Memorandum of Law
Amazon Watch Request For Investigation of Chevron Corporation
January 30, 2006

The purpose of this memorandum is to briefly articulate the legal basis for our assessment that the highly concerning facts of the Ecuador environmental litigation must be considered "material" according to the legal understanding of the term as discussed in SEC guidance and by the Supreme Court, and thus raise disclosure obligations under SEC regulations with which it appears Chevron is not in compliance.

The Ecuadorian Environmental Litigation

In May of 2003, Ecuadorian plaintiffs representing 30,000 aggrieved rainforest inhabitants filed a lawsuit against Chevron in the Corte Superior de Justicia in Nueva Loja, Ecuador.[1] The plaintiffs allege, and Chevron has admitted, that from 1970-1992 Texaco (acquired by Chevron in 2001) dumped 18.5 billion gallons of crude oil and toxic "formation water" (a byproduct loaded with hydrocarbons and heavy metals) into unlined pits in the rainforest that were known to -- and did -- drain into the surrounding streams and rivers relied upon by plaintiffs for bathing and drinking water. They allege that the company did so intentionally, in order to save costs by not re-injecting the formation water into used wells or other safe subsurface formations, as was legally required of the industry in most U.S. states and other countries for decades. In any event, the environmental situation in "Block 13", where the company operated, is widely considered among the worst on the planet. According to one oil remediation expert, remediation would cost at least $6 billion. This assessment is enclosed.

Chevron contests plaintiffs' contamination figures and also claims that any oil-related contamination is not harmful to human health and thus no remediation is necessary. In the alternative, the company argues that even if remediation is necessary, it is not responsible for any portion of the costs because of a legal release from liability that it received from the Ecuadorian government in 1998 after conducting a $40 million remediation of selected sites. The plaintiffs have responded by noting that the contamination is in flagrant violation of Ecuadorian law, as well as international norms, and must be cleaned up. Plaintiffs also argue that the government only released Chevron from liability flowing from the government; thus the agreement has no effect on an action by private plaintiffs.

Additionally, it has come to light that both Chevron's remediation and the release it obtained are now being investigated by the Ecuadorian government as potentially fraudulent, and scientific results of the site inspections conducted by the Nueva Loja court increasingly support these contentions. These investigations could eventually lead to increased liability -- perhaps criminal liability -- for the company and its executives and legal representatives.

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[1] In 2002 the Second Circuit Court of Appeals affirmed the dismissal of a similar suit by the same plaintiffs brought in the Southern District of New York, on the theory that the case could be more conveniently tried in the adequate alternative forum of the courts of Ecuador. *Aguinda v. Texaco*, 303 F.3d 470 (2d Cir. 2002). The district court had conditioned the dismissal on the defendant's agreement to submit to the jurisdiction of Ecuadorian courts and to waive objections to the use of existing discovery information obtained in U.S. court. *Id.* at 478-79. The appellate court further ordered the district court to condition dismissal on defendant's agreement to waive objections based on a statute of limitations. *Id.* The U.S. courts are prepared to re-hear the case should the defendant rescind any of its waivers, and stand ready to hear any action to enforce a judgment rendered in the adequate and more convenient forum of Ecuador.

Finally, Chevron has attempted to drag the state of Ecuador into the case by filing a claim with the American Arbitration Association seeking a declaration that the state is liable to pay the full amount of any judgment entered against Chevron. The tactic has resulted in a severe backlash of public hostility and negative publicity in both Ecuador and the United States.

The litigation is considered by many legal commentators to be historic -- the first time a class of "third-world" plaintiffs have successfully obtained jurisdiction over and brought to trial a major international oil company on environmental grounds. As such, the case has generated significant publicity in leading media outlets in the U.S., Latin America, and Europe, including in-depth profiles by *The New York Times*, *The Independent*, *The Financial Times*, and others. The case is followed as closely as possible (given the company's lack of disclosure) by the environmental community and the socially responsible investment community. Representatives of several major investments funds, including CALPERS and the New York State Common Retirement Fund, have issued statements and voted in support of shareholder resolutions questioning Chevron's policies with regard to the Ecuador litigation. (See www.chevrontoxico.com for news on the shareholder activity and news reports on Chevron and Ecuador.)

