The Sarbanes-Oxley Act of 2002:

Implications for Environmental Counsel

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THE SARBANES-OXLEY ACT OF 2002: IMPLICATIONS FOR ENVIRONMENTAL COUNSEL

As a result of the Sarbanes-Oxley Act of 2002, securities lawyers and environmental lawyers have finally found professional common ground that will bring their practices closer together. Now we can move beyond the arguments over whose regulations are more complex and occupy more space in the C.F.R. – the tax lawyers will always win that battle anyway. While securities lawyers may not keep abreast of when Congress amends CERCLA or when the Environmental Protection Agency (the "EPA") adopts new regulations, and environmental lawyers may not know of every instance when Congress or the Securities and Exchange Commission (the "SEC") tinkers with securities regulation, both will have to work together very closely to ensure that periodic reports filed by public companies with the SEC accurately and completely disclose liabilities imposed by CERCLA, EPA regulations and any other environmental laws.

Traditionally, when a public company has significant on-going environmental issues, environmental counsel often is asked to identify, evaluate, value and educate management on the environmental and regulatory issues, as well as to draft or comment on the handful of paragraphs describing those issues that appear in the company's periodic reports which are filed with the SEC. For some environmental lawyers, their involvement in the process of preparing and finalizing periodic reports has always been extensive. For others, their involvement has consisted merely of taking an hour or so a few times each year to browse text that has been cut and pasted from the company's last report and ensuring that it is still accurate.

The world has changed under the Sarbanes-Oxley Act of 2002. Congress passed the Sarbanes-Oxley Act in a targeted effort to help restore investor confidence in U.S. financial markets following a series of major corporate financial scandals. Securities practitioners knew

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immediately that the business world had just seen its most significant expansion of federal securities regulation since the 1930s. Like their environmental colleagues though, many securities experts did not immediately appreciate the wide and deep scope of the act's reform and its impact on virtually all significant aspects of public company operations, including persons overseeing those operations. It soon became clear that certain parts of the Sarbanes-Oxley Act represent examples of those rare securities developments that must be understood by environmental lawyers, as well as securities lawyers.

ENVIRONMENTAL DISCLOSURE REGIME

Even before the Sarbanes-Oxley Act, various securities regulations required disclosures of material environmental matters on a quarterly and annual basis in reports filed with the SEC. While the Sarbanes-Oxley Act does not substantively change the required breadth or depth of environmental disclosures that must be included in public companies' periodic reports, its focus on accountability and informational transparency highlight the need for regular internal evaluations of the roles that various persons in the corporate hierarchy play in ensuring that environmental disclosures are being made accurately and completely.

For instance, public companies historically have been required to describe on a quarterly and annual basis any material pending legal proceedings, including environmental litigation and suits brought by environmental regulatory authorities.[1] In addition, public companies must disclose the material effects that compliance with environmental laws and regulations with respect to the discharge of materials or the protection of the environment may have upon the capital expenditures, earnings and competitive position of the company, as well as any material estimated capital expenditures for environmental control facilities.[2] To the extent that environmental trends or uncertainties are reasonably expected to have a material impact on revenues or income from continuing operations or to cause a material change in the relationship

[1] 17 C.F.R. §229.103 (Regulation S-K, Item 103).
[2] 17 C.F.R. §229.101(c)(xii) (Regulation S-K, Item 101(c)(xii)).

between costs and revenues (such as would result, for example, from future increased compliance costs), those trends or uncertainties also must be disclosed in public companies' quarterly and annual reports.[3]

