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Environmental Disclosure Committee Newsletter

Vol. 11, No. 1 **April 2014**

MESSAGE FROM THE CHAIR
David A. Roth, Esq.

The Environmental Disclosure Committee focuses on environmental accounting and disclosure, including under Securities and Exchange Commission (SEC) regulations, and voluntary environmental/sustainability reporting. This issue of the newsletter features articles on an important SEC initiative that could result in sweeping reform of the SEC's disclosure regime, a four-year look back at SEC's climate change disclosure guidance, and complex issues concerning environmental liability disclosures. I would like to express my sincere thanks to Vice Chair Kurt Herman, and to the authors, for their great work on this newsletter.

We are always seeking contributors to our newsletters. If you have an interest in presenting timely national or regional information for your colleagues, please let us know.

There are also opportunities for contributing information for our committee's Web site (Alerts, News, Upcoming Events, References and Resources, Useful Sites and Links of Interest to the Committee), and programming (Webinars and Fall and Spring Conferences).

Now is the time to become actively involved in our committee. Please reach out to us. You can see the entire roster of the vice chairs on the committee's webpage at www.ambar.org/EnvironCommittees. Let's make it a busy Spring! And looking ahead, the Section's Fall Conference this year will be in Miami, October 8–11.

WILL THE SEC'S CURRENT DISCLOSURE REFORM INITIATIVE RESULT IN STRICTER ENVIRONMENTAL AND SUSTAINABILITY DISCLOSURE REQUIREMENTS?
Betty Moy Huber, Esq.

Introduction

The SEC is in the midst of what could be a sweeping reform of its disclosure regime. During the course of this year, the SEC's Division of Corporation Finance, or Corp Fin, will be seeking broad input from companies and investors on how the SEC can improve its disclosure rules. This initiative follows on Corp Fin's lengthy December 2013 report on this topic. Arguably, the SEC's disclosure reform initiative could not have come at a better time for sustainability and environmental groups who have been working for years to achieve better corporate sustainability disclosure. These groups are savvy, dedicated, and have trillions of institutional investor (and other) dollars backing them. With social media, they have become well organized and effective advocates for their cause. In addition, investment banks are taking note and becoming interested in better and more uniform sustainability disclosure in their capacity as underwriters as well as investors themselves. Further, shareholder proponents have submitted a record number of environmental and sustainability shareholder proposals in recent proxy seasons. But

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AMERICAN BAR ASSOCIATION
SECTION OF ENVIRONMENT, ENERGY, AND RESOURCES

CALENDAR OF SECTION EVENTS

May 2, 2014
State of the Practice Symposium
Vanderbilt University Law School
Nashville, TN

May 2-4, 2014
Spring Council Meeting
The Hutton Hotel
Nashville, TN

May 29, 2014
Key Environmental Issues in US EPA Region 2
Primary Sponsor: New York State Bar Association
Columbia Law School
New York, NY

June 4-6, 2014
32nd Annual Water Law Conference
The Red Rock Resort, Casino and Spa
Las Vegas, NV

August 8-10, 2014
ABA Annual Meeting
Sheraton Boston Hotel
Boston, MA

October 8-11, 2014
22nd Fall Conference
Trump National Doral Miami
Miami, FL

For full details, please visit www.ambar.org/EnvironCalendar

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will these sustainability groups succeed in finding common ground with the SEC and, if necessary, convince the SEC that sustainability issues are material or otherwise a priority?

This article describes the relevant aspects of the SEC's current disclosure reform initiative, highlights what sustainability activists have been doing of late to achieve better disclosure, and speculates on the odds of whether or not the SEC will require better sustainability disclosure in the future.

SEC Disclosure Reform Initiative

The U.S. Congress, pursuant to the 2012 Jumpstart Our Business Startups (JOBS) Act, required the SEC to review its disclosure requirements set forth in Regulation S-K and to issue a report outlining how to simplify and modernize the securities registration process to facilitate access to markets for emerging growth companies. Corp Fin released this report in December 2013. The December 2013 report highlights the following themes relevant to environmental and sustainability disclosure, which themes will undoubtedly guide the SEC's disclosure reform initiative:

- A preference for principles-based disclosure requirements (that is, broad disclosure requirements grounded in materiality) as opposed to (arguably) less flexible and dynamic specific line item disclosure requirements;
- A push to reduce repetitive disclosure, for instance streamlining or using cross-references to address identical disclosure that often appears verbatim numerous times throughout a disclosure document, in the case of environmental and sustainability disclosure, such as in the legal proceedings, risk factors, and business sections; and
- A goal to discourage disclosure of "immaterial information" that, like repetitive disclosure, can obscure more pertinent material information.

Corp Fin's December 2013 report also calls out the following specific areas of Regulation S-K for potential further review: (1) requirements governing risk factors; (2) requirements relating to a registrant's business and operations; and (3) corporate governance disclosure requirements.

