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Legal Update: *Have You Crossed the FIN-ish Line? FIN 47 – Big or Small Company, this Interpretation Applies to YOU.*

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Financial Accounting Standards Board (FASB) Interpretation No. 47 (FIN 47) took effect December 2005. This interpretation forces public companies to recognize *contingent* (that is, not known or fixed) compliance, cleanup or disposal costs associated with facilities or equipment being taken out of service, sold, mothballed or being retired. The rule change is

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part of a broader regulatory trend toward requiring greater disclosure of environmental liabilities. When FIN 47 is viewed in conjunction with the personal criminal liability provisions of Sarbanes-Oxley, directors and officers of *any* corporation should sit up and take notice.

FIN 47 requires companies to identify all of their conditional asset-retirement obligations on an asset-by-asset basis. Also, FIN 47 clarifies that owners must quantify and report the financial liabilities they represent as soon as they arise—which is generally when the owner acquires, builds, develops or operates the asset in the course of business. The net effect is that companies will report more liabilities than they did previously and report them sooner.

Initially, FIN 47 appeared to be primarily applicable to owners of chemical-storage sites, power plants and other facilities with identified environmental conditions which required remediation. However, documents filed with and by the Securities Exchange Commission ("SEC") warn that *there is no exemption for any company, large or small: if your company owns an asset with a conditional environmental liability (any piece of property, building, lot, warehouse, etc.), you are subject to FIN 47.* Many companies have heeded the warning in a big way: Ford Motor Company took a $251 million hit in fourth-quarter and annual after-tax profit to comply with FIN 47 *(see* http://www.corporate-ir.net/ireye/ir_site.zhtml?ticker=F&script=412&layout=-6&item_id=806910.) with a significant impact on reported earnings.

What is a conditional asset retirement obligation? In simple terms, it is any legal obligation associated with the asset upon retirement, even if there is no current obligation to take action. The best example under FIN 47 is asbestos remediation expenses: many structures contain asbestos, but where the asbestos is in good condition, removal is not currently required. Accounting before FIN 47 would likely not have reported this as a liability. However, eventual deterioration or demolition of the structure may, depending on the type of asbestos involved, trigger asbestos removal expense. FIN 47 requires a valuation of such expense at the time it can be identified, or as of December 2005 for existing assets. The asbestos example can easily be broadened to any cost which might be incurred at retirement or demolition of the asset, such as the removal of underground storage tanks, lead-based paint and PCBs, or mercury vapor lamp disposal. In addition, under FIN 47, companies are now expected to report detailed valuations of probable compliance obligations under any federal or state environmental law or regulation.

In the past, many companies had been uncertain about what triggered reporting obligations when the specifics of an asset's retirement were unknown (that is, "conditional"). FIN 47 attempts to reduce the subjectivity of the reporting decision by requiring asset owners to report the fair value of the asset-retirement obligations as soon as such liabilities are incurred—i.e., when the owner acquires, builds, develops or operates the asset in the course of business. Even if you can't reasonably estimate what it will cost to retire that obligation in the future, you need to report it now and explain the uncertainty.

Additionally, FIN 47 clarifies FASB 143's definition of "conditional asset retirement obligation" to include even legal obligations whose timing or method of settlement may be uncertain. This definition, in effect, requires companies to fully recognize liabilities even if their cost is currently unknown.

Risks for failing to comply with FIN 47 include not just potential SEC investigations but also potential shareholder suits. In at least one case, *In Re: US Liquids Securities Litigation*, 2002

U.S. Dist. LEXIS 26713 (S.D. Tex. 2002), shareholders are suing Houston-based waste-disposal company US Liquids Inc., alleging the company misled shareholders about material environmental liabilities by failing to adequately quantify and report the costs of known environmental liabilities regarding the dumping of toxic wastes into the Detroit sewer system, to which the company pleaded guilty in November 2002 The plaintiffs are seeking unspecified damages, fees and costs, as well as rescission of common stock and other relief. See also, *Collmer v. US Liquids, Inc.*, 268 F.Supp.2d 718 (S.D. Tex. 2003) If that weren't unsettling enough, in February 2004, the U.S. Court of Appeals for the Fifth Circuit upheld the environmental exclusion in the company's D&O insurance policy—leaving the company's directors and officers on the hook for penalties and damages. *National Union Fire Ins. Co. of Pittsburgh, PA v. US Liquids, Inc*. 88 Fed.Appx. 725 (C.A.5 (Tex.), 2004).

In addition to shareholder suits, companies must satisfy the SEC with regard to their compliance with FIN 47. Recently, the SEC has been issuing comment letters requesting that companies redo their financial statements or make changes in the future—the SEC is pushing companies to estimate costs more completely, and to disaggregate their discussion of environmental liabilities, so shareholders can get a fuller picture of the issues in play.

Although most examples of under-reporting under FIN 47 will likely involve less dramatic circumstances than *In Re: US Liquids Securities Litigation* or a full-blown SEC investigation, the risk is there. How FIN 47 and related regulations will affect companies depends largely on their understanding of environmental requirements that may trigger FIN 47 reporting obligations, and their ability to explain their methods of identifying and quantifying both the liabilities themselves and their costs. For companies that have previously recognized the fair value of each of their conditional environmental asset-retirement liabilities on an asset-by-asset basis, FIN 47's impact will be minimal. But for others, complying with FIN 47 could have serious impacts on the corporate balance sheet. Environmental counsel's assistance is critical to ensuring proper recognition of these conditional retirement obligations.

Our environmental lawyers have helped companies successfully navigate the identification and evaluation of environmental conditional asset retirement obligations ("CAROs") for hundreds of properties to comply with FIN 47. We can help guide you, whether you have site-specific questions or require CARO identification on a portfolio (that is, a multi-site) level. If you or your company has any questions regarding identification and evaluation of environmental CAROs, we can help.

If you have questions on this or any other Environmental issue, please contact Jennifer Smokelin at jsmokelin@reedsmith.com or Lou Naugle at lnaugle@reedsmith.com.