Determining what, if anything, must be said about a particular environmental issue and the proper way to account for that issue at a given time can be intensely fact-intensive. When a company is a party to environmental litigation, some description of the litigation must be made in periodic reports if the proceeding is material to the business or financial condition of the registrant, which, for purposes of U.S. federal securities laws, is the case if there is a substantial likelihood that a reasonable investor would find that the information significantly alters the total mix of information available in making a decision to purchase or sell the company's securities. Similarly, disclosures must be made if the amount of the claim at issue, or the amount of potential monetary sanctions, capital expenditures, deferred charges or charges to income, is greater than 10 percent of the current assets of the company and its subsidiaries on a consolidated basis or if a governmental authority is a party to the proceeding and the company believes that it will incur penalties of $100,000 or more. Similar materiality determinations must be made with respect to other environmental issues that potentially must be disclosed, such as permit non-compliance or material discharges of contaminous matters. The SEC has stated that it believes that appropriate environmental disclosures would include discussions of the nature of the environmental costs, an estimate of the total costs, total costs already accrued, the balance sheet classification of accrued amounts and the range or amount of "reasonably possible additional losses."[4]

Additionally, the Financial Accounting Standards Board's *Statement of Financial Accounting Standards No. 5, Accounting for Contingencies* ("SFAS 5") requires that an estimated loss or expense from a loss contingency be accrued by a charge to income and so

[3] 17 C.F.R. §229.301 (Regulation S-K, Item 301).
[4] See SEC Staff Accounting Bulletin: Codification of Staff Accounting Bulletins, Topic 5: Miscellaneous Accounting (January 23, 2004). SFAS 5 defines "reasonably possible" as "The chance of the future event or events occurring is more than remote but less than likely."

reflected in the company's financial statements if (i) litigation has commenced, a claim has been asserted or the commencement of either is probable, and the outcome probably would be unfavorable, and (ii) the amount of asset impairment or liability can be reasonably estimated. Any such accrued contingency would be reflected in the company's financial statements.

A multidisciplinary group consisting of legal, accounting and environmental representatives, internal and external, as well as the company's senior executives, should be working together and melding their respective areas of factual knowledge and substantive expertise to determine the content of environmental information contained in a company's periodic reports. Although the SEC and the American Institute of Certified Public Accountants (the "AICPA") have offered guidance on the treatment of environmental liabilities that often have been a point of reference for accountants and lawyers (e.g., SEC Staff Accounting Bulletin 92, which addresses accounting and disclosure obligations, and AICPA Statement of Position 96-1, which provides insight into the appropriate recognition, measurement and disclosure of environmental liabilities at various points in the assessment and remediation processes), there is no substitute for the inclusion of substantive environmental expertise in the decision-making process with respect to environmental disclosures and accounting for environmental liabilities. In fact, in a post-Sarbanes-Oxley Act world, extensive participation of environmental practitioners in this process is a virtual necessity. While legal personnel intimately involved in the company's outstanding litigation may be in the best position to gauge their ability to successfully navigate through the litigation process and assess the range of civil penalties that may be incurred under relevant law if they are not successful, environmental personnel likely have the best grasp on the facts giving rise to the environmental issues, the spectrum of options available to address and resolve the company's environmental issues and the cost of any associated capital expenditures that would be required to resolve the matters.

SELECTED KEY IMPLICATIONS OF THE SARBANES-OXLEY ACT

Officer Certifications

One of the most controversial provisions in the Sarbanes-Oxley Act is a requirement that certain senior executive officers at public companies provide public certifications of the company's financial results, with the Department of Justice enforcing criminal penalties for failures of those officers to provide the certifications or to "knowingly" or "willfully" make false certifications. Section 906 of the Sarbanes-Oxley Act, which is titled "Corporate Responsibility for Financial Reports," requires that each annual and quarterly report including the company's financial statements that is filed with the SEC by a public company must be accompanied by a certification of the company's chief executive officer and chief financial officer. The certification must state that the periodic report fully complies with the Securities Exchange Act of 1934 and that the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company. A form of a Section 906 certification is attached as Exhibit A.

Under Section 302 of the Sarbanes-Oxley Act, more elaborate certifications are required. Section 302 requires certifications from public companies' chief executive officers and chief financial officers to the effect that, among other things, the certifying officers have established and maintained disclosure controls and procedures and internal control over financial reporting and that those controls and procedures have been designed to ensure that material information is made known to the certifying officers by all relevant persons within the organization. A form of a Section 302 certification is attached as Exhibit B.

