Environmental Disclosure Committee Newsletter

Vol. 7, No. 1 December 2009

## MESSAGE FROM THE CHAIR

### Scott Deatherage

The environmental accounting and disclosure rules and standards continue to undergo review and revision as non-governmental agencies, pension funds, attorneys general, Congress, the Financial Accounting Standards Board, and the Securities and Exchange Commission have all discussed or taken action with respect to new standards, guidance, rules, and legal proceedings over the last few years. These activities have directly or indirectly affected the parameters and requirements for corporate accounting, disclosure to shareholders or the public, and setting financial reserves related to environmental liabilities.

In this issue of our newsletter, we have three excellent articles discussing important aspects of environmental disclosure. The first, by Christopher Roe, does an excellent job of explaining the current status of FASB's review of the rules relating to accounting for loss contingencies. These rules are particularly important in evaluating and disclosing environmental liabilities, which are perfect examples in many cases of a loss contingency as explained in the article. The development of these rules will be important not only for environmental remediation claims but litigation as well.

Our second piece, by John Fillo, delves into the new standard for acquisitions that imposes fair value accounting for evaluating assets and liabilities when business assets are acquired. John walks us through the "new playing field" of new Financial Accounting Standard 141R and then its application to environmental liabilities in business transactions.

The final article addresses a different aspect of 141R as clarified by 141R-1. The article by Edward Witte and Natalia Minkel-Dumit discusses the challenges for companies and their counsel in managing information related to contingent liabilities that may be relevant to financial disclosure, but may also present information that is protected by the attorney-client or work product protections. Because the fair value accounting process of 141R/141R-1 requires an estimate of the current value of a claim and could release or make discoverable certain internal information related to such disclosures, enough information about the strategy of the company and its counsel to resolve that dispute may become available to compromise the client's position in negotiations or proceedings. Obviously, this is a result that neither the company nor the attorneys would desire and would attempt to avoid. The article provides a suggested list of best practices for attempting to address the potential for disclosure that may prejudice the reporting company in a dispute or legal proceeding.

All of these authors are to be commended on their scholarship and analysis of these most timely issues as FASB continues to consider issues that have a direct effect on environmental disclosure. Kevin Klesh has done an excellent job of bringing these authors to the newsletter and, having been the first newsletter vice

**Environmental Disclosure Committee Newsletter**
**Vol. 7, No. 1, December 2009**
***Kevin J. Klesh, Editor***

***In this issue:***





chair for the committee, I am well aware of the numerous hours he has put in to present this excellent issue.

In addition to other environmental disclosure issues, as climate change regulation continues to develop apace at the state, Congressional, and EPA level, climate risk will continue to grow as a major accounting and disclosure issue for corporations. We intend to devote a significant part of our coming activities over the next year to climate change disclosure issues.

## DISCLOSURE OF LOSS CONTINGENCIES—FASB MOVING FORWARD, BUT MORE CAUTIOUSLY

**Christopher Roe**

On June 5, 2008, the Financial Accounting Standards Board (FASB Board) issued a proposal designed to require substantially more robust disclosures about contingent losses, including pending and threatened claims and environmental liabilities. Two hundred and forty-two comment letters were submitted on the proposal; 201 opposed it, including each of the twenty law firms that made submissions. On Aug. 6, 2009, FASB staff issued a Final Comment Letter Summary, which is available at www.fasb.org/accounting_for_contingencies.shtml, along with the proposal (Exposure Draft), the individual comment letters, and a summary of recent related decisions of the Board.

More than a year has passed since the public comment period closed, and FASB is again taking up the issue. On March 6, 2009, FASB held Roundtables with interested parties, and staff had been working on recommendations to make to the Board in the interim period. Then, at FASB's Aug. 19, 2009, meeting the Board began re-deliberations on the contingent loss disclosure requirements. FASB is proceeding much more cautiously, with a scaled-back approach. It remains possible, though unlikely, that new guidance will be effective in December 2009.

