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1. **WHY IS ENVIRONMENTAL DUE DILIGENCE NECESSARY FOR OFFERINGS?**

- Environmental due diligence is necessary to assess a company’s exposure to environmental liabilities and compliance costs that must be disclosed to comply with the Securities Act of 1933 and the Securities Exchange Act of 1934.

- There has been increased scrutiny of environmental disclosure in recent years from the SEC, Congress, EPA, shareholders and public interest groups. The ABA created a Special Committee on Environmental Disclosure in 2004.

a. **SEC**

   The SEC has initiated several enforcement actions relating to environmental disclosure and made a series of comments indicating that it would apply increased scrutiny to environmental disclosure in public filings.

   ○ In 1998, the SEC issued a cease and desist order to Lee Pharmaceuticals for materially understating its environmental liabilities in several annual filings.

   ○ At the 2001 ABA annual meeting, the SEC announced that it would begin screening 10K’s for violations in environmental disclosure requirements.

   ○ In 2002, the SEC sued the founder and five former officers of Waste Management Inc., alleging, in part, that the company had “established inflated environmental reserves (liabilities) in connection with acquisitions so that the excess reserves could be used to avoid recording unrelated environmental and other expenses.”

   ○ In 2006, the SEC issued a cease and desist order against Ashland Inc. and one of its former employees for violations of the Securities Exchange Act after the SEC found that from 1999 to 2001 the employee had reduced the company’s cost estimates for remediating environmental contamination at dozens of chemical and refinery sites without any reasonable basis. The SEC concluded that Ashland did not establish adequate guidelines for, or require documentation or review of, adjustments to
environmental cost estimates, and, as a result, its system of internal accounting was insufficient.

○ In January, 2004, the SEC announced the entry of a civil judgment against former senior executives of Safety-Kleen Corp., who materially overstated Safety-Kleen’s revenue and earnings from 1998 through 2000 by, among other things, creating fictitious income by arbitrarily reducing several environmental remediation reserve accounts without analysis to support the reductions.

○ In June 2007, the SEC filed settled civil charges against former executives of ConAgra Foods Inc. who allegedly engaged in improper accounting practices, including reducing legal and environmental reserves in order to offset losses in other areas and boost earnings in 2000 and 2001, and thereby caused ConAgra to make false and misleading statements in its periodic filings.

b. Congress

In recent years, Congress has commissioned reports and conducted hearings and symposiums on environmental disclosure issues.

• In October 2002, Senators Corzine, Lieberman and Jeffords asked the General Accounting Office (“GAO”) to review the effectiveness of the SEC’s environmental reporting requirements and the level of compliance with those requirements and to identify changes to the requirements that would encourage greater environmental disclosure. In July 2003 and 2004, Senator Corzine convened Congressional symposia to consider the current state of disclosure of environmental risks. The results of the GAO’s review, “Environmental Disclosure, SEC Should Explore Ways to Improve Tracking and Transparency of Information,” was unveiled in the summer of 2004. The GAO report concluded that:

○ Key stakeholders disagree on whether environmental disclosure requirements provide too much flexibility or are too narrow in scope.

○ It is difficult to determine whether varying levels of disclosure within industries reflect different risks faced by
companies or differences in the extent to which companies are disclosing risks.

○ The adequacy of the SEC’s efforts to monitor and enforce compliance with environmental disclosure requirements cannot be determined.

○ The SEC should take steps to improve the tracking and transparency of its reviews of filings and to improve its coordination with the EPA. Toward this end, the SEC has agreed to make comment letters and company responses available on its website and has started tracking its reviews of company filings to identify trends in environmental disclosures.

• In October 2007, the Senate Subcommittee on Securities, Insurance and Investment held hearings on “Climate Disclosure: Measuring Financial Risks and Opportunities.” Following the testimony, several senators sent a letter to the SEC urging the Commission to issue interpretive guidance on disclosure relating to the risks of climate change.

c. EPA

In 2001, the EPA announced an environmental disclosure initiative to encourage greater compliance with SEC disclosure requirements. To accomplish this objective, the EPA created an online database, Enforcement and Compliance History Online (“ECHO”), which identifies companies’ environmental compliance history, formal enforcement actions and related penalties on a facility-specific basis. The EPA also notifies affected companies that SEC disclosure obligations may apply to pending enforcement actions.

d. Shareholder Suits, Resolutions and Petitions Targeted at Specific Companies

Shareholders have filed complaints, resolutions and petitions with respect to individual companies relating to environmental disclosure.
• Class actions were filed in 1999 by shareholders of US Liquids for allegedly concealing material environmental information resulting in inflated share prices.

