Disclosure Of Environmental Liabilities Under The Securities Laws: The Potential Of Securities-Market-Based Incentives For Pollution Control

Perry E. Wallace

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DISCLOSURE OF ENVIRONMENTAL LIABILITIES UNDER THE SECURITIES LAWS: THE POTENTIAL OF SECURITIES-MARKET-BASED INCENTIVES FOR POLLUTION CONTROL

PERRY E. WALLACE*

I. INTRODUCTION

The dramatic growth of environmental regulation has been one of the important recent developments in modern law. And of those most affected by this impressive growth, the business community ranks at or near the top of the list. In fact, this expanding environmental regulatory sphere is now a constant and imposing presence in the economic, managerial and political lives of many businesses.

The discussion in this article derives from a provocative new phenomenon affecting those businesses, and lying at the juncture of environmental protection, economics, and corporate finance: the dynamic created by the legal duty of publicly held companies to disclose environmental liabilities and obligations to the federal Securities and Exchange Commission (SEC or Commission), to their securityholders, and to the securities markets.

Environmental regulation has become increasingly more substantial and more stringent. Significantly, these estimable new laws are spilling over into other regulatory schemes with the same force that has accompanied their

* Professor of Law, Washington College of Law, American University; B. Engr., Vanderbilt University, 1970; J.D., Columbia University School of Law, 1975. The preparation of this Article was supported by a generous grant from the Washington College of Law, for which I express my appreciation. I wish to thank Steve Masur for his research assistance and Professor Andrew Pike for his valuable observations and commentary on the article.

1. See ROBERT V. PERCIVAL ET AL., ENVIRONMENTAL REGULATION; LAW, SCIENCE, AND POLICY 1 (1992). The following statement well summarizes the growth of environmental regulation:

The spectacular growth of public concern for the environment has transformed American law during the past quarter-century. In the space of a single generation, environmental law has grown from a sparse set of common law precedents and local ordinances to encompass a vast body of national legislation. Numerous federal and state agencies now implement these laws through breathtakingly complex regulations that affect virtually every aspect of our lives. In addition, as environmental concerns increasingly transcend national boundaries, environmental law is now serving as a catalyst for the development of new regimes of international law.


As environmental rules become more complex and enforcement penalties increase, companies are simultaneously having to "do more with less" due to economic pressures. Is there relief in sight? Probably not.

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invasion of the corporate boardroom. Indeed, viewing modern environmental law through the prism of the disclosure-oriented federal securities regulatory system not only reveals the awesome potential reach of the present environmental regulatory system, but also illuminates the huge challenge for businesses to achieve overall legal compliance while competing effectively in the increasingly global markets for products and capital.

A. The Impact of Modern Environmental Regulation on the Business Community

The "command and control" paradigm emerged during the 1970s and 1980s as the modus operandi of modern American environmental regulation. In this mode of regulation, a governmental body sets "performance" or "prescriptive" standards for pollution reduction or limitation and then monitors, investigates, and when necessary, enforces compliance by those discharging pollutants into the environment. Further, while one finds growing sentiment for newer methods, such as market-based ones, and correspondingly, increasing criticism of command and control, the latter method

3. Percival describes the command and control paradigm in this way:
Under the command-and-control approach, government authorities issue specific pollution control commands to regulated firms and then monitor the firms to ensure that the commands are followed. In its original design, the Clean Air Act of 1970 epitomized this approach to regulation, and the overall structure of the Act is still dominated by it.

See PERCIVAL ET AL., supra note 1, at 796.

It should be noted that alternative systems to the classic command and control approach of modern environmental legislation are significant matters of current discussion and debate. Further, certain alternatives, including economic incentive-based ones, are now being put into effect at the federal and state levels. See, e.g., DAVID W. PEARCE & R. KERRY TURNER, ECONOMICS OF NATURAL RESOURCES AND THE ENVIRONMENT 70-119 (1990); Robert W. Hahn & Robert N. Stavins, Incentive-Based Environmental Regulation: A New Era From an Old Idea?, 18 ECOLOGY L.Q. 1 (1991); James Dao, Some Regions fear the Price as Pollution Rights are Sold, N.Y. TIMES, Feb. 6, 1993, at A1.

For a particularly interesting and well received discussion of new, progressive environmental protection approaches, including that of "sustainable development," see STEPHAN SCHMIDHEINZ, CHANGING COURSE: A GLOBAL PERSPECTIVE ON DEVELOPMENT AND THE ENVIRONMENT (1992). Schmidheinz also discusses the advantages and disadvantages of the command and control concept. Id. at 19-20.

4. See SCHMIDHEINZ, supra note 3, at 19:
Traditionally, governments have used command-and-control regulations to achieve environmental objectives. "Performance" standards set a target—often for emissions—and allow companies flexibility in meeting it; "prescriptive standards" may prescribe the actual technology to be used, assuming that it will achieve the desired result. The former allow companies more scope for innovation and efficiency.

5. Many believe that the often ominous and ever costly command and control schemes of American environmental law have not produced nearly the levels of benefit commensurate with associated costs and burdens on business decisionmaking and operations:
The Superfund programme has not been a success. Although it has been running for 13 years, few sites have so far been cleaned up to the [Environmental Protection Agency's] satisfaction. The programme has cost the federal government over $1
has been the vehicle for past successes and is at present the predominating one.  

Several phenomena account for the relatively successful ascendency of command and control environmental regulation; these phenomena also explain why recent environmental laws affect the business community so greatly. First, the sheer number of environmental laws at the federal, state, and local levels is of fundamental importance. Quite apart from the other contributing phenomena, this one alone inspires no small amount of angst among corporate managers. For example, even the threshold identification of applicable duties and liabilities has become an administratively burdensome—and legally perilous—task. Indeed, the virtually institutionalized use of enormous sums are also being spent by polluters and their insurers, not just on cleaning up but also on legal fees, as the courts struggle to decide who should pay what share of the bills. A study published last year by the Rand Corporation ... found that 88% of the money spent by insurers went on legal fees and other paperwork costs.  


For an analytical explanation of why command and control regimes such as Superfund have produced disappointing results, see Celia Campbell-Mohn, Objectives and Tools of Environmental Law, in SUSTAINABLE ENVIRONMENTAL LAW 143, 172-73 (Celia Campbell-Mohn et al. eds., 1993). The author notes that although command and control methods have the advantage of providing clarity and an even playing field, other important disadvantages to the method are apparent:  

The primary detriment of centralized command-and-control standards is that they are inflexible regarding fluctuations in natural systems and the economy .... For example, [they] cannot account for the varying abilities of natural systems to respond to pollutants. They also cannot account for fluctuations within natural systems that increase or decrease the carrying capacity at different times in the natural cycle.  

Present command-and-control regulations are often pollutant specific, not accounting for synergistic impacts among various pollutants.  

Also, in many cases, [they] must rely on scientific evidence where values are unquantifiable. For example, basing regulations on risk assessment requires quantitative valuation of ethical judgments, such as the value of human life.  

Finally, command-and-control regulation creates inefficiency by applying uniform reductions where costs of compliance vary. Present command-and-control regimes tend to disadvantage new sources to the economic advantage of existing sources.  

Id. at 173 (clarification added).  

6. Campbell-Mohn, supra note 5, at 172: Command-and-control regulations are the nuts and bolts of environmental tools. Virtually every environmental statute relies partially on command-and-control regulation. ....  

Some form of command-and-control regulation is unavoidable except within a purely free market system. Because a pure free market system cannot account for generations beyond several decades, all of the objectives of environmental law cannot presently be achieved without some command-and-control overlay within other tools.  

7. See Cahill, supra note 2, at A2: Regulatory agencies, the public and shareholders continue to expect companies to
of the "environmental audit" evolved largely in response to the problems of administration posed by this dizzying maze of compliance requirements. Second, these numerous laws are increasingly ambitious, both in the stringency of the duties imposed and in the magnitude of the penalties assessed for noncompliance. Third, in order to give maximum effect to these more substantial duties and penalties, tougher, more persistent policies toward environmental law enforcement exist. Finally, and critically, this great breadth and intensity of regulation disproportionately affects the business community. Perhaps this is true in part because of businesses' "deep pockets," which make available large sums to clean up the environment. Principally, however, the business community's disproportionate contributions to environmental degradation are the basis of its correspondingly disproportionate liabilities and obligations.

Institute programs to assure that "due diligence" requirements of federal legislation are met (e.g., Section 107(b)(3) of the 1986 Superfund Amendment(s). Indeed, one wonders if fail-safe compliance management is possible. (emphasis added). See also Environmental Audits I-1 (L. Cahill & R. Kane eds., 6th ed. 1989) ("Managing compliance in today's regulatory setting has become an almost overwhelming exercise, involving more and more regulations, and affecting more and more organizations."); Barry Breen, Environmental Law From Resource to Recovery, in Sustainable Environmental Law, supra note 5, at 65, 66:

While environmental law's bulk is scary, its complexity is entangling. Too much detail is held together by too few principles. Environmental law tempts you to learn it by mastering a mass of detail: what standards apply, under what laws, under what circumstances? When do you need a permit, and from whom, and how do you get it? Who is liable for what costs, but what are the exceptions? Unfortunately, trying to "know" environmental law may be impossible. There is too much of it. Id. (emphasis added).

8. See Cahill, supra note 2, at A2:
Within this context [of more complex, ambitious environmental regulation], many companies have instituted environmental audit programs. Audit programs can be very valuable management tools, achieving a number of strategic objectives, including: [1] Defining compliance status for plant managers [2] Providing compliance assurance for senior management [3] Increasing environmental awareness throughout an organization [4] Reducing the number and amount of fines and enforcement actions [5] Enhancing the credibility of the company with investors and the local community. See generally Environmental Audits, supra note 7.

9. See A Survey of Waste and the Environment, supra note 5, at 3 (emphasis added): Environmentalists . . . sometimes seem more concerned to punish those whose products end up on rubbish heaps than to encourage sensible behavior. [Governments, succumbing to such pressures] have sometimes adopted policies whose costs are wildly out of line with their benefits . . . This happens because the costs of such legislation are usually carried, in the first instance, by companies. They are therefore hidden from the voters who demand them.

10. See Ross H. Fishman et al., Environmental Reporting Required By The Securities And Exchange Commission, 22 Env't Rep. (BNA), at 1065 (Aug. 16, 1991). Practitioners describe the phenomenon in this way:

Environmental compliance costs are dramatically increasing as a component of our economy. In a recently released report to Congress, the Environmental Protection
Although all of the phenomena discussed above are important, one can fairly state that command and control environmental regulation is only as successful as its enforcement component. Accordingly, and as a reflection of the growth of modern environmental regulation itself, “[e]nvironmental enforcement has grown dramatically over the last decade. The 1980s ushered in an era of increased environmental regulation which will continue into the 1990s and will raise numerous issues of concern to the regulated community.’”11 Not always, but more often than not, the term “regulated community” translates into “business community.”

Recent enhancements to environmental enforcement capacity include critical increases in authority and resources for administrative as well as civil enforcement. Additionally, and riding the crest of a growing wave of public support for environmental protection, criminal prosecution of environmental violations has assumed a prominent position in the array of means now available to state and federal regulators:

During the 1980s, the criminal provisions of the Resource Conservation and Recovery Act (“RCRA”), the Clean Water Act, and the Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”) were expanded and strengthened. In 1990, felony provisions were finally added to the Clean Air Act.12 Present trends could well continue into the 1990s, not only because of enhanced statutory authority, but also because of other increases in governmental resources. These resources include: computerization of information and data; increased enforcement activity by United States Attorneys, state attorney generals, and local district attorneys, complementing the work of the federal Department of Justice (historically the major enforcement agency

Agency projected that by the year 2000, costs for pollution control activities will total 2.6 percent of gross national product. In comparison, expenditures during 1972 totaled 0.9 percent of GNP and 1990 expenditures totaled 2.1 percent of GNP. While these numbers appear significant as averages, it is also important to realize that the costs are not spread evenly over all industries; some industries are already, and will continue to be, confronted with costs far higher than reflected in the averages.

*Id.* (citations omitted); Roberts, supra note 2, at 2-4 (commenting on magnitude of potential liabilities to businesses from violations of environmental laws).

Implicit in the authors' comments and data is the assumption that these compliance costs are visited overwhelmingly upon the business community. The authors expressly note the concentration of costs within particular industries. Fishman et al., supra, at 1067-69. Commissioner Roberts also notes that “[w]hile both federal and state environmental laws have permeated the consciousness of many businesses, particular industries, such as the pharmaceutical, petroleum, chemical, waste management, and heavy manufacturing segments, among others, must be particularly sensitive to disclosure and accounting issues....” Roberts, supra note 2, at 2. The increased attention necessary for securities regulatory issues is but a reflection of the extent to which these industries contribute to overall environmental pollution problems.

12. *Id.* at 2-3 (citations omitted).
The essential message of these developments is clear: Environmental liability has become more definite, more substantial, and more than likely subject to enforcement. Therefore, while one frequently encounters significant criticisms of the present system among both proponents and opponents of environmental protection, the cumulative effect of current trends in environmental regulation is also clear: They have injected substantial and complex new elements into the calculus of organizational decisionmaking by those subject to such regulation.

Against this background—indeed, because of it—the duty to disclose environmental liabilities and other obligations under the securities laws has become, to a degree, a functional extension of the environmental regulatory system. Similarly, that duty has also become an integral part of the complex decisionmaking process of modern publicly held businesses.

