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Environmental risks and toxic tort liabilities have never been more visible – nor had more of an impact – on a company's overall corporate governance agenda. Accordingly, environmental insurance and alternative risk financing mechanisms are no longer viewed simply as a discretionary purchase, but are increasingly considered key financial and risk management tools for buying down risk, protecting asset value, transferring liability, and, in many cases, unlocking impediments and obstacles that can cause a difficult acquisition or divestiture to stall or fall through. The Sarbanes-Oxley Act of 2002, evolving legal and regulatory guidelines, the mold "epidemic" and an increase in merger and acquisition activity all bring environmental issues to the forefront of risk management considerations.

The goal of *EnviroRisk Manager* is to help you stay up to date, bringing you insights into current trends and possible problems on the horizon; market information; and details on the latest legal actions, how they might impact your company's operations and what risk management steps you should consider to protect your company. If you'd like more information on a topic we've covered – or to see an article on one we haven't – please let us know.

Environmental Issues and Internal Controls: The Interplay Between Accounting Rules, Sarbanes-Oxley and Modern Views on Corporate Governance

By Carla Marino Schwarz

Overview

Environmental issues have always presented especially complex challenges for companies. Whether the exposures come from general business operations or from legacy liabilities, companies must address the immediate issues of clean up, prevention and liability as well as the fiscal repercussions of each.

In the wake of Enron, ImClone and Tyco, corporate America continues to wrestle with the issue of corporate responsibility and how to appropriately account and report liabilities. Environmental liabilities, by their very nature, are problematic because they can intrude in virtually all transactions at any time—past, present and future. Real estate transactions (for both buyers and sellers), merger and acquisition activity (also for both sides), and the general conduct of regular business activity all bring with them environmental liabilities. Those liabilities directly impact the corporate bottom line and shareholder confidence, driving the need for appropriate and timely disclosure.

There is an old saying that there is no bad from which good does not come. In passing the Sarbanes-Oxley Act of 2002 (the Act) early last year, Congress was responding to some clearly bad corporate management. This legislation represents a major push for reform and heightened scrutiny regarding the manner in which corporations disclose their liabilities. Specifically, the Act speaks to the design and composition of audit committees, the nature and timing of disclosures of all types, as well as the form and quality of disclosures. If the goal of the Act is achieved – to increase corporate responsibility, raise the level of

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transparency of corporate operations for shareholders and reduce the likelihood of similar future events – the result will be a good one as it should lead to better corporate fiscal health all around.

The Rise of Corporate Governance

The Organization for Economic Cooperation and Development defines the concept of corporate governance as:

"…the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation…and spells out the rules and procedures for making decisions on corporate affairs…"

The focus for corporate governance today is increased accountability. The desired goal is to create a complete, integrated system of checks and balances that provides methodology and procedures for dealing with all aspects of company operations while building shareholder confidence. A recent study, "Corporate Governance and Equity Prices," by Paul A. Gompers, Joy L. Ishi and Andrew Metrick Gompers, found a correlation between shareholder rights and increases in firm value and profits. The article suggests that companies with fewer restrictions on shareholder rights show higher corporate performance, i.e. higher profits, higher sale sales growth, etc.

Shareholders are looking for companies to make better decisions and that includes taking more responsible measures toward the environment.

Who is Watching?

In addition to shareholders, governmental and regulatory bodies also have concerns about environmental liabilities. The EPA and state agencies are the most obvious players, as the entities that promulgate definitive rules for the management and control of environmental issues. Less obvious but also crucial in this oversight are the SEC and the Financial Accounting Standards Board (FASB).

The SEC (under Regulation S-K) and the FASB have specific rules governing the manner in which publicly traded companies may represent data and information to the public. This includes the way publicly held companies represent liability on the corporate balance sheet, which in turn encompasses environmental liabilities. Sarbanes-Oxley pushed these rules even further. Title III of The Act updates Regulation S-K to mandate requirements for the staffing and activities expected of public companies' audit committees, certifications by CEO and CFO and the rules of professional conduct for attorneys.

