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Environmental Disclosure Due Diligence: Taking the Next Step in Environmental Due Diligence

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On November 30, 2004, Lyondell Chemical Company acquired Millennium Chemicals Inc. in a stock-for-stock business combination. As a result of the transaction, Millennium became a wholly owned subsidiary of Lyondell.

Subsequent to the acquisition, the new Millennium management re-examined Millennium's environmental remediation liabilities in conjunction with the preparation of the financial statements of Lyondell and Millennium for the year ended December 31, 2004. The examination followed

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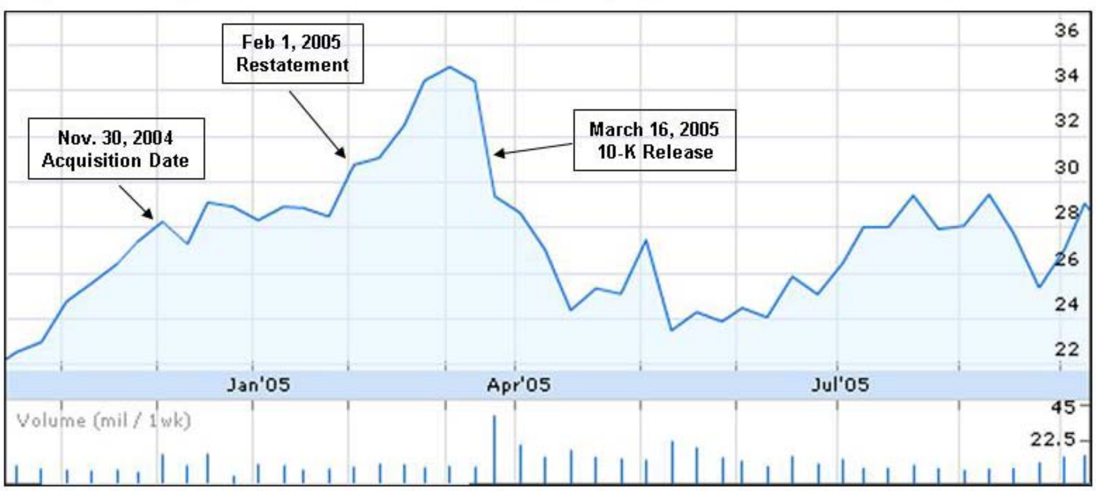
procedures established by Lyondell as part of its internal control over financial reporting under Sarbanes-Oxley. In late January 2005, Millennium's Board of Directors concluded that Millennium's prior financial statements should no longer be relied upon. On February 1 2005, Lyondell issued an 8-K announcing that Millennium would restate its financial statements for the five-year period ending December 31, 2003, and the first three quarters of 2004, to recognize an additional $59 million in its recorded liabilities for environmental remediation.

In its 2004 10-K filed in March 2005, Millennium reported that the errors corrected in the February 2005 restatement were the result of the company's failure to increase the probable liabilities for future remediation spending related to past environmental contamination when the reasonably estimable amounts of such probable future spending increased. The errors were attributable to a material weakness in internal control over financial reporting consisting of: (1) inadequate procedures to verify the appropriateness of period-end balances of recorded liabilities; and (2) ineffective communication among the corporate functions with knowledge and accountability relating to environmental remediation, legal contingencies, accounting, and disclosure.

Within 3-½ months after completion of the acquisition, Lyondell's newly acquired subsidiary was required to correct material errors in previously issued financial statements and report a material weakness in internal control over financial reporting under Sarbanes-Oxley for environmental matters. Although it is not possible to isolate the exact effect of Millennium's environmental accounting errors on Lyondell's stock value, Figure 1 below shows that following the Millennium acquisition, Lyondell's stock climbed from $28.26 on December 3, 2004 to $35.04 on March 4, 2005, when it began to slide. By April 15, 2005, the stock was down 30 percent to $24.37.[1]

Figure 1. Lyondell Chemical Company (Public, NYSE:LYO)



If Lyondell had identified Millennium's environmental financial reporting problems prior to closing, how might it have reacted to better protect itself?