B. SEC Disclosure of Environmental Liabilities

Within the past twenty years, the United States Securities and Exchange Commission has become both more particular and more insistent about the need for disclosure of environmental liabilities and obligations by companies

13. Id. at 2-10.
14. See Barnaby J. Feder, New Battles Over Disclosure, N.Y. TIMES, June 24, 1990, at C10 (discussing problems and challenges facing industry in face of increased environmental compliance duties and concurrently increased focus on securities law disclosure on environmental liabilities and obligations).
15. For a rather nonpartisan description of the failings of the present environmental law regime, see Introduction, in SUSTAINABLE ENVIRONMENTAL LAW, supra note 5, at VII:
   Despite ever-growing public and private expenditures to implement environmental law, surprisingly few actual improvements occur. Often, spending large sums of money has only kept problems from worsening. Meanwhile, the gap between environmental quality and the objectives of environmental law widens. Congress responds to environmental problems by adding more administrative law fixes, creating an acropolis of administrative structures. Still, the administrative capacity to resolve environmental problems diminishes. Eventually administrative institutions become overwhelmed by the piecemeal approach.
16. Accordingly, the debate continues regarding whether this more difficult calculus (no small part of which includes economic considerations) is a justifiable price for securing improvements in environmental compliance and environmental quality.
17. See Mary B. Sammons, Firms Pushed to Reveal Compliance Costs; Agencies and New Laws Force Public Disclosure, CRain's Chi. Bus., Nov. 9, 1992, at T3:
   The financial costs of environmental compliance have long been treated as a company secret.
   But recent legislation, coupled with a government crackdown on companies slow to comply with existing disclosure laws, is making more of that information public, forcing executives to pay closer attention to its effects on a company's bottom line.
regulated under the federal securities laws. The nexus between the securities law disclosure concept and environmental regulatory requirements and trends has been described by SEC Commissioner Richard Y. Roberts:

As society strives to maintain and to improve our environment, costs are imposed that may need to be disclosed to investors under our federal securities laws. Compliance costs associated with regulations restricting development and limiting harmful emissions can have a material effect on the operating expenses of a company. Moreover, environmental laws can impose large liabilities, particularly with respect to past generators of waste materials.

... The potential for large losses attributable to environmental problems is an important concern that many investors will factor into their investment decision ... Indeed, vigorous enforcement of environmental laws likely to occur in the decade to come have made environmental liability a matter of growing prominence for lenders, rating agencies, and acquisition-minded companies, among others.

Commissioner Roberts' remarks regarding securities law disclosure of environmental liabilities aptly state the rationale for the SEC's increased regulatory emphasis on this area. So substantial has been this interest by the SEC that it has begun cooperative discussions and activities with the United States Environmental Protection Agency (EPA), the major—although not the exclusive—federal environmental regulatory agency. On an informal basis, for example, SEC staffmembers receive from the EPA lists of all companies that

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"The federal securities laws consist of six separate statutes, enacted between 1933 and 1940, and the corresponding implementing regulations. Congress designed the Securities Act of 1933 . . . and the Securities Exchange Act of 1934 . . . "to protect investors against fraud and manipulation of stock prices.""

The federal securities laws generally substitute "a philosophy of full disclosure for the philosophy of caveat emptor." The Securities Exchange Commission adopted this spirit in Rule 10b-5, which makes it unlawful for any person, directly or indirectly, to use interstate commerce to defraud another person in connection with the purchase or sale of a security. . . . In addition, Regulation S-K expressly requires all publicly held companies to make certain disclosures concerning, inter alia, contingent environmental liabilities arising under federal, state, or local laws. These disclosures must be included in the appropriate public documents filed by public companies with the SEC.

19 Id. at 129-30 (footnotes omitted).


have been named Potentially Responsible Parties (PRPs) under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).\textsuperscript{22} Also, the EPA provides the SEC with information concerning companies subject to the cleanup requirements of the Resource Conservation and Recovery Act.\textsuperscript{23}

Other types of information provided to the SEC staff include information about criminal cases under federal environmental laws, civil proceedings under environmental laws, and companies barred from government contracts under the Clean Air Act\textsuperscript{24} and the Clean Water Act.\textsuperscript{25} The staff currently utilizes this information in its disclosure review processes. Finally, the SEC is considering whether it will formalize this dialogue through the execution of a memorandum of understanding with the EPA.\textsuperscript{26}

The confluence of enhanced environmental enforcement and increased SEC emphasis on environmental disclosure makes available immense amounts of information and data to those for whom the quality of companies' environmental compliance records and policies is crucial.\textsuperscript{27} And, as one court has noted, the numbers of such investors are substantial:

The importance of Plaintiffs' claims [that the SEC should promulgate rules requiring extensive disclosure of environmental law-related matters by regulated companies] is underscored by a large number of "ethical investors" in this country—individuals and institutions such as our great universities and foundations which have large funds to invest and need the information that Plaintiffs seek in order to make investment and voting decisions in accordance with their high principles and societal interests.\textsuperscript{28}

\textsuperscript{22} 42 U.S.C. §§ 9601-9675 (1988). The Comprehensive Environmental Response, Compensation, and Liability Act is a stringent law affecting environmental pollution by persons generating, transporting, owning, or operating a site containing certain hazardous materials.


\textsuperscript{26} See Roberts, supra note 20, at 16.

\textsuperscript{27} See John Holusha, Environmentalists Assess Corporate Pollution Records, N.Y. TIMES, Dec. 9, 1991, at D1. Commenting on the vast amount of critical information publicly available as a result of regulatory disclosure requirements, the article refers to a current project of the Council on Economic Priorities:

The council's reports are part of a growing effort by public interest and environmental groups to examine and publish analyses of the vast amounts of environmental data that the Government has required companies to file in recent years. Early next year, the Investor Responsibility Research Center, a Washington-based organization that conducts investment research for university endowments and pension funds, will publish statistical summaries of the environmental performance of all 500 companies in the Standard & Poor's index.

\textit{Id.}

Further, "ethical" investors are not the only investors interested in the scope and nature of SEC environmental disclosure rules. To the extent that environmental liabilities and obligations will have a material impact on a company's financial condition and prospects—and may thereby affect the value of that company's securities—traditional or "economic" investors will insist upon full and fair disclosure of such liabilities and obligations.29

The emergence of securityholder interest in environmental disclosure has created a lever of sorts—a potent one, replete with opportunities to promote environmental protection of a type usually discussed under the rubric of "economic" or "market-based" incentives.30 That is, the existence of stringent securities law duties to disclose aggressively-applied environmental liabilities and obligations provides a predicate for investor strategies to create market incentives favoring environmental compliance by companies whose securities are publicly traded.31

This article will outline several important areas of SEC environmental disclosure, commenting on the particularly difficult compliance challenges facing public companies and also identifying areas that have shown potential

29. See B. Feder, New Battles Over Disclosure, N.Y. TIMES, June 24, 1990, at 10: William Steiner of Great Neck, L.I., and Morton Levine of Brooklyn get angry when a company withholds information they believe they have a right to know. What sets them apart is that they may be at the vanguard of a new class of courtroom confrontation: shareholders claiming to have been financially damaged by corporations that have failed to disclose environmental problems.

Mr. Steiner claims that by not disclosing [that a building Western Capital sold had contained asbestos, a fact that later gave rise to a $9.125 million court judgment against the company], Western Capital managed to look profitable enough to issue new stock and debentures in 1985 and inflated its stock price, which has fallen to $4.75 from a peak $21.50 in 1986. Id. (emphasis added); see also Levine v. NL Indus., 926 F.2d 199 (2d Cir. 1991) (involving litigation for environmental disclosure by shareholder against public company).

30. See Part II of this Article, which defines and discusses market-based and other economic incentive systems that promote environmental protection.

31. See Holusha, supra note 27, at 1 (commenting on purpose of reports, based on SEC required and other required public information on corporate environmental obligations, published by Council on Economic Priorities and other public interest organizations). The article goes on to state, "The reports are intended to appeal to socially conscious investors and to encourage companies to minimize pollution." Id.; see also Your Money: New Trend Rising in Socially Responsible Investments (CNN television broadcast, Feb. 6, 1993):

HIGHLIGHT: Socially-responsible funds have become the new trend in investing, which means no tobacco, alcohol, defense and weapons contractors, gambling or known polluters . . .

STUART VARNEY, Anchor: For investors trying to bolster their earnings without compromising their politics, shall we say, socially responsible investing may be the path to many happy returns. A whole host of mutual funds aimed to make money with principal portfolios. Here is Lipper Analytical's list of the best performers of the past 12 months. Leading the pack of socially responsible funds is the Parnassus Fund, up 29%; Pioneer III has a 12-month gain of 18.6%; MAS, the pooled select-value fund, up 18%; Right Times Social Awareness Fund returning 16%; and the Domini Social Index Fund shows a 14% gain.

Id. (emphasis added).
for enhanced enforcement opportunities by the SEC and by securityholders and others. Not the least of the categories of securityholders and others that will be considered in this article are: (1) environmental and other public-interest organizations; and (2) investment funds seeking to purchase the securities of issuers having impressive—or, depending on the strategy involved, dismal—environmental compliance records. In addition, this article explores the prospects of market-oriented approaches for promoting environmental law compliance.

II. SECURITIES LAW PROVISIONS REQUIRING DISCLOSURE OF ENVIRONMENTAL LIABILITIES AND OBLIGATIONS

A. Background

SEC interest in securities law disclosure of environmental liabilities and obligations began during the 1970s, when Congress and environmental regulators started responding to public concern about environmental problems. The SEC’s early rules emphasized disclosure of economic impacts of permit process requirements and other environmental damage prevention, reduction and mitigation concepts. The capital and operating costs of environmental compliance technology, as well as the facts regarding potential and actual


The first and simplest method of SRI is portfolio screening. The investor who practices portfolio screening refuses to invest in an enterprise that engages in activities that are antithetical to his or her moral beliefs... Portfolio screening, also referred to as investor boycott, requires that the would-be investor identify those social, ethical, or political issues that concern him or her and then research the activities of potential investments to determine which investments are incompatible with his or her views.

The second form of SRI is the activist shareholder approach, made famous by Ralph Nader in his campaigns to improve General Motors’ safety record. This technique is distinguished by the investor’s desire to change company behavior by exercising rights that flow from ownership of the enterprise. The activist shareholder invests in a particular firm because the firm engages in objectionable behavior, and the shareholder hopes to change that behavior by convincing the firm that it has ethical obligations to the wider community in which it operates.

Id. (emphasis added) (footnotes omitted).

33. See SCHMIDHEINZ, supra note 3, at 54, 68:
Capital markets will play an important role in the search for sustainable development, but little is known about the constraints, the possibilities, and the interrelationships between capital markets, the environment, and the needs of future generations. Virtually no research has been done on this subject. It is essentially new territory... Despite the need for a great deal more research, there are many signs that capital markets are beginning to play a much more positive role in altering the direction of investments and of resources toward sustainable development.

34. Geltman, supra note 19, at 144.
proceedings that could result in monetary fines based on violations of environmental laws, were to be disclosed in an SEC-regulated company's disclosure filings.

The first SEC release on the topic was a 1971 interpretive release entitled Disclosures Pertaining to Matters Involving the Environment and Civil Rights. This release called for disclosure:

If material, when compliance with statutory requirements with respect to environmental quality e.g., various air, water and other anti-pollution laws, may necessitate significant capital outlays, may materially affect the earning power of the business, or cause material changes in registrant's business done or intended to be done.

Additionally, the release stated that disclosure was required, "where material, of proceedings arising, for example, under the Rivers and Harbors Act of 1899 . . . , the Federal Water Pollution Control Act . . . and the Clear [sic] Air Act . . . as well as under other statutes, federal, state or local, regulating the discharge of materials into the environment, or otherwise specifically relating to the protection of the environment." More specifically, the release provided that:

If such litigation is pending or known to be contemplated but disclosure is omitted on the ground that it is not material, it will be the practice of the Division of Corporation Finance to request registrants to furnish as supplemental information and not as part of the filing, (1) a description of the omitted information and (2) a statement of the reasons for its omission.

While the 1971 release represented an important beginning in the progressive development of SEC environmental disclosure policies, the release soon proved inadequate in the face of growing public sentiment about the importance of environmental protection. Therefore, the SEC promulgated enhanced disclosure requirements in 1973.


Material effects that compliance with Federal, State and local provisions regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment,

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36. Id. (footnote omitted).
37. Id. (citations omitted).
38. Id.
may have upon the capital expenditures, earnings and competitive
position of the registrant and its subsidiaries.\textsuperscript{40}

The 1973 release also required disclosure, \textit{inter alia}, of all environmental
proceedings pending or contemplated wherein a government entity was
involved.\textsuperscript{41} Forcing disclosure of all proceedings, regardless of their economic
significance or materiality, was a controversial new expansion of environ-
mental disclosure requirements. Extending the scope of disclosure far beyond
the bounds of nonenvironmental disclosure matters posed additional burdens
and risks for registrant companies.\textsuperscript{42}

Notwithstanding the SEC's advances in this area, environmental pro-
tectionists were not satisfied. Environmentalism was gaining momentum in
the United States and the voices crying out for more extensive action to
reduce pollution and preserve the environment became louder and louder.
Therefore, in 1973, the Natural Resources Defense Council, Inc. (NRDC)
commenced a suit against the SEC in the Federal District Court for the
District of Columbia, claiming that the SEC had violated the National
Environmental Policy Act by failing to promulgate comprehensive environ-
mental disclosure rules.\textsuperscript{43}

Despite the fact that the SEC prevailed in the NRDC litigation,\textsuperscript{44} the
SEC continued to expand the disclosure requirements pertaining to environ-
mental matters. In 1979, for example, Securities Act Release No. 6130 and
Securities Exchange Act Release No. 16,224 were promulgated, addressing—
and basically interpreting "existing requirements" in an expansive way—
three issues:

(1) When must a corporation disclose, in addition to its planned
environmental expenditures for the next two fiscal years, the total
costs of compliance with environmental statutes?
(2) What disclosures must be made concerning administrative pro-
ceedings involving environmental matters which are contemplated

\textsuperscript{40} \textit{Id.}
\textsuperscript{41} Geltman, \textit{supra} note 19, at 145.
\textsuperscript{42} \textit{See id.} at 145-46 (citing Stephen W. Hamilton, \textit{Environmental Disclosure Require-
ments of the Securities Exchange Commission, in The McGraw-Hill Environmental Audit-
ing Handbook} 2-110 (L. Lee Harrison ed., 1984)). Mr. Hamilton states, "As a result,
multibillion dollar companies which were not required to disclose nonenvironmental litigation
involving hundreds of thousands of dollars were nevertheless required to disclose governmental
[environmental] proceedings involving only hundreds of dollars." Stephen W. Hamilton,
(confirmation added).
\textsuperscript{43} Natural Resources Defense Council, Inc. v. SEC, 389 F. Supp. 689, 692 (D.D.C.
1974).
\textsuperscript{44} Natural Resources Defense Council, Inc. v. SEC, 606 F.2d 1031, 1062 (D.C. Cir.
1979) (reversing district court decision and holding that SEC did not act arbitrarily and
capriciously in denying NRDC petition for promulgation of comprehensive rules requiring
securities law disclosure of environmental impacts of each registrant's business operations).
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by government authorities and what is an administrative proceeding that must be disclosed?

