SIDLEY AUSTIN LLP

SIDLEY

FEBRUARY 4, 2008

ENVIRONMENTAL UPDATE

The Environmental Practice of Sidley Austin LLP

Our **Environmental Practice** consists of approximately 40 attorneys who concentrate on environmental and natural resources law. Established over 25 years ago, our group is now one of the largest environmental practices in the United States, with extensive experience in all aspects of environmental and natural resources law. The depth and range of our practice and the frequency with which we address cutting-edge issues enable us to advise clients quickly and cost-effectively.

For further information on our Environmental Practice, please contact either:

David T. Buente
202.736.8111
dbuente@sidley.com

Robert M. Olian
312.853.7208
rolian@sidley.com

To receive future copies of the Environmental Update via email, please send your name, company or firm name and email address to Rebecca Duncan at rduncan@sidley.com

This **Sidley Update** has been prepared by Sidley Austin LLP for informational purposes only and does not constitute legal advice. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this without seeking advice from professional advisers.

Attorney Advertising - For purposes of compliance with New York State Bar rules, our headquarters are Sidley Austin LLP, 787 Seventh Avenue, New York, NY 10019, 212.839.5300 and One South Dearborn, Chicago, IL 60603, 312.853.7000. Prior results do not guarantee a similar outcome.

SEC Environmental Reporting — 2007 Developments

SEC environmental reporting was in the news during much of 2007. Most of the attention focused upon global warming and the extent to which companies were or should be addressing climate change risks in their public filings. While the climate change debate continues to rage, however, recent accounting pronouncements made by the Financial Accounting Standards Board (FASB) will have a more immediate effect on the evaluation and accounting treatment of certain traditional types of environmental liabilities. Here are some highlights of changes that are on the way.

Fair Value Measurement Expands

FASB continues to pursue opportunities to harmonize U.S. generally accepted accounting standards (U.S. GAAP) with standards of the International Accounting Standards Board (IASB). This harmonization, or "convergence" as FASB refers to it, has resulted in FASB's continued embrace of fair value measurement practices for certain categories of contingent liabilities that, historically, would have been evaluated under traditional FAS 5 criteria.

In December 2006, FASB issued FAS 157, its "how to" standard for measuring fair value for assets and liabilities. Intended to take effect for fiscal years beginning after December 15, 2007, FASB recently proposed deferring for one year the effective date of FAS 157 for "non-financial" assets and liabilities (which would include most environmental obligations).The deferral was prompted by concerns raised by preparers and others about how to implement the standard for non-financial assets and liabilities. See Proposed FASB Staff Position No. FAS 157-b, issued December 14, 2007.

Fair value, at its simplest, is the price that would be received upon selling an asset, or paid in transferring a liability, in an orderly transaction at the measurement date. There is an underlying presumption that an objective "market price" can be determined based upon other transactions for similar assets or liabilities in a similar market (such as an appraisal method for real estate). However, where the asset or liability does not have a ready market, then fair value is to be based upon the reporting entity's assumptions about how an active market would price such asset or liability, based upon best available information. For contingencies, uncertainties both

FASB increasingly mandates fair value measurement

In recent years, FASB has been mandating fair value measurement for various categories of contingent obligations. For example, FASB's FIN 45 called for fair value measurement and expanded disclosure of contingent guarantees, including contingent indemnification obligations. While not specifically directed at environmental obligations, FIN 45 is broad enough to encompass environmental indemnity obligations. FIN 45 recognition took effect for guarantees issued or modified after December 31, 2002 and disclosure was required for financial statements for periods ending after December 15, 2002.

FASB's first mandate of fair value measurement applied specifically to categories of environmental liabilities came in connection with its adoption of FAS 143. FAS 143 required fair value measurement of asset retirement obligations (ARO's) including, as clarified in FASB's Financial Interpretation 47 (FIN 47), where such obligations were contingent or conditional. Under FAS 143/FIN 47, where there is a present requirement to take an environmental action upon the future retirement of a long-lived asset (such as removing asbestos or making special waste disposal arrangements), even if the obligation is conditional, the "fair value" of that obligation must be recognized (meaning accrued) in the financial statements when the asset is acquired or built, rather than when the decision is made to retire that asset.

as to occurrence and amount are factored in using probabilistic estimation techniques to achieve an expected fair value.

