred, contamination is not a contingency, it is a fact. In the case of future liability stemming from macroeconomic conditions such as global climate change, denial is a strikingly shortsighted business strategy. By failing to acknowledge the problem and plan for the appropriate clean up, mitigation or business model changes, management is only fooling themselves by thinking that problems only exist if they are acknowledged.

**STRATEGY 1) DELAY THE QUANTIFICATION OF LIABILITIES**

In order to accomplish the quantitative disclosure of liabilities, a company must conduct some assessment or estimation of the likely magnitude of the liability. The failure of corporations to disclose environmental liabilities often is built upon rationales or maneuvers that lead to a delay in assessment of such liabilities. Current Securities and Exchange Commission (SEC) and Financial Accounting Standards Board (FASB) reporting requirements leave ample opportunities for companies to defer those calculations, in some cases indefinitely.9

In the absence of either a transfer of property or a government determination regarding cleanup criteria, the calculation of liabilities is typically put off by corporations that are liable for contaminated sites. Asset management strategies such as idling or sale of declining assets can have the effect of keeping estimates of substantial environmental liabilities out of corporate financial reports. Through these and similar measures, companies are avoiding public quantification of many significant environmental remediation liabilities – in some instances over the course of decades – even though an immediate review of cleanup costs in comparable

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situations could provide a robust basis for estimation and disclosure of a reasonable range of likely costs.

**STRATEGY 2) AVOID MEANINGFUL QUALITATIVE DISCLOSURE**

Even in the absence of quantitative estimation and disclosure, corporate financial reports are required to include narrative disclosure of conditions indicative of potentially material liabilities as part of the Management Discussion and Analysis (MD&A). Regulation S-K governing disclosure in the MD&A section of a corporate financial report requires a registrant to disclose "where 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 operation." (emphasis added)

However, the requirements for such disclosure under SEC rules are vague. In the absence of specific mandates, corporate management may conclude it is best to say as little as possible – to avoid disclosure of information that may provide fuel for opposing parties in existing litigation or which may call attention to a specific site or issue that could inspire litigation against the company. Often, the qualitative disclosure of key information regarding environmental liabilities in investor reports diverges sharply from the information known to the management and disclosed to other parties, such as banks or insurers. While insurers and banks may insist on site specific disclosures in the course of specific transactions, investors are generally deprived of the same data, even where it would affect most reasonable investors’ appraisal of value.

**STRATEGY 3) HIDE THE BIG ISSUES IN THE FOOTNOTES**

SEC disclosure rules can also be skirted by various reporting strategies that reduce the visibility of issues, such as hiding the relevant information in footnotes or cross references that only the most diligent investors will likely notice. Technically, an item might be “disclosed” if one reads every footnote and cross reference. Despite case law holding that the Securities Exchange Act requires prominent disclosure of material facts,10 important information that deserves the prominent attention of shareholders may often be buried without challenge from the SEC. Therefore, an investor is forced to engage in a “treasure hunt” to piece together the company’s true financial condition.

**STRATEGY 4) PIECEMEAL THE LIABILITY ANALYSIS**

In 1993, the Congressional General Accounting Office (GAO) studied insurance company disclosures, comparing assertions of high remediation costs associated with existing and pending claims to these same companies’ lack of specific related cost disclosure to their own shareholders. In a landmark study, the GAO found that many companies practiced piecemeal accounting, where they looked at environmental liabilities individually, rather than in the aggregate. Despite current accounting guidance advising companies to aggregate “like” circumstances, by determining that each individual liability was unique – for example, a company might have thousands of leaking underground tanks, yet each one is in a different place with different applicable geology, hydrology, zoning, and state regulations – company management may to treat each liability as an individual circumstance. By considering these

liabilities singly, each may be dismissed as “immaterial,” even though the aggregate costs might be highly material and may also represent a significant comment on management’s attitude towards environmental compliance and risk prevention.

Although it is difficult to assess how widely this strategy is still employed, the American Society for Testing and Materials (ASTM), a non-profit forum for the development and publication of voluntary consensus standards serving over 32,000 members from business, academia and government in 100 countries worldwide, found the aggregation issue important enough to develop a specific guidance standard specifically calling for the aggregation of environmental liabilities before assessing materiality.11 Released in 2001, the ASTM standard calling for aggregation provides compelling evidence that ASTM’s extensive membership believes that the practice of piecemealing liabilities to avoid disclosure is still alive and well.

**Strategy 5) Employ Artificial Time Horizons**

In many cases, entities such as insurance providers may required detailed, long-term estimates of anticipated liabilities such as claims related to asbestos exposures. But, in many cases, shareholders will never see these estimates because management usually considers most matters more than five years away to be rendered uncertain by the mists of time. Even when specific and quantifiable claims exist, such as health claims related to asbestos exposure, many companies only accrue or report expected settlements over the next five years, despite the fact that the bulk of the claims may not be anticipated to settle within that timeframe.

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FOOLING INVESTORS:
SEVEN AGGRESSIVE ACCOUNTING AND ASSET MANAGEMENT TECHNIQUES THAT CAN LEAD TO MISLEADING OR FRAUDULENT DISCLOSURES TO INVESTORS

This chapter profiles seven specific tactics that may be used by publicly traded companies that result in the avoidance, deferral, burying or piecemealing of financially material information, and that have the effect of causing expensive environmental liabilities to escape shareholder scrutiny. Some of these tactics are fully permissible under existing accounting rules, some result from aggressively interpreting ambiguities in the law, and still others appear unlawful under any reasonable interpretation of existing laws and rules.

However, whether or not aspects of these tactics may be technically permissible under current rule interpretations, the true legal exposure of corporate management and their boards may hinge more on intent and internal knowledge. If management is aware of material facts about environmental liability, and chooses to conceal these facts from investors, a jury of reasonable investors is likely to consider that to be fraud.

TACTIC 1) MOTHBALL CONTAMINATED FACILITIES

THE PROBLEM

One of the most commonplace corporate asset management strategies is to idle or “mothball” a facility. This is done for various reasons. For example, sometimes it is done because there is excess capacity in the marketplace for production of a particular product. Temporarily idling a particular production unit may be a strategic decision which can be revisited if market conditions change. However, in many other instances, a facility may be idled because the production unit in question has surpassed its productive life, and it would be too expensive to modernize. But, based on the facility’s history of use, environmental contamination may be likely to be present, significantly complicating any sale and representing an unquantified but potentially expensive problem. Keeping the site idle (a practice often called “mothballing”) is often used in such circumstances in order to avoid immediately triggering requirements to resolve potential environmental liabilities. Idling facilities is often preferred over closing, selling or transferring them, because those other options are more likely to trigger requirements for environmental assessments and remediation. Over time, these mothballed sites become “brownfields” – contaminated properties which are a major blight on the urban American landscape and whose often unquantified toxicity is a major obstacle to economically productive reuse.

When potentially contaminated property transfers between owners, the new owner or its financiers often will have a concern about the extent of potential liability attached to the property. Therefore, the purchaser, or its creditors, will typically require at least a preliminary assessment of the extent of contamination. An assessment leads to estimation of the likely costs of eventual remediation. The parties will then make efforts to address the issue in negotiations through pricing, indemnification, insurance or other arrangements.
Once information is developed regarding the extent of contamination, legal requirements may be triggered to notify appropriate levels of government about those findings. Government regulators concerned with site remediation are far less likely to trigger requirements for assessment of ongoing operations (even those that are “idled”) than when a facility is closed.

One article examining the relationship between corporate accounting law and mothballed properties (brownfields) noted:12

“If an investigation of contamination is not performed (don't ask), then there's nothing to report to government agencies (don't tell), and no regulations or laws are violated. In the absence of confirmatory investigations and reporting, regulatory agencies have no basis to compel investigations.”

Thus, in the absence of the closure or transfer of the property to a new owner, there may be few legal or market incentives requiring any determination of the extent of contamination of the property. In certain industries, such as oil refining and chemical manufacturing, this practice of mothballing facilities is commonplace.13 In the absence of assessment, the owner will not generally engage in quantitative or qualitative disclosure in SEC filings.

Very little reporting of the extent of facility mothballing appears in SEC filings, nor does disclosure of the contingent liabilities associated with the eventual remediation of those facilities. Although a petrochemical company may have many sites within its holdings with unassessed environmental liabilities, it may be providing investors with little or no information about the magnitude of these unestimated liabilities or even the existence or number of the mothballed sites.

**Examples**

While it is difficult to obtain comprehensive information about mothballed sites, a wealth of information exists about brownfields. According to a study conducted by Rutgers University's Brownfields Research Center, 40 percent of 60 New Jersey cities surveyed have at least one or more brownfields sites.14 About half of these municipalities consider that site to be a serious detriment to urban redevelopment. Another survey conducted by the U.S. Conference of Mayors in the year 2000 found that 231 cities reported the existence of about 21,000 Brownfield sites, ranging in size from a quarter acre to one that measured 1300 acres.15

**Analysis**

The Financial Accounting Standards Board issued FAS 144 in August of 2001 to address the issue of accounting for the impairment or disposal of long lived assets. The guideline describes “impairment” as the condition that exists “when the carrying amount of a long lived

14 Michael Greenberg, Diana Downton and Henry Mayer, The Impact Of Urban Redevelopment In New Jersey, Rutgers University.
asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of the asset (asset group) is not recoverable if it exceeds the sum of the discounted cash flow expected to result from the use and eventual disposition of the asset (asset group).”

It seems quite probable that many mothballed sites meet this criterion of impaired assets, even without taking account of the remedial liabilities. Since the sites have stopped producing income, are requiring some maintenance costs, and may be worth very little if sold on the open market, the cost of carrying the site may exceed the anticipated eventual cash flow from sale or use. However, even if a company were to treat a mothballed asset as impaired within these criteria, because the costs of locking and guarding the site may exceed the expected value of the eventual sale, the real extent of impairment is not likely to be reflected unless an assessment is also made of the cost of cleaning up the site. The remedial liabilities associated with disposal of highly contaminated oil or chemical industry facilities, for example, may far exceed any income likely to be realized from the sale of such sites. However, without an effective estimation of the extent of needed remediation, there is no realistic calculation of impairment loss or liability.16

FAS 144 also requires special reporting regarding certain operations classified as discontinued. However, to be discontinued the facility in question either has to have been disposed of or classified as held for sale. FAS 144 also states that “a long lived asset that has been temporarily idled shall not be accounted for as if abandoned.” To the extent that the firm has not made a decision whether to hold the property, sell it, abandon it, or to otherwise transfer the property, it may not be reported as discontinued. Therefore, where facilities are simply held in perpetuity, or with a colorable or imaginable scenario of reuse of the site at some time in the future, a company’s disclosures may not report the extent of mothballing. In the event that FAS 144 does not apply because a property has not been designated for disposal, the property may nevertheless appear on the books as a “decommissioning” obligation under the requirements of FAS 143, which relates to accounting for asset retirement obligations.

