



Environmental Liabilities Present High Risks and Management Challenges in Business Operations & Transactions

Environmental Liabilities are High Risk Liabilities

Environmental liabilities are among a number of potentially high risk exposures facing companies engaged in commercial operations and transactions worldwide.¹ There are at least four key characteristics of environmental liabilities that individually or collectively can create a high risk to a company: (1) they involve multiple and complex variables making them difficult to define and analyze; (2) they are long-term in nature requiring continuous monitoring and re-assessment; (3) they have a high degree of uncertainty making them difficult to quantify; and (4) they can cause adverse and material legal, financial and commercial impacts to a company if not properly managed.

Environmental Liabilities Arise from Multiple Sources

Companies are subject to environmental liabilities through a number of avenues including past operational activities, current operational activities, business transactions, and financial accounting and reporting obligations. Environmental liabilities may arise as a result of past improper operational activities that violated environmental laws and that resulted in contamination of property, potable groundwater or other natural resources. This may have occurred either during the ownership of former or currently operating facilities or through shared responsibility with other responsible parties at common waste disposal and recycling sites.

Current improper operational activities can create new environmental problems and liabilities both in the present and the future. For example, industries improperly using large quantities of hazardous substances in their processes or improperly disposing of large volumes of waste products generated could find themselves in violation of environmental regulations governing use of these hazardous substances and recycling/reuse of the waste products.

Environmental liabilities may arise in business transactions. For example, poorly scoped or managed due diligence, inadequate site assessments, inaccurate estimates of known liabilities, or successor liabilities involving bankrupt parent companies could all create environmental liabilities in transactions such as mergers and acquisitions, commercial and industrial property redevelopment ("brownfields"), facility sale and closure, bankruptcy and restructuring, and smaller transactions such as leases and rights-of-way.

Environmental liabilities may also arise from reporting obligations. In the U.S., there is a financial accounting standard that requires companies to account for and report their environmental legal obligations associated with the retirement of their assets even if there is little likelihood of government enforcement or private litigation.² These so-called Asset Retirement Obligations (AROs) result from the acquisition, construction, development and/or normal operation (versus improper operation) of long-lived assets such as property, manufacturing facilities and equipment.

The Range of Environmental Liabilities is Expanding

Historically, companies have viewed environmental liabilities primarily as matters involving property contamination and regulatory compliance.³ Established environmental legislation and case law in the U.S. imposes liability, regardless of fault and retroactively, on current and former owners or operators of contaminated property and facilities. Evolving environmental legislation in other countries appears to be following a similar approach.

The range of environmental liabilities that a company may find it subject to is expanding. This is due to the proliferation of environmental regulations worldwide, and the renewed interest in environmentalism, particularly from investors and shareholders of companies who are increasingly demanding "greener" processes and products. One example is the conditions in the workplace and associated impacts on worker health and safety. Exposure of a company's workers to hazardous or unsafe working conditions could violate existing laws and regulations as well as trigger toxic tort claims.

Any company who fails to thoroughly address their environmental liabilities as part of their risk management strategy can face serious legal, financial, and commercial consequences.



An example of an emerging environmental liability is the growing concern over global warming or climate change. Current U.S. securities law mandates disclosure of trends that are likely to have a material effect on a company's financials.⁴ Investors, environmental advocacy groups, and public interest groups have petitioned the U.S. Securities and Exchange Commission (SEC) for clarification that under the existing law, companies should be required to disclose material information related to climate change.⁵ Recent legal developments and a growing trend toward voluntary reporting will put further pressure on companies to address this issue.⁶ Trade media articles are already discussing the potential liabilities to corporate officers and directors of companies who fail to do so.

Another example is the exposure to specific chemicals or substances such as asbestos and silica, lead-based paint, and mold. The environmental liabilities resulting from exposure to these substances include toxic tort suits, property damage, and claims for diminution of property.

Future environmental regulatory requirements could be viewed as another environmental liability in that a company would have to incur and account for costs to meet these requirements. Environmental legislation, directives, and reporting and disclosure requirements continue to evolve and broaden in the U.S. and in the European Union countries. An increased awareness of environmental issues and the promulgation of legislation are also occurring in countries and regions including China, India, Southeast Asia, Africa and Latin America.

Failure to Manage Environmental Liabilities Can Result in Serious Consequences

The failure of a company to manage their environmental liabilities can lead to any one of a number of serious legal, financial and commercial consequences including: investigations and enforcement actions (both criminal and civil) brought by federal and state environmental regulatory authorities and by federal securities authorities such as the U.S. SEC; re-statements of the company's financials, declines in stock price, and market capitalization losses; personal liability of the directors and officers of the company, shareholder and investor suits, third-party contribution claims and toxic tort suits; and damage to a company's reputation and diminution of its brand in the marketplace.

