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Report to the Chairman, Committee on Energy and Commerce, House of Representatives

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ENVIRONMENTAL LIABILITY

Property and Casualty Insurer Disclosure of Environmental Liabilities

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Resources, Community, and
Economic Development Division

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The Honorable John D. Dingell
Chairman, Committee on
Energy and Commerce
House of Representatives

The Honorable Ron Wyden
House of Representatives

In connection with the ongoing debate over the Superfund liability system and the upcoming Superfund reauthorization, your March 5 and May 24, 1991, letters asked us to examine a number of Superfund issues. One of those issues was the amount that property and casualty insurers had paid in claims for Superfund cleanup costs. As an initial response to that request, we surveyed the top 20 property and casualty insurers and on October 14, 1992, provided you with claims payment data that reflected what property and casualty insurers had incurred in Superfund cleanup costs from 1980 to 1991.[1]

In light of the concerns about the Superfund liability system expressed by the insurance industry to the Committee, you asked us to assess for this report whether environmental liabilities are publicly disclosed to the Securities and Exchange Commission (SEC). In addition, you asked us to determine what environmental—particularly, Superfund—data 16 of the top 20 property and casualty insurance companies had disclosed in their fiscal year 1990 and 1991 annual reports to SEC.

Results in Brief

Hazardous waste cleanup costs in the United States may total hundreds of billions of dollars over the next several decades. Representatives of several insurance companies have repeatedly testified before the Congress that, if insurance companies are found liable for these cleanup costs, the solvency of the industry could be threatened. Faced with increasing numbers of environmental claims and inconsistent state court decisions, property and casualty insurance companies have been in litigation over whether they are liable for cleanup costs and/or their policyholders' legal expenses.

[1]The findings of this survey were reported to the Committee in our correspondence on Superfund Pollution Claims (GAO/RCED-93-45R, Oct. 14, 1992).

SEC requires companies to disclose environmental liabilities when they are "material," that is, when a company determines that a substantial likelihood exists that an investor would consider such information important to an investment decision, such as whether to buy or sell securities or how to vote. Only 2 of the 16 largest property and casualty companies in 1990 and 3 in 1991 disclosed dollar amounts related to environmental claims in their annual reports. However, five in 1990 and eight in 1991 stated that they were involved in litigation over environmental claims. In addition, when requested by SEC, five companies in each year disclosed environmental claims costs and expenses. None of the companies disclosed costs that they indicated were material to their financial condition.

Background

SEC requires that publicly held companies disclose in annual and quarterly reports what companies determine to be material financial and business information, including pertinent environmental matters related to both historical and future events. Under SEC disclosure requirements, property and casualty insurance companies, like other publicly held companies, must report material information, including environmental matters, necessary for investors to make informed decisions.

The disclosure requirements are generally found in two regulations: one dealing with business and management matters and the other governing the content of financial statements prepared in accordance with generally accepted accounting principles (GAAP). The disclosures are included in companies' annual and quarterly reports filed with SEC.

Business and Management Matters

According to SEC, the regulation that relates to business and management matters contains two key provisions that pertain to insurance companies' environmental liability disclosure. The first provision requires a discussion of both material historical (3-year comparison) financial results and future prospects resulting from known trends, events, or uncertainties that are "reasonably likely" to have a material effect on a company's financial condition and operations. This discussion, known as "Management's Discussion and Analysis of Financial Condition and Results of Operations" (MD&A), includes the disclosure of prospective information, such as potential environmental liabilities. The MD&A section should interpret and explain material changes in the financial statements. Under SEC guidance, when it is reasonably likely that potential environmental liabilities will have a material effect, a known uncertainty exists that must be disclosed.

However, if management determines that the event is not reasonably likely to occur or that the event is not reasonably likely to have a material effect, no disclosure is required.

The second provision requires a description of material pending legal proceedings, other than ordinary routine litigation incidental to the company's business. Proceedings arising under environmental laws are not considered ordinary litigation if (1) such a proceeding is material to the business or financial condition of the registrant and (2) such a proceeding involves a claim for damages or charges to income in an amount that exceeds 10 percent of a company's consolidated assets.

Financial Statements

The second regulation governs the content of GAAP financial statements filed by insurance companies. A property and casualty insurance company is required to include a separate line item in its balance sheet stating its reserve—which is an estimate of ultimate loss—for unpaid claims and claim adjustment expenses. Unpaid claims include those that have been reported but not settled; many of these involve pending litigation. Unpaid claims also include losses that have been incurred but not reported (IBNR); these are insured events that have occurred but for which a claim has not yet been filed. Claim adjustment expenses include all costs to settle a claim, including litigation costs. The company must also disclose the basis for estimating these ultimate losses in the financial statements. The insurance company's estimated claims expenses for environmental matters would be included in the reserve, depending on the extent to which the company writes insurance contracts that expose it to environmental claims.