Fair Value Now Extended to Business Combinations

In December 2007, FASB issued a revised Business Combination standard, FAS 141R. Among other changes, FAS 141R requires a buyer of business assets, or a party acquiring a controlling interest in business assets, to recognize and/or disclose the fair value of contingent assets and liabilities acquired or assumed in a business combination. FAS 141R will be effective for transactions closing on or after the buyer's first annual reporting period beginning on or after December 15, 2008.

Under FAS 141R, environmental loss contingencies of an acquisition target that are assumed by the buyer will likely require different accounting treatment once the deal closes. Contingencies identified in a transaction context that were not recognized in the seller's books using FAS 5 criteria may now have to be put on the buyer's books using FAS 141R fair value principles.

In general, FAS 141R requires contingencies that are assumed or acquired through a business combination, including environmental contingencies, to be fair valued as of the acquisition date. However, different criteria apply depending on whether the contingencies stem from contractual or non-contractual obligations.

- Contractual contingencies must be recognized at fair value as of the acquisition date. Examples of environmental "contractual contingencies" might include a pre-existing environmental indemnity agreement entered into by the company being acquired or conditional future funding obligations under a Superfund consent decree.

- Non-contractual contingencies must only be recognized if it is *more likely than not* that, as of the acquisition date, the contingency represents a liability (defined by FASB as a present obligation arising from past events that will require future outflows). However, it is clear that FASB considers the obligation to "stand ready to perform" to be a present obligation. Practical translation: if there is greater than 50% chance of a future liability, then the non-contractual contingency must be accrued at fair value as of the acquisition date. Examples of possible non-contractual environmental contingencies might include waste contributions to a site undergoing cleanup

even if there has been no demand or request for information to date, or known contamination that has been reported to regulatory authorities but for which there has been no present call for action. In each case, however, the buyer must first conclude that it is more likely than not that a liability will result.

Substituting fair value measurement for FAS 5 criteria in evaluating contingent environmental liabilities has two major effects:

- **More contingencies are captured** — FAS 5 requires recognition of a loss contingency only if (1) the loss is "probable," meaning likely to occur and (2) is reasonably estimable. In fair value measurement, existing uncertainty about whether and to what degree the liability will, in fact, materialize, is factored into the amount to be recognized, rather than being a prerequisite to recognizing the liability. The net result is that under fair value, more contingent liabilities must be booked.
- **Expected value replaces low end of the range** — Under FAS 5, where the reasonable estimate is a range and no amount within the range represents a better number, then the liability may be recognized at the lower end of the range. Under fair value, probabilities of various outcomes must be weighed so as to produce an "expected value," meaning a single number. In many cases, expected value may be a higher value than the low end of a range.

Practical Implications

FASB's embrace of fair value measurement for contingencies in transactions will require a more coordinated effort between the environmental professionals conducting diligence and the buyer's financial and accounting advisors. Such coordination will be necessary to ensure that, post-closing, diligence findings are properly accounted for. For environmental professionals, grey areas will remain in applying FAS 141R. For example, the more likely than not criteria is hardly clear cut, particularly with respect to potential remedial obligations that do not have a specific regulatory trigger. But environmental diligence that extends to sampling, and any cost estimates developed out of diligence, may now have a new purpose independent of their use in negotiating contractual provisions and integration planning. Once the deal closes, to the extent such findings and estimates relate to assumed liabilities, then FAS 141 requires a careful review to determine proper post-closing accounting of such liabilities.

For more information on the topic of this update, please contact:

Maureen Crough
212.839.7323
mcrough@sidley.com

Laura Leonard
312.853.7620
lleonard@sidley.com

Judith Praitis
213.896.6637
jpraitis@sidley.com

David Buente
202.736.8111
dbuente@sidley.com

Sam Boxerman
202.736.8547
sboxerman@sidley.com

Sidley Austin LLP, a Delaware limited liability partnership which operates at the firm's offices other than Chicago, London, Hong Kong, and Sydney, is affiliated with other partnerships, including Sidley Austin LLP, an Illinois limited liability partnership (Chicago); Sidley Austin LLP, a separate Delaware limited liability partnership (London); Sidley Austin, a New York general partnership (Hong Kong); Sidley Austin, a Delaware general partnership of registered foreign lawyers restricted to practicing foreign law (Sydney); and Sidley Austin Nishikawa Foreign Law Joint Enterprise (Tokyo). The affiliated partnerships are referred to herein collectively as Sidley Austin, Sidley, or the firm.