

Sarbanes-Oxley and Environmental Matters

February 9, 2004

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Pre-Existing General SEC Rules

- For purposes of this presentation, we use the term “SEC rules” as shorthand for the full range of legal and accounting requirements under securities laws
- The general scope of existing SEC rules cover three separate but related areas:
 - **accrual** in financial statements
 - **disclosure** in financial statement footnotes and in SEC filings
 - **estimation** for both accruals and disclosures
- Estimation is the key problem for us, and we will return to it again and again

General SEC and Accounting Rules -- Attorneys and Accountants

- Compliance with SEC requirements involves both attorneys and accountants
- The line between the roles of attorneys and accountants has always been murky
- The new Sarbanes-Oxley rules compound this problem
- The new Sarbanes-Oxley rules will undoubtedly require additional dialog between a company's attorneys and its accountants, on at least a quarterly basis

General SEC and Accounting Rules “Materiality”

- Certain of the SEC and accounting rules apply only to matters that are “material” to the financial condition of the company
- The SEC has declined to define materiality for purposes of Sarbanes-Oxley, relying on established case-law
- Generally, a matter is “material” if a prudent investor would reasonably want to know about it
- Size of the company is relevant, but there are also other factors
 - compliance with regulatory requirements
 - concealment of an unlawful act

Pre-Existing Rules that Apply Specifically to Environmental Matters

- There are four:
 - 1 - Description of Business (S-K 101)
 - 2 - Legal Proceedings (S-K 103)
 - 3 - Management Discussion and Analysis (S-K 303)
 - 4 - Contingent Liabilities (FAS 5)

Pre-Existing Environmental Rules

1. Description of Business (S-K 101)

- Companies must disclose material effects that compliance with environmental law will have on:
 - Earnings
 - Competitive position
 - Capital expenditures
- Additionally, they must disclose estimated material capital expenditures for “environmental control facilities”
 - for current fiscal year
 - for next fiscal year
 - for further periods, if material

Pre-Existing Environmental Rules

2. Legal Proceedings (S-K 103)

- Must disclose environmental legal proceedings:
 - Pending or known to be contemplated
 - Administrative or judicial
 - Even if initiated by the company
 - If material, or
 - If a government agency is a party and monetary sanctions may be \$100,000 or more (whether or not material)
- USEPA has announced an “environmental liability enforcement initiative,” which eventually may provide for notice to respondents of SEC disclosure requirements
- USEPA Enforcement and Compliance History Online (ECHO)
 - Public database, launched in 2002, providing compliance and enforcement information for EPA-permitted facilities

Pre-Existing Environmental Rules

3. Management Discussion and Analysis (S-K 303)

- Companies must disclose, in the MD&A, “known trends, events or uncertainties” that may have a material effect on the company’s financial condition
- A 1989 SEC Interpretive Release emphasized this applies to environmental trends and uncertainties such as:
 - Anticipated new regulations
 - Superfund liabilities
- As we will see later, MD&A disclosure would be made considerably more detailed under a proposed new Sarbanes-Oxley-related SEC rule on “critical accounting estimates”

Pre-Existing Environmental Rules

4. Contingent Liabilities (e.g. Superfund)

- The fourth pre-existing rule is the most complex
- Accounting and SEC guidance specify when and how contingent liabilities (e.g. Superfund) must be
 - **estimated**,
 - **accrued**, and/or
 - **disclosed**
- FAS 5 is the basic general accounting pronouncement
- There are supplemental guidance documents specific to environmental liabilities, particularly Superfund/RCRA:
 - SEC SAB 92 (also covers certain product liabilities)
 - AICPA SOP 96-1

Pre-Existing Environmental Rules

4. Contingent Liabilities - Accrual

- Accrual usually requires a charge against **current** income and earnings of the **entire** amount of the estimable liability, even though the actual cash outlay will be spread out over a number of years into the future
- FAS 5 requires a liability to be accrued if it is:
 - probable, and
 - reasonably estimable

Pre-Existing Environmental Rules

4. Contingent Liabilities - Accrual (continued)

- “Probable” means “likely”
 - often not a difficult issue
- “Reasonably estimable”
 - usually the most difficult accrual issue
 - cannot delay accrual until there is a single estimate
 - at early/middle stages, usually a **range** of estimable liability
 - must accrue “best estimate” within the range
 - if no “best estimate,” must accrue low end of range