Handling these complexities is no simple task for corporations. They must sort out the key issues of timing and materiality, i.e., what to disclose, and when and how to disclose it.

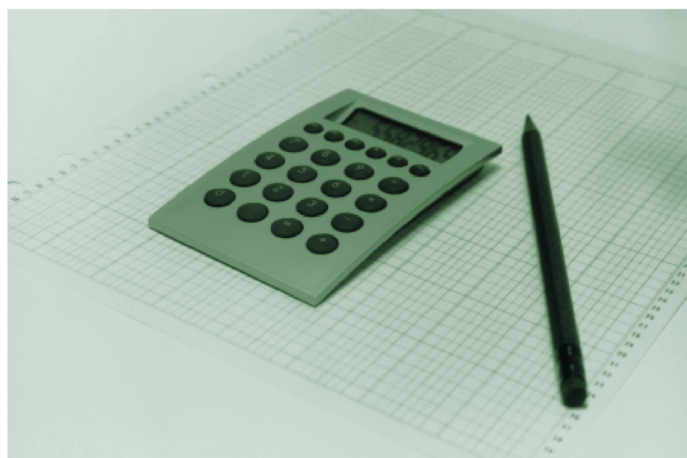
Flexible Timing and Murky Materiality

In the past, corporations flew under the radar on disclosure issues, and in particular environmental disclosures, by relying on FASB, Statement 5. This rule affords corporations some flexibility in accounting for contingencies. It allows a company to assign the present or future cost of a past environmental problem or legacy issue to the time when the problem arose initially. The room for flexibility comes with FASB 5's probable and reasonably estimable standard for accruals and the equally forgiving minimum loss range parameters for disclosure of loss contingencies. In short, FASB 5 leaves room for decision makers to determine in what period a loss will ultimately be incurred.

Regulation S-K Section 101 (xii) uses a materiality standard for disclosure for environmental liabilities. The concept of materiality, however, is murky. SEC Staff Accounting Bulletin 99 offers guidance on materiality, stating that "facts can be considered material if they bear on the ethics of management, its integrity or its law compliance record irrespective of the financial sums involved." It is questionable whether SAB 99 effectively clarifies materiality.

The accounting rules, coupled with Regulations S-K's loose definitions of materiality surely must have made for some rather interesting filings over the years—particularly when there was little data available that would paint a truly clear picture of an environmental liability.

Materiality appears again in Item 103 of Regulation S-K regarding the disclosure of legal proceedings where such proceedings may be material to the business or financial condition of the registrant. Here, the regulation defines "material pending legal proceedings" and in instruction 5 to Item 103 sets forth criteria for registrant disclosure of such proceedings.



* *Harvard Quarterly Journal of Economics* 118(1), February 2003

Despite such attempts, there is no definitive guidance on the concept of materiality. There are, however, high expectations for disclosure in Regulation S-K. These expectations will likely increase in the current climate.

Under Regulation S-K Section 229.303-Item 303, Management's Discussion and Analysis if Financial Condition and Results of Operations, the registrant company must:

"(ii) Describe any known material trends, favorable or unfavorable, in the registrant's capital resources. Indicate any expected *material changes* [emphasis added] in the mix and relative costs of such resources. The discussion shall consider changes between equity, debt and any off-balance sheet financing arrangement."

The purpose of this requirement is to give the investor information relevant to making an assessment of the financial condition of the registrant company. The result – and what may prove particularly applicable to environmental liabilities – is that in disclosure of liabilities the company will need to provide an analysis of both its historical condition as well as its prospective situation. While registrants will attest that they are already doing this and indeed have always reported environmental liabilities in this fashion, the increased likelihood of SEC audits will likely shine a spotlight on registrant CEOs and CFOs to raise the standard of care in the disclosure of such information. There are additional CFO and CEO responsibilities for reporting as well, but in general, the level of personal responsibility for the most senior corporate decision-makers has increased significantly. (See sections 302 and 409, 307 and 205 for corporate counsel responsibilities.)

