Environmental Disclosure Due Diligence:

The Next Step in Environmental Due Diligence

By C. Gregory Rogers

Key stakeholders who rely on corporate financial statements, such as investor organizations and researchers, have long maintained that the financial reporting requirements allow too much flexibility and are too narrow in scope to capture important environmental information. Because most of this "flexibility" involves matters of legal judgment, lawyers are not disinterested bystanders. "Don't ask, don't tell" is a legal strategy well known to lawyers that deal with environmental remediation liabilities.

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But now several new and forthcoming accounting pronouncements from the Financial Accounting Standards Board (FASB) are changing the way many types of environmental matters are reported in corporate financial statements. These changes in generally accepted accounting principles (GAAP) are drawing attention from the Securities and Exchange Commission (SEC) and causing independent financial auditors to scrutinize environmental financial reporting like never before.

Reporting companies are feeling the pain. Prior to 2006, two U.S. public corporations had reported restatements for environmental matters. In 2006, seven U.S. public corporations restated their balance sheets to properly account for environmental liabilities. Many more companies delayed their 10-K filings. And conditions will get worse before they get better. CFO.com recently reported that environmental financial reporting is among eight relatively unknown areas of risk that will be felt in 2007. These developments will affect environmental due diligence and the role of the deal lawyer.

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Environmental *disclosure* due diligence (ED3) is a process for identifying and responding to risks associated with environmental financial reporting in the course of pre-merger and acquisition (M&A) due diligence. ED3 is different from traditional environmental due diligence. Whereas traditional environmental due diligence is intended to address the financial impacts from *environmental risk*, ED3 is intended to address the financial impacts from *financial reporting risk*. Financial reporting risks are the risks associated with misstatements in corporate financial statements arising from unrecognized, misclassified or improperly valued environmental liabilities and impairments.

ED3 does not replace the need for traditional environmental due diligence. Rather, ED3 completes it. Nor is ED3 warranted in every transaction or even most transactions. Yet, in some transactions, it could be the single most important component of due diligence.

This article summarizes what lawyers involved in M&A due diligence need to know about ED3.

Financial Reporting Risk Is Different from Environmental Risk

Financial reporting risk is fundamentally different from environmental risk. Until the lawyer grasps the difference between financial reporting risk and environmental risk, he or she cannot appreciate the difference it makes.

Greater consequences—Restatement of the seller's financial statements to reflect unrecognized, misclassified or improperly valued environmental liabilities and impairments can have adverse consequences on the buyer that far exceed the financial consequences of the underlying environmental risk. For example:

- Fixing a seller's inadequate environmental financial reporting processes and controls will add cost and time to the buyer's post-closing integration efforts.
- In transactions involving public companies, prior misstatements made by the seller can result in an SEC investigation of the buyer following the sale.
- Misstatement of environmental liabilities or misleading representation about a company's environmental due diligence practices, if made public, can undermine a company's reputation for corporate social responsibility and possibly give rise to shareholder litigation.
- Late SEC filings or restatement of the seller's financial statements may give the seller's lenders grounds to call in outstanding loans.
- Restatement of the seller's financial statements may be grounds for rescission of the seller's preexisting D&O insurance policies.
- Deterioration in reported asset values and debt-to-asset ratios may be grounds for lenders to withdraw financing in the eleventh hour of the transaction or following closing.
- In the most extreme cases, failure to perform a full preclosing accounting of all environmental liabilities and impairments that would have shown the seller to be technically insolvent (liabilities in excess of assets) (or on the verge of insolvency) could expose the buyer to post-acquisition fraudulent conveyance claims.

Shorter time horizons—Sophisticated parties understand that environmental risks often have distant time horizons, especially in an era of declining regulatory enforcement. The financial impact of these risks may not be realized for decades. By that time, the assets and operations may have been repackaged and sold several times subject to a series of successive indemnity agreements, each attempting to protect the parties from environmental conditions arising on "someone else's watch." Although environmental risks may not adversely affect cash flow within a relevant time period, buyers nonetheless should be aware of potential financial reporting risk.