(3) When is a corporation required to disclose its policies concerning, or approach toward, compliance with environmental laws?45

The 1979 release was superseded in 1982 by certain provisions of Regulation S-K of the SEC's Integrated Disclosure System. Again, the growing momentum of the environmental movement was probably a major impetus for the continued evaluation and amendment of SEC policy on disclosure of environmental issues.

B. Current Regulatory Scheme Governing Securities Law Disclosure of Environmental Liabilities and Obligations

The SEC's current disclosure requirements regarding actual or potential environmental liabilities and obligations are contained in Regulation S-K, Item 101 (Description of Business), Item 103 (Legal Proceedings), and Item 303 (Management's Discussion and Analysis of Finances and Results of Operations). The Financial Accounting Standards Board (FASB) has also promulgated standards for disclosing "loss contingencies" as possible environmental liabilities; such standards are incorporated into the securities laws. In addition, section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5,46 promulgated thereunder, prohibit the making of fraudulent misstatements or omissions in connection with the purchase or sale of a security. Failure to make the necessary disclosures under Regulation S-K, relevant accounting standards, or Rule 10b-5, or the failure to adopt amendments that make prior disclosures not misleading, could result in governmental prosecutions seeking to impose civil or even criminal liability. Finally, shareholders and investors may sue privately for damages alleging that they have incurred losses because a registrant has made misleading statements or omissions regarding material information. The following discussion examines in depth these pertinent areas of law requiring disclosure of environmental liabilities and obligations.

1. Regulation S-K
   a. The Integrated Disclosure System

For nearly a half century, the SEC's view that the Securities Act of 1933 and the Securities Exchange Act of 1934 promoted different objectives served as an impediment to the implementation of common disclosure requirements.

Because the [Securities Act of 1933] is oriented toward protecting offerees in public distributions of securities whereas the [Securities Exchange Act of 1934] is directed toward protecting secondary market trading, it is not surprising that during the first four decades of its existence the SEC administered the disclosure requirements of the two acts with strict obeisance to the view that their dissimilar objectives precluded any common disclosure requirements.48

However, the SEC's Integrated Disclosure System reflects a rejection of that old view and an acceptance of a view that securities regulation is grounded in the Efficient Capital Markets Hypothesis.49 "The overall objective of the SEC's integrated disclosure program is to eliminate overlapping and unnecessary disclosure and dissemination requirements without compromising the information needs of investors so that the regulatory burdens on issuers are reduced."50

Regulation S-K was promulgated as part of the integrated disclosure system in 1982.51 Regulation S-K, along with the Rules and Regulations of the Securities Act and the Securities Exchange Act, the Interpretative Releases under those Acts, and the forms under those Acts, "state[ ] the requirements applicable to the content of the non-financial statement portions of"52 the disclosure documents that public companies must file with the SEC. The three provisions of Regulation S-K that are pertinent to environmental disclosure are discussed below.

b. Item 101: Description of Registrant’s Business

Item 101 of Regulation S-K generally requires registrants to provide a description of their business. In regard to environmental matters, registrants

   An efficient market is one in which the interaction of a large number of buyers and sellers results in prices that fully reflect publicly available information about the goods traded and that react virtually instantaneously to reflect new information as it becomes available.

   Of all recent developments in financial economics, the efficient capital market hypothesis ("ECMH") has achieved the widest acceptance by the legal culture. It ... structures debate over the future of securities regulation both within and without the Securities and Exchange Commission; it has served as the intellectual premise for a major revision of the disclosure system administered by the Commission; and it has even begun to influence judicial decisions and the actual practice of law. In short, the ECMH is now the context in which serious discussion of the regulation of financial markets takes place.

Id. (footnotes omitted) (emphasis added).
50. Cox et al., supra note 48, at 48.
52. Id. § 229.10(a) (application of Regulation S-K).
must disclose whether environmental compliance may have any "material effect" on the "capital expenditures, earnings and competitive position of the registrant and its subsidiaries."\(^5\)

Commentators have observed that Item 101 can present considerable difficulties for registrants in an era of continual expansions of obligations through changes in applicable environmental laws. Especially troublesome is the requirement that the "registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material."\(^5\)\(^4\) Additionally, because this requirement essentially incorporates the 1979 release,\(^5\) it also necessitates the disclosure of any information needed to make the primary disclosures not misleading. And, as to the disclosure of future estimated expenditures, the basis of those estimates may need to be disclosed, to the extent such disclosure would prevent the estimates from being misleading.\(^5\)\(^6\)

One example of the difficulty of compliance with Item 101 in the modern age of environmentalism arises from a basic characteristic of modern statutes like the Clean Air Act Amendments of 1990 (Clean Air Amendments). The Clean Air Act Amendments enhanced certain already stringent, "technology-forcing" features of the Clean Air Act directed at air pollution emissions control.\(^5\)\(^7\) The problem for registrants is that "[t]hey know that there likely will be material effects of compliance with the new law, but,

\(^{53}\) Id. § 229.101(c)(1)(xii).

\(^{54}\) Id.

\(^{55}\) Geltman, supra note 19, at 151.

\(^{56}\) See Fishman et al., supra note 10, at 1065 n.13.


The 1990 Amendments require "the maximum degree of reduction in emissions of the hazardous air pollutants subject to this section (including a prohibition of such emissions, where achievable) that the administrator" determines is achievable "taking into consideration the cost of achieving such emissions reduction, and any non-air quality health and environmental impacts and energy requirements . . . ." This standard is commonly referred to as "maximum achievable control technology" or "MACT."

... The 1990 Amendments require that "[n]o emission standard or other requirement promulgated under this section shall be interpreted, construed or applied to diminish or replace the requirements of a more stringent emission limitation or other applicable requirement . . . of this Act or a standard issued under a state authority." See Clean Air Act § 112(d)(2), (d)(7), 42 U.S.C. § 7412(d)(2), (d)(7) (Supp. 1993). The impact of the 1990 amendments, therefore, is to require at least the stringency of prior law, but in many instances to institute an even higher standard of air pollution control. See also Percival et al., supra note 1, at 838-44 ("[W]hen Congress considered the 1990 Clean Air Act Amendments, mobile source controls were a subject of great controversy . . . Congress ultimately chose to expand the scope of mobile source controls [beyond the previous tailpipe-oriented approach] through an even broader effort at technology forcing. The 1990 Amendments seek to force development not only of better tailpipe controls but also of cleaner fuels and cleaner engines . . . .").
because no implementing regulations have been promulgated, the registrants
are unable to predict either the cost of compliance or the effect compliance
is likely to have on capital expenditures, earnings, and competitive posi-
tion."

\[8\]

c. Item 103: Disclosure of Proceedings

Item 103 of Regulation S-K concerns disclosure of legal proceedings. It
reads as follows:

Describe briefly any material pending legal proceedings, other than
ordinary routine litigation incidental to the business, to which the
registrant or any of its subsidiaries is a party or of which any of
their property is the subject.

\[\ldots\]

Include similar information as to any such proceedings known
to be contemplated by governmental authorities.\[59\]

Instruction 5 of Item 103 clarifies that an environmental proceeding
shall not be deemed ‘ordinary routine litigation incidental to the business’
and must be disclosed if:

A) [It] is material to the business or financial condition of the
registrant;
B) [It] involves primarily a claim for damages, or involves potential
monetary sanctions \ldots and the amount involved \ldots exceeds
10 percent of the current assets of the registrant and its sub-
sidiaries on a consolidated basis; or
C) [The government] is a party to such proceeding and [the]
proceeding involves potential monetary sanctions [amounting
to \$100,000 or more], unless the registrant reasonably believes
that the proceeding will result in no monetary sanction or the
sanctions \[will be\] less than \$100,000.\[60\]

When disclosing, the registrant must include all important information about
the proceeding. Further, the SEC construes the term “proceeding” in Item
103 broadly. This means, for example, that businesses must disclose admin-
istrative orders issued by a government agency regardless of whether they
are the result of a formal proceeding. Similarly, Notices of Violation (NOVs)
issued by the EPA must be disclosed, although some courts have hesitated
to mandate disclosure because such notices may lead to settlement. Finally,
and notably, Item 103 reflects a retreat from the prior requirement of
disclosure of all proceedings, regardless of their economic materiality or
significance.

\[58\] Geltman, supra note 19, at 151.
\[60\] Id. § 229.103(5).
At one point businesses were anxious to determine whether designation as a PRP under the CERCLA requires a registrant to make disclosure of such designation under Item 103. The concern was understandable because CERCLA is an aggressive federal statute reflecting Congress's intent to require that the parties responsible for contaminating abandoned land sites or allowing them to remain contaminated clean up such sites. The statute has been interpreted expansively and harshly: CERCLA imposes strict liability, often jointly and severally, upon four broad categories of persons. Liability is retroactive, and the available defenses are limited and rather narrow. However, the SEC answered the question in the negative, in Securities Act Release No. 6835, stating that "[d]esignation as a PRP does not in and of itself trigger disclosure under item 103 . . . [or Instruction 5] because PRP status alone does not provide knowledge that a governmental agency is contemplating a proceeding." But in an important caveat, the SEC cautioned that "a registrant's particular circumstances, when coupled with PRP status, may provide that knowledge." Addressing another pressing CERCLA-related issue under Item 103, Securities Act Release No. 6835 defines costs incurred in remedial agreements under Superfund as "charges to income" or "capital expenditures," instead of "monetary sanctions" under Instructions 5(B) or 5(C) to Item 103. Thus, businesses do not have to disclose these costs. Additionally, as a related matter, registrants may consider, when relevant, contribution, insurance, and indemnification when determining whether they have satisfied the criteria for disclosure under Instructions 5(A) and 5(B). This type of interpretation could reduce any disclosure requirement under Item 103, or obviate the requirement entirely. Further, it reflects the general interpretive approach to Item 103 requiring substantial, but not unreasonable or draconian, disclosure.

d. Item 303—Management’s Discussion and Analysis of Financial Condition and Results of Operations: The MD&A Disclosure Requirement

While Item 303 of Regulation S-K does not explicitly address environmental liabilities and obligations, its provisions have been interpreted to

65. Monsanto, 858 F.2d at 173.
66. See CERCLA §§ 107(b), 42 U.S.C. § 9607(b).
68. Id.
69. See CERCLA § 122, 42 U.S.C. § 9622 (1988), authorizing the government to enter into settlement agreements obligating "potentially responsible person[s]" to perform cleanup activities at hazardous waste sites.
require disclosure of environmental matters under relevant circumstances. Therefore, in accordance with the general scheme of Item 303, management must disclose, *inter alia*, environmental liabilities and obligations that they could foresee in the future, and in doing so, disclose estimates of relevant dollar amounts.

The SEC has described the purpose of Item 303 Management's Discussion and Analysis (MD&A) disclosure requirements as follows:

'[T]o give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's financial condition and results of operations, with particular emphasis on the registrant's prospects for the future.'

Under Item 303, management is required to prepare a narrative report disclosing the registrant's financial condition and results of operations. This requirement differs from the Item 101, Description-of-Business requirement in several ways, but the most significant difference is that disclosure must include a discussion of "currently known trends, events, and uncertainties that are reasonably expected to have material effects," as opposed to simply those that have such effects only on a current basis. These potential future effects could include environmental liabilities and obligations.

Additionally, disclosure must include "material events and uncertainties known to management that would cause" the information reported not to reflect actual future results of operations, or financial conditions. This requirement covers events and uncertainties that were important only in the past, as well as those that will be important in the future. Item 303 also makes reference to the safe harbor rule for "forward-looking" information, encouraging management to voluntarily disclose information for which disclosure is not required, but that may affect future operations.

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71. *Id.* at 22,429.


73. *Id.* § 229.303(b)(2); *see also* Management's Discussion and Analysis, *supra* note 70, at 22,429 (distinguishing between the "prospective" information required to be discussed in Item 303 and "forward-looking" information—both of which are protected by the safe harbor of Securities Act Rule 175(c)).

Both required disclosure regarding the future impact of presently known trends, events or uncertainties and optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required. Required disclosure is based on *currently known trends, events, and uncertainties that are reasonably expected to have material effects*, such as: A reduction in the registrant's product prices; erosion in the registrant's market share; changes in insurance coverage; or the likely non-renewal of a material contract. In contrast, optional forward-looking disclosure involves *anticipating a future trend*. 
A key question in the analysis of disclosure obligations under Item 303 is: What constitutes a contingent event that requires disclosure of an environmental uncertainty? Securities Act Release No. 6835 provides a two-part test:

Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

(1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.

This evaluation must be objectively reasonable at the time made. Significantly, however, the MD&A test of Item 303 does not contemplate the typical "materiality" analysis of Rule 10b-5 of the Securities Exchange Act of 1934 and several other disclosure provisions of the securities laws. Indeed, Securities Act Release No. 6835 expressly precludes application of the Rule 10b-5, probability/magnitude materiality test of Basic, Inc. v. Levinson, calling it "inapposite" to the materiality analysis of Item 303. Instead, the standard requires management to assume the existence of a circumstance, for disclosure purposes, even though management is not even able to determine whether that circumstance is likely to occur. Then management must proceed to disclose, and somehow "evaluate objectively the consequences" of the matter, unless that undeterminable—and necessarily rather abstract—occurrence is "not reasonably likely to have a material effect."

To be helpful, Securities Act Release No. 6835 sets forth a CERCLA-PRP hypothetical and analyzes it from the standpoint of Item 303 materiality or event or anticipating a less predictable impact of a known event, trend or uncertainty.

The rules establishing a safe harbor for disclosure of "forward-looking statements" define such statements to include statements of "future economic performance contained in" MD&A.

Id. (emphasis in original).

