

Environmentally Insolvent

Fair Value Measurement of Environmental Liabilities Poses Solvency Risk

By C. Gregory Rogers

A new approach to valuing contingencies under U.S. and international accounting standards could enable creditors and shareholders to argue that corporate environmental liabilities are vastly understated. Asarco, which filed bankruptcy in 2007 with unfunded and undisclosed environmental cleanup liabilities estimated between \$500 million and \$1 billion, is a case in point.

Older accounting standards that favored certainty over projections are being replaced with standards that favor (market-based) projections over certainty. The result will be more recorded liabilities and higher estimates. Although the new standards will not be fully phased in for years, motivated creditors and shareholders need not wait to use these standards to show that seemingly viable companies are in fact insolvent and that companies now in bankruptcy were insolvent long before.

Under new accounting standards that will take effect in 2009, the surviving company in a business merger or acquisition must report certain types of contingencies, including most environmental liabilities, at market value. For

example, the new standards will require recognition of environmental cleanup obligations without regard to the likelihood of government enforcement or the probability that the company will ever spend money to clean up the site. Whereas existing accounting standards do not require recognition of liabilities that cannot be “reasonably estimated,” the new standards assume that any contingency, no matter how uncertain, has a market value. As corporations, attorneys, accountants, and environmental professionals become experienced with fair value measurement of environmental liabilities, expect to see aggrieved creditors and shareholders making the case that companies with a history of polluting activities are “environmentally insolvent.”

Determining Solvency

Solvency issues arise under corporate and bankruptcy laws. When determining solvency, courts are not restricted to valuing only the debtor's loans and trade payables. They also can consider contingent and off-balance-sheet liabilities. A finding of insolvency can serve as the basis for legal and contractual claims including fraudulent conveyance, involuntary bankruptcy, illegal dividends, and loan covenant violations.

There are two distinct tests for determining solvency: (1) the “balance sheet” test and (2) the “cash flow” or “equity”

test. The balance sheet test compares the fair value of the debtor's liabilities to the fair market value of its assets. The cash flow test compares a debtor's ability to generate cash (from continuing operations, disposition of assets, or other capital-raising activities) to the payments required to satisfy its obligations as they mature. Both tests consider off-balance-sheet liabilities and contingencies, as well as recorded liabilities.

A loss contingency is an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. Examples of loss contingencies include pending or threatened litigation, actual or possible claims and assessments, product warranties, standby letters of credit, and guarantees. Environmental liabilities generally are considered loss contingencies arising from litigation, claims, or assessments.

Although courts uniformly agree that loss contingencies must be included in a solvency determination, there is no clear standard for measuring them. Most courts apply a “probability discount” approach to determine the fair value of contingent liabilities. This method values a loss contingency based on the likelihood of an actual loss. It is relatively straightforward when applied

Rogers is counsel with Guida, Slavich & Flores, P.C., in Dallas, Texas. His e-mail is rogers@gsfpc.com. This article appeared in the June 2008 issue of the Business Bankruptcy Newsletter.

to a financial contingency with a face value such as a standby letter of credit. Its application in valuing nonfinancial contingencies with no face value is more problematic.

Valuation of nonfinancial contingent liabilities such as pending or threatened litigation is highly complex and subject to professional judgment. Valuation of environmental liabilities involves special considerations that can compound this complexity. Uncertainties may exist as to whether a site is actually contaminated; whether there is a legal duty to perform an investigation; whether knowledge of contamination imposes a legal obligation to perform cleanup; whether a government agency or private party will ever compel cleanup; whether related claims for bodily injury, property damage, or natural resource damages will arise; the scope of the contamination; the technology that will be required to remediate the site; and how long the cleanup will take. These uncertainties, among others, present a difficult challenge to any creditor or judge seeking to estimate a creditor's environmental liabilities for purposes of determining solvency.

It might seem reasonable to expect that valuation of contingencies for solvency purposes should be guided by generally accepted accounting principles. However, historical accounting standards for contingencies avoid the complexity of market-based valuation in favor of simplistic models that can be more easily applied. Consequently, accounting standards have been of little relevance to solvency determinations, until recently. As explained below, the application of "fair value measurement" to contingencies under recently adopted accounting standards promises to better align the valuation of contingencies for accounting and solvency purposes.