Under the terms of FAS 143, “retirement obligations” of tangible long-lived assets are to be recognized. The purpose is to provide a fair assessment of the total value of an asset by integrating the costs and liabilities associated with retiring an asset. However, the vagaries of FAS 143 have left substantial uncertainty as to which environmental liabilities would need to be accounted for and when, especially if there is uncertainty as to the timing and method by which remediation might be required. In a recent “exposure draft”17 FASB concluded that the uncertainty surrounding the timing and method of settlement should not affect whether the fair value of a liability for a conditional asset retirement obligation would be recognized, but rather should be factored into the measurement of the liability. The Board also decided that the ability to indefinitely defer settlement of an asset retirement obligation, or the ability to sell the asset, does not provide the entity discretion to avoid the future sacrifice, nor does it relieve the entity of the obligation.

16 Of course, the extent of needed remediation often depends on the planned reuse, which may in many cases be undetermined. For example, sites targeted for industrial reuse may often require a lower level of remediation than those targeted for residential housing development or schools. However, it would still be possible to provide shareholders with a range, where the industrial clean up scenario represented the low end cost and the residential use the high end.
In addition to requiring reporting of such asset retirement obligations, the exposure draft notes that there may be some instances in which there is insufficient information to estimate the fair value of an asset retirement obligation. It notes that if the liability’s fair value cannot be estimated reasonably, that fact and the reasons shall be disclosed. In other words, a footnote to the financial statements would indicate that there are retirement obligations associated with particular assets that have not been estimated and why. The MD&A might well expand on the footnote to ensure that the issue receives appropriately prominent attention. The examples given in the appendix to the exposure draft show how this could be relevant to environmental remediation and potentially mothballed sites question:

**FASB Exposure Draft: Asbestos Conditions**

An entity acquires a factory that contains asbestos. At the acquisition date, regulations are in place that require the entity to handle and dispose of the asbestos in a special manner if the factory undergoes major renovation or is demolished. Otherwise, the entity is not required to remove the asbestos from the factory. The entity has several options to retire the factory in the future including demolishing, selling, or abandoning it. The entity is able to estimate the initial fair value of the liability for the special handling of the asbestos using the present value embodied in the acquisition price. Although performance of the asset retirement activity is conditional on the factory’s undergoing major renovation or demolition, existing regulations create a duty or responsibility for the entity to remove and dispose of asbestos in a special manner, and the obligating event occurs when the entity acquires the factory. Although the entity may decide to abandon the factory and thereby defer settlement of the obligation for the foreseeable future, the ability to abandon the factory and thereby defer settlement does not relieve the entity of the obligation. The asbestos will eventually need to be removed and disposed of in a special manner, since no building will last forever. Additionally, the ability of the entity to sell the factory prior to its disposal does not relieve the entity of its present duty or responsibility to settle the obligation. The sale of the asset would transfer the obligation to another entity and that transfer would affect the selling price. Therefore, an asset retirement obligation should be recognized when the entity acquires the factory. Uncertainty surrounding the timing and method of settlement should be factored into the measurement of the fair value of the liability.

**FASB Exposure Draft: Oil Refineries**

An oil company acquires an oil refinery. Legislation requires the company to dismantle and dispose of the refinery and clean-up any existing soil contamination in a special manner should the company discontinue operating the refinery. The company and its competitors have historically upgraded and maintained their refineries such that very few have been dismantled. Due to the lack of objective evidence regarding useful lives of refineries, the company believes that the refinery has an indeterminate useful life; therefore, sufficient information to estimate a range of potential settlement dates for the obligation is not available.

Although performance of the asset retirement activity is conditional on removing the refinery from service, existing legislation creates a duty or responsibility for the entity to dismantle the refinery in a special manner, and the obligating event occurs when the company acquires the refinery. Therefore, an asset retirement obligation should be recognized. Although the useful life of the refinery is not infinite, the company believes that the refinery has an indeterminate useful life because of maintenance and replacement activities. Therefore, the company cannot reasonably estimate the fair value of the obligation upon the refinery’s acquisition. Accordingly, the company does not recognize a liability for the asset retirement obligation when it acquires the refinery, but it is required to disclose (a) a description of the obligation, (b) the fact that a liability has not been recognized because the fair value cannot be estimated reasonably, and (c) the
reasons why fair value cannot be estimated reasonably. The company would recognize a liability in the period in which sufficient information is available to estimate its fair value.

The latter example of the oil refinery shows a commonplace situation that often leads up to properties becoming mothballed or brownfields sites – leaving the extent of contamination and remedial obligation unknown. In the face of uncertainty about when the obligation will be triggered and how much cleanup will be required, the exposure draft would impose a duty to disclose the existence of the obligation, but not to quantify the remedial obligations or characterize the extent of contamination.

Another possible legal domain applicable to the assessment and disclosure of mothballed sites is the Sarbanes Oxley Act. Under the Sarbanes Oxley Act, corporate officers who make willfully false financial statements may receive a fine of $5 million or a prison sentence of 20 years, or both. Environmental liabilities related to many brownfields sites have been undisclosed by some corporations in the past through the policy of "don't ask, don't tell" with regard to investigation, valuation and reporting. As the authors of the previously cited article on brownfields and accounting ask, "Is don't ask, don't tell an exercise in willfully and knowingly misstating environmental liabilities and thereby the financial health of a corporation?"

It is an open question whether the Sarbanes Oxley Act, or other SEC or FASB guidelines will be enforced to stop this widely practiced “don't ask, don't tell” strategy of mothballing of properties to avoid quantifying remedial needs.

**SOLUTION**

The SEC should clarify that listing of mothballed sites, estimation of the range of potential liabilities, and narrative discussion of the scope and materiality of potential liabilities should be included in financial reports, especially for sectors such as the petrochemical industry where the aggregate impact of multi-site idling is likely to be concealing material liabilities.

The FASB should clarify in revising its exposure draft that FAS 144 requires in its calculation of impairment loss a reasonable estimation of the remedial liabilities associated with a contaminated site, even if it is done by calculating the number of acres of a site against rough benchmarks of the range of remedial costs based on experience at other sites and companies.

**TACTIC 2) “NO LOOK” AGREEMENTS**

**THE PROBLEM**

In some instances, due to changing business patterns, strategic restructuring or a variety of other factors, a company may wish to sell a facility which the company, based on its internal knowledge about its own past use of the facility, has reason to believe may be contaminated. However, despite questions about the facility’s environmental condition, the physical facility of a chemical plant or refinery which is potentially contaminated could be of great value to another owner. In this variant on the “don’t ask, don’t tell” strategy, some landowners and their lawyers have tried to establish creative legal mechanisms whereby the property can change hands without assessment by either party of the extent of contamination. As a result, the extent of
contamination is neither assessed nor disclosed to investors. Moreover, the assets may easily be overvalued, and the related liabilities are most assuredly underreported.

**Example**

Tosco sold to Ultramar Diamond Shamrock a Martinez, California refinery known as the Golden Eagle Refinery, despite likely contamination of the site. In the course of the sale they entered an agreement known as a “no look agreement,” under which the purchaser agreed not to review or assess the extent of environmental contamination for the subsequent 10 years. Clause 13.03 of the Purchase and Sale agreement, on “environmental investigations,” which was disclosed in SEC form 8-K at the time of the sale, states:

“For a period of ten (10) years after the Closing Date, except to make reports that are required by SH&E Law, Buyer shall not take any action to request, initiate, encourage, or induce an applicable government agency to require any site assessment or investigation that could lead to the discovery of an SH&E Condition and which would involve drilling or penetration of the surface of the ground, unless (i) such site assessment or investigation is performed in the ordinary course of business such as for geophysical studies for equipment foundations or in connection with construction, remodeling or demolish and rebuild work at the Refinery, or (ii) ordered to conduct such as assessment or investigation by any federal, state, or local governmental authority having jurisdiction thereof.”

This risky agreement, which treated environmental contamination in a hands-off manner, was not specifically identified for investors when the property was subsequently sold to a third oil company, Tesoro. Tesoro acquired the property from Ultramar in August 2000. However, in a subsequent lawsuit filed in 2003 seeking to avoid up to $100 million in cleanup liabilities, Tesoro now alleges that it unknowingly acquired a wide range of undisclosed problems known to and concealed by Tosco. Such problems included abandoned storage tanks and pipes, arsenic contaminated soils and asbestos tainted debris. Tesoro’s lawyers assert that Tosco fraudulently concealed pollution on the property by removing documents and failing to disclose certain information that it already had about the contamination of the facility. Tesoro pointed to the contract condition as one reason it had to rely on information provided by the prior owners to know the extent of environmental problems.

Investors would want to know of the existence of such an agreement, but would have to have read through the entire original transaction between the first two companies to understand how the contract dealt with this issue. In an unwittingly ironic and relevant quote in the Contra Costa County Times, an industry consultant said that the provision made sense because contamination of the refinery is likely to be more extensive than is now known, and without such an agreement a thorough investigation “would diminish the value of the refinery and kill the deal.” In other words, the agreement allowed the seller to sell the property in excess of its actual value. **Investors in both companies may have been misled as to the actual value of the property.**

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18 Most of the information in this section based on, *Refinery’s ex-owner requests lawsuit’s shift to arbitration*, Contra Costa County Times, Sunday, February 8, 2004.
19 Id.
Such “no look” agreements may eventually be found by a court reviewing them to be void under the legal principle which invalidates contract clauses which undermine important public policies.\textsuperscript{20} Such an agreement may be found to constitute a conspiracy to not evaluate and remediate environmental contamination that may threaten public health or the environment, and therefore be voided.

