Disclosing Contingent Environmental Liabilities: Navigating In A New Environment

By Jeffrey B. Gracer and Andrew Beck

The Sarbanes-Oxley Act and its implementing regulations are increasing the level of scrutiny given to public companies' disclosure of contingent risks. Environmental issues, however, have not necessarily been at the top of the list. Most of those responsible for designing Sarbanes-Oxley compliance programs are not environmental professionals and may not fully appreciate the challenges inherent in designing a system that will produce reliable environmental disclosure. This article highlights some of the challenges presented for Sarbanes-Oxley compliance in the environmental arena, identifies potential solutions to those challenges and examines some of the consequences that are likely to flow from increased environmental disclosure.

Sarbanes-Oxley has not changed the rules governing environmental disclosure, but it has raised the stakes and tilted the playing field toward greater disclosure. The key drivers are (1) the statutory requirement that CEOs and CFOs certify disclosures in SEC filings, including the results of their ongoing evaluation of disclosure controls and procedures; (2) potential penalties for false certifications; and (3) upcoming requirements that public accountants attest to CEO and CFO evaluations of internal financial controls. Environmental advocacy organizations and shareholder activists can also be expected to use these reforms as an opportunity to promote greater environmental disclosure. They are scrutinizing corporate environmental disclosures within particular industries and issuing reports criticizing companies that provide less complete disclosure than others. In this climate, it is becoming increasingly important for companies to develop and implement a coordinated, thorough and defensible approach to environmental disclosure that meets applicable requirements.

The environmental disclosure arena presents two challenges that may be underestimated by non-environmental professionals tasked with Sarbanes-Oxley compliance. First, a company's environmental management system will not necessarily collect or report information about potential environmental remediation liabilities. Environmental site assessments and analyses of anticipated remediation liabilities are prepared for the purpose of acquisitions, divestitures and ongoing operations on a routine basis, but may not be collected and reported in a systematic manner. Second, judgments regarding potential environmental remediation contingencies are not always easy to make. To determine whether an environmental remediation at a particular site is "probable" or "reasonably estimable," a company and its accounting firm are likely to require input from environmental counsel familiar with applicable remediation laws and regulations, as well as input from environmental professionals who are capable of benchmarking remediation estimates. Only then can a determination be made whether the environmental risks, individually or in the aggregate, are material. Because of the complexities inherent in assessing environmental risks, proper environmental disclosure requires careful planning. Existing information must be collected and reported to team members who have the background and experience to properly assess the issues from a legal, technical and accounting perspective.

Jeffrey B. Gracer (jgracer@torys.com) is a Partner in the Environmental Group and Andrew Beck (abeck@torys.com) is a Partner in the Securities and Corporate Governance Groups at Torys LLP in New York.

Is The Environmental Contingency Probable?

Financial Accounting Standards Board Statement of Financial Accounting Standard No. 5 (FASB No. 5) describes the circumstances under which a "loss contingency," including an environmental contingency, should be accrued.

A loss contingency is defined as "an existing condition, situation, or set of circumstances involving uncertainty as to possible [loss] to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." Under FASB No. 5, a loss contingency should be accrued if it is "probable" that an asset has been impaired or that a liability has been incurred, unless the loss is not "reasonably estimable." An environmental loss is probable – even when a claim has not been asserted – if it is likely that a claim will be asserted and that the outcome of such a claim will be unfavorable. Even if a loss is not probable, footnote disclosure may be required if a material loss is "reasonably possible," meaning that it is "more than remote but less than likely."

The American Institute of Certified Public Accountants' Statement of Position 96-1 (SOP 96-1) provides additional guidance on disclosure of environmental remediation liabilities. Although it includes useful benchmarks for matters arising under the federal Superfund law (CERCLA) and the federal hazardous waste law (RCRA), remediation obligations can arise under a multitude of laws and regulations that are not specifically dealt with in SOP 96-1. In such instances, SOP 96-1 states, quite tellingly, that legal judgments "may be required to assess whether a claim has been or will be asserted."

