Willis Webcast Bulletin

Willis

Environmental Practice December 2, 2004

Environmental Liability Disclosure Obligations and Market Solutions

Corporate governance transgressions and failures of recent years have stimulated unprecedented investor scrutiny, regulatory vigilance and demand for transparency. Disclosure of environmental liabilities – long perceived to be inconsistent and at times misleading – has become ever more important.

This bulletin will review the current requirements for the disclosure of environmental liabilities, outline the steady flow of events that have served to "up the ante," and present environmental insurance solutions that may reassure stakeholders that known and potential environmental exposures are adequately contained, managed and reported to investors.

Background

Environmental liabilities are among the significant issues that impinge on investment decisions. The Securities and Exchange Commission (SEC) therefore requires public companies to disclose both real and contingent environmental liabilities in their annual 10-K filings. However, only those liabilities that are considered "material" are required to be disclosed, and Financial Accounting Standards Board (FASB) rules dictate that a loss contingency should be accrued if it is "probable" that a loss will occur and the amount of the loss can be "reasonably estimated."

Historically, while a number of companies strove to present their environmental liabilities in the most favorable light, many exploited the inherent flexibility of disclosure rules and concealed the full extent of their exposures. A 1998 Environmental Protection Agency (EPA) study found that 74 percent of publicly traded companies were underreporting environmental liabilities. In its more recent review of Fortune 500 10-K filings, the SEC itself acknowledged that many companies are still not adequately disclosing their environmental liabilities.

This problem is epitomized by the manner in which some companies treat their brownfield properties. Reluctant to initiate investigations that might trigger enforcement actions and remediation expenditure, some have adopted a so-called "don't ask, don't tell" policy which involves mothballing potentially contaminated facilities and not reporting potential remediation obligations.

Mounting Pressure for Change

The Sarbanes-Oxley Act of 2002 (SOX) does not specifically address environmental disclosure, but it has changed the legal and political context in which such disclosure requirements must be interpreted. It requires that CEOs and CFOs personally endorse the disclosures made by their organizations.

Willis Webcast is a semi-monthly series of interactive webcasts featuring Willis practice group leaders addressing current risk management topics. Webcast access information and agendas are available on www.willis.com. Additional information about the series is available by calling the Willis Client Hotline at 866 704 5115 and asking for details on the Willis Thought Leadership Initiative.

An increasingly influential group of environmental advocacy organizations contends that the under-disclosure of environmental liabilities directly harms investors and could potentially create the next accounting scandal. They are attempting to leverage SOX and the events that led to its enactment in order to force further reforms in environmental reporting.

The Rose Foundation, for example, issued a report in July that highlighted the ineffectiveness of the current disclosure process and specifically recommended that investors seek information on risk mitigation provisions such as adequate environmental liability insurance. The report was supported by a group of institutional investors (socially responsible investment groups or SRIs) that collectively hold some $2 trillion in assets.

These concerns have come to the attention of Congress. In July 2004, a symposium entitled "Coming Clean: Corporate Disclosure of Environmental Issues in Financial Statements" was co-hosted by Senators Corzine and Lieberman. Several reports released at this event outlined the inadequacy of the current system. Most prominent was a report by the Government Accounting Office which made specific recommendations, including a suggestion that the SEC work directly with the EPA to assess the adequacy of reporting.

Recent Developments

Several developments in the past few months have raised the bar even further and may combine to change the way corporations report environmental liabilities. The most significant are:

- New 8-K disclosure requirements – The SEC's new interpretation means that certain environmental liabilities, such as a determination that one of the company's assets is contaminated, will now compel companies to file an 8-K.

- New interpretation of FASB 143, "Accounting for Conditional Asset Retirement Obligations" – This will require companies to recognize and report an environmental liability even if the liability is likely to occur at some unspecified point in the future. This should effectively close the don't ask, don't tell loophole and prevent companies from deferring the reporting of liabilities by mothballing sites.

A Matter for the Boardroom

The EPA and shareholder interest groups are increasing pressure on the SEC to step up enforcement activity relating to the reporting of environmental liabilities. Although companies may avoid enforcement actions, they may ultimately find that their environmental performance becomes the focus of unwelcome attention. As companies improve the accuracy of their disclosures, and to the extent that such disclosures result in significant increases in reported liabilities, they may encounter adverse consequences. Those companies whose share values are dramatically affected may become targets for securities class action suits.

Risk Management Solutions

In the era of corporate transparency and heightened investor scrutiny, proactivity is imperative. Environmental risk management should include reevaluation of the adequacy of existing disclosure policies, establishment of appropriate systems for ensuring accurate data collection and consistent evaluation of environmental liabilities, and thorough assessment of available risk management tools.

Once an environmental liability has been identified and determined to be "material," there are several mechanisms available to mitigate the exposure and demonstrate that it is thoroughly and adequately managed. These options might include accelerated cleanup of a contaminated site, sale of relevant sites or operations, and/or use of risk transfer arrangements such as environmental insurance.

Environmental Insurance and Product Offerings

Environmental or pollution insurance has grown from a niche specialty class into a mature, mainstream product line. It can be used to assure stakeholders that known and potential environmental liabilities have been adequately contained, managed and disclosed to investors. Further it can be used to:

- Reduce the materiality of specific environmental liabilities (the SEC has made it clear that the availability of insurance is a factor that influences whether an event is material)
- Quantify environmental liabilities and remove associated financial uncertainty
- Realize maximum value from the sale or redevelopment of brownfield properties or unwanted businesses
- Reduce the risk of liability rebound after a sale

Major product categories include Pollution Liability Insurance (for unexpected pollution losses such as third-party claims and mandated cleanup costs); Remediation Cost Cap Insurance (to cover unanticipated cost overruns associated with known remediation activities); and Blended Insurance Programs (that address known costs and exposures and the associated financial uncertainty through a combination of risk funding and risk transfer).