Whereas the financial impacts of environmental risk are generally long term in nature, the adverse impacts of financial reporting risk can materialize even before the transaction is closed (e.g., busted deal financing) or soon thereafter. The timing of financial reporting risk operates independently of financial impacts of environmental risk.

Higher probability—The probability that an actual loss will result from a contingent environmental risk is often remote or only reasonably possible. Incurrence of a loss may be conditional on a variety of future events that may or may not occur. For example:

- It may be possible to use and sell

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the property without undertaking an investigation that might trigger regulatory reporting and remediation requirements by, for example, using "no look" provisions in purchase agreements that prohibit future buyers from conducting subsurface investigation either before or after the sale.

- Discovery of the underlying environmental condition by government regulators or adverse parties may never occur if actions that might trigger reporting requirements are carefully avoided.
- Future investigation of uncharacterized pollution conditions may show these conditions in fact do not represent a material risk of loss.
- Legal action against the buyer may never be initiated, and, if it is, the buyer may have valid legal defenses.
- Settlement of the obligation may be deferred for a long period of time, thus reducing the net present value of the obligation to an immaterial amount.
- The business might legally organize or restructure in ways that would limit its future expenditures for cleanups by, for example, separating its assets from its liabilities using subsidiaries or special-purpose entities.

By contrast, the adverse consequences associated with correction of materially misstated financial statements are not contingent on the incurrence of an actual loss from the underlying environmental condition. The restatement itself is the contingency.

All at once instead of one at a time—Individual environmental risks often will be immaterial standing alone. And while the aggregate amount of numerous unrecognized, misclassified or improperly valued environmental liabilities and impairments may be quite large, a company likely would never be required to settle (spend cash to extinguish) all of its environmental obligations at one time. By contrast, the correction of numerous misstatements will have an aggregate effect on the financial statements. Whereas environmental risks tend to materialize one at a time, financial reporting risks tend to materialize all at once.

Lower risk tolerance—Whereas buyers may have a high tolerance for environmental risk, due to the long-term, low probability, and disaggregated nature of such matters, buyers will have a lower tolerance for financial reporting risk that could have an immediate and material adverse effect on the transaction, create operational problems and erode value during ownership, and impede the buyer's exit strategy.

Financial Reporting Risk Is Increasing

Financial reporting risk is increasing due to recent changes and imminent future changes in financial accounting standards in the United States and Europe. These standards are changing the way companies must account for various environmental matters in their financial statements.

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Following is a list of U.S. and international financial accounting standards previously adopted or currently under consideration, and a brief description of their relevance to accounting for environmental matters.

- Statement of Financial Accounting Standards (SFAS) No. 141-R (issuance projected for mid-2007 with an effective date of 2009)—Environmental loss contingencies, including environmental remediation liabilities and pending and incurred but not reported (IBNR) asbestos and toxic tort claims.
- International Accounting Standard No. 37 (revision projected in 2008)—Environmental loss contingencies and asset retirement obligations.
- SFAS No. 157 (2006)—Fair value measurement of environmental assets and liabilities.
- FASB Interpretation No. 47 (2005)—Asset retirement obligations.
- FASB Interpretation No. 45 (2002)—Environmental guarantees and indemnities.
- SFAS No. 144 (2001)—Asset impairments.

Same environmental risks, but different effect on the financial statements—These new financial accounting standards are causing familiar environmental risks to be reported differently in the financial statements. The change in accounting may come in one of three forms:

1. Current recognition of liabilities (or asset impairments) for environmental matters not previously subject to financial reporting.

Example: In its 2005 10-K, Ford Motor Company reported $251 million in asset retirement obligations associated with future abatement of asbestos-containing building materials and PCB equipment. ConocoPhillips reported $417 million in asset retirement obligations for future cleanup at domestic refineries and underground storage tanks at U.S. service stations. Prior to the adoption of an FASB pronouncement in March 2005, these matters had not been considered liabilities under GAAP and were not subject to financial reporting.