75. Id.
77. The release provides:

MD&A mandates disclosure of specified forward-looking information, and specifies its own standard for disclosure—i.e., reasonably likely to have a material effect. This specific standard goes in the circumstances in which Item 303 requires disclosure. The probability/magnitude test for materiality approved by the Supreme Court in Basic, Inc., v. Levinson, 108 S. Ct. 978 (1988), is inapposite to Item 303 disclosure.

78. Id. at 22,430.
and disclosure. In the hypothetical, a registrant has just been "correctly" designated a PRP by the EPA regarding the cleanup of three hazardous substance sites.\(^7\)

Being one of several named PRPs, having no available statutory defenses, and being unsure about the ability to obtain contribution from other PRPs or the extent of insurance coverage, management's position is rather predictable—as well as rather common—at this early stage of investigation of the matter: "Management is unable to determine that a material effect on future financial condition or results of operations is not reasonably likely to occur."\(^8\) Therefore, concludes the SEC, "MD&A disclosure of the effects of the PRP status, quantified to the extent reasonably practicable, would be required."\(^9\) However salutary the intent of the Item 303 materiality formulation and the related environmental cleanup hypothetical, significant criticism of both exists.

The very facts of the hypothetical itself have been said to be problematic. For instance, it is not a foregone conclusion in every instance—particularly in the early investigatory stages—that any registrant has been "correctly" designated a PRP.\(^1\) Indeed, some registrants actually contest the designation in their SEC disclosures.\(^2\)

Yet another criticism of the SEC disclosure requirements has to do with timing problems. Given the hypothetical's setting, "[t]he registrant is in the process of preliminary investigations of the sites to determine the nature of its potential liability and the amount of remedial costs necessary to clean up the sites," there could be no reasonable certainty as to the propriety of the PRP designation and other EPA determinations until reviews existed of both legal and technical environmental aspects of the matter. The potential problem here is that a disclosure filing could well be due before such reviews are completed.\(^3\) One might observe, in this regard, that the probability/magnitude formulation of Basic allows, indeed, requires, an evaluation of the likelihood and significance of the situation prior to disclosure. Thus, it has been expressed that the Item 303 materiality standard could result in premature disclosure, thereby provoking undue response from the public, the SEC and the registrant's auditors.\(^4\)

Other related criticisms of the Item 303 disclosure formulation with respect to environmental issues are that it "underestimates the difficulty of quantifying potential liability without detailed investigation into the avail-

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79. Id.
80. Id. (emphasis added).
81. Id.
82. See Geltman, supra note 19, at 162-64.
83. Id. at 163-64 (discussing 1990 Annual Report on Exchange Act Form 10K of Sunstrand Corporation). In the 1990 Annual Report on Exchange Act Form 10K of the Sunstrand Corporation, Sunstrand discloses that while EPA has designated it a PRP with respect to a certain site, the company disputed the designation. "Based on the currently available information [Sunstrand] believes that there is no connection between its operations and the [identified] site." Id. (explanation added).
84. Id. at 162-63.
85. Id. at 165.
ability of contribution, insurance coverage, and legal defenses such as the innocent purchaser defense [and it] overlooks the potential for misleading disclosure statements in situations where registrants are forced to make disclosures based on uncertainties. 86

The MD&A environmental disclosure requirements of Regulation S-K Item 303 are the most complex of all the pertinent provisions. Correspondingly, they present some of the most difficult compliance challenges. What must now emerge from the SEC and the courts is an effective approach to interpretation and enforcement, not only as to Item 303, but also as to all applicable disclosure provisions.

e. Resolving Disclosure Issues Under Regulation S-K:
The Importance of a Balanced Enforcement Policy

Notwithstanding the criticisms of Regulation S-K, environmentalists, ethical investors, and even economic investors, would support the regulation's environmental disclosure requirements. To these groups, the bare fact of disclosure, accompanied by some discussion and explanation of the matter disclosed—however imperfect, and however unpleasant for management—is useful. In short, and quite frankly, these groups probably would want to know about any reasonably important matters involving environmental issues. And while managers are wise to be concerned about the sometimes precipitous responses of the public, the regulators, and the product and financial markets, managers should not make the facile assumption that the markets and their participants are naive creatures, incapable of processing and analyzing information accurately.

This same point emerged as part of the rationale in Justice Blackmun's opinion in Basic, Inc. v. Levinson. 87 In Basic, the Supreme Court rejected the "agreement-in-principle" definition of materiality in part because "[i]t assumes that investors are nitwits, unable to appreciate—even when told—that mergers [about which the plaintiff had contended preliminary negotiations should have been disclosed] are risky propositions up until the closing." 88 Justice Blackmun observed, in this regard:

We have recognized time and again, a "fundamental purpose" of the various securities acts, "was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."

...  

* * *

The role of the materiality requirement is not to "attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations"... but to filter out essentially useless

86. Id. at 171.
information that a reasonable investor would not consider significant, even as part of a larger "mix" of factors to consider in making his investment decision. 9

Although these views emerged in the context of the Basic probability/magnitude materiality analysis of the disclosure duty—expressly rejected by the SEC in Item 303—the thrust of those views transcends the specific issue in that case. This language in Basic identifies decisionmaking by fully knowledgeable investors as one of the fundamental objectives of the securities regulatory system; it assumes that those investors, and the market, will assess information reasonably and rationally.

Perhaps one question in particular may be both illuminating and helpful in the debate over the quite understandable concerns raised by promanagement interests about Item 303 environmental disclosure: Precisely how will the SEC and the courts react to careful, reasonable, good faith attempts by registrants to comply with Item 303, given the almost demon-like constraints of uncertainty, time, and cost? A reasonable—but disclosure-oriented—interpretation of the duty of registrants under Item 303 would greatly facilitate that provision's effectiveness and fairness to all parties concerned.

2. Rule 10b-5 and the Duty to Disclose Environmental Liabilities and Obligations

Some commentators have called section 10(b) of the Securities Exchange Act of 193491 and Rule 10b-5,92 promulgated under the authority of Section

90. Rule 10b-5 does not begin to exhaust the field of antifraud or other liability provisions of the securities laws; nor does this Article purport to exhaust that field. But, because the rule constitutes the broadest, most frequently asserted antifraud provision in the securities laws (even when other provisions are asserted concurrently), and because the analysis of cases under other provisions includes some of the same elements and dynamics as Rule 10b-5, that rule has been chosen for analysis here.

As to the full range of liabilities, including the antifraud provisions, see generally Cox ET AL., supra note 48.

91. 15 U.S.C. § 78j(b) (1988). Section 10(b) makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

92. 17 C.F.R. § 240.10b-5 (1991). Hereafter, both Section 10(b) and Rule 10b-5 will be referred to collectively as "Rule 10b-5." Rule 10b-5 provides in full as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility
10(b), a "broad, catch-all" antifraud provision. Indeed, the Supreme Court, in a now well-known phrase, has referred to the rule as "a judicial oak which has grown from little more than a legislative acorn." Although no general duty to disclose information exists under the rule, when the requisite elements of a Rule 10b-5 cause of action are pleaded and proved, defendants in these actions may be held liable for material misstatements or omissions made in connection with the purchase or sale of a security. Further, the rule would apply even when none of the initial, periodic, or continuous mandatory disclosure provisions of the 1933 and 1934 Acts that draw upon Regulation S-K apply, so long as the underlying circumstances can be construed to create a duty of disclosure. This additional layer of disclosure, creating a sort of "interstitial" disclosure requirement when considered along with the mandatory disclosure provisions, only adds to the anxieties of managers who are concerned about the effect of environmental disclosures upon the financial image of their companies.

a. The Evolution of the Rule 10b-5 Cause of Action and Prospects for Actions Based on Environmental Matters

A series of Supreme Court and other federal court decisions over the past fifty years have elucidated the basic features of Rule 10b-5, including the basic elements of a Rule 10b-5 cause of action. The following discussion summarizes the more significant holdings and comments on the prospects for Rule 10b-5 actions based on failures to disclose substantial environmental liabilities and observations.

During its early years, the rule enjoyed rapid growth in its use by private litigants. Especially pivotal in this regard were a spate of cases interpreting the rule expansively. Kardon v. National Gypsum Co., holding

of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

96. Mandatory disclosure filing requirements are those expressly required by the securities laws. Included here are those statutes and rules requiring filings for initial distributions of securities, quarterly and annual reports, proxy materials, and the like. See COX ET AL., supra note 48, at 45-49.
97. 73 F. Supp. 798, 802 (E.D. Pa. 1947). It is noteworthy that by the time the retrenchment bound Supreme Court of the mid-1970s had a chance to address the implied private right of Rule 10b-5, it had been an accepted part of the rule's jurisprudence for three
that an implied private right of action existed under Rule 10b-5, is a well-known example. From the mid-1970s forward, however, the Supreme Court handed down a series of opinions having the effect of making Rule 10b-5 narrower in scope and certainly more complicated analytically.

In Blue Chip Stamps v. Manor Drug Stores,\(^9\) for example, the Supreme Court construed the rule's language "in connection with the purchase or sale" of securities to impose a standing requirement: the rule would be available only to plaintiffs who had purchased or sold the securities at issue during the relevant period of the fraud.\(^9\)\(^9\) Ernst & Ernst v. Hochfelder\(^1\) further limited the scope of the rule to those instances in which defendants had acted with "scienter," described by the Supreme Court in that case as "a mental state embracing intent to deceive, manipulate, or defraud."\(^1\)\(^0\)

Caselaw holdings subsequent to Ernst & Ernst lessened its restrictive effect to some extent, including "recklessness" within the definition of scienter.\(^1\)\(^0\) In environmental cases, this development would not be helpful to defendants. Extensive monitoring, reporting, and recordkeeping requirements\(^1\)\(^0\) in many modern environmental statutes give rise to an


\(^{99}\) Also, the facts of Kardon illustrate another feature of Rule 10b-5 that contributed to its expansive applicability: that securities fraud involving private as well as public companies are includable in the scope of the rule. See, e.g., Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947) (describing four person owned corporation whose stock was at issue). This expansive scope (unique among the Exchange Act liability provisions, which otherwise tend to apply only to "registered" Exchange Act securities) derives directly from the language of Section 10(b). That section declares it unlawful:

- To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance . . . .


Finally, from a jurisdictional standpoint, Rule 10b-5 offers numerous advantages: nationwide service of process; liberal venue provisions; generous discovery rules; opportunity to include state law claims under federal pendent jurisdiction concepts; and no bond or security for expenses statutes for derivative suits, as in some state courts. The "interstate commerce" requirement was also quite easy to meet. See ROBERT W. HAMILTON, CORPORATIONS 948-49 (4th ed. 1990).

\(^{98}\) 421 U.S. 723 (1975).
\(^{99}\) Id. at 749-55. One must bear in mind, however, that this limitation does not apply to the SEC.

\(^{100}\) See ENVIRONMENTAL AUDITS, supra note 7, III-10 to III-13:

- [T]he environmental statutes impose [monitoring, reporting and recordkeeping requirements on] regulated entities and there are varying but significant penalties for corporations and individuals for the failure to report, the submission of false information, and/or the destruction of required records. Criminal penalties are imposed for knowing and willful false statements.
abundance of facts to support prosecutorial allegations that environmental violations were intentional, or at least reckless. Thus, liberal interpretations of the term scienter only serve to make the prospects more bleak for defendants in environmental cases.

In *Santa Fe Industries v. Green*, the Court continued the narrowing process, purporting as always to base its conclusion on a strict construction of the statute. The Court held in *Santa Fe* that when a complaint alleges facts or transactions that are “neither deceptive nor manipulative” there can be no cause of action under Rule 10b-5. While this requirement, like the scienter requirement of *Ernst & Ernst*, could pose problems of proof in environmental cases, the same counterveiling reasons why proof of this element is still eminently achievable apply here as in the scienter situation.

Continuing its prior thrust, the Court elaborated further on the place of common-law fraud elements in Rule 10b-5 jurisprudence. Causation and reliance, of course, have been incorporated, although their proof requirements were reconfigured, both to make up for common-law deficiencies and to take into account the special problems of proof presented by the nature of modern securities transactions and markets. Interestingly, the interpretations of causation and reliance (e.g., its acceptance of the “fraud-on-the-market” theory of reliance) constitute virtually the only expansive ones in recent years by the Supreme Court in the Rule 10b-5 area.

Materiality is another common-law fraud element that has been incorporated into Rule 10b-5. Because materiality, in some form or another,

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*Ernst & Ernst* makes clear that in deciding whether a complaint states a cause of action for “fraud” under Rule 10b-5, “we turn first to the language of [section] 10(b), for ‘[t]he starting point in every case involving construction of a statute is the language itself.’"
106. *Id.* at 474.
107. See Geltman, *supra* note 19, at 143 n.97:
Proof of this requirement [“transaction causation,” which, along with “loss causation” constitute the element of causation] may be subsumed under the elements of reliance, materiality, and the purchaser-seller requirement.

With regard to the “new-and-improved” proof requirements for reliance, see O’KELLEY & THOMPSON, *supra* note 93, at 889.

In Basic Inc. v. Levinson [485 U.S. 224 (1988)], a four-justice majority accepted the fraud on the market theory... . . . The theory permits plaintiffs to meet the reliance requirement by reliance on the integrity of the market price rather than directly on the challenged disclosure. Thus investors do not have to show that they read the misleading documents. Even prior to *Basic*, federal courts had interpreted the reliance requirement in a way to assist plaintiffs. In the case of omissions, courts recognized the difficulty of proving reliance on silence and presumed reliance. See Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). Fraud-on-the-market extends a similar presumption to all omissions or affirmative misrepresentations for actively traded stocks.
tends to be central in triggering a duty to disclose in the securities laws, its precise definition is obviously important. So, the Court’s decision in *Basic v. Levinson, Inc.*, resolving a conflict among the circuits, was a much awaited development in Rule 10b-5 law. The Court held that the test of materiality under the rule was the same as the test it had earlier articulated in *TSC Industries v. Northway, Inc.*, 108 in the context of Exchange Act proxy solicitation disclosure:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.109

... there must be 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 made available.110

Because the subject matter of the action in *Basic* concerned the duty to disclose preliminary merger negotiations, the Court elaborated on the *TSC Industries* formulation, discussing the nature of the materiality analysis in the context of “contingent or speculative information or events.” Quoting from the Second Circuit’s opinion in *SEC v. Texas Gulf Sulfur Co.*,111 the Court stated:

[Materiality, in these special circumstances] will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.112

The probability/magnitude test of materiality appears to be particularly applicable to environmental cases, given that environmental liabilities are usually “contingent or speculative in nature”113 and thus invite the kind of analysis contemplated in *Basic, Inc. v. Levinson*.114 Further, in the current climate of high probabilities and substantial magnitudes of environmental liabilities and obligations, positive determinations of materiality are a definite possibility.