• Shareholder resolutions requesting enhanced disclosure of environmental issues, particularly relating to climate change, have multiplied in recent proxy years. See Section 6.k. below.

• Since the late 1990’s, shareholder groups, institutional investors, environmental organizations, including Friends of the Earth and the World Resources Institute, unions, and public interest groups have alleged frequent noncompliance with environmental disclosure rules and called for stricter SEC enforcement of such rules.
  ○ In 1998, the United Steel Workers of America (a member of the Corporate Sunshine Working Group) petitioned the SEC alleging that Phelps Dodge failed adequately to disclose environmental liabilities and cleanup costs associated with a contaminated site.
  ○ In 1999, two shareholders petitioned the SEC to investigate Crown Central Petroleum for, in part, failing to disclose certain environmental penalty proceedings.
  ○ In March 2001, Friends of the Earth petitioned the SEC to investigate the Scotts Company for alleged failure to disclose trends in UK environmental regulations which the group contended were potentially material to Scotts’ peat extraction business.
  ○ In June 2001, nine institutional investors petitioned the SEC to require Abbott Laboratories to disclose recent scientific findings relating to chemicals associated with the production of polyvinyl chloride (PVC) plastic.
  ○ In August 2004, two institutional investors sought an SEC investigation of Dow Chemical’s allegedly misleading statements made during an annual shareholder meeting and omissions from SEC filings relating to the 1984 explosion in Bhopal, India, dioxin contamination in Midland, Michigan and the chemical defoliant Agent Orange.
e. Institutional Investor and Public Interest Groups

- Institutional investors and public interest groups have asked for enhanced disclosure and enforcement by the SEC.
  - In 2001, the World Resources Institute and the Calvert Group, a socially responsible mutual fund, requested the SEC fully to enforce regulations that require companies to disclose known environmental risks and uncertainties that are likely to affect future financial performance.
  - In 2002, the Rose Foundation, a coalition of charitable foundations and socially responsible investment funds, submitted a rule-making petition to the SEC calling for enhanced disclosure of environmental liabilities.
  - In February 2004, the California State Treasurer launched an initiative calling on the California Public Employees Retirement System (“CalPERS”) and the California State Teachers’ Retirement System to (1) use their financial clout in pressing the SEC to strengthen environmental disclosure rules, (2) target private investment in environmental technologies, and (3) invest in stocks of environmentally responsible companies. In April 2004, CalPERS recommended that the SEC begin public hearings within six months on the reporting of environmental risks by public companies.
  - In recent years, shareholder interest groups have filed a number of petitions with the SEC seeking enhanced disclosure relating to climate change issues. These petitions are described in Section 6.k. below.

- Public interest groups have published a number of reports regarding the inadequacy of environmental disclosure.
  - In 2000, the World Resources Institute released a report alleging that the pulp and paper industry is not properly disclosing environmental risks.
  - Since 2002, Friends of the Earth, an environmental organization, has published an annual survey of climate change disclosure by publicly traded companies in the automobile manufacturing, integrated oil & gas, insurance, petrochemicals, and utilities industries. The most recent survey (2006) concludes that disclosure of the risks of
climate change has improved, but the quality of disclosure is inconsistent.

○ In 2004, the Rose Foundation published a study detailing accounting strategies employed by corporations to limit disclosure of environmental risks and liabilities.

○ A 2004 report authored by Robert Repetto detailed ten case studies of mining company disclosure and concluded that nine of the hard rock mining companies failed to disclose known financially material risks arising out of environmental issues.

2. **PRINCIPAL ENVIRONMENTAL LAWS**

- Environmental laws can be divided into three broad categories.

  a. **Laws relating to Contamination (CERCLA):** The Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”) and similar state Superfund statutes impose liability on current owners and operators of a contaminated facility, former owners and operators at the time of disposal, generators who send waste to contaminated facilities, and transporters. Such liability is strict, retroactive, and joint and several.

  b. **Laws relating to Compliance (e.g., Clean Water Act, Clean Air Act, the Resource Conservation and Recovery Act (“RCRA”), and OSHA):** Many environmental compliance statutes authorize penalties of up to $25,000 per day per violation and also provide for criminal liability even if the defendant did not “knowingly” violate the law. Citizen suits may also be brought under many of these statutes.

  c. **Toxic Torts:** Common law theories of nuisance, negligence, trespass, and strict liability for ultra-hazardous activities can be asserted in connection with exposure to hazardous substances (e.g., exposure to asbestos, toxic air emissions, contamination, and mold). Damages can include personal injury, property damage, and medical monitoring for increased risk of future injury.
3. PRINCIPAL SEC DISCLOSURE REQUIREMENTS FOR ENVIRONMENTAL LIABILITIES

- Item 101 (Business) of Regulation S-K: Requires disclosure of material environmental compliance costs.
- Item 103 (Litigation) of Regulation S-K: Requires disclosure of material legal proceedings, proceedings for which costs could exceed 10% of the current assets, and any enforcement proceedings that reasonably may be expected to result in sanctions of $100,000 or more.
- Item 303 (MD&A) of Regulation S-K: Requires disclosure in MD&A of contingencies that are reasonably likely to have a material effect and requires quantification of potential liability to the extent reasonably practicable.