Pre-Existing Environmental Rules

4. Contingent Liabilities - Disclosure

- In addition to accrual of best estimate or low end of range, company must **disclose** in financial statement footnotes (and possibly in MD&A)
 - estimate of “reasonably possible” additional material liability
 - or state that such an estimate cannot be made
 - disclosure has no immediate effect on financial statements, but tells investors what may be coming
- “Estimation” is usually the most difficult disclosure issue

Pre-Existing Environmental Rules

4. Contingent Liabilities - Estimates

- SOP 96-1 states that the **estimate** for remediation liability can be derived by separately analyzing **components** of the liability, i.e.
 - Remedial Investigation (RI) costs
 - Feasibility Study (FS) costs
 - Remedial Design (RD) costs
 - Remedial Action (RA) costs
- For example, company may be able to make a “best estimate” for RI/FS, but only a “low end of range” for RD/RA
- **Accrual** would be sum of “best estimate” plus “low end of range”
- **Disclosure** would be required for “reasonably possible” estimates of material additional amounts

Pre-Existing Environmental Rules

4. Contingent Liabilities - Estimates (continued)

- SAB 92 and SOP 96-1 state that estimates for accrual and disclosure should be based on
 - Current law and methodology (i.e. can’t assume that law or methodology will become more favorable)
 - Existing industry-wide experience and EPA data
 - Existing technology (but can take expected productivity improvements into account)
 - Net present value, but only if amounts are “fixed or reliably determinable”
- Must revise accrual/disclosure estimates whenever new information becomes available, and at “benchmark” points, e.g. RI, FS, ROD, RD

Sarbanes-Oxley and the New SEC Rules -- The Basics

- Enron and similar scandals led to enactment of the Sarbanes-Oxley statute in July 2002, which requires new SEC rules that supplement and enhance pre-existing SEC rules
- Of the new SEC rules required by Sarbanes-Oxley
 - some have been adopted in final form
 - some are still in proposed form

What is the Relationship between Sarbanes-Oxley and Environmental Matters?

- While Sarbanes-Oxley was not motivated by environmental issues, the statute and new SEC rules are written so broadly that they encompass environmental matters
- More basically, environmental matters have been carved out for special treatment under existing SEC rules since the 1970s
- And there are those within the SEC, EPA and the environmental community who are seeking to use Sarbanes-Oxley to force more extensive SEC disclosure of environmental matters, including:
 - Superfund liability
 - Enforcement proceedings
 - New or modified regulations
 - Climate change/global warming issues

What will be the Impact of Sarbanes-Oxley on Environmental Attorneys?

- The new Sarbanes-Oxley/SEC rules, while basically directed at public companies and their top management, impose expanded responsibilities on in-house and outside attorneys
 - as counselors, and
 - as police men and women
- Corporate and securities attorneys will feel the heaviest impact
- **However, because environmental issues are carved out for special treatment, environmental attorneys will also feel a heavy impact, probably heavier than attorneys in most other substantive areas**

What are the Key Take-aways for Environmental Attorneys

- Environmental attorneys will all be paying more attention to both the pre-existing and new SEC rules
- We will have to understand both sets of rules and how they apply to matters for which we have responsibility
- In most cases, this will simply involve paying closer attention to the details and making sure management shares this focus
- In some cases, however, we may become involved with complex and controversial issues which will require considerable judgment

New Sarbanes-Oxley Rules Disclosure Controls and Procedures

- Arguably the most important requirement adopted pursuant to Sarbanes-Oxley for environmental practitioners.
- Requires CEOs and CFOs to certify that the company has an internal management system consisting of “disclosure controls and procedures” which ensure that
 - **information required to be disclosed in SEC reports is**
 - accumulated, recorded, processed, summarized and
 - communicated to management

New Sarbanes-Oxley Rules Disclosure Controls and Procedures (continued)

- Specifically, the rule requires CEOs and CFOs to certify, on a quarterly basis in 10Qs and 10Ks, that the company has adequate “disclosure controls and procedures”
- It also requires CEOs and CFOs to
 - evaluate the disclosure controls every 90 days
 - disclose to the company’s auditors and to the Audit Committee of the Board
 - all significant deficiencies and weakness in the design or operation of the controls
 - any fraud, whether or not material, that involves employees who have a significant role in the controls (e.g. plant managers and EHS personnel?)