The Shadow of Enron?

Section 401 of the Act addresses disclosure of off-balance sheet arrangements and contractual obligations, which received much public scrutiny following the Enron collapse. Section 401 (a) requires registrants and foreign issuers to describe, in the Management's Discussion and Analysis section of their periodic reports, the off-balance sheet transactions that have or will likely have a material effect on the financial condition, liquidity, etc. of the company. The decision to undertake an off-balance sheet approach for any liability, including environmental liabilities, would be subject to the same accounting rules and regulations discussed above. Use of off-balance sheet techniques may cause the regulatory agency to pay even closer attention to the transaction, particularly where the liability in question finally resides at the end of the day.

Help Running the Gauntlet

Thus, the path of disclosure may be perilous for some corporations. Now, more than ever, it is clear that the accurate and timely disclosure of contingent environmental liabilities, known and potential, legacy or otherwise, cannot be taken lightly. Heightened scrutiny by regulators and investors will push these issues to the forefront. At the same time, there are solutions for managing environmental liabilities and shareholder expectations and relief can be found, in many situations, through the design and use of environmental insurance products.

In the context of real estate and M&A transactions, environmental policies are often essential for closing the deal. Programs can be written on a straight risk transfer basis or in the alternative market in a blended program that joins today's dollars with insurance to manage a long-term clean up, operation and maintenance or closure programs. The policies can be written around a single liability or clean up concern, or on a master worldwide policy to cover all of a company's facilities and operations.

Many companies, as part of their environmental management programs, are setting aside escrow monies to allay the future cost of clean up at sites they know are of specific or potential concern. Those escrow monies can be used to purchase coverage for the potential future clean up. In these cases, the escrow monies are generally more than adequate for the purchase of the insurance program, thus freeing up capital for the company to invest or use elsewhere.

Ultimately, a company can experience multiple benefits from environmental insurance:

- Assurance that the cost for a known clean up can be capped and a budget for clean up preserved.
- Security in the knowledge that for real estate and M&A transactions there will be coverage to respond to an unknown or new environmental condition.
- After a clean up and regulatory sign off, a policy can respond to re-opener issues where the regulatory agency comes back later seeking additional remedy.

- The ability to offset disclosed liabilities and essentially quell shareholder concerns for balance sheet strength.

Result: improved shareholder confidence.

Finally, there may be some special situations where environmental insurance can be designed in a way that allows a company to remove a liability from the balance sheet entirely. Risky? Perhaps. However, with qualified accounting opinions and strict compliance with disclosure rules and reporting obligations, these kinds of options are viable.

Keeping Corporations Green

The developments of the recent past point toward a heightened awareness of corporate governance issues, aggressive shareholder pressure to keep corporations "green", increased regulatory scrutiny for disclosures and appropriate controls, and an acute sensitivity toward negative corporate image. While implementation of the Sarbanes-Oxley Act is just starting, corporations can be expected to expand the depth and scope of environmental reporting and seek ways to relieve the financial burden associated with managing known and potential liabilities.

Environmental insurance is an essential and useful tool for securing real estate and M&A transactions, as well as for managing long-term clean up, operation and maintenance issues. Corporate executives, including in-house legal departments, will always seek ways to address the pressing certification issues that can not only impact the bottom line but can put them personally at risk. This is a time of slow, steady change. With eyes wide open, we should see the good that is to come.