4. PRINCIPAL ACCOUNTING STANDARDS FOR FINANCIAL STATEMENT DISCLOSURE

- FASB Statement 5: FASB Statement 5 provides that loss contingencies must be disclosed if (i) available information indicates that it is probable that “an asset has been impaired or a liability has been incurred at the date of the financial statements” and (ii) the amount of the loss can be reasonably estimated. Under FASB Statement 5, even if both conditions cannot be met, disclosure of the loss contingency is required where there is “at least a reasonable possibility” that the loss has been incurred. This disclosure is required to state the nature of the contingency, and give an estimate of the possible loss or range of loss, or state that an estimate cannot be made.

- SAB 92: Under SEC Staff Accounting Bulletin (“SAB”) No. 92, detailed disclosures regarding material environmental loss contingencies must be furnished in the notes to financial statements to prevent those financial statements from being misleading. Under SAB 92, contingent environmental losses must be accrued by a charge to income if it is probable that a liability has been incurred and if the amount of the liability can be estimated. The liability must be recorded separately from any expected insurance recoveries and contribution/indemnification rights. With respect to joint and several liabilities for a contaminated site, if there is a
reasonable method of apportioning costs, and it is probable that other PRPs will contribute, then the registrant need only recognize the estimate of its portion of the liability. A note on the uncertainties relating to contributions by other PRPs may be necessary.

- **SOP 96-1**: Provides accounting guidance with respect to environmental remediation liabilities that relate to pollution arising from historic conduct.

- **FASB Statement 143 ("SFAS 143") and FASB Interpretation No. 47 ("FIN 47")**: SFAS 143 requires companies to record the fair value of a liability for an asset retirement obligation (i.e., legal retirement obligations resulting from the acquisition, construction or normal operation of tangible, long-lived assets, such as utility plants, mines and landfills) in the period in which it is incurred if a reasonable estimate of “fair value” can be determined. SFAS 143 does not apply to “immaterial” obligations or to legal obligations resulting from the improper operation of an asset, such as a catastrophic spill. FIN 47 clarifies that an asset retirement obligation that is conditional on a future event is within the scope of SFAS 143.

- **FASB Statement 141(R) (SFAS 141(R))**: SFAS 141(R) requires an acquirer in a transaction to measure and recognize the assets acquired and the liabilities assumed at their “fair value” as of the acquisition date, with limited exceptions.

- **FASB Statement 157 (SFAS 157)**: SFAS 157 applies to a broad array of FASB pronouncements that utilize “fair value” as a measurement, including asset retirement obligations in accordance with SFAS 143 and business combinations in accordance with SFAS 141(R). SFAS 157 defines fair value generally as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value estimates may often be higher than estimates resulting from the application of FASB Statement 5, which permits recognition of liabilities at the low end of a range of estimates if no number within the range is a better estimate. Under a fair value analysis, probabilities of various outcomes must be weighed and factored to arrive at the point within the range that is most representative of fair value under the circumstances.
5. **ENVIRONMENTAL DUE DILIGENCE STEPS IN CONNECTION WITH OFFERINGS**

a. Submit environmental due diligence document request.

b. Review environmental documents at issuer’s or attorney’s offices and, if possible, make copies of significant or critical documents.

c. Conduct telephone and/or in-person interviews of some or all of the following:
   - Corporate Director of Environmental, Health & Safety
   - In-house Environmental Counsel
   - CFO and possibly the Company’s accountants (with respect to environmental accounting issues)
   - Director of Human Resources (or other person responsible for health and safety issues, if such issues do not fall within scope of responsibility of environmental director)
   - Facility Environmental Managers (to the extent that corporate environmental manager does not have information regarding facility-specific environmental issues)
   - Outside Environmental Counsel (for any potentially material environmental legal proceedings)
   - Outside Environmental Consultants (for any potentially material environmental investigations/remediations)

d. Request follow-up documentation, as necessary, based on results of interviews.