Overall, Rule 10b-5 has had an illustrious career, commencing in grand style and later losing some of its expansive scope primarily at the hands of the Supreme Court. Yet, notwithstanding the relatively constrictive rulings as to its scope in recent years, the rule continues to be a powerful tool for

110. Id.
111. 401 F.2d 833 (2d Cir. 1968).
114. Geltman, *supra* note 19, at 139.
both private plaintiffs and the SEC in deterring failures to disclose material misstatements and omissions of fact in connection with the purchase or sale of securities.

b. Some General Observations about Rule 10b-5 and Environmental Disclosure

The basic import of the previous discussion is that if the elements of a Rule 10b-5 cause of action are established, corporations may be liable to securityholders and the SEC when managements cause those companies to make material misstatements or omissions with respect to environmental liabilities and obligations. Further, the practical effect of the rule on managements is to obligate them to make disclosures, in qualifying instances, at times that may be considerably prior to those imposed by mandatory disclosure requirements. Given management angst about the problems of timing, uncertainty and cost discussed above with respect to initial, periodic and continuous mandatory disclosure, one can imagine the potential for mischief the rule poses.

Rule 10b-5 has considerable potential for effective use as a weapon against securities fraud involving inadequate environmental disclosure. Although there is at present a dearth of cases invoking the rule to attack allegedly misleading statements on environmental matters, the highly "material" nature of environmental issues in modern times is likely to be the central, driving force in the high prospects for Rule 10b-5 applicability in environmental matters.


a. Accounting Standards and the Securities Laws

In addition to the array of potential environmental disclosure obligations under Regulation S-K and Rule 10b-5, SEC-regulated companies may also have to reflect environmental liabilities and obligations in the financial statements that they must file along with their SEC disclosure documents.

The obligation of SEC-regulated companies to include financial statements with their filings was usefully described by a federal district court in Arthur Anderson & Co. v. SEC:

115. See Levine v. NL Indus., 717 F. Supp. 252 (S.D.N.Y. 1989), aff'd, 926 F.2d 199 (2d Cir. 1991) (dismissing, on "materiality" grounds, suit by shareholder claiming material misstatements and omissions regarding environmental liabilities in disclosure documents, but not disavowing validity of environmental disclosure actions under Rule 10b-5).

116. One of the few cases in this area—and certainly the best-known one—is Levine v. NL Indus., 717 F. Supp. 252 (S.D.N.Y. 1991), aff'd, 926 F.2d 199 (2d Cir. 1991). There, the district court's dismissal was affirmed at the circuit level. The allegedly omitted material information regarding potential environmental liability was "immaterial" because the federal agency involved had agreed to indemnify the nondisclosing company for any environmental liability. 926 F.2d at 203.

Companies subject to the jurisdiction of the SEC... are required to include financial statements together with [an independent public accounting firm's] audit reports thereon and filings under the various [securities] Acts which are administered and enforced by the SEC. These filings include, but are not limited to registration statements filed pursuant to the Securities Act of 1933 and annual and periodic reports and proxy statements filed pursuant to the Securities Exchange Act of 1934.

In all of these filings, the [company] is required to observe the rules and regulations promulgated by the SEC which govern the form and content of financial statements; in particular, the plaintiff is required to observe the SEC's Regulation SX governing accounting presentations and filings with the SEC."

"Because financial statements are the heart of SEC disclosure, the Commission has been given power to fix accounting principles with respect to all these disclosure documents... [Yet] despite its power to fix accounting principles, the task is far beyond the Commission's means and has been ceded to the accounting profession." For example, in its 1938 Accounting Series Release (ASR) No. 4, entitled Administrative Policy on Financial Statements, the SEC stated:

In cases where financial statements filed with this commission pursuant to its rules and regulations under the Securities Act of 1933 and the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is not substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate... Thus, through the establishment of this negative presumption against accounting practices not generally accepted within the accounting profession and the respected published papers, opinions, and other literature in the area, ASR No. 4 had the effect of promoting adherence to then evolving Generally Accepted Accounting Principles (GAAP). Standing behind the SEC's policy was its "lead pipe" authority to prevent a company from selling securities to the public or to seek—administratively or judicially—other forms of drastic relief.

But, again, the SEC has chosen to act more as an overseer when rulemaking is concerned, reserving its exercise of power mostly for the

121. FIFLIS, supra note 119, at 91-95.
compliance and enforcement spheres. Accordingly, Accounting Series Release No. 150 announced that:

[P]rinciples, standards and practices promulgated by the [Financial Accounting Standards Board, the principal independent accounting standards rulemaking body] will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.122

b. Accounting for Environmental Contingencies

Under certain circumstances, businesses may reasonably expect that they will have certain liabilities or obligations, based on past activities, but not resulting in a claim or assessment until some time in the future. Perhaps, for example, an explosion occurred or some harmful substance escaped into the environment during the production process, resulting in serious injury to company employees and local citizens and causing damage to the property of others. So far, however, no one has filed a claim, but there is, of course, a strong possibility that suits will be filed.

In the aftermath and at the point when management prepares its financial statements for the period inclusive of those events, it is reasonable to think that some amount representing what the company may eventually have to pay, based on harm it clearly caused, should be reflected in the liabilities and (reduced) earnings of that company.123 Such reasoning would be valid even though lawsuits—and judgments—are not yet a reality, but are probable. This is the basic idea behind accounting for loss contingencies.

The FASB Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*,124 addresses "loss contingencies," for which a certain likelihood exists that a "future event or events will confirm the loss or impairment of an asset or the incurrence of a liability."

Paragraph 8 of SFAS No. 5 is the heart of the rule; it sets forth the standard by which a company must judge whether it must *reduce its earnings*, as reflected in its financial statements, based on a contingency:


123. A major objective of accrual accounting, which is the type of accounting represented by GAAP, is the proper "matching" of revenues and expenses that by some reasonable standard should be reported in the same period. The "Periodic Report Convention" is to accrual accounting, and gives rise to the need for accrual and deferral procedures in accounting. See generally Fifus, supra note 119, at 69.

Accounting for contingencies is a logical extension of this basic philosophy, applied to past events involving a company that create losses by some other person, or create rights in them, but which have not yet been reduced to a legal right to collect by some other person.

124. ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Fin. Accounting Standards Bd. 1975) [hereinafter SFAS No. 5].

125. Id. ¶ 3.
An estimated loss from a loss contingency . . . shall be accrued by a charge to income if both of the following conditions are met:

(a) Information available prior to issuance of the financial statements indicates that it is probable\textsuperscript{126} that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

(b) The amount of loss can be reasonably estimated.\textsuperscript{127}

As SFAS No. 5, paragraph 8 indicates, both of its conditions must be met before a charge to earnings is required. But even when "one or both of the conditions . . . are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency [in the notes to the financial statements] shall be made when there is at least a reasonable possibility that a loss or an additional loss may have incurred."\textsuperscript{128} Further, FASB Interpretation No. 14 requires accrual of the most likely estimate of the loss.\textsuperscript{129}

One can easily envision the applicability of SFAS No.5 to environmental matters. Such an assumption is only further strengthened by the examples of loss contingencies provided in paragraph 4 of the rule. They include "[p]ending or threatened litigation" and "actual or possible claims and assessments."\textsuperscript{130} Indeed, these categories, along with obligations to make capital and operating expenditures, constitute the main sources of the economic burden of environmental regulation.

The difficulty of arriving at environmental cleanup estimates is not a problem under the rule. To be sure, it is true that "[e]stimates can vary dramatically due to the myriad of contaminants and their effect on the environment, the many alternative cleanup technologies, and the problem that neither the Superfund law nor the . . . EPA clearly defines what constitutes an acceptable cleanup."\textsuperscript{131} But the rule addresses this scenario by requiring "textual," or written, disclosure, at a minimum, and probably also the actual accrual of a minimum cost figure in the financial state-

\textsuperscript{126} "Probable" is the highest level of likelihood of occurrence under SFAS No. 5. When a future event that "will confirm the loss or impairment of an asset or the incurrence of a liability," is likely to occur, it is "probably" under the rule. Id. ¶ 3(a).

"Remote" means the chance of the future event or events occurring is slight," id. ¶ 3(c), while "reasonably possible" lies between "probable" and "remote." Id. ¶ 3(b).

\textsuperscript{127} Id. ¶ 8 (emphasis added).

\textsuperscript{128} Id. ¶ 10 (emphasis added). "The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." Id.

\textsuperscript{129} Karen M. Doren, Hazardous Waste Treatment Costs Emerge as a Significant Accounting Issue, INSIGHTS, Apr. 1990, at 35.

\textsuperscript{130} SFAS No. 5, supra note 124, ¶ 4(e), (f).

\textsuperscript{131} Doren, supra note 129, at 35. Additionally, further investigation may give rise to changes in estimates, and the existence of several designated PRPs can truly complicate the estimation process. Id.
ments. In fact, an SEC staffmember has expressed this same view.

Another difficult area under SFAS No. 5 concerns a registrant’s accrual or disclosure obligations in instances of litigation, claims and assessments. Paragraph 33 of the rules provides that:

[The] following factors ... must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

(a) The period in which the underlying cause ... of action ... of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

(b) The degree of probability of an unfavorable outcome.

(c) The ability to make a reasonable estimate of the amount of loss.

This complex area of disclosure not only presents difficulties for management, but also creates legal and ethical dilemmas for the company's legal counsel and auditor. Nevertheless, the SEC appears to be more than willing, in these days of emphasis on environmental disclosure, to put the company to the test of providing the greatest amount of information reasonably possible.

As in the previously discussed areas, the definite and substantial nature of environmental liabilities and obligations, considered along with the fundamental emphasis on disclosure under GAAP, makes the prospects for applicability of SFAS No. 5 in this area considerable.

132. Id. at 35.

133. Theresa Iannaconi, Current Accounting Issues and Related Developments Affecting the Division of Corporation Finance, Course Materials, The Role of the Lawyer in Advising on SEC Accounting Requirements 17 (May 20, 1992) (unpublished course material; transcript on file with the Washington and Lee Law Review) ("If management is able to determine that the amount of the liability is likely to fall within a range and no amount within the range can be determined to be the better estimate, the registrant should record the minimum amount of the range pursuant to [FASB Interpretation No. 14]"). Generally, Ms. Iannaconi observes:

The [SEC] staff believes that it is the responsibility of management to accumulate on a timely basis sufficient relevant and reliable information to make a reasonable estimate of its probable liability.

... .

The measurement of a liability for environmental cleanup should be based on currently enacted laws and regulations on existing technology. A registrant should consider all available evidence including the registrant's prior experience in cleaning up contaminated sites, other companies' experience, and data released by EPA.

Id. See also SEC Staff Accounting Bull. No. 92, 58 Fed. Reg. 32,843 (1993).

134. SFAS No. 5, supra note 124, ¶ 33.

135. See First, supra note 119, at 349-58 (describing this complicated dynamic, which can pit management, legal counsel and auditor against one another).

C. Final Observations Pertaining to SEC Environmental Disclosure Requirements

Without question, rigorous environmental regulation and rigorous securities disclosure regulation have created an atmosphere in which failures of compliance, or even lax compliance, can be perilous, and even terminal, for businesses. Against this backdrop, and specifically considering the economic and financial dynamics created by this regulatory setting, the next topic for consideration is the new prospects for market-oriented environmental compliance incentives directed towards public companies.

III. Disclosure, Securities Markets, and the Prospects of Economic Incentives to Promote Environmental Protection

A. The Emergence of Economic Incentives in Environmental Regulation

Recently, "economic incentive approaches for enhancing environmental quality have moved to center stage in Washington [D.C.]." \(^1\) \(^1\) \cite{137} Echoing this observation is a 1991 public policy study promoted by U.S. Senators Timothy Wirth and John Heinz, which states that: "Over the past two years, we have witnessed dramatic changes in the political landscape of environmental policy. Legislators, bureaucrats, environmentalists, business persons, and citizens of all kinds have come to recognize that market-based instruments belong in our portfolio of environmental and natural resource policies." \(^1\) \cite{138}

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137. Hahn & Stavins, supra note 3, at 20 (clarification added); see PERCIVAL ET AL., supra note 1, at 824:

The Bush Administration has actively sought opportunities for incorporating market-based policies into the Air Act, a bipartisan group chaired by Senator Wirth and the late Senator Heinz endorsed this strategy, as did the Environmental Defense Fund. While Congress previously had enacted a tax on emissions of chlorofluorocarbons as part of the strategy for protection of the ozone layer, . . . the acid rain control program incorporated in title IV of the 1990 Amendments arguably provides the first robust test of market-based policies.

See also SCHMIDHEINZ, supra note 3, at 19, in which the author explains:

[T]hree basic mechanisms can be used to move business to internalize environmental costs, to pay for the costs of pollution, or to limit damage to the environment by other means:

- **Command and control:** These are basically government regulations, including performance standards for technologies and products, effluent and emission standards, and so on.
- **Self-regulation:** These are initiatives by corporations or sectors of industry to regulate themselves through standards, monitoring, pollution reduction targets, and the like.
- **Economic instruments:** These are efforts to alter the prices of resources and of goods and services in the marketplace via some form of government action that will affect the cost of production and/or consumption.

Id.