It is also possible that such agreement may violate requirements that a corporation have adequate internal controls over its financial accounting. Under the Sarbanes Oxley Act, enacted in the wake of the corporate finance scandals such as Enron and Worldcom, corporate officials are required to certify in financial reports that they have adequate “internal controls over financial reporting.” The SEC has defined such controls in its regulations as those necessary:

\textit{“to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:}

\begin{itemize}
  \item \textit{(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant… [and]}
  \item \textit{(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles….”}\textsuperscript{21}
\end{itemize}

A policy that prevents effective assessment of the extent of contamination, and therefore projection of the level of asset degradation and liability, would seem to directly contradict the intent of this regulation. It is hard to argue that such liabilities are “internally controlled” if they are not assessable in accordance with the terms of acquisition of the property.

Such a contract provision also seems appropriate to be disclosed under the requirements to report in the management discussion and analysis information needed to clarify the financial condition of the company and its assets. Clearly, the existence of a “no look” clause could demonstrate that the asset has been or may have been overvalued.

A “no look” clause is similar to other off-balance sheet arrangements implicated in the corporate accounting scandals of Enron and other companies. Under the Sarbanes Oxley Act, Congress directed the Securities and Exchange Commission to issue rules specifically requiring companies to disclose such arrangements in a specific section of the management discussion and analysis. In January 2003 [68 FR 5982] the SEC issued a final rule regarding “Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations," Release #33-8182. This created a separate section of the management discussion and analysis to address off balance sheet contractual arrangements. The requirement

\textsuperscript{20} Sternamen v. Metropolitan Life Ins. Co, 62 NE 763 (N.Y. 1902) (“The power to contract is not unlimited. While as a general rule there is the utmost freedom of action in this regard, some restrictions are placed upon the right by legislation, by public policy, and by the nature of things. Parties cannot make a binding contract in violation of law or of public policy.”)

was imposed as a result of the Sarbanes Oxley Act, though in promulgating this requirement the SEC noted that such contractual arrangements should have already been reported in the management discussion and analysis as a result of the general requirements of pre-existing SEC rules:

The MD&A rules already require disclosure regarding off-balance sheet arrangements and other contingencies. They are designed to cover a wide range of corporate events, including events, variables and uncertainties not otherwise required to be disclosed under U.S. generally accepted accounting principles ("GAAP"). For example, the current MD&A rules require disclosure of:

- Information necessary to an understanding of the registrant's financial condition, changes in financial condition and results of operations;
- Any known trends, demands, commitments, events or uncertainties that will result in, or that are reasonably likely to result in, the registrant's liquidity increasing or decreasing in any material way;
- Any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations and, in each case, the extent to which income was so affected;
- Matters that will have an impact on future operations and have not had an impact in the past;
- Matters that have had an impact on reported operations and are not expected to have an impact upon future operations.

Accordingly, while only one item in our current MD&A rules specifically identifies off-balance sheet arrangements, the other items clearly require disclosure of off-balance sheet arrangements if necessary to an understanding of a registrant's financial condition, changes in financial condition or results of operations.

As with the off-balance sheet contractual relationships engaged in by the likes of Enron, the “no look” agreement, if deployed at major assets or if widely deployed within a company, would appear to legally merit prominent disclosure in the MD&A.

**Solution**

The SEC should declare the use of environmental “no look” clauses to be analogous to other examples of off-balance sheet contractual arrangements that conceal liabilities and distort shareholder value. Prominent disclosure should be required for the existence of any such agreements.

The SEC and/or the Public Company Accounting Oversight Board should clarify that “no look” agreements may violate Sarbanes Oxley internal control requirements.

Regardless of any regulatory action, shareholders who become aware of such “no look” agreements should question whether the company’s audit committee has exercised appropriate due diligence.
TACTIC 3) BLAME NONDISCLOSURE ON THE GOVERNMENT

THE PROBLEM
Another corporate strategy that deprives investors of information regarding the likely level, or potential range of levels of remedial costs associated with a particular site involves using and abusing the fact that the locus of decision-making regarding the standard for eventual environmental remediation lies with the government, rather than with the site owner. Although the government process of decision-making leaves uncertainty as to the eventual costs of remediation, it need not prevent a range of liability estimates from being developed and disclosed to investors.

A company should be able to estimate the range of possible costs associated with a remediation based on what has occurred at comparable sites long before a government agency determines the level of remediation required at a particular site. Yet, current rules and practice discourage estimation and disclosure within the realistic range of likely liabilities.

EXAMPLE: HONEYWELL’S “MERCURY LAKE”
Honeywell International reports in its 10-K for 2003 the following:

In accordance with a 1992 consent decree with the State of New York, Honeywell is studying environmental conditions in and around Onondaga Lake (the Lake), in Syracuse, New York. The purpose of the study is to identify, evaluate and propose remedial measures that can be taken to remedy historic industrial contamination in the Lake. A predecessor company to Honeywell operated a chemical plant which is alleged to have contributed mercury and other contaminants to the Lake and certain surrounding areas. In May 2003, Honeywell submitted to the New York State Department of Environmental Conservation (DEC) a draft Feasibility Study for the Lake and certain surrounding areas. In November 2003, the DEC issued formal comments on the Feasibility Study. Those comments include a request for further evaluation of remedies for the Lake and surrounding areas. Accordingly, pursuant to the consent decree, Honeywell is required to submit a revised Feasibility Study on or before May 3, 2004. Provisions have been made in our financial statements based on our expected revisions to our Feasibility Study. We do not expect that this matter will have a material adverse effect on our consolidated financial position. However, should the DEC ultimately require a substantially more extensive remedy than that expected to be proposed in the revised Feasibility Study and should Honeywell agree to undertake such a remedy, such outcome could have a material adverse impact on our consolidated results of operations and operating cash flows in the periods recognized or paid.

This vague disclosure gives an inadequate picture of the extent of problems facing Honeywell at the site. The company inherited extensive site contamination from its acquisition of Allied Chemical. The acquired company had, for decades, dumped 22 pounds of mercury per day into the Onondaga Lake near Syracuse, New York – a total of 165,000 pounds of mercury. The entire three thousand acre lake contains extensive mercury contamination. The New York State Department of Environmental Conservation is evaluating the extent of remediation that will be required after having received a lake sediment remediation feasibility study from Honeywell in May 2004.

Based on established cleanup processes at comparable sites, the high end method would involve dredging the entire lake to remove all of the mercury. The feasibility study that Honeywell commissioned rejects out of hand the more costly remedies for the lake such as dredging the entire lake bottom.\textsuperscript{23} As implied by the company’s own reporting, it remains to be seen whether the state of New York will require such measures.

If Honeywell were required to conduct remediation, the cost of dredging would be affected by factors including depth of water, number of feet of soil to be dredged in a given location, and the means of disposal or treatment associated with the material that is dredged from the lake. Thus, the calculation of a \textit{precise} cleanup estimate is impossible.

Despite these uncertainties, a rough figure based on results at other sites could have been provided to investors by Honeywell. For example, the Sediment Management Working Group, an industry forum of which Honeywell is a Steering Committee member, has reviewed the costs of remedial dredging at 22 different sites, and \textbf{found that the overall costs of remedial dredging have run from $44 to $1842 per cubic yard}, with a median cost of $200 to $275 per cubic yard.\textsuperscript{24} Honeywell surely knows of the Working Groups’ findings – why isn't this information used to provide Honeywell shareholders with a basis for estimating Honeywell’s own exposure?

Using the lower median figure one could estimate that if the New York DEC orders dredging of the entirety of Onondaga Lake, where seven million cubic yards are mercury contaminated, the cost might approach or exceed $1.4 billion dollars.

Investors could think that a potential $1.4 billion dollar liability is a material fact for which they have a right to know. But Honeywell has elected not to provide their shareholders with any range of outcomes, and the SEC has been complacent regarding Honeywell’s current level of (non)disclosure.

\textbf{ANALYSIS}

The typical rationale for the slow quantification of environmental liabilities is that “reasonable certainty” will only arise after government specifies how clean a property must be made. Corporate decision makers attempting to conserve resources on behalf of the corporation tend to wait until the course of external events requires the firm to conduct the assessment.

Both quantitative and narrative disclosure issues are involved. First, there is a need to identify at what point a company should prepare and publish a quantitative estimate of liability in its financial reporting that is more than just the low-end estimate currently utilized or accrued. Under current practices, the dollar figures that a company tends to publish are the amounts accrued for environmental remediation. Typically, the company only reports the amount of money committed to study and that the company expects to spend on remediation during the current year. The report may include other amounts which, because of a settlement or other

\textsuperscript{23} Personal communication with Kevin Kelley, NY Department of Environmental Conservation, July 1, 2004.
specific order, the company has been required to commit. In other instances, companies may report the amount committed for the subsequent five years, even though they have elsewhere – in correspondence with insurers, for instance – provided much larger figures based on estimates of their expected liabilities for the subsequent 50 years.

By contrast, quantifying the potential range of liabilities from a site like the Onondaga Lake area by developing comparative analysis with other sites is possible and may provide shareholders with a much better understanding of the true scope of the liabilities. Currently, neither the SEC nor FASB require conducting such comparative quantitative analysis. In fact, current accounting guidance seems to discourage it. The American Institute of Certified Public Accountants (AICPA) (SOP) 96-1 indicates that specific types of reporting of remedial liabilities should occur at specific benchmarks. The standard instructs that during the Remedial Investigation and Feasibility Study phase, a corporation should report the cost of the study. It also clarified that once the study was complete and an action plan was chosen, a corporation should disclose an estimated cost of the action plan. But, during the entire time that a corporation is conducting the Remedial Investigation and Feasibility Study – which may be many years – AICPA (SOP) 96-1 only requires corporations to report the known minimum (widely interpreted to be simply the cost of the study) instead of the usually much larger cost of the cleanup itself. Full disclosure may be delayed for a number of years until the study is complete.25

Regardless of whether Honeywell develops and discloses a specific dollar amount associated with potential remediation costs, the example demonstrates that a company’s narrative disclosure in the management discussion and analysis (MD&A) of the elements that will go into the scale of required cleanup is important to investors. Since the draft Feasibility Study was still being evaluated by the New York Department of Environmental Conservation at the time of publication for the 2003 10-K, Honeywell could not accrue an accurate amount for the eventual clean up cost. The MD&A could, however, note the discharge of 22 pounds per day of mercury into the lake for decades and the contamination of the entire three thousand acre lake. In addition, the MD&A could explain the potential high-end remedy would require dredging the entire lake, and provide some comparative basis with other sites. Such disclosures would give the investor evaluating Honeywell a much better idea of the potential extent of costs associated with remediation.