2. Reclassification of previously recognized environmental liabilities.

Example: In 2006, Goldspring Inc. was required to restate its financial statements, among other things, to reclassify $453,786 in mine reclamation costs from an asset retirement obligation to an environmental remediation liability.

3. Revaluation of previously recognized environmental liabilities using different measurement techniques.

Example: Buyer's environmental

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consultants estimate the range of environmental remediation costs at one of seller's facilities as follows: known minimum value—$250,000 (annual budgeted costs for operating a pump and treatment system); most likely value—$5 million; worst case—$15 million; and expected present value—$6.5 million. Seller has accrued a reserve of $250,000 and produces an unqualified audit opinion from a Big Four accounting firm. Buyer's accountants review the cost estimates and require the reserve to be increased to $6.5 million.

In general, these new accounting standards will result in more recognized liabilities and higher estimates associated with the same environmental risks.

The closer you look, the more you will find—As sophisticated buyers and financial auditors begin to focus on the application of new financial reporting standards, they are likely to find a variety of errors, and in some cases fraud, in the application of preexisting standards. Here are a few examples from ED3 in practice:

- Estimates of 30-year post-closure care and monitoring obligations that extend only three years because "things might change."
- Alleged inability to reasonably estimate environmental liabilities at contaminated facilities, even though a $3 million price discount was negotiated for environmental remediation when the facilities were acquired just a few years earlier.
- Assertions that environmental remediation liabilities are immaterial even though no attempt has been made to assess and measure them.
- CFOs who say, "We have Phase I's for every property we own so we don't have a reporting requirement." Unfortunately, all of the Phase I's have recognized environmental conditions and many recommend Phase II investigation.
- Environmental remediation managers who say, "Sure I have support for that environmental reserve. Give me 30 minutes so I can put something together."
- Expected value estimates that don't include certain realistic scenarios because "we would be bankrupt if that happened."
- Reliance on a 10-year indemnity granted in 1990 to offset an environmental liability in 2005.

Different accounting for buyers and sellers—A change in accounting standards for business combinations expected to be issued in mid-2007 will require buyers to account for contingent liabilities in a manner different than sellers beginning in 2009. As a result, buyers may be required to recognize additional environmental liabilities and significantly higher estimates compared to the seller's financial statements.

FASB's proposed standard would require contingent environmental liabilities assumed in a business combination to be measured and recognized at their fair values as of the acquisition date, *without regard to the probability of loss*. Most lawyers that work with environmental matters are familiar with the long-standing rule that a liability for an environmental loss contingency is recognized only if it is "probable" that a liability has been incurred as of the date of the financial statements. Generally, a loss is considered probable only if legal action against the company has been asserted or is otherwise thought to be imminent. Under the proposed new business combination rule, however, a buyer would be required to recognize a liability for the fair value of environmental remediation obligations assumed in the transaction, without regard to the probability of future litigation, claims, or assessments.

"Sure I have support for that environmental reserve. Give me 30 minutes so I can put something together."

For example, consider the following scenario. Buyer is purchasing an operating oil terminal from Seller for $100 million. The purchase agreement includes a 10-year, $30 million indemnity for environmental cleanup costs but prohibits Buyer from conducting subsurface investigation to fully characterize the contamination either before closing or for 10 years after closing. If Buyer undertakes subsurface investigation in violation of the purchase agreement, Seller's indemnity obligation terminates, and Buyer becomes obligated to indemnify Seller without limitation as to time or amount. Buyer's environmental experts estimate that there is a 20 percent chance that the state regulatory agency will initiate enforcement action to compel cleanup during the next 10 years. Based on the limited available information, estimated cleanup costs range from $10 to $50 million. Seller has recorded no liability because regulatory enforcement is not considered probable. Under the proposed new standard, however, Buyer would be required to record a liability for the fair value of the cleanup obligation. That amount would depend on various factors but likely would be upwards of $6 million ($30 million x 0.20). This liability must be displayed separately from the potential right of recovery for the indemnity. The amount would be increased by potential exposures for property damage and bodily injury claims. Moreover, it is not inconceivable that Buyer's financial auditors would require it to (a) perform subsurface investigation in order to reasonably estimate the cleanup liability, thereby reversing the indemnity, and (b) disclose the nature of the "no look" agreement and its relationship to the parties' indemnity obligations.