Corp Fin, at the direction of SEC Chair Mary Jo White, is currently seeking information from companies and investors regarding the recommendations contained in its December 2013 report as well as ways in which disclosure overall can be improved. While the SEC has shown frustration with certain other Congressional mandates, it appears to have embraced this directive to assess Regulation S-K as an opportunity to overhaul its disclosure regime, which reportedly has not undergone a comprehensive review since 1996. The SEC's stated goal is for investors to tell it what type of disclosure information investors want, when they want it, and how companies can best present it. From there, Corp Fin will aim to present specific recommendations for updating Regulation S-K and generally addressing disclosure overload. According to the SEC's February 2014 *Draft Strategic Plan: Fiscal Years 2014–2018*, areas of focus will include a review of operational and risk management disclosures, each of which are relevant to environmental and sustainability issues. A key uncertainty coming out of Corp Fin's December 2013 report, however, is whether the SEC will launch a comprehensive or targeted reform of disclosure issues. While that report recommended a comprehensive, sweeping review, SEC Commissioner Daniel Gallagher, a key leader in this disclosure reform initiative, has urged for a targeted approach, recognizing the real risk that a comprehensive review could be derailed due to resource constraints, competing priorities, or a perceived need for perfection. In any event, disclosure reform is undisputedly a SEC priority.

How Are Sustainability Groups Seeking Better Disclosure?

Various investors and nonprofit groups are working together toward better sustainability disclosure. Most prominent is the Sustainability Accounting Standards Board, or SASB, on whose board of directors former SEC Commissioner Elisse Walter sits. SASB, using the U.S. securities law definition of "materiality," is developing disclosure guidance standards for 88 different industries to govern their respective disclosure in SEC filings. SASB, which briefs the SEC quarterly on its work, appears cognizant of how its standards could fit nicely into the SEC's disclosure reform process. Other groups include various environmental and sustainability investors and pension funds representing over $11 trillion in assets under management, including CalPERS, CalSTRS, Walden Asset Management, and Trillium Asset Management, whose collective efforts in this regard are, to a large extent, led by Ceres, a leading sustainability nonprofit organization. Dissatisfied with the SEC's lack of follow-through on its own 2010 Climate Change Disclosure Guidance, Ceres released a detailed report in February 2014 entitled *Cool Response: The SEC & Corporate Climate Change Reporting—SEC Climate Guidance & S&P 500 Reporting—2010 to 2013*, which report recommends that the SEC undertake further efforts to improve climate change disclosure. The report also contains various recommendations to issuers, including a relatively buried, but poignant, message to issuers that, at least in Ceres' view, climate risk is now a major concern of the "reasonable investor" (whose needs dictate what is "material" under U.S. securities law). In short, these groups are pushing forward their conviction that sustainability disclosure is material and what all reasonable investors need to know to make an informed investment decision.

Will These Groups Succeed?

Yes? One could argue, yes, for the following reasons. First, both SASB and the SEC essentially agree on the definition of "materiality" (i.e., the U.S. securities law definition) and both want better disclosure. In addition, Corp Fin specifically named investors (in which group Ceres and its affiliates clearly sit) and standard setters (in which group SASB squarely falls) as constituencies it wants to be involved in the disclosure reform process. Further, in support of its emphasis on a principles-based approach, Corp Fin acknowledged the key role that SEC disclosure guidance documents could serve to flesh out specific disclosure issues. Coupled with the fact that the SEC believes the disclosure reform process should also include a review of existing SEC disclosure guidance (which would include the SEC's 2010 Climate Change Disclosure Guidance), this focus on guidance documents could serve as a favorable hook for sustainability groups to open the discussion to climate change matters, a key issue for them. Moreover, the SEC noted on numerous occasions that it could update its existing industry guides as part of this disclosure reform process. Any review of these outdated guides could provide SASB with an excellent opportunity to propose its industry-specific standards as stakeholder-drafted, turnkey replacements. Finally, the SEC's draft 2014–2018 Strategic Plan highlights the SEC's guiding principle that all investors should have "equal access" to information regarding their investments. Is it fair and equal when companies are increasingly engaging with certain shareholders regarding sustainability issues in connection with shareholder proposals or similar concerns, but not with others? Would requiring better sustainability disclosure help ensure equal access?

In addition, sustainability groups may have an interesting legal argument to wield. The SEC adopted its specific environmental line item requirements in Regulation S-K (Items 101(c)(1)(xii) and 103 of Regulation S-K) in 1973 to comply with the National Environmental Policy Act of 1969, or NEPA. NEPA generally requires federal agencies to consider the environmental impacts of their decisions that could significantly affect the environment. Sustainability groups might effectively argue that a comprehensive reform of securities disclosure rules requires the SEC to consider again environmental impacts pursuant to NEPA and thus, consider environmental and sustainability disclosure concerns. Indeed, Corp Fin, in its December 2013 Report mentions its 1973 rulemakings were part of the SEC's consideration of NEPA's impact on the disclosure regime.