These certification requirements should encourage companies to adopt, formalize or review their written procedures for gathering and verifying information regarding environmental liabilities. Such procedures should require that environmental practitioners accumulate and retain sufficient background information to support the environmental disclosures made in

companies' periodic reports and any determinations that particular environmental matters are not material enough to merit disclosure, including information related to the results of environmental testing, Responsible Party Agreements, agency orders and judicial judgments. The procedures, which are likely to be only a part of a larger company-wide system implemented by management for the purposes discussed in this article, may follow the format of other existing procedures for ensuring the accuracy of the accounting treatment of environmental matters, such as an ISO style format.

While the language contained in the text of these certifications may sound bland to environmental practitioners, the penalty provisions for not making the certifications or making false certifications certainly are sobering. "Knowingly" making a false certification or failing to certify the company's financial results can result in a fine of up to $1 million and a maximum of 10 years imprisonment for the certifying officer, while "willfully" doing so carries a fine of up to $5 million and a maximum of 20 years imprisonment. Further, certifying officers may be required to repay to the company any bonuses or other incentive compensation received as a result of any false certifications or actions necessitating an accounting restatement. These penalties are in addition to any penalties that may apply if the false certifications also violate other relevant laws, such as any state laws relating to the fiduciary duties of corporate officers.

In preparation for providing these certifications, chief executive officers and chief financial officers have come under increasing pressure to take all possible precautions to ensure the accuracy and completeness of the content of companies' periodic reports, including disclosures related to environmental matters. Given that environmental matters often represent some of the most material issues facing public companies, it is crucial to certifying officers that environmental disclosures in companies' annual and periodic reports and the accounting treatment of environmental contingencies reflected in companies' financial statements are unimpeachable. To achieve those ends, certifying officers are likely to ask for more hands-on involvement from their environmental experts in all phases of the preparation of periodic reports

than they have in the past and have begun to ask more pointed questions about the basis for statements made in disclosures about environmental liabilities.

Rather than merely asking for a "thumbs up/thumbs down" on the text of the environmental disclosures contained in the company's prior report, certifying officers are increasingly becoming personally involved in identifying the members of the environmental group who are knowledgeable about or who helped prepare the information contained in the periodic report and scrutinizing the presentation of that information in tandem with such persons. While environmental practitioners should not be expected to unilaterally determine appropriate environmental disclosure content or proper accounting treatment of environmental matters, the environmental practitioner should expect, as an integral part of a multidisciplinary team that does so, to offer an expert's perspective on the environmental information that goes into making those determinations.

Many companies have begun to obtain "sub-certifications" from environmental employees who are knowledgeable about or helped to prepare the information in the disclosures. The certifying officers then rely, in part, on the sub-certifications in making their Section 302 and 906 certifications. This means that environmental personnel who provide these sub-certifications are, at the least, putting their reputations on the line, and perhaps also the certifying officers' pocketbooks and liberty, if they do not vigilantly ensure that the appropriate environmental disclosures are accurate and complete in all material respects.

Up-the-Ladder Reporting

Section 307 of the Sarbanes-Oxley Act requires the SEC to establish "minimum standards of professional conduct" for attorneys appearing and practicing before the SEC in the representation of public companies. In response to Section 307, the SEC has issued rules requiring attorneys who represent public companies and become aware of "credible evidence of

a material violation"[5] of U.S. federal securities and other laws to report that evidence "up the ladder" within the company, first to senior officers such as the chief legal officer or the chief executive officer, and, if necessary, to the audit committee or another committee of independent directors of the board. To the extent that the company has formed a Qualified Legal Compliance Committee (the "QLCC") of the board of directors to receive such reports, attorneys alternatively may report evidence of a material violation to the QLCC to fulfill their obligation under Section 307 and the SEC's implementing rules. These reporting requirements are significantly greater than those imposed by many state ethical rules under which lawyers practice. Attorneys reporting information "up the ladder" can take comfort from the fact that Section 1107 of the Sarbanes-Oxley Act criminalizes any harmful retaliatory action taken against whistleblowers as a result of reporting truthful information.