Companies must also disclose material contingent liabilities, which are uncertainties not considered to be normal and recurring. For a property and casualty insurer, such uncertainties could include potential costs and expenses related to environmental claims being litigated and for which court decisions are pending but will eventually confirm the amount of any such losses. This liability disclosure can be an estimated range.

Insurance Industry Is Concerned About Potential Environmental Liabilities

Hazardous waste cleanup costs in the United States may reach $750 billion over the next 30 years, including $150 billion for Superfund, according to a 1991 University of Tennessee study.[2] These costs do not include the amount that companies are spending in litigation to determine who will pay for these cleanups. Insurance companies, as well as responsible parties, are legally challenging their responsibility for cleanup costs. Recognition of such costs in a company's financial statement may be delayed because of the uncertainties involved in determining who is responsible for these costs. Representatives of several major insurance companies have repeatedly testified before the Congress that, if insurance companies are found liable for these cleanup costs, the solvency of the industry could be threatened.

Insurers' incurred cleanup costs are escalating, as our survey findings of the top 20 property and casualty insurers reflect. We reported in our October 1992 correspondence that, from 1982 to 1991, 13 companies made indemnity payments for Superfund cleanup costs totaling about $156 million. Moreover, the indemnity payments for these 13 companies increased from $305,000 in 1982 to about $55 million in 1991. These payments are exclusive of transaction costs and any property damage and bodily injury claims associated with Superfund sites.

The numbers of pending claims are also increasing for these 16 insurance companies. A recent Rand Corporation study of four property and casualty insurance companies estimated that pending hazardous waste claims averaged approximately 2,200 per insurer in 1989.[3] In a February 1991 report, we stated that 13 of the top 20 property and casualty insurers reported that they had about 50,000 pending claims and about 2,000 pending lawsuits over pollution claims.[4] Asbestos, hazardous waste, and Superfund claims are subsets of these pollution claims.

The senior vice president of one of the largest property and casualty insurance companies testified before the Congress in 1990 that "if a majority of courts were to decide that waste cleanup costs are covered by CGL [Comprehensive General Liability] policies, the resulting exposure

[2]Milton Russell, et al., Hazardous Waste Remediation: The Task Ahead, University of Tennessee, Waste Management Research and Education Institute (Dec. 1991).

[3]J. Acton and L. Dixon, Superfund and Transaction Costs: The Experiences of Insurers and Very Large Industrial Firms, Rand Corporation (1992).

[4]Hazardous Waste: Pollution Claims Experience of Property/Casualty Insurers (GAO/RCED-91-59, Feb. 5, 1991). Our report Hazardous Waste: Issues Surrounding Insurance Availability (GAO/RCED-88-2, Oct. 16, 1987) revealed that 50 insurers had nearly 11,900 pending pollution claims.

would almost certainly bankrupt every major liability insurance carrier in this country, and many of their foreign reinsurers as well."

In September 1990, another insurance company executive (representing 1 of the 16 property and casualty insurers covered in our review) testified before the Congress that insurers "face considerable potential liability for hazardous waste cleanup costs" and "insurers have refused to pay [such hazardous waste] claims, resulting in extensive and ongoing litigation." This litigation has involved both the question of whether the insurance contract covers any pollution claims and the question of whether the insurer is obligated to defend its insured in an action brought against the policyholder for pollution damages.

In a 1991 court brief on behalf of a third large property and casualty insurer, the insurer's counsel maintained "that in light of [the] massive increase in liability arising under new environmental legislation, transferring the burden to [this company] would work a grave injustice and threaten the economic viability of the insurance industry."

Environmental Liabilities Were Not Often Disclosed

Of the top 20 property and casualty insurance companies, 16 are publicly held and are therefore required to file annual disclosure reports with SEC. In the fiscal year 1990 and 1991 public disclosure reports, few of the 16 property and casualty companies separately disclosed their paid claims or estimated liability for unpaid claims and expenses related to environmental events (e.g., involving Superfund, asbestos, toxic or hazardous waste); none separately disclosed Superfund losses. Three of the 16 companies disclosed in annual reports that they expected their future results to be adversely affected by losses and litigation expenses for reported and unreported environmental pollution claims; they did not disclose an estimate of these potential liabilities.

After SEC specifically requested supplementary information, some companies disclosed paid claims costs and expenses and reserves for unpaid environmental pollution and/or asbestos claims and expenses but did not indicate that these were material. We did not assess whether these or other undisclosed liabilities were material to any company's financial condition or business operations because we do not have access to essential company data used by accountants, attorneys, and auditors to make such a determination.