To ultimately succeed, however, these groups may need to demonstrate that their concerns are shared by mainstream (and not simply niche) investors and that the disclosure they seek is not just what some people might find of interest. In support of the argument that their concerns may be mainstream, it is undeniable that companies are now taking the concerns of these investors seriously. It is now commonplace (and, in many instances, prudent) for companies and/or their boards to engage with shareholders and proxy advisory firms on environmental and sustainability issues, particularly in connection with shareholder resolutions. For example, investors filed in 2014 a record number of climate change proposals supported by Institutional Shareholder Services, a leading proxy advisory firm, recommending that shareholders vote "yes" for climate change resolutions. Shareholder support for environmental and sustainability proposals increased to 21 percent in the 2013 proxy season, with similar increases expected for this current 2014 proxy season. Notably, in January 2014 FirstEnergy, one of the country's largest energy companies, agreed to work toward reducing its carbon emissions in exchange for shareholder activists, including As You Sow and the New York State Comptroller, agreeing to withdraw their joint climate change proposal. Many companies (including some Fortune 500 companies as well as certain currently privately held companies anticipating a public float in the future) have joined SASB's various industry working groups to have a hand in shaping these disclosure standards. And as to whether Ceres represents mainstream investors, its president, Mindy Lubber, is rumored to be in the running for the top post at the White House's Commission for Environmental Quality, a decidedly conventional position.

What could also be compelling is the SEC's interest in better harmonizing global securities markets. The SEC has acknowledged the increasing globalization of the securities markets as a reason to examine its disclosure regime and perhaps seek more global uniformity. In this regard, according to its draft Strategic Plan 2014–2018, the SEC, as the overseer of the U.S. Financial Accounting Standards Board, will consider whether a single set of high-quality global accounting standards is achievable. It should be noted that in February 2014 the European Parliament and the European Council agreed on proposed legislation requiring certain large European Union-listed companies and other designated public interest entities (such as financial institutions) to disclose environmental and social information. As a result, to the extent the SEC disclosure review will seek more uniformity between U.S. and European standards, environmental and sustainability concerns may very well be a focus.

No? On the other hand, one could easily argue that these groups have a tough battle ahead of them. The SEC, and in particular, the current Director of Corp Fin, Keith Higgins, have strenuously criticized what they call "information overload" in SEC filings and the obfuscatory effect of too much disclosure. In particular, in a March 2014 address at the Thirteenth Annual Institute on Securities Regulation in Europe, Director Higgins criticized the "follow the leader" approach to reporting whereby if one company includes new disclosure in its filings, other companies tend to copy and include similar disclosure in their filings, without giving adequate thought as to whether such disclosure is even relevant to their particular facts and circumstances. Indeed, due in part to the "follow the leader" effect, environmental disclosure has grown in length over the years, with companies sometimes including three or four separate environmental risk factors, as well as the same environmental disclosure replicated several times, but in different places, in the same document. Sustainability groups could have a difficult time convincing the SEC to require more sustainability disclosure if the agency already believes that there may be too much of it already.

In addition, SEC commissioners have voiced significant frustration with calls for politically motivated disclosure, particularly with respect to the SEC's conflict minerals and resource extraction rules, which rules Congress required the SEC to promulgate under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. In fact, SEC Commissioner Gallagher went so far as to call these rulemaking mandates "distractions" and "ill-advised anomalies." He further directed that the SEC should not allow its disclosure regime to be used "to advance policy objectives unrelated to providing investors with [material] information."

SEC Chair White gave perhaps an even more critical speech in October 2013 entitled "The Importance of Independence," highlighting these concerns. She described how the SEC, during its 1970s adoption of the environmental disclosure requirements in Regulation S-K, received investor requests for disclosure of more than 100 different "social matters" covering a "bewildering array of special causes." The SEC, according to Chair White, ultimately declined to require disclosure on any of these issues, stating that disclosure of such "non-material information" would have rendered disclosure documents unwieldy, at a cost that would not provide a commensurate benefit to investors. In short, SEC Chair White—specifically choosing environmental disclosure as her example—cautioned against the perceived need to appease those who seek to effectuate social change through the SEC's powers of mandatory disclosure.

If the SEC views the calls for sustainability disclosure to be politically motivated, unnecessary, or obfuscatory in any particular context, then the SEC may not have much patience for investors advocating for the same. For instance, as Ceres detailed in its February 2014 report, the SEC has not followed through with the commitments and other next steps outlined in its 2010 Climate Change Disclosure Guidance, including leveraging its ability to comment on filings, hosting a public roundtable to discuss climate change disclosure, and the like. In addition, as the SEC is currently busy issuing the remaining reports and rules required of it by the Dodd-Frank Act (having about 60 more rules or reports left to issue, which process could take several more years), it simply may not have the bandwidth to focus on environmental and sustainability disclosure issues, assuming it has the will to do so.

Potential Timeline

Whether and when the SEC will determine if stricter sustainability disclosure is warranted will depend on a variety of factors including whether the SEC decides to conduct a targeted or comprehensive reform. That said, it would be realistic to expect some answers by June 2016 when Commissioner Gallagher's term expires, and certainly within the next five years before Chair White's term expires in June 2019. Public companies and other stakeholders should pay close attention to discern whether their sustainability disclosure (and companies' underlying corporate governance control) will need to be improved.

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SEC CLIMATE CHANGE DISCLOSURE GUIDANCE: WHAT HAVE WE LEARNED FOUR YEARS LATER?

Jehmal Hudson, Esq.