The SEC's rules implementing Section 307 place the reporting obligations on any "attorney appearing and practicing before the Commission in the representation of an issuer."[6] The definition of "attorney," and the rules in general, make no distinction between outside lawyers and in-house counsel. While the concept of "appearing and practicing before the Commission" includes traditional notions of the practice of securities and corporate law, other attorneys who represent issuers on other types of matters may have reporting obligations under certain circumstances. For instance, the SEC's rules define "appearing and practicing before the Commission" to include attorneys who advise issuers whether information or a statement, opinion or other writing is required to be filed with, submitted to or incorporated into any document that will be filed with or submitted to the SEC. The only limitations on the broad scope of these rules are that the attorney must be providing advice "in respect of" the U.S. securities laws and the attorney must "have notice" that the document will be filed with the SEC.[7]

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[5] 17 CFR Part 205, § 205.3(b).
[6] 17 CFR Part 205, §§ 205.1, 205.3(b).
[7] 17 CFR Part 205, § 205.2(a)(1)(iii)

As a result of these rules, it is not clear whether non-securities attorneys who are asked to contribute to or review periodic reports would be subject to Section 307. For example, an environmental litigator who is asked to summarize a pending suit for the "Legal Proceedings" section of an Annual Report on Form 10-K may be subject to the up-the-ladder reporting rules. That environmental lawyer would have notice that the report will be filed with the SEC, and the environmental lawyer arguably is "providing advice in respect of U.S. securities laws" by helping to determine whether and how to disclose information related to the suit in a report mandated by U.S. securities laws. This means that environmental counsel could find that inaccurate or incomplete environmental disclosures appearing in periodic reports filed with the SEC directly impact them on a personal level.

Violation of the up-the-ladder reporting rules by any attorney subjects the attorney to the civil penalties and other remedies available in the case of violations of the federal securities laws. In addition, attorneys who violate the rules may be suspended or barred from practice before the SEC through administrative proceedings. While the rules expressly state that they do not create private rights of action, violations could be construed as evidence of an attorney's breach of his or her fiduciary duty to the issuer or its shareholders.

As a result, it is imperative that environmental counsel thoroughly evaluate at all stages of the report preparation process whether environmental liabilities are appropriately recorded and accurately disclosed, whether all relevant environmental personnel have been involved in the disclosure process and whether all environmental liabilities and proceedings are reported in a manner that gives an accurate picture of the impact of those liabilities and proceedings on the company as a whole. While it may be tempting to merely transmit comments to a draft and turn responsibility over to the persons who traditionally ensure that the report is filed on time, it should not be lost on environmental practitioners that the responsibility for the environmental information in the periodic report, as it is filed, lies with them.

SUMMARY

While it certainly is not intuitive that environmental counsel would be impacted by securities reform or that they would be "appearing and practicing before the Commission" or "providing advice in respect of U.S. securities laws," they very well may be doing so for purposes of the Sarbanes-Oxley Act. Given the significant penalties and immeasurable loss of public goodwill that could result from a violation of the Sarbanes-Oxley Act, public companies have been forced to become exponentially more vigilant when it comes to their disclosures in the companies' period reports filed with the SEC, including by expecting increased cooperation and involvement from environmental counsel. To fully serve the needs of such companies in the wake of sweeping reform, environmental counsel should be prepared to play a larger role in companies' periodic reporting processes and to accept a new disclosure regime where they are more directly accountable for potential problems with environmental information contained in periodic reports.