25 A related issue involves the ability of companies to, in the face of uncertainty, report their liabilities according to the lowest possible estimate, often considered to be nearly “zero.” SEC Staff Accounting Bulletin (SAB) 92, clarifies that companies that have a range of possible liabilities must generally report a “nonzero” estimate of liabilities. Instead of simply reporting zero as the minimum of the range, post-SAB 92 it became accepted practice for a company to develop a range of estimates internally, but to only accrue and report the low end of the range to shareholders. Defaulting to the known minimum was justified by the “uncertainty” of the environmental cost estimates and by language in SAB 92 which stated that if future costs were uncertain, corporations should develop a range of amounts and just accrue and report the “known minimum.” The understanding of “known minimum” became further narrowed to mean what management knew it would spend in the next fiscal year for environmental costs and liabilities. So, while SAB 92 moved most minimum environmental disclosure above zero, it still did not ensure financial transparency or require companies to fully disclose material environmental liabilities to their shareholders.
By contrast, current law and guidelines may be understood to allow and encourage the weak disclosures that have occurred at Honeywell and Dow.

**SOLUTION**

FASB guidelines should clarify that in the absence of a definitive government-approved remedial plan, corporate disclosures should:

a) Describe a reasonable range of potential liabilities based on comparable sites and cases;

b) Describe key liability-impacting features such as acreage, contamination levels, range of remedial options, etc., that may allow investors to assess the relative magnitude of potential liabilities.

The SEC should either issue new regulations or a staff accounting bulletin that responds to citizen petition 4-463, filed in 2002 by the Rose Foundation and supported by institutional investors including state pension funds, labor organizations and charitable foundations representing a combined total over $1 trillion in assets. The petition calls for two specific actions which would terminate or curtail many of the aggressive accounting tactics discussed in this paper and go a long way towards closing some of the main gaps in GAAP which many company’s exploit to the detriment of their shareholders.

**SEC Petition # 4-463**

**Go Beyond the “Known Minimum”:** The SEC should require the use of the expected value methodology as described in ASTM Standard Guide for Estimating the Monetary Costs and Liabilities of Environmental Matters E 2137-01 when estimating and disclosing environmental liabilities. By requiring companies to disclose a probability weighted expected value of their environmental liabilities, rather than limiting disclosure to the artificially low “known minimum,” investors and other financial statement users would receive much better estimates of the true extent of the costs associated with a company’s environmental liabilities because the probability-weighted average would take into account not only projected costs, but also the probability that the various scenarios that underlie the projections will actually occur. In rare instances in which there is not enough information available to derive a robust expected value, the standard calls for a hierarchy of alternative methodologies, ranging from most likely value to range of values.

**Aggregate Before Determining Materiality:** The SEC should require the use of the aggregation guidelines as described in ASTM Standard Guide for Disclosure of Environmental Liabilities E 2173-01. Requiring aggregation before making a determination of materiality will prevent individual liabilities from being swept under the rug one by one and would allow investors to examine the totality of a company’s environmental exposure, providing shareholders with a valuable context for evaluating risk exposure and management performance in conserving corporate assets.

For more information about the Rose Foundation’s SEC Environmental Disclosure Petition, please visit [www.rosefdn.org](http://www.rosefdn.org).

At least until the SEC issues a staff accounting bulletin that provides for better disclosure of environmental liabilities, SEC staff should allow shareholder resolutions to ask for disclosure
of the range of risks and liabilities with associated environmental or remedial matters. The SEC should reconsider prior rulings that disallow such shareholder resolutions, since currently these resolutions may be the only way for shareholders to ask for information about clearly material environmental liabilities.

**Tactic 4) Pass the Buck**

**The Problem**

Liabilities are often handed off to other companies as part of asset transfers. A receiving company may, under terms of a sale or spinoff, assume the primary responsibility and liability to conduct the environmental remediation or decommissioning, and therefore report those liabilities in their financial reports. Typically, this arrangement includes an obligation to indemnify the company that is the seller or former parent. **However, if the acquiring companies are small and undercapitalized, they may not realistically be able to bear the costs.** Thus, the remediation and closure costs and other liabilities to third parties may be returned to the seller, through subsequent litigation in which the government or other parties pursue remedial costs from the more fully capitalized entity. In the meantime, those liabilities have typically been scrubbed from the seller’s financial reporting. In the intervening period, value may have been artificially inflated.

**Example: Sell the Old Wells**

In the Gulf of Mexico, a fairly mature oil field area, many of the wells that were developed by the larger companies during their production heydays have been or are in the process of being transferred to smaller companies which may be undercapitalized and face a prospect of bankruptcy. **Large companies list their plugging and abandonment liabilities for oil wells until the sites are transferred to smaller companies. After the transfer, however, the costs become the responsibility of the smaller companies. In some cases, as the productivity of the wells drop off, the new owners, who are saddled by strained cash reserves, are left with no ability to pay decommissioning costs.**

For instance, the small company Panaco acquired numerous offshore Gulf assets from major oil companies. In 2002, the federal Minerals Management Service filed a claim for $60 million to cover the cost of plugging and abandoning Panaco’s 50-plus wells in federal waters. But once the decommissioning costs became more definite, Panaco went bankrupt. The $60 million was three times more than Panaco had set aside through escrow and bonds to cover the company’s plugging and abandoning liabilities in both federal and state waters.

The company’s 8-K filed with the SEC of February 11, 2003 summarized the history of underestimation that led to the bankruptcy:

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26 This is even more of a problem if the decommissioning costs were lowballed in the first place, or were concealed from the buyer through mechanisms such as “no look” agreements.

27 This example is largely based on the article “Gulf Hides $10 Billion Hazard,” East Bay Business Times & MSNBC, March 28, 2004.
Prior to the filing of the Chapter 11 proceedings, Panaco estimated the total future abandonment costs for all of its properties at approximately $22 million, approximately half of which was funded via established escrow agreements. A report commissioned by the Debtor during the Chapter 11 proceedings now estimates these future P&A costs at $66,119,862.

Liabilities for these decommissioning costs are likely to return to the prior owners. In the Panaco case, the prior owners include BP, ConocoPhillips, Chevron USA, Oxy USA and Atlantic Richfield.

Panaco is expected to be only one of the first of many other small companies, who, after acquiring declining wells from big oil companies, proved unable to cover the closure costs as the bills came due. Approximately 4,000 oil and gas platforms currently are active on the Outer Continental Shelf of the Gulf. A quarter of these are 25 years old, or older. Currently about 186 are decommissioned annually. Already, the number of platforms being removed outpaces the rate of new construction in the Gulf. This trend is expected to place more financial pressure on the small companies that bought the wells in the 1990’s.

Legal experts who work in the Gulf region believe that there will be many more bankruptcy cases involving decommissioning liabilities, because a common industry practice is for big oil companies to sell declining wells to small companies. Also, though the smaller companies may be bonded for cleanup, the bond companies are expected to fight against payment of the bonds. Those bond companies may themselves be undercapitalized to face the widespread liability due to the many small companies that have taken ownership of declining wells.

**EXAMPLE: THE SPIN-OFF SHUFFLE**

In 1997, the Monsanto company spun off its chemical division, in effect passing an array of liabilities to its spin-off, Solutia Inc. Remaining portions of Monsanto were later acquired by Pharmacia and Upjohn to become Pharmacia Corp. Later the agricultural and biotech elements of Monsanto were spun out of that, once again under the name Monsanto. In December 2003, Solutia filed chapter 11 bankruptcy in light of legacy liabilities of $100 million per year, including 570 asbestos cases involving 3500 to 4500 plaintiffs, about 30 PCB exposure cases, and roughly 90 general and product liability claims. In addition, Solutia was liable for the health care and insurance of 20,000 Monsanto retirees and their dependents. Most of these claims and obligations related to activities prior to the spin-off.

A review of Monsanto’s SEC filing record reveals that in the course of the spin-off of Solutia, Monsanto did note that the spun off chemicals division would indemnify Monsanto for certain liabilities incurred by the chemicals division. The disclosure statement included the caution that “however, the availability of such indemnities will depend upon the future financial strength of chemicals and the company. No assurance can be given that the relevant company will be in a position to fund such indemnities.” But what is difficult for investors is to assess the relative magnitude of liabilities handed off to Solutia as compared with the likely revenue.

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The value of Solutia stock fell from $2.54 to 33.5¢ during the week it declared bankruptcy.

**Analysis**

While any one of these transactions or eventual bankruptcies may be individually understood as part bad luck and part business cycle, the overall pattern is similar to the junk bond craze that swept the Savings and Loan (S&L) industry in the 90’s. In that instance, the depositors’ cash money was replaced by speculative junk bonds. When these bonds failed, the S&L’s went belly up – at enormous cost to the U.S. Treasury, which had to step in and make the innocent depositors whole. A similar dynamic is at play here. The company that created the original contamination and had originally (at least in theory) set aside appropriate reserves to cover closure is able to pass the liability on to some other entity – in many cases a far less capitalized one. Meanwhile, the government may be forced to step in and deal with very real decommissioning problems and may have to engage in expensive litigation to force payment by the responsible parties. The shareholders of both the small and larger companies may be receiving misleading information due to the lack of accurate assessment of decommissioning costs or liabilities.

**Solution**

The SEC should require firms that sell or transfer sites with decommissioning costs to smaller companies to maintain a contingency for the costs of decommissioning those sites.

**Tactic 5) Hide Insurance Disclosures from Investors**

**The Problem**

Corporations provide far more information to insurance companies about the extent of their environmental liabilities than they do to investors. As a result, the disclosures and projections of environmental liabilities provided to investors can be orders of magnitude lower, and seem far more uncertain than correspondence with insurers, and internal corporate estimates and projections would otherwise demonstrate.