Background

Approximately 40 years ago, the Securities Exchange Commission (SEC or Commission) first addressed material environmental disclosures by issuing an interpretative release stating that registrants should consider filing environmental compliance and its financial impact on their companies. SEC Release No. 33-5170 (1971). In 1982, the SEC adopted a final and current rule that mandated disclosure information related to litigation or business costs arising out of environmental regulation. SEC Release No. 33-6383 (1982). On January 27, 2010, the Commission voted 3-2 to publish an interpretative guidance entitled the *Commission Guidance Regarding Disclosure Related to Climate Change* (the Guidance). While many considered that the existing SEC disclosure rules were adequate with respect to corporate reporting on climate change, the Guidance clarified how publicly traded corporations should apply existing SEC disclosure rules to certain mandatory financial filings with the SEC regarding the risk that climate change developments may have on their businesses. U.S. Securities and Exchange Commission, SEC Issues Interpretive Guidance on Disclosure Related to Business or Legal Developments Regarding Climate Change (Jan. 27, 2010), available at http://www.sec.gov/news/press/2010/2010-15.htm; and Commission Guidance Regarding Disclosure Related to Climate Change (Feb. 2, 2010), available at http://www.sec.gov/rules/interp/2010/33-9106.pdf. Specifically, the Guidance stated what companies could be required to disclose related to climate change under the SEC's Regulation S-K (17 C.F.R. pt. 229), including Forms 10-K (17 C.F.R. pt. 240) and 20-F (17 C.F.R. 249.220f).[1] Effective on February 8, 2010, the Guidance aimed to clarify more clearly existing disclosure rules that may require a public company to disclose the corporate or public policy developments related to how climate change may impact its business. SEC Release No. 33-9106 (2010). This article reviews the regulatory and legislative perspectives of the Guidance, as well as examines its impact on public corporations.

The SEC Guidance

Corporate disclosure requirements generally must meet the materiality test, meaning that information should be disclosed if a reasonable investor wants it to make an informed investment decision. Paul S. Atkins, SEC Commissioner, Remarks to the "SEC Speaks in 2008" Program of the Practicing Law Institute (Feb. 8, 2008). Former SEC Chairman Mary Schapiro stated that the materiality principles form the bedrock of the disclosure framework and that the Guidance would ensure the Commission's rules were applied consistently so that investors get reliable information. Mary Schapiro, Statement Before the Open Commission Meeting on Disclosure Related to Business or Legislative Events on the Issue of Climate Change (Jan. 27, 2010), available at http://www.sec.gov/news/speech/2010/spch012710mls-climate.htm.

Furthermore, the former chairman stated that the Guidance provided "interpretive guidance on existing public company disclosure requirements as they relate to business or legislative events on the issue of climate change."*Id.* Thus, the Guidance attempted to clarify how certain climate change legal developments, such as climate change legislation and regulation, climate change international accords, regulation or business trends and their indirect consequences, and climate change physical impacts, should be disclosed under then-current SEC corporate disclosures.

The SEC Decision

When the Commission voted to adopt the Guidance, the former SEC Chairman stated that the Commission was not making any statements regarding the facts related to climate change or global warming. *Id.* However, SEC Commissioner

Luis A. Aguilar reasoned that a clear consensus had been established on the reality of climate change. *Id.* Moreover, he argued that climate change had become ever more material to corporate affairs and corporate investors. *Id.* Commissioner Aguilar found that because of climate change's prominence and several legislative and regulatory responses to the issue, the Guidance would help foster a better understanding of how the SEC's existing disclosure requirements applied to climate change. *Id.* As a result, he believed that climate change and related governmental action could create risks and opportunities for companies and, clearly, material information disclosure would inform and aid investors in their decision making. *Id.*

In her dissent, former SEC Commissioner Kathleen Casey contended that climate change science and the law lacked certainty and the usefulness of climate change disclosure guidance information to most investors was at the very least questionable. Kathleen Casey, Statement at Open Meeting on Interpretative Release Regarding Disclosure of Climate Change Matters (Jan. 27, 2010), available at http://www.sec.gov/news/speech/2010/spch012710klc-climate.htm. Commissioner Casey believed the existing SEC disclosure regime related to climate change was highly developed and robust, and registrants were well aware of, and had decades of experience complying with, the disclosure requirements. *Id.* Additionally, she stated that the issuance of the Guidance when climate change science, law, and policy were in flux did not seem reasonable. *Id.* Thus, Commissioner Casey did not believe that the Guidance would result in greater availability of material and decision-useful information geared toward the needs of the broad majority of investors. *Id.*

Congressional Reaction

Although no legislation in the 113th Congress has been introduced to date addressing the Guidance, there were various congressional actions in both the 111th and 112th Congresses. During the 111th Congress, two Senators supported the Guidance. Former Senate Committee on Banking, Housing, and Urban Affairs Chairman Christopher Dodd believed that investors have the right to know if their investments may be helped or harmed by global warming or climate change policies. He also believed that the Guidance would ensure that investors could make well-informed decisions. News Release, U.S. Congress, Senate Comm. on Banking, Housing, and Urban Affairs, Dodd, Reed, Praise SEC Decision on Climate Risk Disclosure (Jan. 27, 2010), available at http://banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=76a31da5-ecc6-9a2e-6847-aece2d94c719&Region_id=&Issue_id=. Likewise, former Senate Banking Subcommittee on Securities, Insurance, and Investment Chairman Jack Reed was pleased the SEC issued the Guidance regarding climate change disclosure. The Senator stated that the Guidance would increase informational transparency and that climate change created new opportunities and risks in the economy. Additionally, major environmental risks and liabilities could significantly impact corporations' future earnings and, if undisclosed, could impair investors' ability to make sound investment decisions. *Id.*