Update: Environmental Coverage

Mold emerged as one of the hottest topics of 2003. Accentuated by headline cases such as the $55,000,000 Hilton Kalia Tower remediation – and trumpeted by the media as the next generation "asbestos" – mold is on every underwriter's mind. Mold exclusions have been added to virtually every liability and property policy issued, but most of the major environmental markets now offer coverage under Pollution Liability forms. Underwriting requirements are strict, with the insured being required to develop mold management protocols, conduct in-house training, and provide mold survey results as part of the underwriting submission. One very positive note resulting from the mold and fungal issue is the development of bio-terrorism coverage. Based on the standard Pollution Liability policy, the inclusion of terrorism coverage for biological agents provides a significant increase in coverage for hospitals, laboratories and other establishments susceptible to biological attacks. **Contractors Pollution Liability** (including forms combining general or professional liability) is a key coverage product. Due to exclusions in the General Liability coverage, contractors working in the building trades are now faced with the need to protect themselves from the ever-widening web of mold claims, thereby adding further to the many uses of Contractors Pollution Liability Insurance.

Blended Finite Programs for Legacy Liabilities. A key driver for such programs are provisions of the Sarbanes-Oxley Act of 2002 that are compelling organizations to achieve greater transparency in their financial reporting. This in turn has reinforced the need for corporations to identify, quantify and fully understand the balance sheet impact their environmental liabilities – especially if there is uncertainty surrounding the extent of such liabilities – can have on areas such as stock price, corporate financing and even corporate image. Companies must make shareholders comfortable with the way these liabilities are being managed. They must then develop strategies to mitigate the consequences of these liabilities. One way is to purchase environmental insurance. Another is through the use of Blended Finite Programs for Legacy Liabilities. Many organizations are developing financial strategies which allow them to "walk away" from environmental liabilities associated with remediation and long-term operation, maintenance and monitoring (OM&M) activities. With the disappearance of uncollateralized surety as a method to provide financial assurances and carriers becoming increasing reluctant to provide closure/post-closure or reclamation financial insurance due to their inability to withdraw from a program once they enter into it, self-funding (finite) options are playing an important role in the financial assurance arena.

Uncertainty in the global economy, manifested in part by the continued consolidation and retrenching of many industry segments, continues to stimulate **Property Transfer Coverage**. With merger and acquisition activity on the increase, we are beginning to see an increasing demand for property transfer insurance programs to back environmental representations, warranties and indemnities and to protect both buyers and sellers from the financial consequences of unknown environmental contamination. Coverage enhancements such as Natural Resource Damages, Non-Owned Disposal Sites, and the contingent protection in the event of financial failure of any of the parties to a transaction ensure continued growth in this market segment.

Remediation Cost Cap programs remain a significant segment of the environmental market. Projects with values less than $2,000,000 will continue to be difficult to insure under a Cost Cap program. Probabilistic cost modeling is now used to set attachment points, establish co-payments, and compute premiums. For insureds looking to utilize Cost Caps, employing a broker with probabilistic modeling experience is critical in formulating an optimal program.

Underground Storage Tank (UST) coverage has re-emerged as a significant issue. With the rising insolvency and sunset provisions of many State UST Funds, the method of choice to provide financial assurance for underground tanks is returning to UST insurance programs. Policies will range from individual tanks operated by contractors to multi-site convenience store portfolio programs.

The Willis Environmental Team: New People News

Willis is committed to maintaining its market-leading position and we welcome several new team members to our organization.

John Reynolds has joined Willis to lead our Global Environmental Practice Group. He is based at Willis' North American headquarters in New York. John brings over 25 years of executive level insurance industry experience to Willis. Immediately prior to joining Willis, he served as Executive Vice President of Aon's Combined Specialty Group.

We have further strengthened our corporate environmental team with the addition of **Rick Secchia**, Senior Vice President. Rick has 15 years of environmental liability management experience, involving roles in engineering, consulting, insurance and reinsurance. He joins us from Aon's Combined Specialty Group. Rick is also based in New York.

Bringing a global perspective to our US-based environmental clients is **Mike Balmer**, Senior Vice President, who transferred here in early August from the London office of Willis, where he previously led our environmental practice activities in the UK/Europe. Mike is based in Boston.

We are very pleased to say "Welcome back!" to **Carla Marino Schwarz** who has rejoined us after a brief stint with Marsh. Carla is an attorney with long experience in the environmental arena. She works out of our New Jersey and New York offices.

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