**Example**

When corporations seek recovery of substantial environmental claims from their insurance carriers, the insurers typically require a long-term estimate from the claimants of the amount of liabilities anticipated. These estimates may project liabilities as much as 50 years into the future. The insured and the insurer sometimes utilize such projections to negotiate a near term buyout of the liability claims of the insured.

Despite such long range disclosures to insurers, the same companies may project liabilities for investors on a much shorter time horizon – one year, five years or ten years, and assert that beyond that, the future claims are too uncertain to estimate. As a result, the same company may tell its insurer to expect liability claims of $2 billion while telling investors that it expects liabilities of $200 million over the subsequent five years, and that the future beyond that is too uncertain.
For example, many companies develop long term estimates of asbestos liabilities for their insurers who they are asking to pay for the claims, but then only provide far shorter timeline estimates for shareholders. Some companies limit their investor disclosure estimates for asbestos claims to a time horizon of ten or 15 years, and/or to claims already pending or to claims nearing settlement. For instance, Enpro Industries, facing at least 118,800 asbestos claims, reports in its form 10-K for 2002 that it provides estimates of liability only in a very short window – once claims have reached advanced stages:

In accordance with internal procedures for the processing of asbestos product liability actions and due to the proximity to trial or settlement, certain outstanding actions progress to a stage where the cost to dispose of these actions can be reasonably estimated. These actions are classified as actions in advanced stages. With respect to outstanding actions that are in preliminary procedural stages, as well as any actions that may be filed in the future, insufficient information exists upon which judgments can be made as to the validity or ultimate disposition of such actions, thereby making it impossible to estimate with any degree of accuracy or reasonableness what, if any, potential liability or costs may be incurred. Accordingly, no estimate of future liability has been included for such claims.

Arbitrary cutoffs, typically based on a rationale that the management describes as what it reasonably believes it can estimate, also has the effect of sharply reducing the estimates of liability below what would be a realistic projection of its \textit{total} liability. For a more detailed examination of how arbitrary cutoff dates may be used, please refer to the next section, "Avoiding Disclosure of Worker Health Impacts."

**ANALYSIS**

There is an enormous gulf between requirements for disclosure imposed by insurers, and those provided under SEC filing requirements. While investors need less detailed information than insurers, a summation of the disclosures made to insurers would greatly benefit investors by providing a better sense of the magnitude of likely liabilities. If long term estimates of liability are material to insurers, there is a strong argument that they are material to investors as well.

**SOLUTION**

The SEC and FASB should adopt guidelines to ensure that corporations disclose:

a) estimates of claims made to insurers and/or  
b) instances when estimates of liability provided to investors diverge significantly in time horizon or magnitude from those provided to insurers.

The West Conshohocken, Pennsylvania based American Society for Testing and Materials (ASTM) conducted a seven year long process to develop guidelines and to set forth methodologies that corporations should use to develop appropriate estimates of environmental costs and liabilities. The ASTM Committee released two standards to guide corporations in estimating and disclosing environmental liabilities and costs. According to a participant in the process, one reason for the standards, E2137-0 on estimation, and E2173-0 on disclosure, is to
improve consistency between the information corporations report to insurers and to investors.\textsuperscript{29} The standards would provide greater disclosure to investors by providing clearer criteria for when and how to estimate liabilities, and ensuring that disclosure of “material” environmental liabilities is determined by assessment and aggregation of the full array of environmental liabilities facing a corporation. As noted in the previous section, the Rose Foundation has submitted a petition to the SEC urging the Commission to adopt those standards as guidelines for corporate financial disclosure. Since the formal submittal of the petition in 2002, investors representing over $1 trillion in assets under management have contacted the SEC in support.

**TACTIC 6) AVOID DISCLOSURE OF WORKER HEALTH IMPACTS**

**THE PROBLEM**

This tactic is a hybrid that typically may involve hiding big issues in the footnotes, hiding insurance disclosures from investors, using artificial time horizons to limit disclosures, and ignoring comparable liability information generated by other companies.

Environmental health and safety of the workforce is well recognized as a corporate value driver.\textsuperscript{30} For example, according to the Global Environmental Management Initiative (GEMI), 81\% of Global 500 Executives rate environmental health and safety as one of the top ten factors driving value in their businesses. Yet, despite (or perhaps because of) the recognition that forward looking environmental practices build value, many companies are very reluctant to provide information to shareholders about worker health liabilities related from past practices and products. But these past exposures, to materials such as asbestos or toxic chemicals, can lead to big bills – even for companies such as Dow Chemical who are partners in the GEMI program.

A review of corporate shareholder disclosures related to asbestos liabilities demonstrates that many companies may have routinely underestimated and underdisclosed asbestos liabilities related to worker exposure.

**EXAMPLE: HALLIBURTON “HIDES IT IN THE FOOTNOTES”**

In December 2003, Halliburton Corporation filed for Chapter 11 bankruptcy protection for its DII Industries LLC subsidiary (formerly Dresser Industries Inc.), including DII's Kellogg Brown & Root construction unit as a result of asbestos liabilities. The bankruptcy filings were made in U.S. Bankruptcy Court in Pittsburgh, Pennsylvania, because most of the claims had originally been filed against Harbinson-Walker Refractories Co., a Dresser subsidiary based in Pittsburgh. Back in 1998, when Halliburton acquired Dresser Industries, it engaged in very little disclosure of the relevant liabilities. On May 15, 1998, Halliburton filed an S-4 form that provided shareholders with information regarding its proposed merger with Dresser Industries. The joint proxy statement/prospectus included the Agreement and Plan of Merger between the two companies that made certain representations and warranties regarding Dresser’s environmental and litigation liabilities. The filing does not highlight Dresser’s asbestos liabilities.

\textsuperscript{29} Gayle Koch, consultant, The Brattle Group of Cambridge, Massachusetts, Panel Discussion at CERES 2003 Conference.

liabilities but instead says that the company has no litigation or environmental problems except for those outlined in other referenced documents. Review of other documents, such as Dresser’s 1998 10-K report reveals that Halliburton had employed a classic “hide it in the footnotes” strategy to downplay 66,000 pending asbestos-related claims – a figure which actually turned out to be far lower than the amount of claims that ultimately drove the company into bankruptcy. Further inquiry might reveal whether the number of claims pending in 1998 were less than those anticipated by Dresser.

By 2001 it had become apparent that the liabilities had been dramatically underemphasized. In late 2001, DII Industries retained an expert to estimate the probable number and value, including defense costs, of unresolved current and future asbestos and silica-related bodily injury claims asserted against DII Industries and its subsidiaries for the subsequent 50 years. Utilizing methodologies said to be similar to those used by claimant groups, the expert arrived at an estimate through 2052 of between $2.2 billion and $3.5 billion as of June 30, 2002. The lower end of the range, $2.2 billion, was then accrued by the company.

Further negotiation with asbestos and silica plaintiffs led to a plan to create a $4.2 billion trust fund to handle all current and future asbestos claims against Halliburton under an agreement by 400,000 asbestos and silica claimants. Halliburton would pay about $2.78 billion in cash, and $1.22 billion in stock and notes into the fund. DII Industries filed for bankruptcy as part of that plan.31

EXAMPLE: DOW “DISCOVERS” $2.2 BILLION IN ASBESTOS LIABILITIES

Dow Chemical did not report any asbestos liabilities when it acquired Union Carbide in 2001. But two years later, Dow reported a $2.2 billion asbestos liability associated with the acquisition, a figure arrived at by finally looking at comparable lawsuit outcomes at other companies. A Dow shareholder may draw one of two conclusions – either the company’s management failed to diligently analyze the Union Carbide acquisition, thereby blindly buying into massive liabilities, or Dow’s management knew about the asbestos liabilities but failed to adequately assess and disclose them to shareholders.

EXAMPLE: MAXXAM/KAISER IGNORES JOHNS MANSVILLE’S EXPERIENCE

Kaiser Aluminum, a subsidiary of Maxxam Corporation, underestimated its asbestos liabilities in the mid-1990’s. A few years later Kaiser was driven into bankruptcy, in part because the spiraling asbestos litigation costs finally caught up with them.

In its 10-K report for 1995, Kaiser estimated that future cash payments in connection with asbestos litigation would be approximately $13 to $20 million for each of the years 1996 through 2000, and an aggregate of approximately $78 million thereafter through 2008. The company noted there was no reasonable basis for estimating such costs beyond 2008. One could have predicted much greater asbestos liability, however, by comparing the amount per case that Kaiser was using to calculate its liabilities against the much greater amounts that were being paid out per case by other comparable companies in the course of their asbestos settlements. For example, asbestos cases against the Johns Manville trust had, by 1990, paid an average of $43,500 each on the first 24,000 claims. Maxxam, by contrast, had accrued only $160 million

for 59,7 thousand cases pending in its 1995 10-K. If Kaiser had multiplied the 60,000 cases by the average Johns Mansville settlement figure of $43,500, they would have calculated a total potential loss of $2.5 billion – far more than the amount accrued by Maxxam/Kaiser.

By 1999 the Kaiser estimates had risen to $387.8 million until 2009, more than double the previous estimate. In 2000 Kaiser’s parent Maxxam made a third quarter charge for an increase in the net asbestos liability, and Kaiser's senior unsecured and subordinated debt was downgraded by Moody's Investor Services. According to a report in Dow Jones news service, after completing a thorough review Moody's decided to lower Kaiser’s ratings on a series of notes. Moody's noted that the inherent uncertainties surrounding the asbestos liability, coupled with Kaiser's high leverage, vulnerability to volatile aluminum prices, and fairly high operating costs could adversely affect the company’s ability to refinance certain notes.

By 2002, Moody’s assessment proved true; Kaiser and 24 subsidiaries filed for bankruptcy. The company reports in its 2003 10-K, filed March 2004, that:

“[t]he necessity for filing the Cases by the Original Debtors was attributable to the liquidity and cash flow problems of the Company and its subsidiaries arising in late 2001 and early 2002. The Company was facing significant near term debt maturities at a time of unusually weak aluminum industry business conditions, depressed aluminum prices and a broad economic slowdown that was further exacerbated by the events of September 11, 2001. In addition, the Company had become increasingly burdened by asbestos litigation and growing legacy obligations for retiree medical and pension costs. The confluence of these factors created the prospect of continuing operating losses and negative cash flows, resulting in lower credit ratings and an inability to access the capital markets.