Sometimes the issue is relatively straightforward. For example, when a company has received notice from a third party or governmental agency that it is potentially responsible for remediation of a site, and the company's nexus to the site has been established (either because it owned or operated the site at time of disposal or because it generated waste that was disposed of at the site), SOP 96-1 observes that in all but the rarest of cases, it should be presumed that the outcome of the litigation will be unfavorable, at least to a certain extent. Even when no claim has been asserted, applicable law and regulations may make it probable that a remediation liability will arise. For example, if the company has data showing that the site is contaminated at levels above regulatory cleanup standards, such data must be reported under the applicable law, and because the reporting of such data typically triggers a demand for remediation from regulatory authorities, the loss contingency may be considered probable.

In other cases, the legal, technical and accounting judgment becomes more difficult. When a company has no site data and is not obligated to develop such data, but reasonably suspects that the property is likely to be contaminated because of its past uses, the loss contingency could be probable, reasonably possible or remote depending on whether the property is currently being used for industrial or commercial purposes, on whether offsite impacts have been documented or are likely, and on the applicable regulatory rules and practice. Especially for sites located in jurisdictions where environmental requirements are not mature or predictable, such legal judgments require careful, coordinated analysis by environmental counsel, environmental consultants and the company's accountants. Because these judgments are being certified by the company's CEO and CFO, it will be important to demonstrate that available information was collected and that considered judgment was brought to bear when making accounting and disclosure decisions.

Is The Environmental Contingency Reasonably Estimable?

As noted above, if an environmental loss contingency is probable, it should be accrued under applicable accounting rules if the loss is reasonably estimable. When the rules applicable to environmental contingencies first came out, environmental consultants were less able than they are now to reliably estimate site costs. Over time, as environmental regulations have matured and as science has advanced, in most instances it has become possible for consultants to provide reasonable best and worst case estimates on the basis of best professional judgment. And in corporate transactions it is now common practice for consultants to do so. Reports with such estimates may be located in a transaction file that has long been sent to offsite storage.

Because companies often have documents in their files that estimate potential remediation costs for particular sites, it is important to resist the temptation to summarily dismiss a potential environmental liability on the ground that the remediation costs are not reasonably estimable. That may be the case, but that judgment should be based on available information. Accordingly, when corporate environmental managers are asked to provide subordinate certifications as backup to CEO and CFO certifications, they will most likely apply a higher degree of rigor to environmental loss contingencies than they did in the past. Disclosure controls and procedures should be carefully crafted to protect a company from saying something in its public disclosure documents that is contradicted by extensive documentation in its environmental files.

Evaluating Disclosure Controls And Procedures

As in-house counsel evaluate whether existing or newly implemented disclosure controls and procedures meet Sarbanes-Oxley requirements, environmental disclosure controls should be part of that evaluation. Environmental management systems, which are designed to identify regulatory requirements and best practices applicable to ongoing operations, will not necessarily capture the type of information needed to properly disclose environmental contingencies. Indeed, in many companies, reserves for environmental remediation costs are established on a separate track from regulatory compliance audits, and the process for establishing such reserves is not always systematic. Companies should assess, as an initial matter, whether a system is in place to collect the information necessary to make decisions about accrual and disclosure of contingent remediation liabilities. Such a system should track environmental site assessment data and engineering cost estimates so that they can be collected and analyzed in a reliable manner. It also may be advisable to develop a legal protocol for evaluating whether a remediation contingency is probable, and another protocol for establishing remediation estimates. Because Sarbanes-Oxley emphasizes the need to periodically review and if necessary revise disclosures, the system should capture new information and ensure that it is taken into account when periodic disclosures are made. The design and implementation of a company's disclosure controls and procedures could build on existing environmental management systems, but would likely require additional protections to ensure accurate and timely disclosure. A solid system can be built to do this, but careful thought and planning will be required to marshal the facts and ensure that appropriate professional judgment is applied to those facts.

Impact On Asset Divestiture And Brownfield Development

As companies tighten up their disclosure controls and procedures for environmental matters, a broader range of potential environmental liabilities is likely to be publicly disclosed. This, in turn, will create incentives for public companies to examine and resolve potential liabilities associated with contaminated properties. Recent amendments to federal and state environmental and tax laws to promote redevelopment of such properties and the emergence of a strong environmental insurance market have created significant opportunities for companies to generate revenue and limit or effectively eliminate environmental liabilities. It makes sense, strategically, for companies to evaluate these favorable opportunities as they wrestle with ways to best quantify and disclose their contingent environmental liabilities. There may well be light at the end of the tunnel if the issues are managed carefully and proactively.