Why so much emphasis on market forces? In answer to this question, the Wirth and Heinz study gives the following answer:

Selective and careful use of economic incentives can enable us to achieve greater levels of environmental protection at lower overall cost to society. A central principle is that as consumers and as producers, each and every one of us needs to weigh the full social costs and consequences of our decisions before acting . . . . Market-based environmental policy mechanisms provide various ways to make consumers and producers recognize these social costs and consequences, and thus provide incentives for environmental protection. The creativity and power of the market—the awesome strength of millions of decentralized decision-makers—can be deployed on behalf of environmental protection, instead of against it.139

Although there is no definitive statement of what constitutes a market-based, or economic, instrument, "all of them involve intervention by government in the marketplace through mechanisms such as pollution taxes and charges, tradable pollution permits and resource quotas, deposit-refund systems (as with glass bottles), performance bonds, resource saving credits, differential prices (as with unleaded versus leaded gasoline), special depreciation provisions, and the removal of subsidies and barriers to market activity."140 These government-initiated vehicles attempt to alter the prices of resources and of goods and services in the marketplace with the express intent of affecting the nature and cost of production or consumption.141

1. Is Securities Regulation an Economic Instrument for Environmental Pollution Control Purposes?

Notwithstanding the fairly wide range suggested by the parameters and examples described above, the complex nature of the subject here warrants a careful answer to the question posed. Specifically, one can most accurately state that the dynamic created by securities law duties to disclose environmental matters exhibits some characteristics of an economic instrument.

To illustrate this dynamic, we start with the basic proposition that the federal regulatory scheme requiring disclosure of material environmental liabilities by public companies greatly facilitates the transmission of mean-

139. Id. at 25; see also SCHMIDHEINZ, supra note 3, at 21-22:

The growing interest in the use of economic instruments stems from four needs: to provide continuous rewards and incentives for continuous improvements, to use markets more effectively in achieving environmental objectives, to find more cost-effective ways for both government and industry to achieve these same objectives, and to move from pollution control to pollution prevention.

140. SCHMIDHEINZ, supra note 3, at 22.

141. Id. at 19.
ingful information to the securities markets. This transmission is likely to diminish the value of an issuer's securities where the information has negative implications with respect to profitability. Such an undesirable economic consequence may carry the potential for inducing changes in...
company environmental policies and practices. Correspondingly, fines and other penalties for violations of those same disclosure requirements may tend to induce both future securities law compliance and changes in company operating behavior.

The diminution of security prices, or the imposition of penalties for nondisclosure, can be characterized as "taxes" or "effluent charges" in an economic-incentive structure:

Faced with these taxes or "effluent charges" [in the form of reduced value of its securities, or non-disclosure penalties], each firm [may] find it in its own interest to reduce pollution by an amount related to the cost of [pollution] reduction, and through the use of the least-cost means of doing so. It would compare the cost of paying the effluent charge with the cost of cleaning up pollution, and would choose to remove pollution up to the point where the additional cost of removal was greater than the effluent charge. A company will not automatically change its environmental behavior in every instance in which negative information could damage its stock prices. The company will compare its cost of environmental compliance with the benefits of doing so (higher stock prices, or no penalties for nondisclosure), and it will decide whether, or to what extent, it is advantageous to enhance its environmental policies and practices. This "least cost" approach, whereby "[f]irms are assumed to choose their combination of inputs so as to minimize the total cost of production," is a fundamental principle in the micro-economic decisionmaking process of the firm and is a typical component of the diminished market value of existing publicly held stock.

Indeed, so substantial is the adverse effect on issuers and underwriters of distributions under these circumstances that the SEC found it necessary to promulgate Rule 10b-6, 17 C.F.R. § 240.10b-6 (1992). Adopted in 1955 by the SEC under the authority of Section 10(b) of the Exchange Act, Rule 10b-6 has the specific objective of deterring issuers and other "key participants in a distribution from bidding or purchasing securities of the same class as those being distributed until they have completed their participation in the distribution. The rule is intended to prevent those involved in the distribution of securities from artificially conditioning the market for securities to facilitate the distribution." Cox et al., supra note 48, at 314.


Least-cost rule: To produce a given level of output at least cost, a firm will hire factors until it has equalized the marginal product per dollar spent on each factor of production. This implies that

\[
\frac{\text{Marginal product of } L}{\text{Price of } L} = \frac{\text{Marginal product of } A}{\text{price of } A}
\]

Id. at 524. "[The rule] simply states that, whatever the level of output, the firm should strive to produce that output at the lowest possible cost and thereby have the maximum amount of revenue left over for profits or other objectives." Id. at 523.
of economic incentive-based environmental protection schemes.\footnote{147}

Yet, notwithstanding the similarities between the securities law mechanism and many of the emerging systems of economic environmental compliance incentives, some significant differences exist. In the emerging systems, for example, government regulators usually establish charges in such a way that the decision simply to pay charges and continue substantially polluting the environment is economically prohibitive. The ultimate objective, of course, is to promote environmental protection.\footnote{148}

No such procedure or device inheres in the securities law mechanism, primarily because that mechanism merely—and quite unintentionally—creates a \textit{dynamic}. This dynamic consists of a set of relationships between and among environmental liabilities and obligations, their required disclosure, and securities prices. This dynamic sometimes produces useful consequences from an environmental protection standpoint. Therefore, the mechanism is not the result of a set of premeditated objectives in the securities laws to protect the environment, but rather, the result of market forces interacting with governmental regulation.

At best, and subject to the cost-benefit relation just described, environmentally beneficial behavior will flow from securities law enforcement only \textit{as a consequence} of the pursuit of the primary goals of securities law: protecting investors and the securities markets through full and fair disclosure. Nevertheless, this securities law dynamic has provided beneficial results from an environmental protection standpoint.\footnote{149} As such, those laws, along...

\footnotetext{147}{See, e.g., Robert W. Hahn, \textit{Economic Prescriptions for Environmental Problems: How the Patient Followed the Doctor's Orders}, J. Econ. Persp., Spring 1989, at 95, 104-06.}

\footnotetext{148}{See Frederick R. Anderson et al., \textit{Environmental Improvement Through Economic Incentives} 5-7, 105 (1977):}

\begin{quote}
The activity would then pay for the resources it consumes, like any other economic activity. Since computing total social damages poses enormous practical difficulties, it will probably not be possible to attain this ideal. However, given a \textit{legislatively determined} level of environmental quality as a goal, the average costs of controlling environmental harms in various industries could be used to design a charge that achieves a high level of efficiency, even if it does not perfectly reflect all of an activity's social costs.
\end{quote}

\begin{quote}
\textit{[C]harges would be used to achieve predetermined environmental standards and would be based on a rough and ready estimate either of the costs of environmental control of various industries, services, and municipalities, or upon an estimate, somewhat sociological in nature, of the charge that will induce citizens and consumers to modify their behavior.}
\end{quote}

\footnotetext{149}{See, e.g., In re Occidental Petroleum Corp., Fed. Sec. L. Rep. (CCH) \textsection 82,622 (July 2, 1980); SEC v. Allied Chemical Corp., Civ. No. 77-373 (D.D.C. 1977). Both cases involved SEC enforcement proceedings in which the defendant companies signed consent decrees requiring them to develop comprehensive audit programs. The purpose of the audit programs was to ensure management awareness of environmental matters and inclusion of those matters in the business decisionmaking process. \textit{See also} Janet D. Smith, \textit{Environmental Disclosures Required by Federal Securities Laws, in Environmental Problems in Financing and Securities Disclosure: Avoiding the Risks} 9, 21-22 (1991).}
with the SEC's enthusiastic application of them, have served to create economic incentives for pollution control in a rather general, but often important, way.

Finally, and independent of the SEC's role, considerable potential may exist for the use of the dynamic by private investors. In fact, some experts have noted the immense potential and have predicted optimistically that, increasingly, investors will act voluntarily and strategically to establish economic incentives for higher levels of environmental protection by public companies. It is in these circumstances that the similarity between the securities law mechanism and other current economic incentive schemes is potentially greatest.

2. SEC Disclosure as a Mechanism to Promote "Full Cost" Accounting of Environmental Costs in Market Valuations of Securities Prices

Another beneficial effect would flow from the dynamic discussed here, even when a company decides no economic advantage exists in changing its environmental compliance patterns, and thus decides to accept adverse effects on its security prices resulting from disclosure of negative environmental information. By requiring disclosure and punishing disclosure violations and other securities-related wrongdoing, securities laws promote the public's interest in the accuracy of securities prices and the general integrity of securities markets. And in so promoting accurate securities prices and reliable markets, the securities regulatory regime contributes to a phenomenon known in the economic and environmental arenas as "full cost pricing" or "green accounting":

[Product prices very often do not represent the actual costs of production. If, for example, a given production process (or activity) produces emissions of deleterious effect to the environment, these

150. See Schmidheiny, supra note 3, at 64-65:
Of growing importance among financial intermediaries in today's markets are the institutional investors, such as insurance companies, pension funds, and portfolio management specialists .... Their significance lies in the sheer volume of funds under their management and the power this provides.

.....
If the message of sustainable development can be transmitted convincingly to these institutions, the cumulative effect could be enormous.

.....
There is also a growing awareness among individual investors of the need to take account of environmental considerations. This concern is currently focussed mainly on more emotive issues, such as deforestation, the greenhouse effect, or endangered species, but it may in time become more sophisticated. Just as public opinion has been seen to oppose investment in certain countries for political reasons (apartheid in South Africa, for example), so it is probable that individual investors will increasingly take account of the environmental performance of individual corporations or economic groups in their portfolio strategies.
emissions generate costs. Deterioration of terrestrial or aquatic environments, health effects, materials damage, or even diminution of aesthetic values, are all costs of the production process. However, these costs are generally not born by the producer but by the society as a whole ("social costs"). Such "externalities" or "spillovers" are the result of the producer's goal to maximize profits . . . The negative effect is multiplied when the consumer, influenced by misleadingly low prices, buys the polluting products, which, in turn, may lead to expanded production.151

Similarly, in the securities setting, the market mechanism would discount the price of a security—a "financial product"—by some figure representing a theretofore undisclosed liability or obligation. That liability or obligation, of course, will have been deemed properly includable as a "cost of doing business." Therefore, when the company discloses that cost, and thereby introduces the information to an efficient capital market, it provides more complete information to be used in pricing the security in accordance with the complete and actual financial condition and prospects of the company.152

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151. Id. at 17 ("The basic equations behind full-cost pricing are simple. For production, whether industrial or agricultural, the full cost is the cost of production plus the cost of any environmental damage associated with it."); Companies Begin Using "Green Accounting" to Pin Down Environmental Costs, 4 BUSINESS AND THE ENVIRONMENT 1, quoting Lenore Goldman, of Goldman Associates, Oakland, California, who suggests that full-cost pricing that includes environmental costs should be expressed in a company's external financial statements, as well as in their internal, managerial decisionmaking accounting papers:

"If you can integrate this information into your company's financial statements, that's where it will have the power to impact the complete retooling of company processes," Goldman noted. "An internal departmental version is a fine first step, and an enormously useful management tool. It starts to move us towards a greater goal, an accounting statement that evaluates performance based on sustainability [of natural resources used in the economic development process]."

Yet, "green accounting" is not so easy to implement. The Business and the Environment article quotes Daniel Rubenstein, a Canadian accountant who has worked on a "sustainable accounting" project for the United Nations:

"Accounting for sustainable development sounds good on paper, but when you really look at the application it gets murky . . . . A business enterprise would ideally base its volume and capacity on the carrying capacity of the ecosystem. To discover that carrying capacity, you get into science, which has an inherent ambiguity that accountants hate. So you get fuzzy accounting—but an emerging approach says that just because you don't have a precise cost, it doesn't mean you don't have a range of costs. Internally, you need that cost information to make an informed decision, whether or not you disclose it externally."

Id.

152. ROBERT A. HAUGEN, MODERN INVESTMENT THEORY 634 (3d ed. 1993), discussing the efficient capital market hypothesis as it relates to the effect of disclosed, or "knowable," information on the pricing of securities, and noting the lively debate about the validity of the hypothesis:

Prices are set by those marginal investors who actively trade in the stock. An advocate of the notion that the stock market is relatively efficient would argue that there exists an "army" of intelligent, well-informed security analysts, arbitrators,
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The overall effect here is a beneficial one: Investors are not defrauded by being induced to purchase securities priced at a higher value than would be assigned under circumstances of full environmental disclosure. Those investors are also in a better position to make an informed decision regarding whether to buy the securities (or hold, as the case may be). And, finally, the reductions in the value of securities as a result of these market dynamics may be so substantial that they create the larger, ultimate effect discussed in this article: an economic disincentive to the issuers of those securities to continue methods of production that generate large environmental liabilities. Correspondingly, as to environmental obligations, such as legal requirements to acquire and maintain certain pollution control technology, the issuer may have an incentive to acquire—or develop—the most economical version of that obligation.

3. The Potential of a Securities Regulatory Dynamic: Specific Features of an Economic Incentive Approach

The SEC's current emphasis on environmental disclosure has generated incentives for both environmental protection and securities market integrity. The foundation of this phenomenon is the required transmission of important information on environmental matters to securityholders and to the markets about public companies. If adverse information relating to environmental liabilities and obligations will have the effect of moving securities prices down in efficient, developed public markets, a company may have

...and traders, who literally spend their lives hunting for securities which are mispriced based on currently available information. These professionals are armed with computers, and they subscribe to data-base management services which are tied into their computers. They have at their fingertips up-to-date information on thousands of companies, and they process this information using state-of-the-art analytical techniques. These people can access, assimilate, and act on information very quickly. In their intense search for mispriced securities, professional investors may police the market so efficiently that they drive the prices of all issues to fully reflect all information that is "knowable" about a company, its industry, or the general economy.

Whether that is the case is a controversial issue. . . .

Id.

153. The fact that environmental liabilities are often significant from a financial standpoint and that access to information regarding such liabilities by the market would be through the relatively costless, credible, and highly accessible medium of SEC disclosure, increases the efficiency of the market mechanism that affects the price of the security. Also, to the extent the stock is actively traded, traded on a major market system, or both, only adds to the efficiency. See Victor Brudney & Marvin A. Chrielstein, Cases and Materials on Corporate Finance 2-3 (1992 Teacher's Update) (summarizing the article by Gilson & Kraakman, supra note 49, at 622-26):

They suggest that the securities market has varying degrees of efficiency in reflecting information in price, depending on differences in the cost of discovery and speed of absorption of different kinds of information. They also relate those differences to the operation of different identified market mechanisms—(1) universally informed trading, most closely approximated with respect to old price information and big
an incentive to ameliorate its environmental problems (or make its handling of environmental concerns more efficient in the case of obligations) in order to preserve the value of its securities as priced by those public markets. Completing this dynamic are the "millions of decentralized decision makers" participating in the public markets. Whether their investment objectives are economic or social in nature, owners of securities are indeed key players in creating incentives for adoption of more enlightened environmental policies by public companies.