ANALYSIS

This is one area where investors often have to go on a “treasure hunt” to piece together a complete picture. For example, in its 10-Ks between 1995 and 2000, Maxxam (and subsidiary Kaiser Aluminum) did acknowledge the existence of substantial asbestos liabilities. But only the most careful reader would systematically cross-reference the asbestos claims acknowledged against the insurance receivables booked against them and contrast those asbestos projections against what other companies were actually paying out in asbestos claims. Only then would an investor learn that the amounts projected might cover only a small fraction of the reasonably anticipated costs.

But despite this prevalence of the treasure hunt strategy, the courts have made it clear that burying important information in footnotes or cross references may not be adequate disclosure. SEC disclosure regulations are not limited to insuring that facts are disclosed; they also must be disclosed adequately – that is, with appropriate prominence as well as content. The “buried facts” doctrine has been used in court cases to find a company’s disclosures to be false and misleading where facts of concern such as conflict of interest could be discerned by the careful reader, but are strategically de-emphasized as against relevant but contrasting positive information.32 However, despite this established legal precedent, the SEC has often allowed companies to bury worker health liabilities in the footnotes.

32 “The Securities Exchange Act requires more than disclosure, it requires adequate disclosure. The more material the facts, the more they should be brought to the attention of the public. To view it otherwise would be to invite
SOLUTION

SEC and FASB should require corporations facing worker exposure liability issues such as asbestos to utilize industry-average litigation outcome figures as a basis for calculating long term liability prospects.

SEC should enforce requirements against “burying” important disclosures regarding worker health liabilities.

TACTIC 7) DENY EMERGING HAZARDS

THE PROBLEM

In our technology-rich economy, a surprising number of products enter the market without full understanding of the risks posed to health or environment. Only after the fact do scientists come to understand the full implications. Examples of the concerns are numerous – in everything from biotechnology, to emerging nanotechnologies, to greenhouse gas emissions, to toxic substances in cosmetics, toys and medical devices.

Scientific developments indicating risks of a company’s products or activities are disclosable developments under SEC rules when they are reasonably likely to pose a material impact on the company either by leading to liability suits, by creating market risks as against competitors whose products do not pose the emerging scientific concerns, or by creating costly pressures on a company to reconfigure production to avoid the newly recognized risks. Unfortunately, vagaries of SEC rules and guidance make it easy for companies faced with emerging scientific concerns or challenges to defer communication of those matters to investors until after lawsuits are in progress. Whether or not the company is winning the lawsuits or the company’s competitive position is actually materially harmed, investors often receive the information too late to take effective, responsive action.

EXAMPLE: PVC AND PHTHALATES POSE PROBLEMS FOR MEDICAL DEVICE COMPANIES

Polyvinyl chloride (PVC) represents more than twenty-five percent of the plastic used in medical devices including IV bags and tubes and enteral feeding bags and tubes. In medical devices, PVC is typically combined with Di(2-ethylhexyl)phthalate (DEHP), a plasticizer used to soften the plastic. DEHP is known to leach out of IV bags, tubing and similar devices, directly entering the bodies of patients. Recent studies have provided evidence that DEHP may harm the reproductive systems of developing males (infants and small children). As a result, the Food and Drug Administration has recommended that certain uses of PVC/DEHP devices be avoided where the products may lead to exposure of developing males.

In October 2000, the Center for the Evaluation of Risks to Human Reproduction of the National Toxicology Program of the National Institutes of Health released an Expert Panel report on DEHP and its risks to human development and reproduction (NTP-CERHR Expert Panel report). The Panel did not consider risks other than those to reproduction and development. The National Toxicology Program’s Expert Panel report focuses concern on three distinct populations at risk of DEHP exposure: critically ill infants, healthy infants and toddlers, and the offspring of pregnant or lactating women. In all three groups the “Panel has concern that exposure may adversely affect male reproductive tract development.” (emphasis added)

A recent risk assessment of DEHP developed by the Chemical Inspectorate of Sweden, representing the European Commission, concluded that efforts should be undertaken to reduce DEHP exposures from medical devices because of health impact concerns. In response to the risk assessment, the European Parliament voted on April 3, 2001 for much stricter standards on the use of PVC, a decision that could push European regulators toward more product phase outs, as well as restrictions on PVC waste disposal. The resolution included the statement that the European Commission should "introduce rapidly a policy on the replacement of soft PVC, in so far as the current risk analysis of phthalates indicates that it is desirable to reduce the exposure of people and the environment." Moreover, European vinyl manufactures have acknowledged that the Parliament vote will have an effect of the markets:

"There will be some damage done to the market. ...It is pushing people in the direction where they will start to think about their purchasing policy."\(^{35}\)

Some of the largest healthcare providers in the U.S., including Universal Health Services, Tenet, Kaiser Permanente, and Catholic Healthcare West, have begun to promote alternatives to PVC, to request that health care product manufacturers provide a comprehensive line of alternatives that meet their needs for price, quality, and patient care. Two state hospitals have formal commitments to continuously reduce and phase out the use of plastics that contain PVC.

Competitive factors in the marketplace are emerging, as some but not all medical device producers become cognizant of, and respond to the changing science on PVC and DEHP. Recently, Pactiv Corp. and Rollprint Packaging Products announced a joint venture to market non-PVC IV bags in the United States. Corpak Medsystems is marketing PVC-free enteral feeding bags.

This emerging information may have significant implications for manufacturers - such as potential for liability shifts in product markets. Product manufacturers such as Abbott Laboratories that use PVC/DEHP are aware of the reports of risks, as well as the changes in markets for these products that are resulting from increased attention to these risks. However,\(^{33}\) The full NTP Panel report is available online at [http://cerhr.niehs.nih.gov/news/DEHP-final.pdf](http://cerhr.niehs.nih.gov/news/DEHP-final.pdf). A final report from the NTP is forthcoming.\(^{34}\) These findings have been confirmed, including by the National Toxicology Program of the U.S. Department of Health and Human Services’ Center for the Evaluation of Risks to Human Reproduction in its Expert Panel Report on Di(2-ethylhexyl)phthalate (DEHP) issued in October 2000.\(^{35}\) Martyn Griffiths, spokesman for the European Council of Vinyl Manufactures in Brussels quoted in Plastics News, April 6, 2001.
Despite Abbott's aggressive lobbying position and active outreach to its customer community to downplay the risks, Abbott has been unresponsive to shareholder requests to include more information about potential liability or loss of market share in shareholder reports.

On June 17, 2001, a group of Abbott Laboratories shareholders holding 670,000 shares of Abbott stock wrote to the SEC asserting that:

Despite such uncertainties, we believe that the governing statutes and rules require that investors be informed about these emerging scientific trends early enough that these investors can make their own judgments and take responsive action, as long as there is a reasonable likelihood of liability or loss of market share.\(^{36}\)

The investors asked that the SEC provide guidance to Abbott Laboratories, as well as all other corporations, as to when emerging scientific hazards should be disclosed in annual and quarterly shareholder reports. But the SEC largely ducked the question. With regard to any SEC communications with Abbott, the agency replied on July 31, 2001 that:

“We cannot… provide you with information as to any conversation or correspondence between Abbott and the staff regarding past, present or future disclosure. Normally, this process is conducted privately between the staff and the company.”

The SEC also noted in its reply that it periodically issues general guidance, but made no commitment to address the issues raised. To its credit, the SEC has recently stated that it will begin to release selected comment letters.\(^{37}\) However, despite this new and welcome increase in the transparency of the SEC’s process in reviewing MD&A filings, the SEC still needs to issue general guidance on disclosures related to emerging science.

As a result of the shareholder and stakeholder pressure, in 2002 and 2004, Abbott Laboratories began tracking the PVC/DEHP issue in its voluntary “Global Citizenship” Reports. For example, in 2004 it wrote, among other things, that:

…Abbott already has a number of alternatives to PVC– and the plasticizer di(2–ethylhexyl) phthalate (DEHP)–containing medical devices, and has made the necessary investment for the development of additional PVC–free alternatives that will offer innovation and value to our customers and patients through additional product features and enhanced performance. We expect to begin introducing these products to the marketplace starting in 2003, with an expanded alternative product line available by 2010.

In response to the recently published draft guidance from the FDA regarding medical devices containing DEHP, Abbott is evaluating options for product labeling, consistent with the therapies and patient groups identified as priorities in the notification. Abbott is committed to providing practitioners with adequate information about product content to allow them to make informed decisions regarding patient care.


EXAMPLE: THE GROWING MACROECONOMIC THREAT OF GLOBAL WARMING

The potential financial toll on public health, coastal infrastructure and natural resources from global climate change is expected to be enormous, rising to perhaps 1.4 percent of U.S. gross domestic product and 1.5 percent of world GDP by the mid-21st century, according to Munich Re, the world’s largest reinsurance company. The weight of the evidence suggests that to avoid this costly disaster, there must be a massive change in global energy use – one at least as large in scale as that which occurred in the 20th century. This technological fix will pose investment risks and opportunities – probably the greatest financial and technological challenge of this century. Yet, many of the companies that are likely to be the most affected include little, if any, disclosure of these issues and their impacts in their reporting to shareholders.

An independent review of disclosures of these issues in shareholder reports, conducted by the Investor Responsibility Research Center (IRRC) on behalf of the Coalition for Environmentally Responsible Economies found that:

The lack of disclosure in securities filings, especially in relation to company statements elsewhere about the risks posed by climate change, raises serious questions about the adequacy of reporting and enforcement of Securities and Exchange Commission rules that compel corporate disclosure of environmental risks to investors.

IRRC reviewed reports with the SEC, including the annual Form 10-K (or 20-F equivalent for non-U.S. companies). IRRC selected companies that are the very large emitters of greenhouse gases, and leaders in their industries, based on revenues. Fifteen of the 20 profiled companies were the largest U.S. emitters of carbon dioxide in three major carbon-emitting industries – auto companies, investor owned electric utilities, and oil and gas companies. In addition, five other large manufacturing companies were selected for analysis based more on their size and market capitalization than for the amount of greenhouse gas emissions they produce (though in some cases their emissions are substantial).