e. Retain environmental consultants, if necessary and cost-effective.
   - Typically, parties conducting environmental due diligence for offerings do not retain environmental consultants to assist in reviewing material.
   - Typically, parties conducting environmental due diligence for offerings do not request environmental consultants to perform new Phase I environmental site assessment. However, issuers will need to have sufficient and current environmental information available and may, therefore, need to have assessments prepared.
6. ENVIRONMENTAL DUE DILIGENCE INFORMATION REQUESTS

- Generally parties conducting environmental due diligence should discuss with the issuer and/or request the issuer to provide, or make available for inspection, documents relating to some or all of the following categories of information:
  - Current and Former Properties
  - Environmental Management
  - Audits/Inspections/Phase I and II Environmental Site Assessments
  - Claims/Information Requests/Notices of Violation
  - Environmental Permits
  - Asbestos/PCBs/Mold
  - Employee Safety and OSHA
  - Audit Letters by Outside Counsel
  - Divestiture/Acquisition Agreements and Agreements with Indemnification, Allocation and/or Cost Sharing Provisions
  - Budgets, Proposed Capital Projects and Other Expenditures for Environmental Matters, and Asset Retirement Obligations
  - Climate Change
  - Financial Reserves for Environmental Matters
  - Insurance Information

- In addition to general requests, due diligence should be tailored to specific environmental concerns associated with specific industries (e.g., utility and automotive companies could face significant costs in connection with climate change issues).

a. Due Diligence Requests Relating to Current and Former Properties

- Sample Request: Identify and describe all real property or other facilities currently or formerly owned, operated or leased, either directly or indirectly (i.e., through subsidiaries, joint ventures, operating units or other related entities). All predecessor companies, discontinued operations and formerly owned, leased
or operated properties should be identified, and, where possible, the information requested below should be provided with respect to both current and former properties and operations.

- Under CERCLA and similar state statutes, both current owners and operators and former owners and operators at the time of the disposal are potentially liable. Therefore, it is important to obtain information regarding environmental conditions at all current and former properties.

- In addition, under CERCLA, a parent company can be held (i) indirectly liable as an owner or operator of its subsidiary’s facility through traditional veil-piercing and (ii) directly liable as an operator if it manages, directs or conducts pollution-related operations at a subsidiary — i.e., operations relating to the leakage or disposal of hazardous wastes, or decisions about compliance with environmental regulations.

b. Due Diligence Requests Relating to Environmental Management

- Sample Request: Identify and describe (i) individuals currently responsible for environmental compliance and (ii) environmental compliance programs and practices. Indicate whether facilities have achieved ISO 14001 certification.

- A strong environmental management program helps provide comfort that environmental issues are being adequately addressed.

- A comprehensive and well-organized internal tracking and reporting system with respect to environmental matters reflects compliance with the Sarbanes-Oxley Act of 2002. See Section 7 below.

- Many global companies have taken steps to achieve certification under the International Organization for Standardization (“ISO”) 14001. ISO 14001 contains voluntary standards relating to Environmental Management Systems (“EMS”). Certification under ISO 14001 requires the following:
  - A policy statement committing to pollution prevention, continual improvement of the EMS and overall environmental performance, and compliance with law.
○ Identification of all of the company’s activities, products and services that could significantly impact the environment.

○ Development of performance objectives to achieve the policy statement’s commitments and implementation of the EMS to meet the objectives.

○ Establishment of a program to conduct periodic audits of the EMS’ operation.

○ Implementation of actions to correct deviations from the EMS, including periodic evaluations of the company’s compliance with law.

c. **Due Diligence Requests Relating to Environmental Audits/Inspections/Phase I/II Site Assessments**

- **Sample Request:** Provide copies of all (i) environmental audits, action plans, reports, impact statements, tests, site investigations or assessments, whether performed internally or by an outside consultant; (ii) reports or other documents relating to any inspection by any governmental entity concerning compliance with environmental laws; (iii) notices or filings pursuant to any environmental law; and (iv) current spill prevention, control or countermeasure plans and emergency response plans. In addition, to the extent known, identify any conditions or events that might give rise to environmental liabilities.

- Some companies conduct routine or periodic environmental audits to assess compliance with environmental laws and regulations.

- Audits may be performed in-house or by outside consultants.

- EPA and many states have audit policies allowing for reduced penalties if a company conducts a voluntary audit, discloses the findings within a specified time period, and promptly implements any necessary corrective action.

- A Phase I environmental site assessment is a review of historical and current information relating to a site and adjacent properties to determine if there are Recognized Environmental Conditions (“RECs”) — problems which indicate known or potential contamination.
Phase I’s are often conducted by purchasers and/or sellers in connection with an acquisition/divestiture or by lenders in connection with financing.