The Next Step in Environmental Due Diligence

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 goes beyond traditional environmental due diligence. Whereas, traditional environmental due diligence is intended to identify and address the financial impacts from *environmental risks*, ED3 is intended to address the financial impacts from *financial reporting risks*.

Environmental risks include contingent liabilities for cleanup costs, bodily injury, and property damages, pollution control costs, asset retirement obligations, and asset impairments related to historical or future pollution conditions. Environmental risks may be addressed using a wide variety of techniques, including purchase price adjustments, carve-outs, indemnities, insurance, escrows, cleanup agreements, and environmental management systems.

Financial reporting risks are the risks associated with misstatements in corporate financial statements arising from unrecognized, misclassified, or improperly valued environmental risks. Techniques used to address environmental risks may also be adapted to effectively address financial reporting risks. However, other techniques may be necessary or appropriate.

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 one of the most important components of due diligence.

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

Financial Reporting Risk is Different than Environmental Risk

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

Different 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 are different in nature and may 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, such as Lyondell's acquisition of Millennium, prior misstatements made by the seller can result in post-closing restatements and an adverse impact to the buyer's stock price.
- 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.[2]
- Late SEC filings or restatement of the seller's financial statements may give the seller's lenders grounds to call in outstanding loans.[3]
- Restatement of the seller's financial statements may be grounds for rescission of the seller's pre-existing environmental and directors and officers (D&O) liability insurance policies.[4]
- Deterioration in reported asset values and debt-to-asset ratios may be grounds for lenders to withdraw financing in the 11th hour of the transaction or following closing.
- In the most extreme cases, failure to perform a full pre-closing 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.[5]

Shorter time horizons

Sophisticated parties understand that environmental risks often have distant time horizons, especially in an era of declining regulatory enforcement of cleanup obligations. 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". If environmental risks will not adversely affect cash flow within a relevant time period, why should buyers worry about them?

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 within a single accounting period thereafter. The timing of financial reporting risk operates independently of the 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 (but not probable). Incurrence of a loss may be conditional on a variety of future events that may or may not occur (and may be partially within the buyer's control). For example:

- Can contaminated property be used and sold without undertaking investigation that might trigger regulatory reporting and remediation requirements by, for example, using "no look" provisions in purchase agreements (see oil terminal example below under "Different accounting for buyers and sellers")?
- Will the underlying environmental condition be discovered by government regulators or adverse parties if actions that might trigger reporting requirements are carefully avoided?
- Will future investigation of uncharacterized pollution conditions show that these conditions in fact do not represent a material risk of loss?
- Will legal action against the buyer be initiated? If so, will the buyer have valid legal defenses?
- Can settlement of the remediation obligation be deferred for a long period of time, thus reducing the net present value of the obligation to an immaterial amount?
- Can the business 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.[6]

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 that gives rise to the financial reporting risks the buyer needs to consider.

All at once instead of one at a time

The financial magnitude of individual environmental risks standing alone may be immaterial, depending on the nature of the risk and value of the company. 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 resources 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 during a single accounting event or period.

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, which can 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. What buyer would want to repeat Lyondell's experience in the Millennium merger?

Financial Reporting Risk is increasing

Financial reporting risk has not been a significant issue in the past, in part due to vague financial reporting standards and lax scrutiny of environmental liability estimates by financial auditors. But the combination of Sarbanes-Oxley and several new and forthcoming accounting pronouncements from the Financial Accounting Standards Board (FASB) is causing financial reporting risk to increase.