New Sarbanes-Oxley Rules Disclosure Controls and Procedures (continued)

- CEOs and CFOs of most public companies have already had to give this certification in 10Qs and 10Ks filed since August 2002
- Will “backup certifications” be required down the ladder?
- EHS managers will have to ask themselves whether their EHS management system constitutes compliance with “disclosure controls and procedures”
 - Most state-of-the-art systems will suffice, though some modifications may be advisable and will generally be necessary to make sure the information goes up the last step in the management chain

New Sarbanes-Oxley Rules Disclosure Controls and Procedures (continued)

- **In any event, most of us will need to be able to determine what “information is required to be disclosed in SEC reports”**
- The information required to be disclosed falls into two categories:
 - General SEC rules
 - Rules specific to environmental matters

New Sarbanes-Oxley Rules

MD&A Critical Accounting Policies/Estimates

- As discussed earlier, existing MD&A rules require a narrative discussion of material “known trends, events or uncertainties”
 - This specifically includes environmental uncertainties
 - Probably also includes certain product liability uncertainties
- SEC staff has long believed this requirement has generally received only “lip service”
- The proposed rule would require much more specific and detailed discussions of “uncertainties”
- While the rule is not yet formally adopted, SEC expects companies to comply, and many companies are already doing so

New Sarbanes-Oxley Rules

MD&A Critical Accounting Estimates (continued)

- What is a “critical accounting estimate?”
 - an “approximation” by management
 - about a matter that is “highly uncertain”
 - where “different estimates” could reasonably have been used
 - that would have a material impact on the company’s financial condition
- The most obvious example of “different estimates” is to compare the “low end of the range” with the “high end of the range” for
 - the impact of a new or modified regulation, or
 - a Superfund site (or the aggregate of all Superfund sites)

New Sarbanes-Oxley Rules

MD&A Critical Accounting Estimates (continued)

- Proposed rule would require management to identify and describe in the MD&A
 - each “critical accounting estimate”
 - the methodology underlying the estimate
 - the assumptions concerning the highly uncertain aspects of the estimate
 - the reasons why different estimates could have been used
 - any known trends, events or uncertainties that are reasonably likely to materially affect the estimate’s methodology or assumptions

New Sarbanes-Oxley Rules

MD&A Critical Accounting Estimates (continued)

- In addition, the proposed new MD&A disclosure must include a “**quantitative analysis**” intended to show the “sensitivity” of the company’s financial condition to changes in the estimates
- Either of two methods can be used for the quantitative “sensitivity analysis:”
 - Assume that “reasonably possible” changes to the company’s assumptions will occur over the next year; or
 - Assume that the accounting estimate is changed to the upper end and lower end of “reasonably possible” outcomes
- Whichever method is used, the company must discuss and **quantify the impact of the changed assumptions** on the company’s financial performance, if material

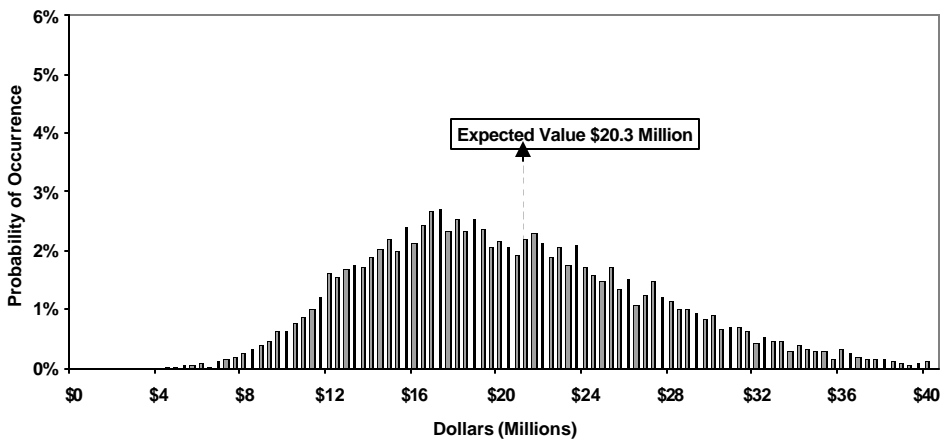
New Sarbanes-Oxley Rules
MD&A Critical Accounting Estimates (continued)
Probabilistic Decision Analysis