These facts make it abundantly clear that Chevron is embroiled in an unprecedented, highly complex, and extremely high-stakes legal contest against a determined class of plaintiffs and the Ecuadorian state. The potential liability is huge, and given the scientific results emerging from the trial, it is simply not credible for the company to assert that there is no risk of an adverse judgment. The risk of such a judgment, combined with the effects of negative international publicity on the company's reputation and competitive position, both at present and in the event of an adverse judgment, together pose a material threat to Chevron's financial condition. Yet as detailed below, the company has not disclosed one word about this matter to the SEC.

Chevron's SEC Reporting Since Acquiring Texaco

In its SEC filings in the four years since Chevron acquired the potential Ecuadorian liability as part of its 2001 merger with Texaco, the company has not once made reference to the unprecedented legal battle it has been waging in Ecuador. Chevron has not properly disclosed this pending litigation in its SEC filings, nor has it accrued it as a loss contingency to income in the financial statements. Instead, Chevron uses boilerplate language to address this issue rather than comply with its environmental disclosure obligations. Text emblematic of this tendency is found in Chevron's 2004 10-K and is repeated nearly verbatim in two different sections – the "Litigation and Other Contingencies" subsection of "Management's Discussion & Analysis" (MD&A) and in the "Other Contingencies and Commitments: Environmental" subsection to "Notes to Consolidated Financial Statements":

> The company is subject to loss contingencies pursuant to environmental laws and regulations that in the future may require the company to take action to correct or ameliorate the effects on the environment of prior release of chemical or petroleum substances, including MTBE, by the company or other parties. Such contingencies may exist for various sites, including but not limited to federal Superfund sites and analogous sites under state laws, refineries, oil fields, service stations, terminals, and land development areas, whether operating, closed or divested. These future costs are not fully determinable due to such factors as the unknown magnitude of possible contamination, the unknown timing and extent of the corrective actions that may be required, the

> determination of the company's liability in proportion to other responsible parties, and the extent to which such costs are recoverable from third parties.
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> Although the company has provided for known environmental obligations that are probable and reasonably estimable, the amount of additional future costs may be material to results of operations in the period in which they are recognized. The company does not expect these costs will have a material effect on its consolidated financial position or liquidity. Also, the company does not believe its obligations to make such expenditures have had or will have any significant impact on the company's competitive position relative to other U.S. or international petroleum or chemicals companies."

ChevronTexaco Corporation, Annual Report Pursuant to Section 13 of 15(d) of the Securities and Exchange Act of 1934 (FORM 10-K). This type of general disclosure, which could apply equally well to any industrial company, is inadequate under SEC regulations and guidance. The SEC has developed and increasingly strengthened disclosure requirements for environmental liabilities over the years precisely because it recognizes that such liabilities often represent the most grave threats facing companies like Chevron. These requirements derive from the fact corporations face powerful incentives to resist disclosure. The SEC recognizes that undisclosed environmental liabilities represent a serious threat to shareholder rights and to the public's ability to make sound investment decisions and further that corporate decision-making regarding environmental liabilities is a key issue of corporate governance about which shareholders deserve all material information. Chevron has clearly failed its shareholders in refusing to disclose its staggering potential liability in Ecuador.

It is worth noting that the fact that the Ecuadorian case has been widely publicized in the popular media, as described above, is no excuse for Chevron's lack of disclosure.[2] Shareholders deserve better than to have to rely on a reporter's version of events, when much higher-quality information is known by the company executives hired to represent shareholder interests.

Regulation S-K, Item 103: Legal Proceedings

Item 103 of Regulations S-K requires disclosure of "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."[3] Thus any legal proceeding must be disclosed if it is (1) material, and (2) not "routine" or "incidental." If triggered, disclosure must include "the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought."[4]

The term *material* "has a well-established meaning under the federal securities laws,"[5] rooted in the Supreme Court interpretation in *TSC Industries v. Northway, Inc*.[6], that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as

[2] *See, e.g., Endo v. Albertine*, 863 F.Supp. 708, 720 (N.D. Ill. 1994) (despite articles on defendant's potential liability "in the *New York Times*, *Los Angeles Times*, *Crain's Chicago Business*, and *The National Law Journal* . . . ***a reasonable investor may have required further information***") (emphasis added).
[3] 17 CFR § 229.103.
[4] Id.
[5] Securities Act Release No. 33-8185, 68 Fed. Reg. 6296, 6303 (Feb. 6, 2003) (codified at 17 C.F.R. § 205).
[6] 426 U.S. 438 (1976).