In the House of Representatives, Florida Congressman Bill Posey wrote a letter to former Chairman Schapiro opposing the Guidance. Twenty House colleagues signed the letter, including former Texas Congressman Ron Paul and House Financial Services Subcommittee on Capital Markets and Government-Sponsored Enterprises Chairman Scott Garrett. Letter from Representative Bill Posey et al. to SEC Chairman Mary Schapiro (Mar. 16, 2010), available at http://posey.house.gov/UploadedFiles/SECLetter-ClimateChangeRegs-March15-2010.pdf. Former House Financial Service Committee Chairman Spencer Bachus also wrote the former SEC Chairman stating that the Guidance overreaches the Commission's authority and would impose potentially significant compliance costs on issuers with little apparent benefit to investors. Press Release, U.S. Congress, Office of Spencer Bachus, Congressman Bachus Criticizes Back-Door Climate Change Rule (Feb. 3, 2010).

During the 112th Congress, legislation was introduced to repeal the Guidance. Both Wyoming Senator John Barrasso and Congressman Bill Posey introduced identical bills (S. 1391; H.R. 2603) to prohibit the SEC from enforcing the climate change disclosure guidance. According to the Members, the legislation's purpose was to prevent the Commission from conducting burdensome and expensive climate analysis. Press Release, U.S. Congress, Office of Bill Posey, Posey, Barrasso Defend Job Creators from Excessive SEC Regulations (July 20, 2011), available at http://posey.house.gov/News/DocumentSingle.aspx?DocumentID=252940.

Public Policy Arguments

Institutional investors, such as labor union and public pension funds, claimed that the Guidance was necessary because given the consensus that climate change is a reality and the legislative and regulatory responses to it, the Guidance would help foster a better understanding of how the SEC's existing disclosure requirements applied to it. In March 2010, a coalition of public pension fund and corporate treasurers, comptrollers, controllers, institutional investors, and asset managers wrote to then-SEC Chairman Schapiro stating that the SEC's new interpretive guidance provides registrants valuable information about how to apply long-standing disclosure requirements to the evolving challenges posed by climate change. Letter to SEC Chairman Schapiro from the Investor Network for Climate Risk (Mar. 3, 2010), available at http://www.ceres.org/files/INCR_SEC_LETTER_March_2010.pdf.

Business interests, particularly the electric utility industry, claimed that the current global climate change science and law remained uncertain. Accordingly, the existing SEC disclosure rules were acceptable related to corporate reporting on environmental change. Furthermore, the climate change disclosure guidance's usefulness for most investors was unclear. In July 2010, the Edison Electric Institute wrote to then-SEC Chairman Schapiro, expressing that the Guidance required too much speculation by corporations in areas such as predicting weather patterns, the likelihood of enacting climate change-related legislation, and potential corporate reputational damage related to climate change. Also, the electric utility trade group was concerned that the Guidance could discourage voluntary disclosures by registrants fearful of liability under securities laws for the contents of such disclosures, which would reduce the total amount of general climate change information provided to investors. They were also concerned that the Guidance might be interpreted as requiring that corporate management conduct a comprehensive review of climate change-related matters, which could be both unnecessary and excessively burdensome. Letter from Richard McMahon, Executive Director of the Edison Electric Institute, to SEC Chairman Mary L. Schapiro (July 13, 2010).

The Guidance Effect on Publicly Traded Companies

Since it went into effect in February 2010, we learned a little bit about the Guidance and its impact on public corporations. Many of the findings that we learned regarding the climate change disclosure guidance impact of public companies were prepared by Ceres, which is a nonprofit coalition of institutional investors, environmental organizations, and other public interest groups. For example, large public companies improved their climate-change risk disclosures in recent years, but more work needed to be done in this area. Jim Coburn, Sean H. Donahue & Suriya Jayanati, *Disclosing Climate Risks & Opportunities in SEC Filings: A Guide for Corporate Executives, Attorneys & Directors*, Ceres, Feb. 2011, at 32, available at http://www.ceres.org/resources/reports/disclosing-climate-risks-2011. According to Ceres, good climate change risk disclosures were rare and many disclosures were either fair, poor, or involved no such disclosure. Ceres also found that when they researched the annual financial filings from the world's top 10 oil and gas companies regarding their climate change disclosures, none of the companies provided disclosure that justified as exceptional reporting. *An Analysis of SEC*

Disclosure by Major Oil & Gas Companies on Climate Risk and Deepwater Drilling Risk, Ceres, Aug. 2012, available at http://www.ceres.org/resources/reports/sustainable-extraction-an-analysis-of-sec-disclosure-by-major-oil-gas-companies-on-climate-risk-and-deepwater-drilling-risk/view. Another report from the law firm of Davis Polk & Wardwell (*Environmental Disclosure in SEC Filings, 2011 Update*) found that numerous energy companies expanded their disclosure reporting. These companies added longer factual updates for legislative, regulatory, and litigation developments. But there was uncertainty whether these companies were disclosing due to the Guidance, an increase in climate change regulations, or some other unrelated factors.[2]