Phase I’s are rarely conducted by underwriters in the securities offering context (but review of Phase I’s previously conducted is a significant part of an underwriter’s document review).

The site assessment is used to support the argument that the owner should be considered an “innocent landowner” or a “bona fide prospective purchaser” and to assist in assessing the business risk of a transaction.

Phase I’s occasionally will include review of compliance, liability for offsite waste disposal and former/divested facilities.

Phase I’s do not include soil and/or groundwater sampling.

- A Phase II environmental site assessment includes soil and/or groundwater sampling to investigate environmental conditions at the site.

d. Due Diligence Requests Relating to Claims/Information Requests/Notices of Violation/Consent Orders

- Sample Request: Provide copies of all administrative or judicial orders, injunctions, notices, records of decision, claims, complaints or correspondence discussing actual or potential liabilities, requests for information, citations or notices of violation relating in any way to environmental matters (including, without limitation, claims for cleanup costs, fines or penalties, property damage and/or personal injury, and notices of liability or potentially responsible party (PRP) status under CERCLA or state law).

- This request is made in order to confirm compliance with Item 103 of Regulation S-K, which requires disclosure of certain environmental legal proceedings. Registrants must disclose any legal proceeding in which the government is a party if such proceeding involves potential monetary sanctions greater than $100,000.
Under this rule, a company with a market capitalization of billions of dollars must still disclose a $100,000 penalty.

A 1998 survey by the EPA’s Office of Enforcement and Compliance Assurance found that 74% of companies failed to report in their 10Ks environmentally related legal proceedings that could result in governmental monetary sanctions over $100,000.

In a 2001 presentation to the ABA, the EPA reported that 96% of companies facing federally-imposed toxic clean-up expenses failed to properly disclose the liabilities to shareholders.

- The due diligence request relating to claims includes a request for PRP notices and requests for information. Large industrial companies with a long history of operation may have been named a PRP at dozens of contaminated sites (including sites where such companies are current or former operators or sites where such companies disposed of hazardous waste).

- The due diligence request relating to claims includes any citizen suits and claims relating to toxic torts.

- During telephone/in-person interviews, parties conducting environmental due diligence should inquire whether there are any threatened claims relating to environmental matters.

e. **Due Diligence Requests Relating to Environmental Permits**

- **Sample Request:** Provide copies of all environmental permits, waivers, exemptions, exclusions, variances, warnings, notices of violation, fines, communications with regulatory authorities regarding compliance with any such environmental permits, and any proposed or pending applications for issuance or renewal of any environmental permits.

- Such information is necessary to assess a company’s compliance with environmental laws and regulations.

- During telephone/in-person interviews of relevant environmental personnel, parties conducting environmental due diligence should inquire regarding the likelihood that critical environmental permits will not be renewed, or that any renewals will contain
requirements for additional pollution control measures requiring material capital expenditures.

f. **Due Diligence Requests Relating to Asbestos/PCBs/Mold**

- **Sample Request:** Provide copies of all documents relating to the presence, use, handling, storage, transportation, removal or disposal of asbestos-containing materials (“ACM”), PCBs or PCB-containing equipment, or mold, including any ACM, PCB or mold surveys or studies, and a list of any properties where any known or suspected ACM, PCBs or PCB-containing equipment, or mold is or was located.

- Potential asbestos liability includes (i) liability arising from claims alleging exposure to asbestos and (ii) costs relating to abatement and/or remediation of asbestos-containing material (“ACM”) at current facilities.

- Liability relating to asbestos claims can be significant.
  - Since 1979, over 80 companies have filed for bankruptcy protection due to liability in connection with asbestos claims.
  - Published reports put the total cost for asbestos losses at $200 billion in the U.S., with defendant corporations paying approximately $78 billion and insurance companies absorbing $122 billion of the costs.
  - After years of pursuing primarily ship building companies and companies that made ACM, asbestos plaintiffs have begun routinely suing second-tier asbestos defendants, such as companies that sold or installed asbestos or products containing asbestos and companies that owned buildings containing ACM.
  - Due diligence queries relating to asbestos claims should include the following:
    - How many total claims have been filed and how many claims remain pending?
    - How many claims are filed each year?
    - How many claims are settled each year?
    - What is the average cost of settling a claim?
• What are the annual defense costs?
• How many claims are covered by insurance? Are defense costs covered by insurance? Is there a cap on insurance liability?
• In general, liability relating to abatement and remediation of ACM at current facilities is not as significant as liability relating to asbestos exposure claims.
  ○ Except for certain categories of facilities (e.g., schools), there is no need to abate/remediate ACM unless such ACM is damaged and friable.
• One of the fastest growing areas of toxic tort litigation is claims arising from exposure to toxic mold. In 2001, a Texas family received a jury verdict of $32 million (later reduced to $15 million) for damages resulting to mold exposure. Since then, more than 10,000 mold cases have been filed against various defendants – including land owners, real estate agents, property managers, developers, employers, contractors, architects and engineers.