having significantly altered the 'total mix' of information made available."[7] The SEC has similarly stated: "The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."[8]

Instruction 2 to Item 103 contains further guidance suggesting that information need not be provided "if the amount involved, exclusive of interest and costs, does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis."[9] However the instruction itself is qualified in some respects[10], and more importantly, in its subsequent discussions of "materiality" the SEC has expressly rejected the use of "quantitative thresholds as 'rules of thumb'" for measuring the materiality of factual misstatements.[11] Rather, the "total mix . . . also includes the factual context in which the user of financial statements would view the financial statement item."[12]

In addition to the billions of dollars in liability at stake in this case, there are many other aspects of the litigation that threaten Chevron's financial health and competitive position and render the litigation highly "material." Along with the other major oil companies, Chevron has invested heavily in improving its reputation for environmental sensitivity and social responsibility.[13] The company produces regular "Corporate Responsibility Reports," sponsors a major "Conservation Awards" program[14], is currently spending millions of dollars on a marketing campaign called “Will You Join Us,” and has gone to great lengths to articulate the environmental and ethical principles behind "The Chevron Way."[15] As the company states in the "Social Responsibility" section of its website,

> In today's competitive business environment, [corporate responsibility] it has also taken on an increasingly strategic role, helping us manage and create value for our company. We recognize that our long-term success depends on our ability to gain access to new resources [and] remain a welcome neighbor in the countries and communities in which we work.[16]

Chevron’s efforts over the last several years to improve its image and garner these strategic advantages -- in particular its ability to maintain relationships with developing countries in Latin America and African countries, which relationships Chevron's CEO himself has emphasized will be particularly important in the years ahead[17] -- have been seriously undermined by the ongoing litigation in Ecuador, and would be all but shattered by a major judgment against the company.

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[7] *Id.* at 449.
[8] 64 Fed. Reg. 45451 (SEC Release No. SAB 99) (Aug. 12, 1999).
[9] 17 CFR § 229.103, Instruction 2.
[10] Id. ("However, if any proceeding presents in large degree the same legal and factual issues as other proceedings pending or known to be contemplated, the amount involved in such other proceedings shall be included in computing such percentage.")
[11] Staff Accounting Bulletin No. 99.
[12] Id.
[13] *See* http://www.chevron.com/social_responsibility/
[14] *See* http://www.chevron.com/social_responsibility/community/programs_conservation.asp
[15] *See* http://www.chevron.com/about/chevtex_way/
[16] *See* http://www.chevron.com/social_responsibility/
[17] *See, e.g.*, "Chevron Chief Believes The Surplus Is Over," International Petroleum Finance, Mar. 9, 2005, *available at* http://www.wbcsd.org/includes/getTarget.asp?type=DocDet&id=13542.

It is simply untenable for Chevron to insist that this multi-billion dollar litigation, with its tremendous implications for the company's reputation and its relations with countries in Latin America and around the world, would not significantly alter the "total mix" of information considered by a reasonable investor, or have an influence on the "judgment of a reasonable person," such that it need not be disclosed to the SEC and shareholders under the expectations laid out in Item 103.

The meanings of the terms *routine* and *incidental* have received less attention from the SEC and the courts, but it is clear that these terms simply do not apply to the Ecuadorian litigation. As discussed above, this case is widely considered by international and Ecuadorian legal experts to be truly unprecedented. Ecuador's political environment is considered unpredictable, especially on the highly contentious issues of natural resource management and national sovereignty, both of which are implicated by this case. Ecuador's legal system is sophisticated, but it is widely admitted the system has never handled an environmental case of this complexity and magnitude. Indeed, an environmental case with stakes in the billions of dollars would be rare anywhere in the world, and certainly cannot be considered "routine" or "incidental."

