DUE DILIGENCE Issues for Environmental Counsel

Acquisitions After Sarbanes-Oxley

BY MARK R. HIGH

Introduction

IN THIS POST-ENRON WORLD, it seems that disclosure has become the primary product manufactured by public companies in this country. Certainly, corporate management has recently spent a great deal of energy trying to understand and comply with new and existing disclosure requirements. Although there may be some movement afoot to scale back some of Sarbanes-Oxley's[1] more onerous requirements, clearly the emphasis on corporate candor is not going away any time soon.

Accountants are now required to review clients' disclosure procedures, and determine whether the procedures and the disclosure itself are adequate. On the environmental front, the Environmental Protection Agency recently introduced the ECHO project[2] and advised the Securities and Exchange Commission (SEC) to pay more attention to environmental issues. At the same time, the Government Accountability Office has recommended that environmental issues need to be more completely disclosed.[3]

Taken together, the result is that companies at all levels are more regularly monitoring environmental issues than in even the recent past. Companies are generating reports and sharing information regarding environmental concerns with people involved in the public reporting process, both inside and outside the company.

At the same time, merger and acquisition activity is on the rise, approaching levels not seen in several years. Many, if not most, acquisitions involve taking control of land and buildings, either through outright purchases of assets or assumed as part of the assets included in the acquired company. More reports and information mean there are more sources from which an acquiring company can obtain facts regarding the target company's environmental status. Even run-of-the-mill property transfers will be affected by these new procedures.

Public and Private Companies?

These are not just the concerns of large, publicly traded corporations; privately held companies can also be subject to Sarbanes-Oxley (SOX).[4] Lenders and customers can require a company to adopt SOX-style procedures. A company's accountants and directors' and officers'

insurance carriers can also prompt them to do so. Companies may want to voluntarily comply with some SOX requirements in preparing for an initial public offering or the company's sale.

Introduction to Disclosure Requirements

There are three main sources for federal corporate disclosure requirements: Regulation S-K, FASB No. 5, and SOX. Most relevant federal laws actually pre-date SOX, but the current disclosure climate has focused attention on them.

Regulation S-K

Regulation S-K[5] acts as an instruction manual for public companies filing their periodic reports with the SEC. Environmental concerns are particularly implicated in three items of Regulation S-K.

Item 101 requires reporting companies to describe their businesses. In particular, companies must disclose the anticipated costs of environmental compliance, and any material effects that these costs may have on their earnings and competitive position.

Item 103 requires disclosure of any pending, non-routine legal proceedings to which they are a party. In particular, Item 103(5) calls for disclosing environmentally-oriented administrative or judicial proceedings if: (1) the company's potential liability is material to the company's business or financial condition; (2) its potential liability exceeds ten percent of the company's assets; *or* (3) a governmental agency is a party to the proceeding and the company's probable liability could exceed $100,000. In the latter case, a situation where a company is cited for a minor violation can quickly escalate to where it needs, by law, to be included in the company's SEC filings.

Item 303 of Regulation S-K requires a company's management to discuss known trends and events that could have a material effect on its business (the so-called Management Discussion & Analysis, or MD&A, report). Some commentators suggest that Item 303 requires a company to discuss, for example, the effect of global warming on its business. While that might be a stretch, a company might want to discuss the uncertainties arising from the barrels just discovered underneath the plant that it acquired two months ago.

FASB No. 5

Statement of Financial Accounting Standards No. 5: Accounting for Contingencies, issued by the Financial Accounting Standards Board, deals with disclosing loss contingencies. Observing FASB No. 5 is part of complying with generally accepted accounting principles, and is a key element to the audit letter process that many are familiar with. It requires a company to establish a loss contingency in its financial statements if: (1) available information indicates that it is probable that the company has suffered a loss; and (2) the amount of that loss can be reasonably estimated. Even if a loss is only possible, or the value of the loss suffered cannot be reasonably estimated, it must be described in a footnote to the company's financial statements.

Sarbanes-Oxley

The new provisions receiving all the publicity come out of the Sarbanes-Oxley Act, adopted in 2002. Most important here are Sections 302 and 404.

Section 302 of SOX requires a company's chief executive officer and chief financial officer to personally certify certain items about the report being filed. This personal responsibility is causing senior executives to demand more detailed information from environmental managers.

Under Section 404, a company has to establish and maintain adequate internal control structures and processes to allow for accurate financial reporting. In the company's annual report, its senior executives need to report on the effectiveness of these control processes. Further, the company's auditors must provide an independent report on management's assessment.

Taken together, these measures can be seen to require reporting companies (and companies otherwise observing these requirements) to:

- implement and periodically evaluate internal controls and procedures for environmental issues;
- include environmental matters in their Item 303 MD&A;
- disclose environmental enforcement actions in periodic reports;
- disclose and value contingent environmental liabilities in financial statements;
- follow their internal controls and procedures, including maintaining internal records, regularly reviewing known problems, and searching out new problem areas, and provide reports up and down the management chain;
- have all of the above reviewed, evaluated, and certified by senior management; and
- have all of the above formally reviewed and audited by their accountants.

Due Diligence Resources

Any company with an interest in acquiring real estate has to look at that list of information sources and be glad. Many companies are now generating information much greater in quantity and quality than that available just two years ago, resulting in a paper trail consisting of reports, evaluations, and assessments that have never been available.