The profiled companies’ 10-K and 20-F filings issued in 2002 were reviewed for any mention of climate change or related statements concerning greenhouse gas emissions controls. According to IRRC, eight of the profiled companies make no mention of climate change or related issues (such as the Kyoto Protocol) in their filings. These include two oil companies, ChevronTexaco and ExxonMobil, and two auto companies, General Motors and Honda. The others were Alcoa, General Electric, IBM and International Paper.

Among the 12 companies that do mention climate change in their securities filings, the disclosure tends not to be very informative. Consider these offerings from electric utilities in 2002:

- **American Electric Power** says it is a “significant emitter” of carbon dioxide and could be “materially adversely affected” by CO2 controls. (AEP is in fact the largest CO2 emitter in North America.) It says CO2 controls could impose “substantial costs on industry and society and erode the economic base” that AEP serves. (This represents one of the more complete disclosures among the profiled companies.)

• **Southern**, which ranks second behind AEP in utility CO2 emissions, lists climate change and electromagnetic fields together as two issues where legislation “could significantly affect” the company.

• **Xcel Energy**, which ranks fourth in investor-owned utility CO2 emissions, mentions a single power plant in Massachusetts that may not be able to comply with CO2 regulations enacted in that state.

• **TXU**, which ranks fifth in investor-owned utility CO2 emissions, says it is “[Unable] to predict the impact, if any, of the [Bush] Administration proposal or related legislation” on climate change.

Even some companies that in most respects are leaders in their governance responses to climate change have offered relatively few insights in their securities filings. For example, **DuPont** states in its Form 10-K, “While well ahead of the target/timetable contemplated by the [Kyoto] Protocol on a global basis, it faces prospects of country-specific restrictions where major reductions have not yet been achieved.”

Other companies' positions are in flux. **Royal Dutch Shell** makes one passing reference in its most recent annual report that the “perceived threat of global warming” and heightened concerns about energy security could lead to greater interest in its hydrogen fuel business. (This is one of the few positive references to a business opportunity posed by climate change.) It also has published separate information on its website providing more details regarding its position on global warming. By contrast in June 2004 Lord Ron Oxburgh, chairman of Shell, stated that:

“No one can be comfortable at the prospect of continuing to pump out the amounts of carbon dioxide that we are pumping out at present ... with consequences that we really can't predict but are probably not good.”

He urged that action be taken to develop a strategy of sequestration of carbon in order to reduce the amount of carbon in the atmosphere.39 However, despite Lord Oxburgh's rather sweeping statements, this level of concern has not yet been reflected in the company’s own reporting and evaluation of the impact on the company.

A recent published survey by Friends of the Earth of companies' 2002 and 2001 10-Ks found that companies are systemically underreporting climate change-related risks.40 The survey found that in 2002 the rate of climate change reporting among automobile, insurance, oil & gas, petrochemical and electric utility companies – all companies expected to be impacted by climate change – in 10-Ks was 38% (a 10% improvement compared with 2001 filings). While a majority of integrated oil and gas companies and large electric utilities now provide climate reporting to investors, large automobile, petrochemicals and insurance companies report at lower rates. Among those firms reporting on climate change, 40 percent forecast that climate risks will adversely impact their firms, while 15 percent maintain that global warming poses little to no

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risks. About 27 percent state that the impact of climate change cannot be estimated, while 18 percent of reporting companies avoid addressing the issue of financial risk altogether.

One example of how investors are faced with significantly different levels of information on climate risk can be observed by comparing the 10-Ks of Ford and General Motors. Ford provided quite analytical and detailed discussion, noting both domestic fuel economy regulations, and the Bush Administration’s climate change policy which was released in February 2002. Ford asserted that other nations are pressing the United States to ratify the Kyoto Protocol, and predicted that the Environmental Protection Agency and individual states might increase regulation of carbon dioxide emissions. The company described these impacts on its domestic sales, concluding that:

"Ford might find it necessary to take various costly actions that could have substantial adverse impacts on its sales volume and profits."

The company further described climate change policies and regulations in Europe, and concluded that:

"taken together such [climate change] proposals could have substantial adverse effects on our sales volumes and profits in Europe."

Finally, Ford also offered a strategy to adapt to these policies, which would involve:

"[curtailing] production of larger, family-size and luxury cars and full-size light trucks, [restricting] offerings of engines and popular options, and [increasing] market support programs for its most fuel-efficient cars and light trucks."

In contrast, General Motors offered investors no discussion of climate risks at all in its 2002 10-K.

**ANALYSIS**

Ascertaining the probabilities of liabilities or market share loss associated with emerging scientific findings regarding risks of a company’s products or activities is difficult. Thus, many companies withhold disclosure by hiding behind the assertion that the emerging trends are not yet "reasonably likely to have material effects," or that such a reasonable likelihood is unknown, even as scientific evidence and consumer concern continue to mount.

Public companies are required to disclose in the Management’s Discussion and Analysis of Financial Condition and Results of Operations (“MD&A”), “known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.”\(^{41}\) The SEC imposes a general presumption in favor of disclosure, stating that disclosure of a trend or uncertainty is required unless the registrant is able to conclude either that (a) it is not reasonably likely to occur or come to fruition or (b) a material effect on the company’s liquidity, capital resources or results of operations is not reasonably

likely to occur.\textsuperscript{42} A 1989 release made clear that, “Each determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time the determination is made.”\textsuperscript{43}

The Supreme Court has defined the threshold of materiality of disclosure as whether the fact in question is something that a reasonable investor would want to know given the total mix of information available.\textsuperscript{44} In light of this definition, it seems likely that far more scientific information is material than is being disclosed. Investors need to be informed about emerging scientific trends early enough to make their own judgments and take responsive action. Waiting until the lawsuits are filed is too late.

Arguably, this is an area where the Sarbanes Oxley Act also may have a bearing. Section 302 of the Act requires a certification by an issuer's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions. The certification, as adopted by the SEC, states that the overall financial disclosure \textit{fairly presents}, in all material respects, the company's financial condition, results of operations and cash flows. The purpose of adding this requirement in the Sarbanes Oxley Act was to ensure that companies do not use loopholes in existing SEC, FASB and AICPA guidelines to avoid disclosure of items of substantial concern to investors. According to the SEC rule implementing the certification requirement, among the things to be examined in determining whether the company is fairly presented are the financial statements (including footnote disclosure), selected financial data, management's discussion and analysis of financial condition and results of operations, and other financial information in a report.\textsuperscript{45} Thus, it is possible that failure to disclose liability related issues could constitute a failure to fairly present the company in violation of Section 302 of the Sarbanes Oxley Act.

In addition to the lack of clarity under current SEC reporting requirements for disclosure in the management discussion and analysis of emerging scientific issues and their potential liability and market risk implications, an additional impediment to disclosure has resulted from a decision of the SEC staff regarding shareholder proposals. Proposals submitted by shareholders to companies requesting disclosure of the risks posed to the company by global warming have been rejected by the SEC as encroaching upon accounting decisions that are “ordinary business” of the company and reserved to the discretion of the management.\textsuperscript{46} The proposals in question explicitly asked registrants to assess the economic risks of emissions and companies’ public stances on emissions reductions, as well as the benefits of committing to a substantial reduction of those emissions. But SEC staff allowed these to be excluded as ordinary business, explaining that the proposals were related to “evaluation of risks and benefits.”\textsuperscript{47} By issuing what is called a


\textsuperscript{44} TSC Industries, Inc. \textit{v.} Northway, Inc. 426 US 438 (1976). A disclosure is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available.

\textsuperscript{45} Certification of Disclosure in Companies’ Quarterly and Annual Reports, \textit{67 FR} 57276 \textit{at} 57279.

\textsuperscript{46} See, e.g., No Action letter regarding Cinergy Corp. (avail. Feb. 5, 2003).

\textsuperscript{47} See, e.g., Cinergy Corp. (avail. Feb. 5, 2003).
“no action letter” in response to the companies’ refusal to place the proposal on the proxy ballot, SEC effectively closed off one of the few avenues shareholders may use to ask questions about material liabilities that are suspected, but may not be adequately addressed (or in many instances may not be addressed at all) in 10-Ks or other filings.

**SOLUTION**

The SEC should issue a staff guidance stating that when emerging peer reviewed literature or other credible scientific reports indicate the potential for significant new health risks related to a company’s products or activities, the company should make this information available to shareholders. Disclosure should occur through either periodic or current SEC reports or other readily accessible publications (such as on company websites). Also, disclosure should be required without regard to whether the company anticipates material impacts in the near term. Such guidance should also state that when emerging science or risk issues are giving impetus to emerging market or consumer trends or public policies encouraging consumption of alternatives to a company’s products, the company should specifically report on such trends, and may, in its discretion, report as to whether it is engaged in research and development to market its own alternatives. In the event that the company expresses its own scientific opinions in opposition to the findings of the emerging scientific studies, the company should be required to state the basis for its scientific opinions.

The SEC should issue a specific staff accounting bulletin on the disclosure of global warming related risks and liabilities. In developing the bulletin, the SEC should draw from a memorandum of May 11, 2004, where the Coalition for Environmentally Responsible Economies (CERES) specifically recommended to the SEC\(^{48}\) that its staff should clarify that:

- The MD&A disclosure requirements – specifically the requirement to disclose known trends and uncertainties likely to affect materially a registrant’s results of operations – should be read to require disclosure by registrants in a variety of industries regarding the direct and indirect effects of climate risk and regulatory responses, as well as the opportunities presented by climate change, although the necessity for and substance of this disclosure will vary depending on industry- and registrant-specific factors.

- A registrant should start from the premise that climate change impacts – both positive and negative – must be disclosed unless the registrant finds that no material effect on liquidity, capital resources or results of operations is reasonably likely to occur either in the short- or long-term. This requirement is consistent with the Commission’s explanation in the 2003 MD&A Release that known material trends and uncertainties include those “on which the company’s executives are focused for both the short and long term . . . ”\(^{49}\)

- In determining whether the effect of climate risk and/or regulatory initiatives is reasonably likely to be material to a registrant’s results of operations, the registrant should not rely solely on a best-case scenario, but should consider the full range of possible outcomes; in other words, decisions about reasonableness and materiality must be made on the basis of a complete analysis of available scientific and other information.


\(^{49}\) 2003 MD&A Release, supra note 14.
• Quantitative disclosure, although not required in all instances, may be required if quantitative information is reasonably available; if other registrants in a registrant’s industry provide quantitative disclosure, the registrant should disclose its reasons for not providing similar quantitative disclosure.