- The preamble to the proposed rule states the company should also disclose “estimated probabilities where applicable”
- This presumably refers to probabilistic decision analysis
- The recently adopted ASTM “Standard Guide for Estimating Monetary Costs and Liabilities for Environmental Matters” (May 2001) encourages the use of probabilistic decision analysis
- An investor group has petitioned the SEC to formally adopt the ASTM Standard for estimating environmental liabilities
- Probabilistic decision analysis can generate:
 - an “expected value” -- the probability weighted average of the various outcomes, and
 - a “probability distribution”

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New Sarbanes-Oxley Rules
MD&A Critical Accounting Estimates (continued)
Probabilistic Decision Analysis -- Example



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New Sarbanes-Oxley Rules
MD&A Critical Accounting Estimates (continued)
Probabilistic Decision Analysis

- Probabilistic decision analysis is a useful case management tool
- However, it can present serious problems if it is attempted to be used for accrual and disclosure purposes
- Does it tell us a “best estimate?”
- Does it tell us the low and high ends of the range?
- Attorneys, accountants and economists will grapple with these issues

New Sarbanes-Oxley Rules
Standards of Professional Conduct for Attorneys
Overview

- Partial final rules were adopted January 29, 2003 and became effective on August 5, 2003
- Applies to attorneys who are “appearing and practicing” before the SEC -- broadly defined; can include all of us
- Such attorneys who “become aware” of evidence of material violations of securities laws, fiduciary duties or “similar” laws must report such violations “up the ladder” to senior management -- CLO, CEO or Board of Directors
- Senior management must then make an “appropriate response” to the Reporting Attorney
- Proposed “noisy withdrawal” requirement remains proposed -- requires withdrawal from representation and notification to SEC

Standards of Professional Conduct for Attorneys “Attorney”

- “Attorney” is anyone admitted to practice and acting in legal position within context of attorney-client relationship
- Includes both inside and outside counsel
- Includes both U.S. and non-U.S. attorneys (regardless of whether licensed in U.S.)
- Attorney-client relationship may exist:
 - In absence of formal retainer or other agreement
 - Even if attorney-client privilege is unavailable
- Need not be in legal department to be covered

Standards of Professional Conduct for Attorneys “Appearing and Practicing Before SEC”

- The obvious: attorneys who directly represent the company in proceedings before the SEC or who communicate in any form with the SEC or its staff
- The rest of us:
 - Providing advise regarding any document the attorney has notice will be filed with the SEC
 - Advising a company whether information is required to included in a document filed with the SEC
 - Includes providing advise in the context of preparing, or participating in the preparation of, any such document
- “Supervisory” attorneys also covered

Standards of Professional Conduct for Attorneys “Supervisory Attorneys”

- “Supervisory attorney” is any attorney supervising or directing an attorney “appearing and practicing before the SEC,” regardless of whether the “supervisory attorney” is an SEC-type
- General rule: “Supervisory attorney” must make “reasonable efforts” to ensure that any subordinate attorney who “appears and practices before the SEC” complies with the rule
- A subordinate attorney is deemed to satisfy the reporting obligation after report to supervisory attorney
- Once subordinate attorney makes report to supervisory attorney, supervisory attorney must comply with reporting requirements

Standards of Professional Conduct for Attorneys “Evidence of a Material Violation”

- Means: “credible evidence, based upon which it would be unreasonable under the circumstances for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur”
- “Circumstances” include: attorneys professional skills, experience, familiarity with the client, availability of other attorneys to consult
- No per se duty to investigate; “credible evidence” does not include gossip, hearsay, innuendo or suspicion
- “Reasonably likely” means more than a mere possibility, but need not be “more likely than not”

Standards of Professional Conduct for Attorneys “Material Violation” of What?

- An applicable U.S. federal or state securities law
 - E.g. the requirements regarding SEC environmental reporting we have discussed earlier
- A fiduciary duty arising under U.S. federal or state law, including common law
 - E.g. “misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions”
- A similar violation of any U.S. federal or state law
 - Not defined, but presumably extends beyond the foregoing
- Attorney has reporting obligation regardless of whether the material violation is related to the matter under the attorney’s inquiry or investigation

Standards of Professional Conduct for Attorneys “Report”

- Attorney report must be made “forthwith” (not defined) to:
 - Chief Legal Officer (or equivalent)
 - CEO (or equivalent)
 - Qualified Legal Compliance Committee (explained later)
 - Bypass if futile and go directly to Board of Directors
- Report can be in person, by telephone, by email or in writing
- Creation of documentary record not required

Standards of Professional Conduct for Attorneys “Qualified Legal Compliance Committee (QLCC)”