Savvy acquiring companies (and their lenders) will jump at the chance to learn about their targets' environmental issues from the inside. Savvy targets will keep in mind that even reports that are being generated for "internal" review may actually become available to outsiders.

Fast Facts

✔ Companies are generating reports and sharing information about their environmental issues with the people involved in the public reporting process, both inside and outside the company.

✔ It is no longer sufficient to just poke some holes in the dirt, check on the status of permits, and ask some general questions about environmental history.

✔ This brave new world presents both in-house and outside environmental counsel with significant opportunities to show the importance of their functions to senior management.

Acquirers need to adapt their real estate due diligence checklists to the new informational reality. It is no longer sufficient to just poke some holes in the dirt, check on the status of permits, and ask general questions about environmental history. Acquiring companies now need to:

- expand their review of publicly available information to include the EPA ECHO list and SEC reports;
- specifically inquire about a target's internal review processes and procedures;
- review the target's internal environmental policies;
- examine the internal committees charged with monitoring and assessing the target's environmental compliance;
- consider whether other internal procedures might touch on environmental issues (e.g., as part of the target's accounting and legal functions); and
- obtain all minutes, reports, memoranda, and valuations generated through internal procedures.

Information gathered this way not only tells the buyer about the property itself, it can also be used to better value the transaction, i.e., help establish whether the purchase price is right. It can help value and allocate risks coming out of the transaction, making for a more accurate and meaningful indemnification provision. It can also serve as a check on disclosure provided by the seller in the transaction's base purchase agreement, and perhaps provide an indication regarding the company's overall management structure.

In a recent situation we were involved in, our client was purchasing one plant from a public company with several plants around the country. In reviewing the selling company's SEC filings, we noticed a pattern to the impact issues that the seller identified at some of its other facilities. Based on that review, we expanded the sample parameter list in our Phase II environmental review, and the seller was forced to admit this increased scope was reasonable in light of its prior experiences.

Compliance After the Closing

After closing, the acquiring company will have to include the new assets in its future reporting and integrate the new assets into its existing internal controls and procedures. If the acquisition is significant, or consists of a stand-alone business, the buyer may have to develop new internal controls and procedures to cover the new assets. Perhaps in a worst case, the target has developed its own procedures that the buyer now has to evaluate and either adopt or discard and replace.

In this light, pre-acquisition due diligence must be considered as part of the post-acquisition reporting process. On a more practical basis, acquiring companies may want to look at the calendar when scheduling transaction closings to gain a few more weeks to integrate the acquired entity and its potential problems into the buyer's financial reports.

Opportunities for Environmental Counsel

This brave new world has brought significant change to the way environmental issues need to be handled. It also presents both in-house and outside environmental counsel with significant opportunities to demonstrate the importance of their functions to senior management.

On the internal compliance side, environmental counsel must prepare internal controls and procedures that are both comprehensive and workable. Once those procedures are in place, preparing detailed yet concise reports will help management provide the SOX Section 302 certifications. In evaluating potential liabilities that may exist, environmental counsel can play a vital role in fostering communication among managers, engineers, and accountants to arrive at a proper reserve valuation. All of these functions must be performed on time, as missing an SEC filing deadline can be very damaging to a reporting company and its management.

On the acquisition side, environmental counsel should make sure that due diligence checklists cover all the new information sources. When an acquisition comes along, they should get involved in the due diligence process at the outset, and stay involved. It is important to keep an eye on the reporting calendar, and anticipate post-closing reporting requirements while doing the pre-closing review.

Counsel for sellers, or potential sellers, should review (or establish) reporting processes and systems, and prepare (or monitor) the resulting reports as though they were the subject of a due diligence request.

Above all, environmental counsel should stay visible, available, and involved. Information is a product that becomes more valuable every day; environmental counsel have access to some of a company's most valuable information. Monitoring, organizing, and distributing that information is a critical function that, when done well, can materially benefit a company and all its constituents. ◆

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Footnotes

1. Sarbanes-Oxley Act of 2002, Pub L No 107-204, 116 Stat 745 (codified as amended in scattered sections of 18 USC), is a broad-ranging statute adopted in the wake of several high-profile corporate accounting scandals. In relevant part, it seeks to increase the level of corporate disclosure, and places increased responsibility on top corporate officers to verify that the disclosure is accurate.
2. EPA's Enforcement and Compliance History Online database, or ECHO, is an online summary of state and federal environmental permit, compliance, and enforcement histories covering the past three years for the over 800,000 companies regulated under EPA or EPA-delegated programs. The database is available at http://www.epa.gov/echo.
3. United States Government Accountability Office, *Environmental Disclosure: SEC Should Explore Ways to Improve Tracking and Transparency of Information,* 1, GAO-04-808, July, 2004, available at http://www.gao.gov/new.items/d04808.pdf.
4. See Justin Klimko, *The Sarbanes-Oxley Act: Possible Impacts on Privately Held Companies,* 83 Mich BJ 36 (2004); Ben L. Pfefferle, III, *The Sarbanes-Oxley Act: Implications for Environmental Management,* Baker & Hostetler LLP Executive Alert, Sept. 2004.
5. 17 CFR Part 229, adopted under the Securities Act of 1933, 15 USC 77a et seq., and the Securities Exchange Act of 1934, 15 USC 78a et seq.