A company's responsibility, or potential responsibility, for an environmental investigation and clean-up is a

prime example of a contingent loss: a situation or condition involving some uncertainty about a potential loss to the company in which the existence and amount of that loss will be determined in the future. Accounting for a contingent loss could be triggered, for example, by: receipt of a notice letter asserting potential responsibility for clean-up, the discovery of a condition that regulations require be investigated and cleaned up, receipt of a clean-up order, or being named in litigation related to clean-up or harm from or exposure to hazardous materials.

FASB had perceived that, under existing standards, too little information was being disclosed about loss contingencies (the focus was not primarily environment-related loss contingencies) for a variety of reasons. The reasons included that: (1) information about loss contingencies was not being disclosed until a material accrual was recognized, (2) the existing threshold for reporting under FAS 5, that the contingency be "at least reasonably possible," was too often leading to the nondisclosure of potentially material contingencies, and (3) the option of the reporting entity to state that "an estimate of the possible loss or range of loss cannot be made," was used too frequently to deny investors of any information regarding the quantitative nature of a potential loss. In general, FASB had concluded that more information needed to be provided to investors regarding potential loss contingencies, earlier.

In June 2008, FASB issued its proposal as a Proposed Statement of Financial Accounting Standards, Disclosure of Certain Loss Contingencies, amending FAS 5, "Accounting for Contingencies," which is the primary document for evaluating and accounting for contingent losses, and FAS 141(R) (see also FSP 141R-1), "Business Combinations," which requires accounting for contingent losses, if possible on a "fair market basis" in the buying and selling of a company.

The proposal was issued as "an exposure draft" (issued for public comment) that would expand the scope of loss contingencies to be disclosed, require disclosure of specific quantitative and qualitative information about the loss contingencies, and require tabular reconciliation of recognized loss contingencies to allow the overall amounts to be more readily tracked over time. The proposal would allow an exemption from disclosure in certain limited circumstances where disclosure would be prejudicial to the disclosing entity's position in a dispute. By way of example, under the proposal, an entity would have had to disclose the amount of a claim or assessment against the entity, such as the plaintiff's demand in a complaint, or, if no claim or assessment amount is provided, the reporting entity's best estimate of the maximum exposure to the loss.

A significant number of the comment letters received expressed grave concerns about the potential prejudicial effects that the proposal might have on disclosing entities. Central among the concerns were fears that the attorney/client privilege and work product protections might be lost due to the nature of the information required, for example, the evaluations of maximum exposures in litigation. In addition, concerns were raised about the ability of the auditor to obtain the information necessary to support the disclosure, given attorneys' concerns about confidentiality obligations. Other concerns related to potential strategic disadvantages to disclosing companies in litigation and negotiations, as well as the concern that disclosure in securities filings of the full amount of a plaintiff's demand in a lawsuit might be inherently misleading and result in a disproportionate effect on stock prices. Concern was expressed that the mere threat of a lawsuit that would trigger disclosures could potentially force companies into settling meritless claims to protect the stock price.

The FASB Board began its re-deliberations on the disclosure of contingent losses on Aug. 19, 2009. This is a first step in a process that may lead, as a next step, to a new exposure draft or, potentially, to a final revised guidance on loss contingencies.

At the August meeting, FASB focused on loss contingencies associated with litigation and, according to the summary it published on its web site, decided on the following general objective:

> An entity shall disclose qualitative and quantitative information about the loss contingency to enable a

financial statement user to understand the nature of the contingency and its potential timing and magnitude.

It also established three broad principles it would apply moving forward:

1. Disclosures about litigation contingencies should focus on the contentions of the parties, rather than predictions about the future outcome.
2. Disclosures about a contingency should be more robust as the likelihood and magnitude of loss increase and as the contingency progresses toward resolution.
3. Disclosures should provide a summary of information that is publicly available about a case and indicate where users can obtain more information.