Many Companies Still Manage Their Environmental Liabilities in an Ad Hoc Fashion

In spite of the high risk nature and expanding range of environmental liabilities, a surprising number of companies are negligent about managing these risks. In a recent survey of 320 business executives around the world, 43% of the respondents indicated that environmental risk management is frequently managed in an ad hoc fashion or not at all. Only 41% said they conducted environmental assessments when developing new products or services; 26% when planning geographical expansions, and only 19% when planning mergers and acquisitions.⁷ The survey also suggested that if environmental risk management activities are to be successful, they must be considered as part of the company's overall risk management strategy and not managed as a separate process only when problems arise. The takeaway here is that while environmental liabilities are rising up the corporate agenda, many companies are still at the early stages of this process.

Managing Environmental Liabilities Requires Three Fundamental Steps

Given the nature and extent of the risks and future trends, companies should be proactive in managing their environmental liabilities. Arguably, there are three fundamental or basic steps in managing environmental liabilities. The first step is a periodic review or inventory and a preliminary assessment of the company's current and foreseeable environmental liabilities. This first step would likely be done by a company's risk manager with input from in-house counsel and/or in-house corporate financial or accounting managers. A company might also want to consider seeking outside expertise from environmental consultants and legal counsel to assist in this step for the sake of completeness and thoroughness.

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The second step would be a quantification and analysis of how these environmental liabilities might impact a company financially, legally and commercially. At this point, a company might want to supplement its own resources with outside expertise from environmental consultants and legal counsel (if not consulted in the first step), as well as from actuarial experts, outside accounting experts or other financial analysts.

The third step would be to develop a defensible and rational strategy for managing the environmental liabilities. Ideally, this strategy would be consistent with if not an integral part of the company's overall risk management program. One of the obvious strategies for managing its environmental liabilities would be for the company to acquire insurance coverage. The global environmental insurance market today is extremely sophisticated and mature, offering a multitude of products to meet different needs. A company seeking to manage its environmental liabilities through an insurance portfolio would want to supplement its team of aforementioned experts with insurance professionals including forensic insurance experts who could identify and evaluate the company's historical insurance coverage, and insurance brokers who could assist the company in identifying and acquiring the right insurance products to complete the needs-coverage matrix.

Summary

Environmental liabilities present high risks to companies engaging in commercial operations and transactions around the globe. The long-term, complex, and uncertain nature of these liabilities make them a formidable challenge for companies to define, quantify and analyze, and manage. This challenge will only become more difficult as environmental regulations around the world continue to proliferate and broaden, and general concern for the environment continues to grow. Any company who fails to thoroughly address their environmental liabilities as part of their risk management strategy can face serious legal, financial, and commercial consequences.

Endnotes:

1. Other high risk liabilities include: product liability, mass and toxic tort liability, and intellectual property liability.
2. Statement of Financial Accounting Standards (SFAS) No. 143, "*Accounting for Asset Retirement Obligations*" (ARO's). Financial Accounting Standards Board. June 2001.
3. A U.S. EPA December, 1996 report, *Valuing Potential Environmental Liabilities for Managerial Decision-Making*, lists six categories of traditional environmental liabilities: (1) compliance obligations related laws and regulations that apply to the manufacture, use, disposal and release of chemical substances; (2) remediation obligations (existing and future); (3) obligations to pay fines and penalties for statutory or regulatory non-compliance; (4) obligations to compensate private parties for personal injury, property damage and economic loss; (5) obligations to pay punitive damages for grossly negligent conduct; and (6) obligations to pay for natural resource damages.
4. The issue of what constitutes "material" has been addressed by the U.S. Securities and Exchange Commission (SEC) in their S-K Regulations.
5. In September, 2007, Ceres, a coalition of twenty investors, environmental groups and other public interest organizations who collectively manage more than \$1.5 trillion in assets, petitioned the SEC to require publicly-traded companies to assess and disclose their financial risk from climate change. Since the petition was filed, the SEC has received supportive comments from more than 50 additional investors. In June, 2008, Ceres (along with others) filed with the SEC a supplement to the 2007 petition citing the growing body of U.S. and international laws and regulations aimed at reducing the greenhouse gas (GHG) emissions as new evidence that an immediate response from the SEC is needed.
6. In April, 2007, the U.S. Supreme Court issued a decision that the U.S. Environmental Protection Agency (EPA) has the authority to regulate GHG emissions as air pollutants under the Clean Air Act [*Massachusetts, et al., v. Environmental Protection Agency, et al.*, 549 U.S. 497; 127 S. Ct. 1438 (2007)]. The December 2007 passage of the Omnibus Spending Bill mandates that EPA issue regulations requiring companies to report their GHG emissions by June, 2009.



7. *Under the spotlight: the transition of environmental risk management.* March, 2008. The Economist Intelligence Unit (EIU). The EIU surveyed respondents from a wide range of industries in Asia, Australasia, North American and Western Europe. About half of the respondents represent businesses with annual revenue of more than US\$500 million. All of the respondents influence or are responsible for strategic decision making concerning risks at their companies.

About the Firm:

DOUGLAS C. ALLEN, P.A. provides strategic consulting services to businesses, their legal counsel, insurers and investors to help them define, quantify and manage their high risk exposures so they may mitigate adverse and material consequences to their operations and financial strategies.

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