Key stakeholders who rely on corporate financial statements, such as investor organizations and researchers, have long maintained that financial reporting requirements allow too much flexibility and are too narrow in scope to capture important environmental information.[7] Sarbanes-Oxley and new and forthcoming accounting standards are reducing flexibility in financial reporting and changing the way companies must account for various environmental matters in their financial statements, including:

- Environmental loss contingencies, including environmental remediation liabilities and pending and incurred but not reported (IBNR) asbestos and toxic tort claims (projected 2007)
- Fair value measurement of assets and liabilities (2006)
- Asset retirement obligations (2005)
- Environmental guarantees and indemnities (2002)
- Asset impairments (2001)

These changes in generally accepted accounting principles (GAAP) are drawing attention from the Securities & Exchange Commission (SEC) Division of Corporate Finance[8] and causing independent financial auditors to scrutinize environmental financial reporting like never before. Moreover, the SEC is recently showing an interest in environmental enforcement.[9]

Reporting companies are feeling the pain. Prior to 2006, two U.S. public corporations, Millennium and Waste Management, had reported restatements for environmental matters. In 2006, seven U.S. public corporations restated their balance sheets to properly account for environmental liabilities.[10] Many more companies delayed their 10-K filings.[11] 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.[12]

Same environmental risks, but different effect on the financial statements

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, 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, apparently related to future cleanup at domestic refineries and underground storage tanks at U.S. service stations. Prior to the adoption of a FASB pronouncement in March 2005, such obligations generally had not been considered liabilities under U.S. GAAP.

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.[13]

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

   Example: Buyer's environmental 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 treat system); most likely value - $5 million; worst case - $15 million; and expected present value - $6.5 million. The 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.

These new accounting standards can result in more recognized liabilities and higher estimates for the same environmental risks compared to pre-existing accounting standards.

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 pre-existing standards. Here are a few examples from ED3 in practice:

- Estimates of 30-year O&M 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 a 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."
- Controllers who say, "We can't reasonably estimate the fair value of our asset retirement obligations," when the company's real estate group has already calculated the expected sales price discount associated with such obligations.
- 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 five years after the indemnity has expired.

Different accounting for buyers and sellers

A change in accounting standards for business combinations expected to be issued in 2007 could require buyers to account for contingent liabilities in a manner different than sellers starting 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 business combination 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 environmental lawyers 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. Loss contingencies that are not considered probable are typically not quantified in the course of environmental due diligence. Under the proposed new business combination rule, however, a buyer would be required to recognize a liability for the fair value of environmental cleanup, bodily injury, and property damage obligations assumed in the transaction, without regard to the probability of future litigation, claims, or assessments.

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 third-party environmental claims, 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 investigation and 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, Buyer would be required to record a liability for the fair value of the cleanup obligation. That amount would depend on various factors, but would likely be upwards of $6 million ($30 million x 0.20). This liability, which would be increased by potential exposures for property damage and bodily injury claims, would be required to be displayed separately from the potential right of recovery for the indemnity. 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 the buyer's books.

The accountants are getting worried

Changes in accounting standards are 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.[14] To do otherwise could risk waiver of the attorney-client privilege. This means lawyers cannot be expected to list in their response to audit inquiry letters such things as outstanding environmental indemnities, asset retirement obligations, potential obligations relating to formerly owned and operated facilities, and IBNR asbestos and toxic tort claims. As a result, independent financial auditors are beginning to exercise increased diligence to ensure that environmental matters are properly identified, assessed, measured, and reported.

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

Environmental lawyers can pass responsibility for financial reporting risk to the accountants, right? After all, environmental lawyers are not trained in financial accounting. How can they be expected to understand the alphabet soup of generally accepted accounting principles? There are three problems with this argument. First, environmental lawyers, and not accountants, are responsible for environmental due diligence. Environmental 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 accountant, 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 environmental lawyer gets it wrong — by missing the issue entirely or making the wrong legal judgment — he or she cannot shift accountability to the accountants.

Know when to look

ED3 is not warranted in all deals or even the majority of deals. Yet, depending on the nature of the acquiring and divesting entities, it may be critically important in certain situations. For example, ED3 will not be useful where environmental risks are immaterial to the transaction. At the other extreme, ED3 may be critical in cases where a full accounting of all environmental liabilities and impairments would render the seller technically insolvent. It is therefore incumbent on environmental lawyers to determine when ES3 is appropriate and when it is not.

Know what to look for

Assessment of financial risk may involve one or more of the following activities:

- Expanding the scope of matters investigated during traditional environmental 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.
- Assessing the operational effectiveness of the seller's internal control over financial reporting of environmental matters.