The disclosures, however, may have failed to satisfy investors' legitimate expectations. *An Analysis of SEC Disclosure by Major Oil & Gas Companies*, supra*.* Disclosures did help investors understand corporate exposure to climate risk and potential regulatory developments*. Clearing the Waters: A Review of Corporate Water Risk Disclosure in SEC Filings*, Ceres, June 2012, available at http://www.ceres.org/resources/reports/clearing-the-waters-a-review-of-corporate-water-risk-disclosure-in-sec-filings/view. But Ceres stated that investors expressed the need for adequate disclosures to be met, which would require both corporate commitment and regulatory scrutiny. Jim Coburn, Sean H. Donahue & Suriya Jayanati, *Disclosing Climate Risks & Opportunities*, *supra*, at 32. Thus, greater attention to risks and opportunities would help companies themselves, and improved disclosure will help investors and the broader public. *Id.* at 33.

Conclusion

Since the effective date on February 2, 2010, determining if the Guidance implementation was successful still remains to be seen. There were legitimate concerns that identifying and measuring climate change risks would challenge and broaden the materiality test.[3] Yet, the Guidance did not appear to significantly impact disclosures as many argued. Many corporations did not see a major change in climate change disclosures. But these same corporations were not disclosing vital climate change risk data, such as detailed information on the financial impacts of existing and proposed regulatory requirements on the company. In conclusion, it may be a few more years before we see if this interpretative guidance increases transparency regarding climate change matters.

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Endnotes

[1] Foreign-private issuers registered with the SEC are required to file Form 20-F with the SEC.

[2] In 2008, the New York attorney general's office reached separate agreements with two utility companies, Xcel and Dynegy, which required each of them in public filings with the SEC to provide investors with detailed information on the financial risks posed by climate change on their operations.

[3] A former SEC commissioner characterized the concept of "materiality" thus, "The crux of our federal disclosure system is that all material information must be disclosed . . . [T]he Supreme Court has said that something is material if 'there is a substantial likelihood that a reasonable shareholder would consider it . . . as having significantly altered the "total mix" of information made available.'" Remarks to the "SEC Speaks in 2008" Program of the Practicing Law Institute by SEC Commissioner Paul S. Atkins (Feb. 8, 2008), available at http://www.sec.gov/news/speech/2008/spch020808psa.htm.

CALCULATING ENVIRONMENTAL DEFAULT

John Rosengard

As part of the complex obligation to accurately display and disclose environmental liabilities, we recently looked at whether a fair value estimate appreciably changes when the credit risk of fellow potentially responsible parties (PRPs) comes into play. We found that it generally does, and that the actuarial calculations are no more complicated than those required for a pension or post-retiree benefit liability. Our research showed that these calculations are not only possible and useful, they have also been required for 18 years.

Defining Environmental Counterparties

A component of generally accepted accounting principles (GAAP) added in 1996 requires companies to prepare their financial statements with an assessment of the "ability to pay" of their environmental counterparties (AICPA SOP 96-1, ¶6.20, now ASC 410-30-30-1(b)):

- *Assess the likelihood that other potential responsible parties will pay their full allocable share of the joint and several remediation liability*

As well as ASC 410-30-30-7:

- *An entity should assess the likelihood that each potentially responsible party will pay its allocable share of the joint and several remediation liability. That assessment should be based primarily on the financial condition of the participating potentially responsible party. This assessment requires the entity to gain an understanding of the financial condition of the other participating potentially responsible parties and to update and monitor this information as the remediation progresses. The entity shall include in its liability its share of amounts related to the site that will not be paid by other potentially responsible parties or the government.*

In 2006, GAAP was modified to include "fair value measurement," which includes section ASC 820-10-35-17:

- *The fair value of a liability reflects the effect of nonperformance risk. Nonperformance risk includes, but may not be limited to, a reporting entity's own credit risk.*

Accordingly, both ASC 410 and ASC 820 state the need for companies to know the identity and credit standing of their counterparties, across their portfolio of environmental liabilities, and mark up their reserve for this risk; if necessary, they also need to mark down those same environmental liabilities due to their own (poor) credit standing. If you can imagine a world where your own mortgage or credit card balance would grow or shrink monthly, simply due to changes in your credit score, you have grasped GAAP's requirement of fair value.

On the public sector side, the Government Accounting Standards Board (GASB) published Statement 49 in 2006; in this, paragraph 82 notes the same logic, that if counterparties default from their joint and several liability, any remaining counterparties will record and fund their expected share of a site's liability.

Long-Term Nature of Environmental Liabilities

Under certain conditions, a cleanup project's remedial investigations can last a decade or more; implementation of the final remedy can add another 20 to 100 years to the schedule. Counterparty risks readily accumulate under these circumstances.

Consider a town with a working port and an offshore sediment investigation under way. Every year of delay in transitioning from a study to a remediation increases the orphan share that the town and any remaining PRPs will fund. If you ever joined friends for a large dinner out, you have seen the scramble when the check comes: someone forgot his wallet, another only had a salad, and half the group left before dessert. Environmental liabilities provide the fairly ordinary experience to pay your company's share and then some.