g. **Due Diligence Requests Relating to Employee Safety and OSHA**
• Sample Request: Provide copies of all OSHA inspections, assessments, citations, warnings, notices of violation or other correspondence regarding noncompliance or fines; material safety data sheets (MSDS); studies concerning health effects upon employees in connection with occupational exposure to any substances; and documents relating to Worker’s Compensation claims and amounts paid to employees pursuant to such claims or pursuant to other actions alleging personal injury during the last 5 years.
• Typical OSHA penalties involve minor amounts (e.g., $1,000); however, penalties can be significant if an employee is killed or seriously injured in connection with an OSHA violation.
• Companies that handle certain hazardous substances (e.g., lead) may be required to conduct air monitoring to ensure compliance with regulatory standards and medical monitoring to ensure that levels of toxic substances in employee blood are safe.
• Worker’s Compensation claims relating to exposure to hazardous substances can be costly.

• Cases are being brought to focus on occupational exposure to a variety of substances, including silica dust and benzene.

h. **Due Diligence Requests Relating to Audit Letters**

• **Sample Request:** Please provide copies of all letters or other documents prepared internally or by any legal counsel in response to inquiries by any financial auditors reflecting any information relating in any way to environmental matters.

• Such audit letters often contain well-drafted summaries of potentially material environmental liabilities.

• Typically the audit letters are also requested as part of the main corporate diligence request.

i. **Due Diligence Requests Relating to Agreements**

• **Sample Request:** Provide copies of any contractual indemnity, allocation, or other cost-sharing provisions relating to environmental liabilities, including without limitation all such provisions contained in any acquisition, sale or merger agreement, or in any separate letter agreement or other document.

• Divestiture/acquisition agreements and settlement agreements may contain significant ongoing environmental indemnification obligations as well as benefits and/or contain covenants requiring the performance of costly corrective action.
  
  ○ For example, a company could be a PRP at dozens of contaminated sites based on the historic waste disposal of a predecessor. If the predecessor is financially viable and agreed to indemnify the company for liabilities relating to pre-closing waste disposal, such liabilities may not be material.

  ○ Conversely, a company with currently benign environmental operations could have indemnification obligations in connection with historic operations.
Parties conducting environmental due diligence must conduct a separate analysis as to the status and survival/limitations contained in indemnification agreements.

- Likely recoveries of costs pursuant to such agreements should not be netted out for purposes of recording an environmental liability (i.e., the liability must be recorded separately from any contribution/indemnification rights).

- For acquisitions after December 15, 2008, SFAS 141(R) requires the acquirer to measure and recognize the assets acquired and liabilities assumed at their “fair value” as of the acquisition date, with limited exceptions. As a result, acquirers may have to record contingent environmental liabilities that were not previously accounted for (or recorded at a lower amount) by sellers under FASB Statement 5.

j. **Due Diligence Requests Relating to Capital Expenditures and Asset Retirement Obligations (“AROs”)**

- **Sample Request:** Please provide copies of all budgets, proposed capital projects, and other estimates of capital costs and other expenditures for environmental matters, including AROs.

- Item 101(xii) of Regulation S-K requires disclosure of material effects that compliance with environmental law may have on capital expenditures, earnings and competitive position.

- SFAS 143 and FIN 47 require financial statements to reflect the fair value of liabilities relating to AROs.

- During telephone interviews, parties conducting environmental due diligence should explore the need for capital expenditures in connection with anticipated regulatory changes as well as the basis for AROs.

- If several companies in an industry sector disclose potential capital expenditures in connection with a risk or uncertainty relating to a new or proposed environmental regulation, a competitor’s failure to disclose the risk may trigger closer scrutiny by the SEC, shareholders and/or public interest groups.
k. Due Diligence Requests Relating to Climate Change

- **Sample Request:** Please provide copies of all studies, capital expenditure plans and other programs proposed or being considered by or on behalf of the company relating to the impact of climate change on the business, including any calculations of emission inventories and any calculations of the potential costs (and/or opportunities) associated with reducing greenhouse gas emissions, such as installation of pollution control equipment, operational changes, and the purchase and/or sale of carbon offset credits.