Notably, the Board also decided:

- To maintain the existing requirement to disclose asserted claims and assessments whose likelihood of loss is at least reasonably possible;
- To clarify that "at least reasonably possible" and "more than remote" have the same meaning;
- That certain remote loss contingencies should be disclosed (and directed staff to develop possible approaches for discussion at a future meeting);
- To maintain existing threshold requirements for unasserted claims and assessments and agreed to enhance the existing interpretive guidance about the threshold;
- That entities should not consider the possibility of recoveries from insurance or indemnification arrangements when assessing whether a contingency should be disclosed;
- Not to require entities to disclose information about settlement negotiations; and
- To require disclosure about possible recoveries from insurance and other sources if and to the extent that the information has been provided to the plaintiff in discovery.

With reference to the push for more quantitative information in disclosures, the Board directed the staff to develop an approach that would focus on disclosure of non-privileged, quantitative information relevant to estimating potential losses. This will be considered by the Board at a future meeting.

As to timing, the Board had pushed back its original proposed effective date for the changes to Dec. 15, 2009, at a September 2008 meeting. That date now appears optimistic. However, the Board discussed the effective date at the August meeting, and decided not to rule out the possibility that it could be effective for fiscal years ending after Dec. 15, 2009. In the meantime, FASB is now moving forward again on this important subject, and it will be worth watching where this efforts leads on environmental liabilities and other loss contingencies.

***Christopher M. Roe*** *is a partner in a suburban Philadelphia office of Fox Rothschild LLP. Chris advises clients on environment-related matters in preparing financial disclosures as well as in transactions, product and operational compliance, and with regard to enforcement and litigation. He can be reached at croe@foxrothschild.com.*


**LIKE TO WRITE?**

The Environmental Disclosure Committee welcomes the participation of members who are interested in preparing this newsletter. If you would like to lend a hand by writing, editing, identifying authors, or identifying issues, please contact the editor, Kevin J. Klesh, at (212) 728-8520 or kklesh@willkie.com.

## FAS 141R AND ENVIRONMENTAL CONTINGENCIES: NOT BUSINESS AS USUAL

**John P. Fillo, Ph.D., CPEA**

Publicly traded companies involved in acquisitions are now required to follow Financial Accounting Standards Board (FASB) Statement No. 141R—*Business Transactions* (FAS 141R), a fundamentally different set of principles for acquisition accounting that incorporates the use of fair value to value assets and liabilities. While the essential elements of the rule as originally issued have been maintained, issuance of FASB Staff Position (FSP) FAS-141R (1) provides a mechanism that may defer companies' strict application of fair value to acquisition accounting. This article provides an overview of the new requirements, and explores the potential ramifications of FAS 141R on environmental contingencies and how companies may approach these new requirements.

### Why Is This Important?

Enterprises are involved in transactions on a routine basis; it is a business reality. This mechanism provides opportunities to focus a company's deployment of capital and to build and create potentially more effectively operating enterprises. It is a mechanism to achieve continuous improvement and to build a sustainable business.

While the present state of our economy has limited the extent of major transactions, proper accounting and reporting of environmental exposures and liabilities is necessary nonetheless. An enterprise must assess and manage risk—strategic, operational, compliance, and reporting, both financial and non-financial. And from an environmental perspective, it is not just a matter of performing ASTM-protocol based environmental due diligence and addressing All Appropriate Inquiry requirements. Companies want and need to understand what they're acquiring, how it translates into financial value, and how to manage what they acquire to deliver value from the transaction in the long term. Risk management is critical for an acquisition target or a company involved in a divestiture; understanding the valuation of assets and liabilities is critical to inform transaction negotiations.