Fair Value

Financial Accounting Standard Board (FASB) Statement 5, *Accounting for Contingencies*, provides a two-prong test for recognition of contingent liabilities. A reporting entity should recognize a liability when information available prior to issuance of the financial statements

indicates that it is probable that a liability has been incurred (the "probability" criterion) and the amount of the loss can be reasonably estimated (the "reasonably estimable" criterion). In practice, the probability criterion is interpreted to mean there is a high likelihood of future expenditures. Likelihood of loss rather than the existence of a legal obligation is the determining factor.

According to FASB Interpretation No. 14 (FIN 14), the reasonably estimable criterion is met when a range of loss (low end and high end) can be reasonably estimated. Thus, a loss contingency for which the high end of the range of possible loss cannot be determined should not be recognized as a liability under FIN 14.

If a loss contingency meets the dual recognition criteria under Statement 5, the amount of the liability must be estimated and recorded. FIN 14 provides a simplistic measurement technique for estimating the amount of the liability. When one amount within the range of loss is a better estimate than any other amount (the "most likely value"), that amount is used. When no amount within the range of loss is a better estimate than any other amount, the low end of the range of estimates (the "known minimum value") is used. In practice, most environmental liabilities are recorded at their known minimum value.

Statement of Position (SOP) 96-1, *Environmental Remediation Liabilities*, applies the principles of Statement 5 and FIN 14 to environmental cleanup obligations arising under environmental laws such as the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA or Superfund). Statement 5 and FIN 14, as well as SOP 96-1, which favor certainty over projections, have been criticized for delaying recognition of contingent liabilities, understating recognized liabilities, and failing to provide users of financial statements with useful, transparent, and timely information.

The simplistic recognition and measurement approach in Statement 5, FIN 14, and SOP 96-1, which excludes consideration of contingencies that are not

deemed highly likely to result in a reasonably estimable loss, is incompatible with the probability discount approach (discussed above) used by courts in solvency determinations. When determining solvency, courts are required to consider the fair value of all of the debtor's contingent liabilities. This requires consideration of all contingencies, regardless of the probability of loss, and a more robust valuation methodology. These requirements are met by an emerging accounting principle called "fair value measurement."

Fair value measurement, also known as "mark-to-market," has emerged as the favored measurement principle under U.S. and international financial reporting standards over the past decade. In recent years, the FASB has adopted numerous standards requiring fair value measurement of liabilities and impairments, including those listed in the table below.

Year	Pronouncement
2007	Statement 141R, Business Combinations
2006	Statement 157, Fair Value Measurements
2005	Interpretation 47, Accounting for Conditional Asset Retirement Obligations: An Interpretation of FASB Statement No. 143
2002	Statement 146, Accounting for Costs Associated with Exit or Disposal Activities
2001	Interpretation 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others
2001	Statement 144, Accounting for the Impairment or Disposal of Long-Lived Assets
2001	Statement 143, Accounting for Asset Retirement Obligations

Under the fair value measurement principle, a liability is recognized for a loss contingency whenever there is a present obligation, regardless of the likelihood of loss. Fair value eschews the notion of a "possible liability" that has yet to become "fixed." For example, whereas courts typically regard a guar-

antee as a possible liability that may never become an actual liability, under the fair value measurement principle, a guaranty represents an unconditional obligation to stand ready to perform in the event of specified future circumstances. Thus, a present liability exists and uncertainties about the probability, timing, and amount of potential loss are factored into the measurement.

The fair value of a liability is the price that would be paid to transfer the liability in an orderly transaction between market participants at the measurement date (exit price). A quoted price for the identical liability in an active market is the best evidence of fair value. If an active market does not exist, companies must estimate the exit price based on the assumptions that market participants would use in pricing the liability, including probabilistic analysis, risk premium, and profit margin.

In contrast to the Statement 5/FIN 14 approach, the fair value measurement principle favors (market-based) projections over certainty. It has the effect of accelerating recognition of contingent liabilities, thereby bringing previously off-balance-sheet liabilities onto the financial statements. In addition, market-based estimates of the exit price for a contingent liability can be higher, sometimes much higher, than estimates produced under FIN 14 and SOP 96-1.

The following hypothetical examples help illustrate the application of fair value measurement to environmental liabilities assumed in a business merger or acquisition. Beginning in 2009, acquirers must account for assumed contingencies at fair value. Under Statement 141R, *Business Combinations*, all contract-related contingencies assumed in a merger or business acquisition will have to be recognized at their acquisition-date fair value. Noncontractual contingencies also will have to be recorded at their acquisition-date fair value, but only if legal counsel determines that it is “more likely than not” that a liability exists as of the acquisition date. The determination of liability does not consider the

probability of future expenditures to settle an existing obligation.