The Sarbanes-Oxley Act raises the implications for all involved in the event that periodic reports do not contain accurate and complete assessments of the company's financial position, regardless of the role that the environmental practitioner plays. Surely, no conscientious chief executive officer or chief financial officer of a public company will continue to tolerate a disclosure system where environmental experts possessing significant familiarity with a company's environmental issues do not play a prominent role in crafting environmental disclosures appearing in periodic reports. Likewise, officers certifying periodic reports are much more likely to leave no stone left unturned in their search for any expertise that furthers their comfort in the accuracy and completeness of the reports. To this end, environmental practitioners, as well as experts in other fields that are relevant to a company's disclosures, will be expected to participate and interact to a large degree with management and legal and accounting experts in the disclosure process. After all, each of these other parties are equally as responsible for the accuracy of the information obtained from their environmental colleagues and

relied upon in the disclosure process as environmental practitioners are for the ultimate presentation of the information and expertise that they offer.

One can view the way that environmental practitioners should interact with others in the disclosure process as a variation of the "Prisoner's Dilemma." Nobody can be sure that they are making the best decision without the benefit of knowing what everyone else knows, with a significant down-side existing for all if poor decisions are made. Unlike in the traditional Prisoner's Dilemma, however, public companies with appropriate disclosure control systems in a post-Sarbanes-Oxley world can ensure that all parties essential to the process, including environmental practitioners, are working together in concert to create the accurate and complete periodic reports that keep everyone out of trouble.

Kristen L. Stewart concentrates her practice in the corporate, transactional and securities areas. Ms. Stewart's transactional practice involves matters for public companies, including mergers, acquisitions, transactions among parent and subsidiary corporations, and preparation of related securities disclosure documentation, and matters for privately held companies, including mergers, acquisitions, divestitures and restructurings. She has extensive experience as counsel to issuers in public and private securities offerings, including initial public offerings, debt and equity offerings and exchange offers. Ms. Stewart has represented companies in a variety of industries such as electrical distribution, education, publishing, steel, chemicals, financial institutions, health care and water and wastewater engineering. She has advised corporate clients with respect to securities compliance matters, corporate governance, business planning, and defensive planning and structuring, including the implementation of shareholders rights plans and other defensive devices. Ms. Stewart received her law degree from Duke University where she was an Editorial Board Member for the *Duke Law Journal* and her undergraduate degree from The Pennsylvania State University where she graduated with high distinction.

Jeffrey W. Acre maintains a corporate practice focusing on federal and state securities matters and mergers and acquisition transactions. He has experience in representing publicly-traded and privately-held clients in a variety of stock and asset transactions. Mr. Acre's practice also encompasses public and private securities offerings, as well as securities law compliance issues. In addition, his corporate practice includes counseling corporations regarding structuring and general corporate matters, including corporate governance obligations. Mr. Acre received his law degree from Vanderbilt University and his undergraduate degree from The Pennsylvania State University where he graduated with distinction.

EXHIBIT A
Sample Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the [Annual/Quarterly] Report of _____ (the "Company") on Form [10-K/10-Q] for the [year/quarter] ended _____, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), each of the undersigned, in their respective capacities indicated below, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to [his/her] knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

[Name]
Chief Executive Officer
[Date]

[Name]
Chief Financial Officer
[Date]

EXHIBIT B
Sample Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, _____, _____ of _____, certify that:

1. I have reviewed this [annual report on Form 10-K/quarterly report on Form 10-Q] of _____;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) *[and internal control over financial reporting (as defined in 1934 Act Rules 13a-15(f) and 15d-15(f))]* for the registrant and have;

    (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    (b) *[Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under my supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;]*

    (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

(5) The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent function):

(a) All significant deficiencies in the design or operation of internal control over financial reporting which are reasonably like to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

[Name]
Chief [Executive/Financial] Officer
[Date]

* Bracketed text may be excluded until a company files its first annual report required to contain management's internal control report pursuant to Section 404 of the Sarbanes-Oxley Act of 2002.

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