We investigated whether the recent improvements to commercial credit scoring data and technologies have made it possible to calculate the long-term viability of a pool of counterparties, and when it makes sense to track them. We believed this data would be useful because of the need for all PRPs to comply with GAAP, state and federal goals to implement "polluter pays" aspects of public policy, and our expectation that predictive data analysis can prevent default.

Key ERCI Findings

1. The U.S. Environmental Protection Agency's (U.S. EPA) ABEL (ability to pay) model looks at tax return data from the three most recent years and provides a result valid for immediate use only; no prediction of ability to pay is available.
2. Commercial credit scoring systems from Standard & Poor's, Dun & Bradstreet, Experian, Fitch, and others only make short-term forecasts, with typical validity of 12 months using data from the most recent three years.
3. Advances in Markov Chain Monte Carlo modeling allow desktop software to link chains of short-term data to construct a long-term forecast. There is newly available commercial transition matrix data, detailing how often parties change from having good credit to bad or none, and vice versa.

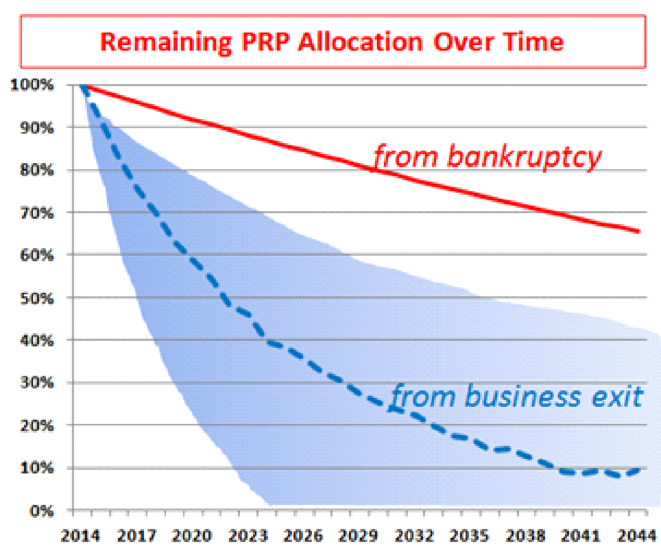
Defining Environmental Default Rates

The U.S. rate of bankruptcy filings is fairly consistent, running about 1.4 percent/year, according to Dun & Bradstreet (2002). However, the U.S. Census and D&B annually track "business exit," a different metric based on whether a business simply ends, with or without a formal bankruptcy filing. This rate averages 8.4 percent/year, but within different credit score levels, the rate ranges from <1 percent for the best performing companies, and over 30 percent for the weakest groups.

Our experience working with the historical 1.4 percent bankruptcy rate was that it understated the scope of our clients' counterparty risks; while we did see a few outright defaults from a sudden bankruptcy filing, more often we saw a lengthening string of successors, assigns, guarantors, indemnitors, acquirers, and others that become financially responsible (for the moment).

Publicly traded Fortune 500 parent companies typically do not enter Chapter 11 bankruptcy (reorganization) or 7 (liquidation). Recent exceptions are General Motors, Chrysler, and American Airlines. However, subsidiaries and privately held companies dissolve and close down on a regular basis without declaring bankruptcy. It is this latter definition of "business exit" that ASC 410-30-30-7 prompts us to track on a frequent basis, as this is our population of likeliest defaulters.

If we worked on a 30-year Comprehensive Environmental Response, Compensation, and Liability Act site thinking about business exit as well as bankruptcy filings, we can lose half of the original PRP group members in just 7.5 years; see the graph below.



The Value at Risk

The common use of creditworthiness in an operating business is to determine payment terms. A customer with excellent credit may get "net 90 days" payment terms and a high credit limit. Weaker customers may be obligated to pay completely in advance. In contrast, environmental counterparty risk spans decades.

Picture a CFO's dilemma by comparing the way it does business with an industrial customer: the sales department will sell up to $1 million with "net 30" payment terms; the environmental team will have a $10 million risk running for 20 years. If that customer defaults, the sales department may show a $1 million claim, while the environmental department explains the $10 million reserve increase.

We find that tracking counterparties—the right ones—adds value by preventing reserve increases. Halving the business rate per $1 million of preventable liability loss is worth $41,000/year.

To estimate counterparty default, companies have to be ready to compile and scan credit score data. To prevent default, companies will have to periodically assert claims with imperfect information, securitize the claims with a third-party financial instrument, or simply document a new successor/assign.

Importance in Due Diligence

GAAP notes that liabilities should generally be valued as a combination of:

- Market value, as set at the time of a transaction
- Present value or current value, based on the discount rate selected
- Expected value, taking in a range of outcomes with probabilistic weighting
- Fair value, taking in outlier events like remedy failure and counterparty default

During the due diligence process, buyers and sellers have the duty to be fully aware of counterparty default risk, and adjust the values of any indemnification accordingly.

Value in PRP Group Administration

Understanding counterparty risk is useful in setting cash calls and determining viability standards for PRPs remaining in a PRP group (or cashing out). Decisions about the urgency of pursuing de minimis and insurer-funded claims can also be justified when the group understands how project timelines increase counterparty risk.

PRP group administrators can add value by monitoring the condition of certain types of PRPs actively. Entities which lack employees or revenue, for example, may have begun the process of "business exit."