- The Kyoto Protocol, which entered into force in 2005, sets mandatory greenhouse gas emission limits for the more than 175 nations (including EU, Russia, Canada, Mexico, China, Norway and Japan) that ratified it. In accordance with the protocol, in 2005 the European Union established a cap and trade system for greenhouse gas emissions, known as the European Union Greenhouse Gas Emissions Trading Scheme. Companies that operate in countries that have ratified the Kyoto Protocol may be required to disclose in their MD&A any material costs of compliance with the protocol.

- In 2001, the US announced that it would not ratify the protocol. However, it now appears likely that some form of federal legislation mandating a cap and trade system for greenhouse gas emissions will pass. In the absence of federal regulation, a patchwork quilt of regional, state and local regulation of greenhouse gas emissions has developed in the US. A nonexhaustive list of such initiatives includes the Regional Greenhouse Gas Initiative, the Western Climate Initiative, the Midwestern Greenhouse Gas Reduction Accord, and the California Global Warming Solutions Act.

- The climate change litigation docket has been active in recent years. In 2007, in *Massachusetts v. EPA*, the U.S. Supreme Court held that carbon dioxide is a pollutant for purposes of regulation under the Clean Air Act. In addition to lawsuits seeking regulatory action on climate change issues, a number of climate change lawsuits have been filed seeking: (i) monetary damages and/or injunctive relief on the theory of public nuisance, (ii) damages in
connection with Hurricane Katrina, and (iii) consideration of climate change issues in environmental permitting decisions.

- In the absence of specific standards for mandatory disclosure of the risks of climate change, a variety of voluntary disclosure frameworks have been developed and proposed, including the Carbon Disclosure Project, the Global Reporting Initiative, the Global Framework for Climate Risk Disclosure, and the Carbon Principles.

- There have been a number of institutional investor initiatives requesting the SEC to provide guidance with respect to disclosure of climate change issues.
  - In April 2004, 13 major public pension fund leaders called on the SEC to require companies to disclose the financial risks of global warming.
  - In a June 2006 letter to SEC Chairman Christopher Cox, 28 institutional investors with over $1 trillion under management wrote that climate change poses material financial risks to many of their portfolio companies and called on the SEC to enforce existing disclosure requirements; provide greater interpretive guidance on the materiality of risks posed by climate change; and require companies to include in their proxy statements shareholder proposals asking companies to report on financial risks due to climate change.
  - In March 2007, a group of more than 60 investors managing over $4 trillion called on Congress to formulate a national policy on climate change that would include, among other things, action by the SEC to clarify what companies should disclose to investors on climate change in their regular financial reporting.
  - In September 2007, CERES, a group of environmental advocates and investors managing over $1.5 trillion, petitioned the SEC to issue interpretive guidance on how companies should report climate-related information in corporate disclosures under existing law. According to the petition, the guidance should direct companies to report to disclose any physical risks from climate change, any financial risks associated with present or probable regulation...
of greenhouse gas emissions, and any legal proceedings related to climate change.

- A number of surveys regarding the financial impact of climate change issues have been published in recent years. Although many companies believe climate change poses a legitimate financial risk, disclosure of climate change issues has been inconsistent.
  - A recent survey conducted by Carbon Disclosure Project (an investor group concerned about the financial risks of global climate change) of the 500 largest global companies found that most companies consider climate change to be a legitimate financial risk that will have a growing impact on profitability.
  - Since 2002, Friends of the Earth has published an annual Survey of Climate Change Disclosure in SEC Filings of Automobile, Insurance, Oil & Gas, Petrochemicals and Utilities Companies. The most recent survey (released in 2006) notes that corporate disclosure of climate change risks has nearly doubled in the last 5 years; however, the quality of disclosure is inconsistent across companies.

- Climate change has been the subject of a large number of shareholder resolution campaigns. In the 2004 and 2005 proxy seasons, at least 28 and 33, respectively, global warming and climate change shareholder resolutions were filed. In 2006, the number decreased to 24, but a record 43 shareholder resolutions were filed in 2007. As a result of such shareholder pressure, a number of companies (including American Electric Power, Cinergy Corp., Southern Company, TXU, Great Plains Energy Inc., Alliant Energy, WPS Resources, MGE Energy, Ford Motor Co., General Motors, Anadarko Petroleum, The Home Depot, Lowes, Chubb, Costco, Toronto-Dominion, Simon Property Group, Hartford Insurance and Prudential Financial, Inc.) agreed to disclose risks related to potential future constraints on carbon dioxide and other emissions.