If FASB's proposed business combination rule is finalized, buyers will no longer be safe to assume that the seller's environmental liabilities can be carried forward "as is" onto its books.

The accountants are getting worried—Changes in accounting standards are

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increasing the risk of independent financial auditing firms. For one thing, auditors can no longer rely on attorneys to ensure that all reportable environmental liabilities are identified in audit inquiry letters. Auditors understand that a 1975 treaty jointly developed by the AICPA and the American Bar Association, "Statement of Policy Regarding Lawyer's Responses to Auditor's Request for Information," instructs lawyers not to provide the auditor with information about unasserted claims unless, and only to the extent that, the client has requested the attorney to comment on specific unasserted claims. To do otherwise could risk waiver of the attorney-client privilege. This means lawyers will not list in their response to audit inquiry letters such things as outstanding environmental indemnities, asset retirement obligations, and potential obligations relating to formerly owned and operated facilities.

As a result, the auditors are taking steps to ensure that environmental matters are properly identified, assessed, measured, and reported. For example, a major accounting firm recently created a new position for a national environmental audit partner to drive consistent audit and risk management practices throughout the firm. As a first step, the firm is adding environmental matters to the list of major risk areas that each audit partner must personally address.

It's the Deal Lawyer's Responsibility to Understand Financial Reporting Risk

Although lawyers are not trained in financial accounting and might not be expected to fully understand the alphabet soup of GAAP, lawyers representing buyers in M&A transactions cannot simply pass responsibility for financial reporting risk to the accountants. First, the buyer's lawyers, and not its accountants, are responsible for environmental due diligence. Lawyers establish the scope of due diligence and advise their clients on the business ramifications of the findings. Second, the work of the accountant follows the work of the lawyer after completion of due diligence. The accountant cannot account for what has not been identified and assessed by the lawyer. If the lawyer has not anticipated the conclusions of the accountants, it is the lawyer, and not the accountant, who will look foolish and unprepared. Finally, financial reporting determinations for environmental matters quite often are based upon matters of legal judgment. If the buyer's lawyer gets it wrong—by missing the issue entirely or making the wrong legal judgment—he or she cannot shift accountability to the accountants.

ED3 is not warranted in all deals.

Know when to look—As previously noted, ED3 is not warranted in all deals or even the majority of deals. Yet, it may be critically important in certain situations. It is therefore incumbent on transactional lawyers to know when ED3 is appropriate and when it is not.

Know what to look for—ED3 involves several types of due diligence activities that are not typically performed in traditional environmental due diligence. These activities may include expanding the scope of traditional due diligence, assessing the seller's financial reporting compliance, reconciling the results of due diligence with the seller's financial records, reviewing the seller's documented accounting polices and procedures, interviewing the seller's employees responsible for establishing environmental reserves, and assessing the operational effectiveness of the seller's internal control over financial reporting of environmental matters.

Become literate in environmental financial reporting—What most deal lawyers know about environmental financial reporting is rapidly becoming obsolete. Lawyers must know more than to simply ask, "Is it probable and reasonably estimable?" Transactional lawyers must develop a basic literacy in environmental financial reporting as it exists today and make a commitment to stay current with future developments. Without this skill, they will be wholly unable to advise their clients on financial reporting risk.

Understand how the financial statements affect the transaction—Armed with an understanding of the financial reporting risks in a transaction, the next responsibility of the buyer's counsel is to develop strategies to address those risks, including

- The impact of changes in the financial statements on corporate valuation, financing, operating costs, future exit strategies and certifications under Sarbanes-Oxley.
- The timing and scope of due diligence.
- Preclosing negotiations and remedies under the purchase agreement.
- Post-closing remedies.
- Seller due diligence.

Whether or not the client chooses to act on its lawyer's advice, the lawyer will have done his or her job by presenting the risk along with viable risk management strategies.

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