Of course, disclosure alerts the EPA, as well as public interest groups, increasing the prospect of environmental litigation and, possibly, associated liabilities. And in any event, the prices of securities in developed public markets reflect the internalized costs of environmental damage to society caused by the company in the course of production and in pursuit of profit.

One important question should be addressed on this topic, in order to delineate the precise benefit of the dynamic being discussed: Of what use is the securities law mechanism if command and control or other express environmental regulatory systems already operate to implement environmental protection policies? One way in which the securities laws may have the effect of promoting environmental protection over and above that required by the environmental laws themselves is in forcing early disclosure of environmental issues. In this regard, the ability to delay compliance and the payment of fines and penalties through litigation or through administrative maneuvering is a major shortcoming of command and control regulation.155 On the other hand, the essence of the securities laws is that disclosure must take place early enough for the markets to absorb the disclosed information and for the securityholders to be able to make informed decisions with respect to the company. Failures of compliance could lead to serious disruptions in business transactions or operations, as well as early, stiff monetary penalties.156

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155. Anderson et al., supra note 148, at 158:
Under a charge [economic incentive] system, a firm is almost certain to have to pay the charge [for polluting], or spend money to abate in order to reduce its charge payments. Under direct regulation [command and control], however, an industry might conclude that because the enforcement mechanism is so cumbersome and ineffective, it either will not have to pay for the most expensive kinds of abatement techniques, or will be able to gain the monetary advantages of years of delay past the official deadlines.

156. See, e.g., William R. McLucas, Stop Order Proceedings Under The Securities Act of 1933: A Current Assessment, 40 Bus. Law. 515 (1985) (discussing SEC authority, under §§ 8(b) and 8(d) of the 1933 Act, to issue refusal orders and stop orders, in connection
Hence, whether the subject of disclosure relates to (1) future required capital expenditures for Clean Air Act pollution control under Regulation S-K, Rule 101; (2) designation as a Superfund Potentially Responsible Party in certain instances, in advance of litigation and judgment, under Regulation S-K, Rule 103; (3) future financial implications of present environment-related activities and trends under Regulation S-K, Rule 303 (MD&A); (4) material environment-related information under Rule 10b-5; or (5) accrual of an environmental liability under SEC and GAAP principles, the securities laws often require advance disclosure. To the extent these disclosures are material, they will affect security prices. And, when the cost of eliminating the source of liability, or finding a cheaper means of meeting an obligation (such as capital investment for pollution control), compares favorably to the adverse consequences of disclosure, a company will likely change its environmental behavior. This change or, perhaps more realistically, the decision to change would occur prior to the required action by the environmental regulatory regime (such as cleanup and abatement of the pollution problem, or payment of costs or expenditures for obligations).

Another area in which the securities law mechanism may be useful, above and beyond the force and effect of express environmental laws, is in providing a lever for demanding environmental quality standards higher than those required by environmental regulation. In this instance, the disclosure aspect of securities law is not necessarily the most important one, although disclosure may be useful in ascertaining a company's environmental practices and in determining that it is only meeting minimum environmental law requirements. More specifically, other features of security ownership possess great potential for influencing environmental policies and practices.

with incomplete, inaccurate, or false and misleading registration statements). These powers allow the Commission to act expeditiously to thwart the public sale of securities, often wreaking havoc on a company's finances and reputation:

In a given case . . . the Commission's issuance of a stop order may have a crippling impact upon the issuer's subsequent attempts to sell securities, even if the issuer amends the registration statement in accordance with the Commission's order and the registration statement is subsequently declared effective.

*Id.* at 516.

. . . [S]ection 8(d) permits the institution of a stop order proceeding "at any time" that it appears to the Commission that the registration statement includes "any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading."

*Id.* at 519.

Many disclosure provisions under the securities laws require an initial filing of the disclosure document, followed by SEC staff review and approval, before a registrant can take such important steps as selling securities, soliciting proxies, or proceeding with a tender offer takeover. In such instances, there is a particularly high probability of actual discovery of disclosure violations. This, in turn, provides the basis for seeking expeditious injunctive relief.

Hence, if the disclosure is properly made and is correct, adverse information will be conveyed to the market and will lower the price of the registrant's securities. On the other hand, when disclosure is inadequate, SEC staff will refuse to allow the company to take the action proposed, or will seek administrative or judicial relief. All of these possibilities are likely to occur far in advance of any adverse action by environmental regulatory authorities or private parties suing under a citizen suit provision of the environmental laws.
These include advocacy through voting strategies or through various other means, including the decision to sell or not to purchase the security, with the aim of urging corporate adoption of certain environmental policies.

By way of example, the influence of environmentally sensitive shareholders in the wake of the oil spill in Prince William Sound caused by the Exxon corporation played a significant role in forcing various corporations to adopt policies and practices (such as the Valdez Principles) that went considerably beyond minimum requirements of the environmental laws.\textsuperscript{157} Given present trends, companies may increasingly have to respond favorably to shareholder concerns and requests that environmental policies extend far beyond the simple requirements of law.\textsuperscript{158}

Finally, as an over-arching theme reiterated throughout this Article, the attitudes of securityholders about a company's environmental policies can contribute greatly to the impact of the securities law dynamic as an economic or market-based instrument. When those securityholders decide that high environmental standards are important, then the leverage of securities regulation and related market dynamics as an instrument of economic incentive over public companies is correspondingly greater.

\section*{B. The Potential Role of Shareholder Activism}

As was observed in the previous discussion, the SEC is not the only securities market actor capable of affecting the environmental compliance records and policies of public companies by invoking the securities laws.\textsuperscript{159} In fact, securityholders of both the "economic"\textsuperscript{160} and the "ethical"\textsuperscript{161} persuasion have available to them a substantial array of disclosure and other rights, which are often buttressed by express and implied private


\textsuperscript{158}. Id. at 129.

The emergence of socially responsible investment during the 1980s may have come as a surprise. The decade was characterised by the free market and financial deregulation—ending with the defeat of socialist ideology in favour of Western enterprise. \textit{Ironically, we may now be seeing a new form of social control from within corporations as their performance is increasingly judged according to wider economic, environmental and ethical criteria and not just profitability.}

\textit{Id.} (emphasis added).

\textsuperscript{159}. The discussion in this section borrows substantially from a book by the author, currently in progress, on corporate social responsibility.

\textsuperscript{160}. See, e.g., Levine v. NL Indus., 717 F. Supp. 252 (S.D.N.Y. 1989), \textit{aff’d}, 926 F.2d 199 (2d Cir. 1991) (economic investor sued company for failure to fully disclose environmental liabilities for purpose of capital gains and dividends).


The two categories, of course, are not mutually exclusive. Yet, because the categories are often identified with different philosophical or political beliefs—and thus, different views about the objectives and operation of the corporation—it is useful to separate them.
rights of action. With these rights as a foundation, securityholders have the power to achieve even more than requiring proper environmental disclosure: they can promote high levels of environmental compliance, should they desire to do so, through the strategic use of securities laws and securities market dynamics. Discussions of securityholder efforts to affect company policies are usually carried on under the rubric of "shareholder activism."

Shareholder activism has for years been an important means of bringing about changes in corporate management policies. Various engendering fear, respect, and even disdain in corporate boardrooms, this reform device may come into play for the more traditional purpose of enhancing shareholder wealth or for the more progressive purpose of advocating socially conscious corporate action. Further, although the corporate governance environment has been rendered immensely more complex by an emerging, pervasive global economy and an increasingly assertive community of institutional investors, the possibilities for achieving responsive corporate action may be even greater because of those same phenomena.

1. Origins of Shareholder Activism

The roots of shareholder activism are said to lie in the corporate America of the 1930s, when a young Lewis Gilbert attended his first annual shareholders' meeting. Appalled by the dearth of communication between shareholders and management of the Consolidated Gas Company, he vowed to "fight this silent dictatorship over other people's money."

Thanks to the persistence of the Gilberts and others, corporate managements became more accessible, provided greater financial disclosure, and generally increased their regard for shareholders' roles in the corporate governance process. This is not to say, however, that any permanent quantum shift in shareholder powers and protections occurred; yet, compared to past corporate attitudes and practices, the gains spurred by advocates like the Gilberts reflected considerable progress.

The second wave of shareholder activism occurred in the 1960s and 1970s, a period of social and political upheaval that centered on concerns such as civil rights, the environment, the Vietnam War, and consumer protection. Well-known projects such as the Saul Alinsky/Kodak matter, Campaign GM, and the anti-Vietnam War initiatives directed at the Dow Chemical and Honeywell corporations gave concrete form to theories that were emerging regarding ways to influence corporate policies. These projects were successful in generating positive action from corporations on the types

162. See generally Cox et al., supra note 48.
164. Id. at 4.
165. Id. at 4-8.
166. Id. at 12-28; see also Donald E. Schwartz, The Public-Interest Proxy Contest: Reflections on Campaign GM, 69 Mich. L. Rev. 419 (1971) (discussing campaign GM).
167. Talner, supra note 163, at 8-11.
of proposals that were to continue to appear in the future: changes in the scope, nature, and procedures of business operations in the interests of liberty, freedom, equal opportunity, environmental protection, and public health and welfare; shareholder committees to serve as liaisons between management, the shareholders, and the public on critical issues; and membership on the corporation's board of directors of persons having particular knowledge and sensitivity in areas that are the subject of advocacy. Furthermore, subsequent initiatives, concerning such topics as discrimination, nuclear power, environmental pollution, and divestment from South Africa, built upon the basic formuli developed in the earlier projects.

2. The Role of the Institutional Investor

Institutional investors brought on the next important wave in shareholder activism, eschewing for the first time—and with no small amount of controversy—their traditional roles as passive shareholders. In the early stages, the activist institutional investors were mostly universities, foundations and church organizations, but gradually other organizations, including pension funds, emerged to take a prominent place in the movement for greater corporate managerial accountability. Motivating these changes was a growing awareness by institutional investors that certain basic economic, social, and political realities were beginning to frame, in vastly new ways, their positions in, and the nature of their relations with, societies and related institutions throughout the world.

So fundamentally different was the evolving institutional investors' environment that the venerable old "Wall Street Rule"—under which an investor who disagrees with a corporation's policies simply sells that company's stock—began to lose force. Instead, many institutional investors charted a new course: maintaining their holdings and using the power of their considerable share ownership to influence corporate policy.

3. The Size of Institutional Holdings and the Rationale for Retention and Advocacy

Institutional investors own immense amounts of corporate securities, and this fact has much to do not only with why many of them have chosen to become longer term security holders but also with why they are such a major new force in corporate governance. For instance, today, the total assets controlled by pension funds is over $2.5 trillion in equity and fixed-income securities. Institutional investors as a whole own 53% of the stock market value of the top one hundred American corporations. Some of the

168. Id. at 34.
best known examples are General Motors Corp. (82%), Mobil Corp. (74%), Citicorp (70%), Amoco (86%), and Eli Lilly & Co. (71%).

With the twenty largest pension funds owning about one-tenth of the equity in America's publicly owned companies, and institutional investors as a whole controlling nearly 40% of the country's large businesses, corporate managers have noted with no small degree of anxiety that:

The largest and fastest growing [pension] funds, those of public employees, are no longer content to be passive investors. Increasingly, they demand a voice in the companies in which they invest—for instance, a veto over board appointments, executive compensation, and critical corporate charter provisions.

Yet if one looks only at the size of institutional holdings, one may commit the classic mistake of confusing an ox for a bull. Although public pension funds are "bulls" who often engage in aggressive, outspoken criticism of corporate management, they constitute only a modest minority of institutional investors. Most other institutional investors seem closer to "oxen," because they have shown little willingness to oppose corporate managements or even to support dissidents in proxy contests.

This observation by Professor John C. Coffee, Jr., while often ignored or simply not known, is crucial information for any shareholder activist organization seeking to enlist institutional investors's support in its cause.

As noted earlier, fundamental realities account for the institutional investor's decision to maintain its ownership in a corporation and become active in its management ("voice") rather than observing the Wall Street Rule ("exit"). For example, the sheer size of institutional security holdings in a given business creates, in and of itself, potential adverse effects that usually dissuade these investors from simply exiting by selling large blocks at 170.


171. Drucker, supra note 169, at 106.


173. See INVESTOR RESPONSIBILITY RESEARCH CENTER, How INSTITUTIONS VOTED ON SOCIAL POLICY SHAREHOLDER RESOLUTIONS IN THE 1991 PROXY SEASON 9 (1991) (explaining differences in support of social policy proposals at corporate meetings based on type of institutional investor). For example, investment firms were the most "conservative . . . Twelve of the 15 [surveyed] either voted against or abstained on almost every social policy proposal." Banks, once uniformly likely to vote consistently with management, "continue to show more independence." Public pension funds and educational institution were varied in their support for such proposals. And, "[a]s usual, church respondents were the most likely to vote in support of all social policy proposals, though they tended to vote against or abstain on the resolutions relating to contributions for Planned Parenthood and abortion."

of their securities in that business. That is, the substantial price discounts they would have to sustain upon such a sale, as a result of supply-and-demand related price depression, creates a disincentive to sell.  

Another reason offered for institutional abandonment of the exit option is that "nearly one-third of all equity investments held by institutional funds are 'indexed'—that is, they are invested in a portfolio of securities that is intended to represent an accurate proxy for the stock market as a whole." The rationale driving such an investment strategy is that the Efficient Capital Markets Hypothesis works. Having seen evidence of this theory's validity, and thus believing that they cannot outperform the market (without taking on unacceptable risks), many institutionals have staked out indexed buy-and-hold strategies. The institutional investor has thus become, in many instances, a long-term holder of securities.