Example 1: Buyer plans to purchase the stock of Seller. Seller owns an industrial facility with soil and groundwater contamination resulting from historical releases of chlorinated solvents (TCE) caused by Seller. Seller estimates that a thorough site investigation will

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cost \$250,000. Depending on the extent of contamination, cleanup costs are expected to range between \$2 million and \$10 million. In accordance with SOP 96-1, Seller has used the reasonably estimable cost of the investigation as a surrogate for the known minimum value of the total cleanup and booked a contingent liability in the amount of \$250,000. Buyer estimates that it would charge \$5 million to assume cleanup liability for the facility in a stand-alone transaction. This estimate is comparable to a quote obtained from a liability buy-out company. Upon acquisition of Seller, instead of recording a \$250,000 liability, Buyer records a contingent liability in the amount of \$5 million representing its estimate of the acquisition-date fair value of the cleanup liability.

Example 2: Same facts as above, except that preliminary investigation indicates that TCE in groundwater has migrated offsite under a residential neighborhood at concentrations posing a risk of vapor intrusion. As of the acquisition date, Seller has not notified the government or the adjacent property owners and no claims have been asserted against Seller. In accordance with SOP 96-1, Seller has not recorded a contingent liability for unasserted claims for property damage or bodily injury because Seller does not consider litigation to be probable (highly likely) and it believes the amount of the potential loss cannot be reasonably estimated. Based on existing information, Buyer’s

legal counsel concludes it is more likely than not that Seller is liable for trespass and related property damages (but not for bodily injury). Considering possible outcomes of potential litigation, including possible out-of-court settlement, Buyer’s counsel estimates the reasonable worst-case outcome for property damage claims is a loss of \$15 million. Buy-

er obtains three quotes for 10-year environmental insurance policies with limits of \$15 million that would respond in the event of lawsuits by offsite-impacted property owners arising from preexisting pollution conditions (bodily injury and cleanup cost coverage is excluded). Upon acquisition of Seller, Buyer records a contingent liability in the amount of \$1.5 million—the average of the three insurance premium quotes—as its estimate of the acquisition-date fair value of Seller’s offsite property damage liability.

Example 3: Same facts as above, except that Seller recently sold the facility in 2001 and gave the current owner an unlimited contractual indemnity for third-party claims for cleanup costs, property damages, or bodily injury arising from preexisting pollution conditions. At the time of the acquisition, no third-party claims have been asserted and the current owner has made no demand against Seller under the indemnity. In accordance with SOP 96-1, Seller has not recorded a contingent liability for its contractual indemnity obligation because Seller does not consider a claim to be probable (highly likely) and it believes the amount of the potential loss cannot be reasonably estimated. Based on available information and experience with vapor intrusion litigation in other parts of the country, Buyer’s counsel estimates the reasonable worst-case outcome for bodily injury and property damage claims is a loss of \$100 million. Buyer obtains a quote in the amount of

\$10 million for a 10-year, \$100 million environmental insurance policy that would respond in the event of claims for bodily injury or property damage arising from preexisting pollution conditions (cleanup cost coverage is excluded). Only one carrier was willing to underwrite the risk. Upon acquisition of Seller, Buyer records a contingent liability in the amount of \$15 million—\$5 million for cleanup (see Example 1) plus the insurance premium quote for bodily injury and property damage coverage—as its estimate of the acquisition-date fair value of Seller's contractual indemnity obligation.

Conclusion

Judicial approaches to determining solvency contemplate market-based estimates of contingent environmental liabilities. Creditors, judges, and valuation experts, however, lack experience in estimating the market value of

such liabilities. Creditors face even greater challenges in identifying unrecognized off-balance-sheet environmental liabilities. As noted by a Wall Street analyst after independent-

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ly researching the environmental liabilities of a major U.S. corporation, “[O]ur research reflects not a lack of effort or comprehensiveness, but the fundamental impossibility to uncover the liabilities, big or small, that the company may one day be forced to deal with.” Consequently, creditors rarely seek to comprehensively inventory and value a debtor's environmental liabilities to show insolvency.

entities and practitioners become experienced with fair value measurement of environmental liabilities, aggrieved creditors and shareholders will seek to show “environmental insolvency” as a basis for legal and contractual claims, such as fraudulent conveyance, involuntary bankruptcy, illegal dividends, and loan covenant violations.