Environmental Costs in Paid and Unpaid Claims Were Not Separately Disclosed

In December 1989, SEC issued guidance to the property and casualty industry that applies to general business disclosures and reserving practices. This guidance applies to, but does not specifically address, the disclosure of environmental liabilities by property and casualty companies. Officials from SEC's Division of Corporation Finance, who are responsible for reviewing insurance companies' public disclosure reports, told us that they use a comment process to ensure that general guidance is applied appropriately to specific circumstances, such as environmental liabilities.

Our review of fiscal year 1990 reports showed that 2 of the 16 companies separately disclosed costs associated with environmental liability in their original disclosure reports filed with SEC. The remaining property and casualty companies did not separately disclose their environmental liabilities in unpaid claims and expenses in the financial statements or in the MD&A section of their original reports. In reviewing the fiscal year 1990 reports, SEC formally commented on 5 of the 16 property and casualty company reports that addressed the need for additional environmental disclosure.[5] These five companies subsequently disclosed their paid claims and reserves for unpaid environmental and/or asbestos claims. None of the companies disclosed costs they identified as material.

Our review of the fiscal year 1991 reports showed that 3 of the 16 companies separately disclosed costs associated with environmental liability in their original disclosure reports filed with SEC. In its comments on five fiscal year 1991 property and casualty company annual reports, SEC specifically asked that companies disclose adverse claims experience and asked whether the change in their level of reserves was related to asbestos or environmental claims, litigation costs, or the number of claims filed. The five companies subsequently disclosed their increases in reserves to cover asbestos and toxic waste claims costs and litigation expenses for 1989 to 1991. Two of these companies were among the property and casualty companies that separately disclosed environmental losses in their fiscal year 1990 reports but did not identify these as material.

In fiscal year 1991, in response to SEC requests, two companies disclosed the number of pending asbestos and toxic waste claims and associated litigation costs. One company disclosed that it had approximately 5,000 pending claims at year-end 1991 and that the corresponding loss reserves for claim adjustment expenses amounted to $125 million. The other

[5]Included in the five companies are two that originally disclosed costs associated with their environmental liability.

company disclosed 24,900 pending asbestos claims and 7,300 pending environmental claims; corresponding litigation costs amounted to $31 million and $21 million, respectively.

Five companies disclosed in 1991 that they could not estimate IBNR environmental claims costs or litigation expenses and therefore did not record reserves for these potential losses. These insurance companies disclosed that they did not accrue for their potential environmental liabilities because uncertainties prevented the companies from estimating these liabilities.[6] SEC asked two of these five companies to disclose an estimated range of reasonably possible loss for unreported claims. SEC said that if asbestos manufacturers and industrial companies can estimate their exposure to environmental liabilities, then it is reasonable that these companies should be able to determine a range of loss related to IBNR claims. In response to SEC's comments, these two companies stated that their insurance contracts were never intended to cover pollution cleanup costs and that they could not estimate any potential liability.

Potential Environmental Costs in Pending Litigation Were Not Disclosed

A majority of unpaid environmental claims are in litigation. If a company determines that the outcome of this pending litigation will have a material effect on a company's operation, SEC requires that the company's involvement in litigation be disclosed. Five property and casualty companies in 1990 and eight in 1991 acknowledged their involvement in litigation over environmental claims in their annual reports, but none disclosed the potential claims costs associated with this litigation. One of the five in 1990 and a ninth company in 1991 disclosed dollar amounts for settlement agreements associated with one asbestos case.

None of the 16 companies disclosed financial data that reflected their liability associated with pending legal proceedings in their fiscal year 1990 disclosures. One company did disclose its liability for a $142 million asbestos-related settlement. Four other companies disclosed their involvement in lawsuits over asbestos and/or environmental claims, some for substantial amounts. Most reports noted that, in management's opinion, the final outcome of litigation would not materially affect the consolidated financial position of the company.

In the 16 companies' fiscal year 1991 disclosure reports that we reviewed, 8 companies disclosed their involvement in litigation over environmental,

[6]Companies disclosed that these uncertainties concerned evolving judicial interpretations of, and inconsistent conclusions about, legal liability for environmental cleanup.

asbestos, and/or toxic pollution claims but did not disclose the potential costs in their annual reports to SEC. One additional company disclosed the average dollar amounts in settlement agreements associated with one asbestos case. In particular, two of these companies disclosed their involvement in extensive Superfund litigation without disclosing the associated claims costs because they said they could not estimate these costs.

In commenting on the fiscal year 1991 disclosure reports, SEC specifically asked two of the nine companies to disclose the potential or actual outcome of specific asbestos and Superfund litigation and the associated legal expenses. In the asbestos case (in which the company first reported the average amounts of some claim settlements), SEC asked why the insurance company could not report the financial impact on its subsidiary of the court decision over a large asbestos claim because the policyholder had reported in its disclosure report what it expected to recover from this insurance company. The insurance company, in turn, said that (1) the judgment in favor of the manufacturer did not specify a dollar amount of obligation, (2) the decision was under appeal, and (3) the insurance company did not have access to information that would provide a basis for assessing the legitimacy of the manufacturer's expected recovery.