Utility in Liability Valuation

Since GAAP has required counterparty tracking for almost 20 years, corporate liability forecasters should already be familiar with the requirements of ASC 410-30-30-7. However, auditors may not have the experience or data to comment on the preventable problems. If an auditor evaluated the root causes of PRP allocation increases or "liability comebacks," preventable counterparty default should be the principal finding. Secondary findings may include poor use of public-domain data and inadequate oversight of decisions to cash out or securitize (letter of credit) the weaker counterparties. Such a periodic auditing report may minimize future comebacks, uncover material financial consequences to slowly completing *any* cleanup, and recommend credit standards for future purchase and sale agreements that transfer or retain environmental liabilities (ASC 410-30 or GASB 49) or asset retirement obligations (ASC 410-20).

Case Study

Consider a Fortune 500 chemical manufacturer selling an operating plant to its managers through a Leveraged Buyout (LBO). If the LBO group experiences any sort of financial stress, and its credit rating declines, the long-term probability of its insulating the seller from an environmental default drops off, and the counterparty liability (reserve) of the seller goes up.

In this example, the initial counterparty reserve of the seller may be zero, but there is no defense for a zero counterparty reserve the day the LBO was to file for Chapter 11 or 7. Financial stress takes time to accumulate, and thanks to web-based credit reporting, the credit status of any person or company is an open secret.

Consider again the 8.4 percent/year probability of business exit: if there is a 50 percent chance of survival of the LBO in 7.5 years, how easy would it be for the seller to lose track of this obligation, especially where there is no reserve and no budget last year and next year? The credit ratings are available, the transaction is a matter of public record, but the consequences of default can still highlight the fragility of some of the seller's institutional knowledge.

A larger challenge compounding the loss of institutional memory is development of a full catalog of potential environmental defaults. Yet this is also part of GAAP, namely ASC 410-3-50-9, to display to management the "reasonably possible" future reserve changes:

- *Uncertainties associated with environmental remediation loss contingencies are pervasive, and they often result in wide ranges of reasonably possible losses with respect to such contingencies. Further, resolution of the uncertainties and the cash-flow effects of the loss contingencies often occur over a span of many years. Accordingly, this subtopic encourages, but does not require, additional specific disclosures with respect to environmental remediation loss contingencies that would be useful to further users' understanding of the entity's financial statements.*

Building a Counterparty Tracking System

Our experience is that improving a team's ability to assess, book, discharge, and prevent counterparty default takes unique steps, but the solutions readily scale down to single project teams:

A. **Scan** for your significant counterparties
    - In purchase and sale agreements, counterparties are the buyer and seller and any related successors and assigns

- In joint ventures, counterparties are the owners
- For a multiparty cleanup project, this is normally a listing of major PRPs and de minimis parties
- For a transferred environmental liability, counterparties are the successor (former) owner, its insurers, and any guarantors

B. **Prioritize**

- Ignore "low cost + low probability" liabilities, but note key assumptions to justify skipping the analysis
- Focus on uninvestigated or pre-remedial projects with a slow pace to closure; these conditions produce default risk.
- Set credit limits on par with your operating business: "Would we extend this much credit to this PRP if it bought our products?"

C. **Track** and document condition of significant counterparties

- Every quarter: perform credit checks. Flag and resolve where PRPs are "over their credit limits"
- Every year: prioritize watch list of counterparties and sites to preemptively resolve
- Every 36 months: redo the scan of counterparties; begin to include asset retirement obligations

D. **Act** in anticipation

- Pick liabilities to be monetized via a cash-out, or securitized with a letter of credit
- Identify counterparties where a successor/assign needs to step in
- Buy back properties
- Form a voluntary PRP group

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NOMINATE

2014 ABA Award for Excellence IN ENVIRONMENTAL, ENERGY, AND RESOURCES *Stewardship*

2014 CALL FOR NOMINATIONS

The ABA Section of Environment, Energy, and Resources invites nominations for the 2014 ABA Award for Excellence in Environmental, Energy, and Resources Stewardship. This award was established in 2002 to recognize and honor the accomplishments of a person, organization, or group that has distinguished itself in environmental, energy, and resources stewardship.

Nominees must be people, entities, or organizations that have made significant accomplishments or demonstrated recognized leadership in the areas of sustainable development, energy, environmental, or resources stewardship. This may include a major development in law or policy that serves to enhance conservation, responsible development, prudent resource use, and pollution abatement or mitigation, or it may be a recognition for a sustained period of leadership in the development of law and policy in this area. The Award may also be given for significant achievements in legal practice or in business; including corporate charitable contributions of funds, land, or resources; in written articles; in teaching; in advocacy before courts, agencies, legislators, or other institutions; or for any other significant achievement that evidences excellence in environmental, energy, and resources stewardship. Although achievement or leadership can have been exhibited over a number of years or with respect to a single substantial accomplishment, the Section is particularly interested in nominations that can point to specific milestones of achievement by those persons or entities being nominated, with an emphasis on creative thinking, diligence in execution of a plan or program, or sustained progress in innovation or leadership.

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Please address any questions to Cristina Celis, Section Assistant, at (312) 988-5625 or Cristina.Celis@americanbar.org.

Nomination forms are available on the Section website. Please visit www.ambar.org/EnvironAwards.