ED3 focuses on the financial reporting implications of the same types of environmental risks typically included within the scope of environmental due diligence. However, the following areas having significant potential financial reporting risk may warrant special attention during the due diligence investigation phase:

- Environmental conditions potentially giving rise to asset retirement obligations (e.g., asbestos-containing building materials, PCB equipment, RCRA closure and post-closure obligations, activities subject to financial assurance requirements, special asset disposal requirements, land and building restoration obligations, lease termination obligations, and required capital expenditures for pollution control equipment).

- Contractual indemnities and guarantees for environmental cleanup costs and damages where the seller is the indemnitor or guarantor.
- Rights of recovery, such as contractual indemnities and insurance, relied upon by the seller to offset its environmental obligations.
- IBNR claims for environmental remediation, bodily injury, and property damages.
- Environmentally impaired properties and facilities that are unutilized or under utilized.

Much of the investigation needed for ED3 can be performed at the same time as traditional environmental due diligence and with little extra cost and effort. Added value and efficiency can be gained by slightly modifying the scope of traditional environmental due diligence to also encompass additional matters giving rise to financial reporting risk. For example, the same site visit can be used to identify both environmental remediation liabilities within the scope of "all appropriate inquiries" (AAI) and asset retirement obligations that are not within the scope of AAI.

Become literate in environmental financial reporting

What most environmental lawyers know about environmental financial reporting is rapidly becoming obsolete. Environmental lawyers must know more than to simply ask, "Is it probable and reasonably estimable?" Environmental 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 environmental lawyer's next responsibility 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.
- Pre-closing negotiations and remedies under the purchase agreement.
- Post-closing remedies.

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

ENDNOTES

[1] Source: Google Stock Quotes. Millennium's 2004 10-K also reported a restatement and material weakness related to a $15 million understatement of liability for deferred income taxes.

[2] See *Collmer v. U.S. Liquids*, 268 F. Supp.2d 718 (S.D. Texas 2003).

[3] *Id*.

[4] "Restatement Blues: Companies making missteps in their financial reports face a new woe: Insurers might rescind their directors' and officers' liability policies," David M. Katz, CFO.com, November 17, 2000, .

[5] "Not So Fast: The Sealed Air Asbestos Settlement And Methods Of Risk Management In The Acquisition Of Companies With Asbestos Liabilities," Ken Rivlin & Jamaica D. Potts, http://www.law.nyu.edu/journals/envtllaw/issues/vol11/3/potts-rivlin.pdf.

[6] See "Environmental Liabilities: EPA Should Do More to Ensure That Liable Parties Meet Their Cleanup Obligations," U.S. Government Accountability Office Report to Congressional Requesters, August 2005, at p. 4.

[7] "ENVIRONMENTAL DISCLOSURE: SEC Should Explore Ways to Improve Tracking and Transparency of Information," U.S. Government Accountability Office Report to Congressional Requesters, July 2004, at p.3, http://www.gao.gov/highlights/d04808high.pdf.

[8] See http://www.FIN47/sec_comments.htm.

[9] *See In re Ashland Inc. and William C. Olasin*, Administrative Proceeding File No. 3-12487, November 29, 2006.

[10] See http://www.FIN47/restatements.htm.

[11] "Tardy 10-Ks Are Worth the Wait," Marie Leone, CFO.com, March 20, 2006; http://www.cfo.com/blogs/index.cfm/l_detail/5651021?f=home_todayinfinanc.

[12] "Coming Distractions: If these eight risks are not on your radar screen, they will be soon," John Goff, CFO Magazine, April 01, 2006, .

[13] Goldspring, Inc., Form 10-KSB for the year ended December 31, 2005, Item 6. Management's Discussion and Analysis or Plan of Operations, http://www.sec.gov/Archives/edgar/data/1120970/000114420406015178/v040488.htm.

[14] *American Bar Association Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information,* 31 Bus. Law. § 5 (no. 3, Apr. 1976).