Finally, joining size of holdings and efficiency of the capital markets as reasons for institutional retention of corporate securities and advocacy for corporate change are: concern over the erosion of shareholder rights; and pressure from regulatory bodies, such as the United States Department of Labor, who act pursuant to the Employee Retirement Income Security Act of 1974 (ERISA) and contend that institutional fiduciary duties require active participation in corporate affairs. These considerations have propelled many institutional investors into the heart of the corporate governance arena, thus introducing formidable new players.

4. Should Institutional Investors Use their Securities Rights and their Market Power to Support Environmental Protection? Can They Do So?

The fact that growing numbers of institutional investors are becoming increasingly active does not mean they automatically favor investments or advocate strategies that promote environmental protection. Indeed, certain special constraints may constitute obstacles to such pursuits. Specifically, more ambitious proposals, requiring substantial corporate expenditures, and posing the spectre of low corporate profitability and low investor return,

175. Coffee, supra note 172, at 1288-89; Shareholder Activism; The End of the Casino Society, Economist, Jan. 12, 1991, at 60 [hereinafter Shareholder Activism].
176. Coffee, supra note 172, at 1339.
177. See Gordon & Kornhauser, supra note 143, at 765.
178. See Coffee, supra note 172, at 1289 n.33, 1339.
179. Shareholder Activism, supra note 175, at 60; see also USA Meeting Highlights Shareholder Activism, Insights, Nov. 1990, at 29, quoting United States Department of Labor official David Ball on the obligation of pension fund managers to be active in corporate governance:

[F]iduciaries of employee benefit plans have a duty to manage plan assets solely in the interests of the participants and beneficiaries of the plans; . . . the ability to vote proxies is a plan asset; . . . it would be a dereliction of duty if managers of plan assets didn't vote or vote without paying close attention to the implications of their vote for the ultimate value of the plan's holding.
are generally more difficult for institutional investors to support—and they are correspondingly more difficult for investee corporations to adopt:

The extent of institutional activism raises policy questions of considerable importance to companies whose stock institutions own and to the economy in general. There are also significant legal questions: How does the prudent person rule apply to the voting of shares by fiduciaries? Is the issue different from the question of whether a fiduciary may invest based upon factors other than profit considerations? To what extent does the prudent person rule, or any other rule, require or permit a fiduciary to approve resolutions that may have the effect of reducing profits? Is the problem resolved by declaring that the proposal will increase profits “in the long term?” What is the “long term?” . . . Are all institutions—universities, foundations, public and private pension funds—treated alike? . . . Should the fiduciary “pass through” the voting rights to the beneficiaries? Managers and other fiduciaries of institutional investors are constrained and guided in their use of institutional funds by various bodies of law, both common law and statutory. Perhaps the best known, and certainly the most modern, legal regime governing such fiduciary behavior is ERISA, governing private welfare and pension funds. Drawing from the common

182. Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in various sections of 5, 18, 26, and 29 U.S.C.); see Hylton, supra note 32, at 37:
Prior to 1974, the year ERISA was enacted, the common law of trusts, the Taft-Hartley Act, and portions of the Internal Revenue Code delineated the permissible scope of trustee behavior with respect to pension investment decisions.
Id. (footnotes deleted); see also RATNER, supra note 181, at 33:
[ERISA] imposes broad requirements affecting many aspects of private welfare and pension plans. The provisions of the Act are designed to reduce significantly the number of people who pay money into private pension plans expecting to receive retirement income, “only to have their hopes dashed and end up getting nothing.” The Act comprehensively regulates the activities of those who manage or control welfare and pension funds by establishing federal fiduciary standards governing the behavior of trustees and others who exercise authority over such plans. The new fiduciary standards draw from the common law of trusts but modify the traditional rules when necessary to implement the purpose of the Act. The law both expresses these standards in general terms and enumerates specific prohibited transactions.
183. Although public pension funds and their fiduciaries—by far among the most activist of shareholder activists—are not regulated by ERISA, it has often been observed that:
The fiduciary responsibilities set forth in ERISA are often used as the model for public pension systems. ERISA case law may be analogized to [the laws governing fiduciary duties in public pension fund investments].
Additionally, it should be noted that as to other types of activist institutional security-holders, such as universities and the like, ERISA applies directly.
law and other related pre-ERISA laws, Sections 404(a) and 406 of ERISA essentially establish fiduciary duties in the nature of the duties of care ("prudent person" rule) and loyalty, and place those duties upon trustees, investment managers, and investment advisors of pension funds. But, whatever law one considers, the fiduciary duty of prudence in handling funds is still somewhat constrictive:

The promise of flexibility conveyed by the prudent man standard has failed in application, due primarily to interpretations rendered by judges and commentators more receptive to the legal principle of stare decisis than to the evolving economic principles that increasingly inform investment management.

To be sure, ERISA has been construed to allow more flexibility than its common-law antecedents. Nevertheless, as to socially responsible investments or any others, authoritative opinions have expressed that:

[E]conomic considerations are the only ones which can be taken into account in determining which investments are consistent with ERISA standards. Nevertheless, ERISA provides sufficient flexibility to permit consideration of incidental features of investments which are equal in economic terms.

While some disagree with this fairly restrictive view, others with considerable authority have supported this position. Ian Lanoff, Administrator of the Office of Pension and Welfare Benefit Programs in the Department of

184. 29 U.S.C. §§ 1104(a), 1106; Hylton, supra note 32, at 39; see also Longstreth, supra note 180, at 32-36; Ratner, supra note 181, at 33.

185. Longstreth, supra note 180, at 152.


Labor, expressed this view during the Carter Administration. Whatever one's interpretation of the scope of fiduciary prerogative here, in a quite fundamental sense, any theory or rationale by which private pension funds—or any other institutional investors—purport to invest or advocate in favor of higher environmental standards at their investee corporations must be competitively profitable with other similar investment opportunities.

What, then, will it take, in the larger sense, before institutional investors begin directing their considerable resources and power in ways that promote environmental protection? Stephan Schmidheiny, Chairman of the Business Council for Sustainable Development, offers an insightful opinion:

Institutional investors must become increasingly aware of the environmental risks and opportunities embedded in their investment decisions. They have the legal fiduciary responsibility to exercise prudence and due diligence. If the message of sustainable development can be transmitted convincingly to these institutions, the cumulative effect could be enormous. Given the right signals, the institutions holding pension funds may find themselves attracted naturally to the concept of sustainable development, as a long-term view on future values and an emphasis on capital appreciation corresponds to their basic nature and mission.

189. Hylton, supra note 32, at 42-43:
The reality is that if [socially responsible investing] is permitted under any circumstances, as it is, it may only be practiced without fear of liability when the screens, whether positive or negative, have a de minimus effect on the performance of an investment portfolio. Id. at 43.

190. Various approaches have been offered to justify or attack socially responsible environmental investing. Modern portfolio theory, in which the relationship of risk and expected return is at the heart of the “efficient” portfolio investment decision by risk-averse investors, is often seen as counseling against socially responsible investing. Id. at 14. Compared to nonsocially responsible investment possibilities, the socially responsible ones must either have (1) similar risk-return relationships, (2) higher expected returns for higher risks, or (3) lower risks for lower expected returns, in order to be acceptable investment choices. Id. at 16-17; Harry Markowitz, Portfolio Selection, 7 J. Fin. 77, 79 (1952).

Socially responsible investments are often criticized as being more risky, without providing for correspondingly higher expected returns. The rationale generally offered for this conclusion is that the process of selecting socially responsible investments necessarily may eliminate many potential investment choices. Therefore, there is no opportunity to reduce some portion of the overall risk through diversification of investments. Richard A. Posner, Economic Analysis of Law 419-20 (3d ed. 1986). Diversification—basically, not “putting all one’s eggs in one basket”—is considered essential to the choice of an efficient portfolio. Gilson & Black, supra note 143, at 11-15.

Some commentators refer to recent evidence of cracks in the armour of the Capital Pricing Asset Model—the high priest of the investment decisionmaking models—as a basis for defending socially responsible investing. See Hylton, supra note 32, at 23-27. But, whatever the theory or rationale, socially responsible investments must be basically profitable by some reasonable measure. Id. at 49-52.

191. SCHMIDHEINZ, supra note 3, at 64-65 (emphasis added).
Essentially, Mr. Schmidheiny's message is that institutional investors will respond most favorably to a direct and symbiotic nexus between a healthy environment and "clean" or "green" company production processes, on the one hand, and economic productivity and shareholder wealth maximization, on the other hand. Creating and demonstrating the highest possible level of this paradigm will have to be the work of those who would advocate for ambitious corporate environmental protection policies.

The paradigm referred to above is the objective of the theory of sustainable development, a concept currently gaining rapid acceptance. "To be sure, exact definitions of sustainable development are still hard to come by, but the essence of the concept is that economic and environmental concerns cannot be treated separately." 192 Already, the concept has begun to inform those seeking to resolve the conflicts that traditionally have divided pro-trade and pro-environment forces at the international level. Sustainable development is particularly important in debunking the classic myth that an inverse relation always exists between economic productivity and development, on the one hand, and environmental protection, on the other:

If understood in the context of sustainable development, environmental concerns and trade activities are not necessarily at odds, and should be dealt with in an integrated fashion. It is clear that trade policy which does not consider environmental impacts can undermine the natural resource base on which continued, or future, development depends. At the same time, it is obvious that environmental policy, framed without regard to development needs, can be equally short-sighted. 193

Whether or not the concept of sustainable development will be a success in reality remains to be seen. If it succeeds, then a crucial factual predicate will have been established in support of economic incentives for environmental protection. One may view efficient, effective environmental protection practices as a positive influence on company profitability and investor return, rather than as a drain on earnings and a deterrent to investment. 194 That is, if environmental policies and practices conserve resources and lower costs, in addition to reducing the health threats of wastes, then institutional

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193. Id. at 33.

194. See, e.g., AT&T, A Healthy Balance: AT&T Environment and Safety Report (1992) (copy on file with author). Environment & Safety Vice President David R. Chittick reports that "[b]ecoming 'green' doesn't always cost; often it pays, in decreasing operational costs and in avoiding future liabilities." Id. at 1. The report gives several examples of changes in company production and pollution control processes that have improved productivity and reduced pollution.
(and other) investors will view such policies and practices as desirable features in potential investee companies. The economic incentive cycle would then be complete. At a minimum, the concept has sparked lively debates and discussions that will forever change the way the world views the cycle of natural resource extraction through resource recovery. But the ultimate success of the concept is crucial to the idea of economic incentives using the securities market dynamic.

5. "Green Funds" and Public Interest Organizations

Increasingly, public interest organizations and investment companies have used their knowledge of the securities laws and the stock market—and their considerable financial resources available for investment, as well—to affect the environmental policies of corporations. One prominent example of successful advocacy in this vein is the widespread adoption within the corporate community of the "Valdez Principles," ten principles generated in the wake of the Valdez oil spill that "address the release of pollutants, the sustainable use of natural resources, reduction and disposal of waste, energy efficiency and conservation, and risk reduction to employees and surrounding communities." 195

In fact, some of the best models of shareholder activism in the public interest today come from the environmental movement. For example, the Coalition for Environmentally Responsible Economies (CERES) is a public interest group made up of investors controlling $150 billion in pension and mutual fund assets. Among Ceres's membership are the National Wildlife Federation, the Sierra Club, the National Audubon Society, New York and California state pension funds, and religious groups. 196 One would not have difficulty imagining that CERES can get an audience with the managements of corporations in which its members own securities.

The CERES example is only one of a burgeoning group of organized efforts at using economic incentives to promote high quality environmental policies and practices within the corporate community. Moreover, business responsiveness to advocacy of this sort has grown rapidly within the last fifteen years and promises to become much stronger in the future. 197

Finally, various investment funds have emerged over the past two decades, seeking public funds to invest in companies with purportedly high quality environmental policies and practices. Accompanying this growth is

195. JOHN C. HARRINGTON, INVESTING WITH YOUR CONSCIENCE: HOW TO ACHIEVE HIGH RETURNS USING SOCIALLY RESPONSIBLE INVESTING 227 (1992) (the principles "also address the marketing of safe products and services, damage compensation, disclosure of potential hazards, the inclusion of an environmental representative on corporate boards of directors, and annual and independent corporate environmental audits.").


197. See HARRINGTON, supra note 195, at 225-47 (offering thorough description of investment-related initiatives and favorable responses from the corporate community).
a burgeoning body of literature on the subject.198 These funds, along with the focused investment strategies of public interest organizations, could eventually grow into an especially powerful incentive affecting the business environmental policy landscape. Noteworthy here is the reasonable presumption that the individual beneficiaries of these funds have consented to the inclusion of environmental quality as a leading feature of the funds’ investment portfolio decisionmaking calculus. In this sense, they will have "ratified" the investment strategy, probably on the rationale that the strategy is "economically sound because the consumption benefits of social investing . . . are, in economic analysis, as real as investment benefits."199 This not only relieves, in some respects, some of the pressure to match or surpass the performance of nonenvironmentally sensitive portfolios, but also expands the legal protections of fund managers against actions for violations of their fiduciary duties to beneficiaries.200

IV. CONCLUSION

The confluence of environmental regulation and securities regulation has created a portentous phenomenon: the expansive, pervasive scope of environmental regulation, combined with the recognition by securities regulators and courts that environmental liabilities and obligations may be material to investment decisionmaking and thus should be disclosed, has created a powerful market dynamic that investors can use to promote environmental protection.

The evolution of SEC policies regarding disclosure of environmental issues, having gradually become more and more demanding, has by itself provided strong economic incentives for publicly held companies to improve their environmental policies and practices. Now, however, institutional investors, environmentally oriented investment funds, and public interest organizations have joined the ranks of market actors, and they possess considerable potential for affecting corporate environmental behavior. One can expect that in the future, more and more of these organizations will realize the great power of the securities markets to generate such incentives. The result should be not only more accurately priced securities and more informed decisionmaking by securityholders, but also perhaps considerable progress toward a healthier environment at the hands of a new and powerful economic vehicle for environmental protection.

198. See, e.g., Bruyn, supra note 188; Harrington, supra note 195; Simpson, supra note 157.
200. Id. at 104-07; Hylton, supra note 32, at 48.