- Company may, but not required to, establish a QLCC as the body to which attorney reports are to be made
- QLCC composition:
 - At least 1 member of the Audit Committee; and
 - 2 or more independent directors
- Reporting to QLCC satisfies attorney reporting obligations
 - No requirement for attorney to consider appropriateness of response
- CLO receiving an attorney report may refer to QLCC in lieu of conducting own inquiry

Standards of Professional Conduct for Attorneys The CLO’s Obligations

- CLO must conduct such inquiry as he/she “reasonably believes appropriate” to determine whether violation exists
- If CLO determines no violation, must notify Reporting Attorney of basis of that conclusion
- If CLO determines violation exists, must take reasonable steps to cause company to adopt an “appropriate response” and advise the Reporting Attorney of that response
- Instead of conducting own review, CLO may refer matter to QLCC, and is then relieved of obligation of responding to Reporting Attorney

Standards of Professional Conduct for Attorneys Back to the Reporting Attorney

- If Reporting Attorney “reasonably believes” CLO has provided an “appropriate response” within a “reasonable time,” the Reporting Attorney’s reporting obligation is satisfied
- If Reporting Attorney does not so believe, must take the matter to:
 - the Audit Committee of the Board
 - or another Board Committee comprised solely of independent directors
 - or to the full Board
- If Reporting Attorney believes reporting to CLO or CEO in first instance would be futile, may initially proceed as above

Standards of Professional Conduct for Attorneys “Appropriate Response”

- A response that provides a basis for the Reporting Attorney to “reasonably believe” one or more of the following:
 - No material violation has occurred, is ongoing, or is about to occur
 - The company has adopted appropriate remedial measures to stop any violation and minimize the likelihood of a recurrence
 - The company, with the consent of the Board or QLCC, has retained an attorney to review the evidence and either:
 - Has substantially implemented any recommended remedial actions, or
 - Has been advised the company may assert a colorable defense in any applicable investigation or proceeding

Standards of Professional Conduct for Attorneys “Appropriate Response” (continued)

- “Appropriate response” to be measured against a reasonableness standard
- If no “appropriate response within a reasonable time,” Reporting Attorney must inform CLO, CEO and Board why he/she believes this to be the case

Standards of Professional Conduct for Attorneys Failure to Receive an “Appropriate Response” “Noisy Withdrawal”

- What happens if no “appropriate response?”
- Initial proposed rule required “noisy withdrawal,” i.e. Reporting Attorney would have to:
 - Withdraw from representation, and
 - Notify the SEC
- Currently, no “noisy withdrawal” requirements. However, there is a revised “noisy withdrawal” proposed rule

New Sarbanes-Oxley Rules Additional Noteworthy Provisions

- There are four additional SEC rules that have implications for environmental attorneys
 - Improper Influence of Audits
 - Auditor Independence
 - Retention of Records by Auditors
 - Whistleblower Encouragement and Protection

New Sarbanes-Oxley Rules Improper Influence on Conduct of Audits

- Adopted
- Applies to officers and directors and to **any person** acting under their direction, including
 - in-house and outside environmental **attorneys**
 - in-house environmental **managers**
 - outside environmental **consultants**
- Prohibits any action to mislead any independent public accountant engaged in an audit
 - includes providing an auditor with inaccurate or misleading legal or technical analysis of, e.g. an environmental liability

New Sarbanes Oxley Rules Auditor Independence

- Prohibits accounting firms from providing any of 10 enumerated services to audit clients
- Basically, this means you probably will not be able to use your audit firm to provide “expert” services

New Sarbanes-Oxley Rules Retention of Records by Auditors

- Adopted
- Requires outside auditors to retain the following for 7 years:
 - workpapers, memoranda, correspondence, communications and all other records
 - that contain conclusions, analyses or financial data
- The retention requirement ensures that documents remain available for later investigations and litigation
- **Note that, if a document or communication which is otherwise privileged is given to an auditor, the privilege will generally be deemed waived**

New Sarbanes-Oxley Rules Whistleblower Encouragement and Protection

- Immediately effective statutory provision
- Requires Audit Committee of the Board to establish procedures for “the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters”
- Employees who report or assist in investigation of a potential violation of securities laws are protected from retaliation
- Employer is subject to criminal penalties for retaliation, and employees can recover damages
- Some employees might aggressively use these provisions to advance their own agendas regarding disclosure of environmental matters