Regulation S-K, Item 103: Conflict of Interest

An additional concern we have with Chevron's disclosure (or lack thereof) under Item 103 arises from the fact that the in-house attorney responsible for managing the Ecuadorian litigation for Chevron has a clear conflict of interest. This person, Ricardo Reis Vega, represented Texaco during the negotiation of a remediation process for environmental damage in the mid-1990s, and he negotiated the legal release that Chevron now uses as its primary defense at trial. As mentioned, all of these agreements and processes are now under investigation by Ecuadorian authorities as being potentially fraudulent. The Ecuadorian investigation is in part fueled by incriminating information flowing from the litigation -- in particular from the damning scientific evidence being produced by the ongoing judicial site inspections of the sites that Mr. Reis Veiga had claimed were properly remediated. Thus Mr. Veiga is directing a litigation that threatens to produce results rendering him personally liable under Ecuadorian criminal law. Moreover, the legitimacy of the release and the remediation are key factual issues in the plaintiff litigation, making Mr. Vega an essential fact witness in his own trial.

The presence of these conflicts certainly makes Mr. Veiga's presence in the case ethically questionable, but more importantly they suggest that ultimately his interests may be at odds with shareholders. This triggers a further duty by the company to disclose the Ecuadorian litigation under the guidance of Item 103, Instruction 4 of which requires the registrant to disclose "any material proceedings to which any … affiliate of the registrant … has a material interest adverse to the registrant or any of its subsidiaries."[18]

Regulation S-K, Item 303: Management's Discussion and Analysis (MD&A) of Financial Condition and Results of Operations

According to SEC guidance, the purpose of the MD&A is primarily forward-looking and should give the investor "an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business."[19] Item 303 of Regulations S-K, which delineates the requirements for the MD&A, instructs companies to discuss any "known

[18] 17 CFR § 229.103, Instruction 4.
[19] SAR 33-6835

trends or uncertainties…reasonably expect[ed] [to] have a material . . . unfavorable impact on net sales or revenues or income from continuing operations,"[20] and "that would cause reported financial information not to be necessarily indicative of future operating results or future financial condition."[21]

In 1989 the SEC issued Securities Act Release (SAR) 33-6835 to address the concern that companies' narrative descriptions in MD&As were not adequately disclosing environmental liabilities. SAR 33-6835 clarifies that companies must disclose when a "known trend, demand, commitment, event or uncertainty" is reasonably likely to occur *and* reasonably likely to have "a material effect on the registrant's financial condition or results of operations."[22] Moreover, the MD&A should include "a discussion of all the material impacts upon the registrant's financial condition or results of operations, including those arising from disclosure provided elsewhere in the filing."[23]

Under this rule, Chevron must disclose the pending Ecuadorian litigation in its MD&A, unless the company can show a judicial decision against its interests is not reasonably likely or that an unfavorable judgment is not reasonably likely to have a material effect on the company. As emerging scientific test results from the plaintiffs *and* the defendant overwhelming favor the plaintiffs, it becomes increasingly untenable to argue that an unfavorable judgment is not reasonably likely.[24] Similarly, it is unreasonable to believe that this multi-billion dollar litigation, with such tremendous implications for the company's worldwide reputation and access to markets, will not have a material effect on the company's operations and financial condition. Even twenty years ago, when environmental disclosure requirements were less stringent, the SEC required detailed disclosure in similar cases.[25]

SFAS No. 5, FIN No. 14, SAB No. 92, SOP 96-1: Reporting Contingent Liabilities in Financial Statements

Finally, we believe Chevron is in violation of the financial accounting and reporting standards of the Financial Accounting Standards Board (FASB) for recognition and disclosure of contingent

[20] 17 CFR § 229.303.
[21] 17 CFR § 229.303, Instruction 3.
[22] SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures [Release Nos. 33-6835; 34-26831; IC-16961; FR-36] 54 Fed. Reg. 22427; 22430 (1989).
[23] SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures [Release Nos. 33-6835; 34-26831; IC-16961; FR-36] 54 Fed. Reg. 22427; 22430 (1989).
[24] All 18 sites inspected by the Ecuadorian court, 15 of which should have been remediated by Chevron, show levels of toxins in violation of Ecuadorian law according to defense and/or plantiff studies.
[25] In *In re Occidental Petroleum Corporation*, the SEC found Occidental Petroleum's cursory treatment of its significant exposure due to improper discharge of wastes at Love Canal and Niagara Falls to be inadequate. In the Matter of Occidental Petroleum Corporation, Admin. Proc. File No. 3-5936, Release No. 16950, July 2, 1980. The SEC found that Occidental's potential liabilities, which figured in excess of hundreds of millions of dollars as a result of pending lawsuits, was material, and that general statements in Occidental filings that the company might incur future material liabilities were insufficient disclosure. Twenty years later, Chevron is treating the Ecuadorian litigation as Occidental treated Love Canal, merely noting in the MD&A section of its 2004 Annual Report that the company may be subject to loss contingencies and additional liabilities but these are not determinable and will not have a material adverse effect on the company's financial position, liquidity, or competitive position relative to other petroleum companies.