• Boilerplate disclaimers and generic disclosure will not satisfy registrants’ disclosure obligations, nor will disclosure of isolated facts related to climate change, including regulations or proposed regulations, without a substantive discussion of the relationship between those facts and the registrant’s financial results. As it did in the 2003 MD&A Release, the Commission can assist registrants by providing examples of adequate and inadequate disclosure.

• The obligation to make disclosure regarding climate change (assuming such disclosure is required under the known trends and uncertainties standard), includes a requirement to disclose the actions registrants are taking to address the resulting risks and opportunities, including but not limited to the role of the board of directors and/or any board committee in monitoring developments related to climate change and formulating company responses. This requirement is consistent with the Commission’s statement in the 2003 MD&A Release that the MD&A should “provide insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties …as well as the actions they are taking to address these opportunities, challenges and risks.”50

The SEC should reverse its recent decisions regarding shareholder resolutions that seek to require companies to disclose risks and liabilities related to issues such as global warming or toxic chemicals, allowing such resolutions to be submitted and voted upon by shareholders.

50 2003 MD&A Release, supra note 14 (emphasis added).
TOWARDS ENVIRONMENTAL TRANSPARENCY

GENERAL RECOMMENDATIONS

Current law requires all corporations to disclose financially material environmental conditions to investors in periodic and annual filings. However, as this paper illustrates, many companies employ layers of accounting and asset management strategies and tactics that – however well intentioned – have the effect of concealing serious and expensive liabilities from investors. The development and use of what are often extremely aggressive interpretations of existing accounting guidance and reporting regulation has been exacerbated, and even encouraged, by the vague nature of the existing accounting guidance, combined with regulatory loopholes and a passive enforcement climate.

The Securities Exchange Commission (SEC) must act immediately to clarify environmental disclosure regulations, as well as embrace their mandate to enforce the law regarding the disclosure of financially material environmental conditions. However, the SEC cannot effectively close the loopholes and police its beat without help from Financial Accounting Standards Board (FASB) and the Public Company Accounting Oversight Board (PCAOB). FASB must address the loopholes and inconsistencies regarding environmental estimation and reporting that exist today in the framework of Generally Accepted Accounting Principals (GAAP). The PCAOB must work cooperatively with FASB in this endeavor, and must also specifically address the role of corporate audit committees and independent auditors in ensuring that their mandate to protect the integrity of a company’s financial accounting systems specifically includes reviewing the financial impacts of environmental conditions.

Finally, while this paper focuses exclusively on environmental and environmental health liabilities, in the real world, corporate environmental conditions and performance is often inextricably linked with labor, human rights and other social issues. These interwoven issues create complex choices for corporate management and equally complex challenges for corporate transparency – both in terms of required public filings and the relationship of companies to their local communities and host countries. In the past, SEC has exerted leadership in catalyzing forward looking dialogue through the creation of blue ribbon panels. The ensuing dialogue educates the development of any eventual new regulation, and also deepens registrants’, regulators’ and investors’ understanding of the dynamics and interpretations that underlie the current regulatory framework. While urging immediate response on the specific environmental accounting and reporting issues identified in this paper, it is also clear that the broad arena of environmental and social disclosure begs the creation of a blue ribbon panel to examine overall environmental and social reporting issues.
SPECIFIC RECOMMENDATIONS

1) CLOSE THE MAIN REPORTING LOOPHOLES
The SEC should either issue new regulations or a staff accounting bulletin that responds to citizen petition 4-463, filed in 2002 by the Rose Foundation and supported by institutional investors including state pension funds, labor organizations and charitable foundations representing a combined total over $1 trillion in assets. The petition calls for two specific actions which would terminate or curtail many of the aggressive accounting tactics discussed in this paper and go a long way towards closing some of the main gaps in GAAP which many company’s exploit to the detriment of their shareholders.

SEC Citizen Petition 4-463:

a) Go Beyond the “Known Minimum”: The SEC should require the use of the expected value methodology as described in ASTM Standard Guide for Estimating the Monetary Costs and Liabilities of Environmental Matters E 2137-01 when estimating and disclosing environmental liabilities. By requiring companies to disclose the expected value of their environmental liabilities, rather than limiting disclosure to the artificially low “known minimum,” investors and other financial statement users would receive much better estimates of the true extent of the costs associated with a company’s environmental liabilities.

b) Aggregate Before Determining Materiality: The SEC should require the use of the aggregation guidelines as described in ASTM Standard Guide for Disclosure of Environmental Liabilities E 2173-01. Requiring aggregation before making a determination of materiality will prevent individual liabilities from being swept under the rug one by one and would allow investors to examine the totality of a company’s environmental exposure, providing shareholders with a valuable context for evaluating risk exposure and management performance in conserving corporate assets.

2) SHAKE OUT THE MOTHBALLS
The SEC should clarify that listing of mothballed sites, estimation of projected liabilities, and narrative discussion of the scope and materiality of potential liabilities should be included in financial reports, especially for sectors such as the petrochemical industry where the aggregate impact of multi-site idling is likely to be concealing material liabilities.

3) SCRUTINIZE THE “NO LOOK” AGREEMENTS
The SEC should declare the use of “no look” clauses to be analogous to other examples of extraordinary and now-condemned contractual arrangements utilized by corporations such as Enron and Worldcom that concealed liabilities and distorted shareholder value. Prominent disclosure should be required for the existence of any such agreements.

a) SEC and/or the PCAOB should clarify that “no look” agreements violate Sarbanes Oxley internal control requirements.

b) Regardless of any regulatory action, shareholders who become aware of such “no look” agreements should question whether the company’s audit committee has exercised appropriate due diligence.
4) **DON’T BLAME THE GOVERNMENT (IT DIDN’T CAUSE THE CONTAMINATION)**
SEC, FASB and PCAOB guidelines should clarify that in the absence of a definitive government-approved remedial plan, corporate disclosures should:

a) Describe a reasonable range of potential liabilities based on comparable sites and cases.

b) Describe key liability-impacting features such as acreage, contamination levels, range of remedial options, etc., that may allow investors to assess the relative magnitude of potential liabilities.

5) **IF IT’S MATERIAL TO INSURERS, IT’S PROBABLY MATERIAL TO INVESTORS**
The SEC should require companies to provide shareholders with the same kind of estimates of potential liability expenses that are developed for insurers. This is a particular area where adoption of the ASTM standards could benefit investors, because companies would have to analyze and report on the probability of various exposures and provide estimation of the aggregate costs.

6) **THE BUCK STOPS HERE**
The SEC should require firms that sell or transfer sites with decommissioning costs to smaller companies to maintain a contingency for the costs of decommissioning those sites.

7) **COME CLEAN ABOUT WORKER HEALTH COSTS**
The SEC should close the two most common worker exposure reporting loopholes.

a) SEC regulations and FASB guidance should require corporations facing worker exposure liability issues such as asbestos to utilize industry-average litigation outcome figures as a basis for calculating long term liability prospects.

b) SEC regulations and FASB guidance should require companies to extend projections beyond artificial time horizons to encompass the full range of anticipated future worker-related environmental health costs.

8) **DON’T ANALYZE TOMORROW’S RISKS UNDER YESTERDAY’S SCIENCE**
The SEC should issue a staff guidance stating that when emerging peer reviewed literature or other credible scientific reports indicate the potential for significant new health risks related to a company's products or activities, the company should make this information available to shareholders. Disclosure should occur through either periodic or current SEC reports or other readily accessible publications (such as on company websites).

a) Disclosure should be required without regard to whether the company anticipates material impacts in the near term. Such guidance should also state that when emerging science or risk issues are giving impetus to emerging market, consumer trends or public policies encouraging consumption of alternatives to a company's products, the company should specifically report on such trends, and may, at its discretion, report as to whether it is engaged in research and development to market its own alternatives.

b) The SEC should issue a specific staff accounting bulletin on the disclosure of global warming related risks and liabilities.
9) **CLARIFY ACCOUNTING GUIDANCE**
FASB should adopt its exposure draft regarding FAS 143 regarding liabilities with uncertain timelines. In addition, FASB should require the use of data from comparable sites or companies as benchmarks for stand-in projections of liabilities pending further site or company specific studies. It should also revisit inconsistencies in the framework of GAAP, and resolve issues such as the guidance related to aggregation vs. piecemealing and the tension between “known minimum” and “fair value.” Similar to the Rose Foundation’s petition to the SEC, FASB should consider adapting concepts developed by the ASTM which calls for probability-weighted analysis and aggregation before materiality in updating its accounting guidance.

10) **RESTORE RIGHTS OF SHAREHOLDERS TO FILE RESOLUTIONS.**
SEC staff should allow shareholder resolutions to ask for disclosure of the range of risks and liabilities associated with environmental or remedial matters. Many of these resolutions are currently being dismissed as “ordinary business,” closing one of the few avenues that shareholders can use to ask management tough questions about material expenses and cost centers that would otherwise remain shrouded in secrecy.

11) **AFFIRM AND POLICE THE AUDITOR’S MANDATE**
PCAOB should adopt specific regulations to ensure that corporate audit committees and independent auditors include reviewing the financial impacts of environmental conditions and environmental liabilities as part of their scope.

12) **EXAMINE THE LARGER ISSUES**
While enacting the specific reforms recommended herein that are immediately necessary to stop misleading financial disclosures that can lead to environmental accounting fraud, SEC should convene a blue ribbon panel to examine the broad and forward looking questions around corporate environmental and social transparency. The panel should involve stakeholders from business, banking, insurance, investment, regulatory, environmental, labor and human rights communities.

13) **ACT LIKE REAL OWNERS**
Shareholders, especially those in a position of long-term fiduciary trust such as pension fund and foundation trustees, should be more active in exercising their Duty to Monitor their portfolio’s performance. Shareholders should insist on adequate environmental disclosure from their portfolio companies and should equally insist that the SEC clarify and enforce its environmental disclosure regulations. Particular attention should be paid to stopping the problem practices identified in this paper, such as hiding material information in the footnotes, employing artificial time horizons and “no look” clauses, delaying the quantification of existing contamination, and refusing to provide meaningful estimates of the extent of unquantified liabilities.