- Parties conducting due diligence of climate change issues should inquire whether the company has assessed regulatory risks, legal risks, and physical risks relating to climate change and greenhouse gas emissions.
○ Regulatory risks include potential costs relating to current or future compliance with the Kyoto Protocol (for multinational companies), and the patchwork quilt of regional, state and local initiatives pertaining to climate change. Companies that are significant emitters of greenhouse gases may have calculated such emissions and potential costs to install pollution control facilities to reduce greenhouse gas emissions or purchase offset credits.

○ Legal risks include whether the company has been named a party to any climate change litigation or is likely to be subject to substantial monetary or operational consequences as a result of litigation against similarly situated companies.

○ Physical risks relating to climate change (such as changing temperatures, rising sea levels, and more severe storms) may have significant implications on companies in certain sectors (e.g., insurance, agriculture).

I. Due Diligence Requests Relating to Financial Reserves

• Sample Request: Please provide information regarding any financial reserves in connection with environmental matters, and a complete breakdown of any such reserves.

• Various accounting obligations relating to contingent environmental liabilities can affect disclosure and, consequently, environmental due diligence inquiries. Such accounting obligations are reflected in FASB Statement 5, SAB 92, SOP 96-1, SFAS 143, FIN 47, SFAS 141(R) and SFAS 157.

• A telephone interview of the company’s CFO and its accountants may be necessary to explore the company’s environmental accounting policies and the implementation of those policies.

• FIN 47 should cause companies to conduct diligence to (1) identify all of their asset retirement obligations and (2) value the identified obligations. Such valuations must be conducted without regard to any “undue cost or effort.”
m. Due Diligence Requests Relating to Insurance Information

- Sample Request: Please provide copies of all insurance claims, notices or other communications with insurance carriers relating to environmental liabilities since 1980.

- There have been many environmental insurance litigations relating to historic contamination under old Comprehensive General Liability (“CGL”) policies drafted at a time when neither party anticipated CERCLA-type environmental liability. These old CGL policies are “occurrence” policies (rather than “claims made” policies) and can provide coverage if the insured can show that contamination occurred during policy years. Coverage often depends on whether the environmental incident was “sudden and accidental.” Some companies have settled with their insurance companies for significant sums under these policies.

- Some insurance companies, like AIG and Chubb, are now offering environmental insurance products in an attempt to bridge gaps in environmental indemnities. Such insurance products include:
  - cleanup cost cap insurance (capping environmental cleanup costs in order to mitigate the uncertainty in estimating cleanup costs)
  - pollution legal liability insurance (providing coverage for losses due to pre-existing and unknown pollution conditions)
  - environmental pollution programs (combining elements of cleanup cost cap and pollution legal liability coverage)

- Some insurance companies offer environmental insurance products to address ongoing environmental risks (e.g., spills during policy period).

7. IMPACT OF SARBANES-OXLEY ACT OF 2002 ON ENVIRONMENTAL DISCLOSURE

- The Sarbanes-Oxley Act requires CEOs and CFOs to file certifications with their company’s quarterly and annual SEC filings providing the following:
○ To the CEO’s/CFO’s knowledge, the report does not contain material omissions or misstatements.

○ To the CEO’s/CFO’s knowledge, the financial statements fairly present in all material respects the company’s financial condition, results of operation and cash flows.

○ The CEO/CFO is responsible for establishing and maintaining, or causing to be established under his or her supervision, a system of disclosure controls and procedures designed to ensure that information required to be disclosed is reported in a timely manner; and the CEO/CFO has evaluated the effectiveness of the disclosure controls as of the end of the period covered by the report and has provided its conclusions with respect to such evaluation in the report.

○ The CEO/CFO is responsible for designing, or causing to be designed under his or her supervision, a system of internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external use in accordance with GAAP; the CEO/CFO has disclosed any change in internal control over financial reporting that occurred during the last fiscal quarter (the fourth quarter in the case of an annual report) which has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and the CEO/CFO has reported (1) any significant deficiencies or material weaknesses in the design or operation of the internal control over financial reporting and (2) any fraud, whether or not material, involving management or other employees who have a significant role in the registrant’s internal control over financial reporting, to the registrant’s audit committee and outside auditors.

- The Company’s environmental disclosure and the accounting treatment of environmental liabilities are therefore covered by the CEO/CFO certifications. Management should review environmental reporting and financial reporting practices and, if necessary, adopt new procedures for assessing and reporting environmental liabilities.
The attorney up-the-ladder reporting requirement could also require the company’s counsel (internal or external) to report to the CLO, CEO, audit committee or board if the lawyer believes there is a material violation of the securities laws, including a material misstatement in the environmental disclosure.