liabilities. FASB's Statement of Financial Accounting Standards (SFAS) No. 5 "Accounting for Contingencies" sets forth the basic requirements for reporting environmental liabilities. Paragraph 1 of SFAS No. 5 defines a loss contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible [loss] to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."[26]

An estimated loss from a loss contingency must be accrued to income in the financial statements if two conditions are met: 1) information available prior to issuance of the financial statements indicates it is probable that an asset had been impaired or a liability incurred at the date of the financial statements, and 2) the amount of loss can be reasonably estimated.[27]

Recent authoritative guidelines issued by the American Institute of Certified Public Accountants (AICPA) state that if litigation for environmental remediation has commenced, and a company's nexus to the contaminated site has been established,[28] it should be presumed, except in the rarest of cases, that the outcome of the litigation will be unfavorable, thereby satisfying the first condition for accrual.[29]

In determining whether an amount of loss can be reasonably estimated, SEC guidance states that recognition of a contingent liability cannot be delayed until only a single amount can be reasonably estimated. Rather, if management is able to determine that the amount of liability is likely to fall within a range but no amount within that range can be determined to be the better estimate, the company should recognize the minimum amount. Recognition of a loss equal to the lower limit of the range is necessary even if the upper limit is uncertain.[30] Uncertainties regarding the company's share of an environmental remediation liability should also not preclude the company from recognizing an estimate.[31] If accrual *is* required, disclosure of the nature of such accrual, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.[32]

Even when accrual is not appropriate, because one or both of the two conditions is not met, companies must provide footnote disclosure in the financial statements if there is at least a *reasonable possibility* that a loss may have been incurred.[33] Additionally, companies must provide disclosure in the footnotes of financial statements if exposure to loss exists in excess of an amount accrued and there is at least a reasonable possibility that the additional loss may have been incurred.[34] Disclosures in both cases 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.[35]

[26] Statement of Financial Accounting Standards (SFAS) No. 5 "Accounting for Contingencies" March 1975, Paragraph 1.
[27] SFAS No. 5, Paragraph 8.
[28] A nexus is established when the company is the current or previous owner or operator of the site, or if it arranged for the disposal of hazardous substances or transported hazardous substances to the site. American Institute of Certified Public Accounts Statement of Position SOP 96-1, Paragraph .109.
[29] American Institute of Certified Public Accounts Statement of Position SOP 96-1, Paragraph .109.
[30] Staff Accounting Bulletin No. 92, 17 CFR §211, Interpretive Response to Question 3.
[31] American Institute of Certified Public Accounts Statement of Position SOP 96-1, Paragraph .116.
[32] SFAS No. 5, Paragraph 9.
[33] SFAS No. 5, Paragraph 10.
[34] SFAS No. 5, Paragraphs 10 and 39.
[35] SFAS No. 5, Paragraph 10.

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As noted, since acquiring the potential Ecuadorian liability as part of its 2001 merger with Texaco, Chevron has not once made specific reference to this unprecedented litigation in its SEC filings. Chevron has not recorded this potential liability in its income statements despite AICPA's guidance anticipating an unfavorable outcome determination in nearly all pending environmental remediation litigation with a clear nexus. Chevron does not contest its nexus with the site but simply argues that the contamination has not had a negative impact on people's health, and alternatively, that it is not responsible for the site since it signed a liability release agreement with the Ecuadorian government. Moreover, although determining a precise estimate early in litigation is difficult, independent studies have already specified a minimum estimate as to how much remediation will cost, so it would be disingenuous for Chevron to argue that it cannot establish a minimal estimate.

However, even had Chevron determined accrual to be inappropriate, the company should have provided footnote disclosure since, as previously outlined, it is simply not credible to argue that there is no reasonable possibility a loss may have been incurred. Nevertheless, in four years of SEC filings, Chevron has consistently failed to provide any disclosure regarding the Ecuadorian litigation in the footnotes to the financials.