In the Superfund case, the property and casualty insurer disclosed potential cleanup costs ranging from approximately $15 million to $60 million that its subsidiary might have to incur but disclosed that the ultimate outcome of litigation over these costs would not have a material adverse effect upon the insurer's subsidiary. SEC commented on this company's disclosure, saying that "it appears the estimated cost of remedial action would be material to the results of operations" to both the insurance company and its subsidiary and that "a liability should be accrued . . . unless it is not probable that a loss will be incurred."

At present, no one claim in litigation may be material to any one company. The SEC regulation requiring that material legal proceedings be disclosed applies to one claim or set of related claims for damages that exceed 10 percent of a company's assets. A set of related environmental claims would be those claims associated with the same physical property or site and/or the same pollution event. However, the ultimate cleanup costs associated with thousands of pollution claims, coupled with the costs to litigate the coverage issues, could be significant to individual insurance companies as well as to the property and casualty insurance industry as a whole.

Conclusions

Some property and casualty insurance companies are contending that their ultimate liability in environmental cleanup costs, and especially Superfund-related costs and expenses, could threaten the financial health of their industry. At the same time, the top insurance companies have rarely disclosed the amount of this exposure in environmental claims and expenses in their annual reports to SEC. In some cases, they have disclosed costs and expenses that they did not indicate were material.

Incurred environmental claims costs and expenses may not yet be material to property and casualty insurance companies; however, the potential exists for these costs to grow quickly. These potential environmental liabilities are not only in pending claims and lawsuits but also in IBNR losses. Furthermore, a company's total litigation expenses for environmental claims, as the companies themselves have noted, could be as significant as the ultimate cleanup costs.

We recognize the uncertainties involved in determining a company's ultimate exposure to environmental liabilities and in determining whether these losses will be material in the future. We believe, nonetheless, that investors should have information about a company's environmental liabilities whether or not these liabilities currently meet a company's criteria for materiality. The magnitude of the insurance industry's potential exposure to environmental claims and litigation expenses that insurers could incur warrants that, at a minimum, these potential liabilities be discussed in public disclosure reports.

Recommendations

We recommend that the Chairman of SEC revise the agency's guidance to specifically address insurance companies' disclosure of environmental liabilities. This guidance should specify that, at a minimum, insurance companies routinely disclose in their annual reports (1) the number and type of reported environmental claims and (2) an estimated range or minimum amount of associated claims costs and expenses.

Agency Comments

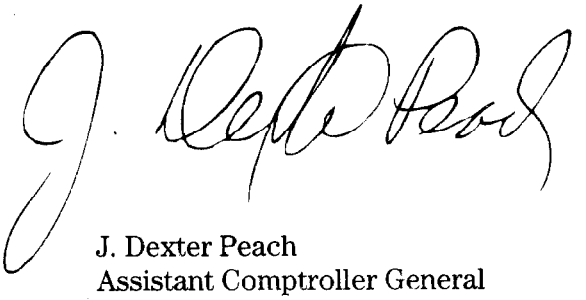
We discussed the facts and the observations contained in this report with SEC officials from the Division of Corporation Finance, who generally agreed with the presentation, and incorporated their comments where appropriate. However, as requested, we did not obtain written SEC comments on a draft of this report.

Scope and Methodology

We conducted our review between January 1992 and March 1993 in accordance with generally accepted government auditing standards. We reviewed the fiscal year 1990 and 1991 annual disclosure reports (known as 10-K reports) that 16 of the top 20 property and casualty insurers filed with SEC.[7] The 16 property and casualty insurance companies comprise about 59 percent of the general liability market. One of the 16 insurance companies was sold to a foreign company during 1991, and the insurance company did not report results for fiscal year 1991. We also reviewed formal SEC comments on these public disclosure reports and company responses to these comments. We interviewed SEC officials, including those directly responsible for reviewing these insurance company disclosure reports. We also reviewed relevant securities laws, regulations, and guidance applicable to insurance companies' public disclosure of environmental liabilities. We discussed these disclosure requirements and reports with selected insurance industry officials. We also met with EPA and trade association representatives to discuss Superfund-related issues.

As arranged with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies of this report to the Chairman, Securities and Exchange Commission; the Director, Office of Management and Budget; and insurance industry officials. We will make copies available to others upon request.

This work was performed under the direction of Richard L. Hembra, Director, Environmental Protection Issues, who may be reached at (202) 512-6111, if you or your staff have any questions. Major contributors to this report are listed in appendix I.



J. Dexter Peach
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[7]We did not review insurance company reports filed with the states.

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