### Acquisition Accounting before FAS 141R

Prior to issuance of FAS 141R, companies followed established rules to identify, recognize, value, and report environmental exposures and liabilities associated with transactions, including:

- FASB Statement No. 5 (FAS 5)—*Accounting for Contingencies*
- FASB Interpretation (FIN) No. 14—*Reasonable Estimation of the Amount of a Loss*
- American Institute of Certified Public Accountants Statement of Position (SOP) 96-1—*Environmental Remediation Liabilities*
- FAS 141—*Business Combinations*

In summary, under these protocols, a liability is recognized when "*it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements*" and "*the amount of loss can be reasonably estimated*." In accordance with FIN 14, "*When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued*." Valuation is more frequently done on a non-discounted basis, unless both the amount and timing "*are fixed or reliably determinable*." Liabilities and assets associated with environmental contingencies generally are recorded separately on a company's balance sheet, except under selected circumstances.

There was substantial flexibility in accounting for business combination environmental liabilities, in accordance with FAS 141. Recognition was often deferred until after the transaction, when a liability was deemed *probable* and could be *reasonably estimated*. Environmental liabilities were typically valued at current value, with the use of fair value

optional. Consistent accounting practices were thus followed at and following a transaction, with transaction costs integral to the transaction pricing.

## The New Playing Field

FAS 141R requires that "*The acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at their acquisition-date fair value*." Transaction costs are now expensed as incurred and recognized separately from the business combination. As such, companies that utilize valuation specialists, investment bankers, attorneys, environmental consultants, and other specialists will incur these costs during the course of a transaction. Issued in December 2007, FAS 141R applies to business combinations where the acquisition date is on or after the beginning of the first annual reporting period beginning on or after Dec. 15, 2008.

Based on the rule as originally issued, contractual contingencies are recognized at fair value. However, assets and liabilities stemming from non-contractual contingencies are recognized only when deemed to be "*more likely than not*." In this Statement, the "*more likely than not"* criterion applies to whether the acquirer has incurred an obligation to pay due to the contingency. If the entity has a present obligation, uncertainties regarding the timing and amount of future cash flows are incorporated in the fair value measurement. Note that this distinction has been eliminated as a result of FASB's issuance of the subsequent FSP (see discussion below).

Requirements for post-acquisition accounting differ from accounting associated with the transaction. Changes to valuations of acquisition contingencies are predicated on the existence of new information, with liabilities recognized at the higher of the acquisition-date fair value or an estimate under FAS 5. Assets are recognized at the lower of the acquisition-date fair value or estimate of the future settlement amount. Adjustments that occur within the same accounting period as the transaction may require restatement of the transaction valuation if material.

Notably, with the increased attention to the convergence of U.S. Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS), the International Accounting Standards Board has issued a companion standard, IFRS 3—*Business Combinations*.

## FASB Staff Position (FSP) 141R-1

Following issuance of FAS 141R, the regulated, accounting and legal communities raised several implementation issues, which caused FASB to reconsider several aspects of this rule. These issues are listed in detail in the FSP, with a few highlighted herein for consideration:

- How are recognition and measurement of liabilities that arise from legal contingencies to be addressed when the supporting information may be subject to attorney-client privilege? This represents the tip of the iceberg in considering the types of comments provided following FASB's issuance of the Exposure Draft for *Disclosure of Certain Loss Contingencies*.

- How does one distinguish between contractual and non-contractual contingencies? Specific guidance and examples were not provided with FAS 141R.

- How are liabilities from an acquisition-related contingency derecognized? Again, other than general guidance, specific examples, thresholds, or criteria were not provided.

- How is financial statement disclosure of potentially prejudicial information addressed? This is another issue related to FASB's Loss Contingency Exposure Draft.

FASB issued FSP-141R-1 on April 1, 2009 to address application issues raised by preparers, auditors, and members of the legal profession regarding business combination contingencies. The FSP applies as of the original Dec. 15, 2008 date in FAS 141R. The key components of the FSP are highlighted below.

***Initial Recognition and Measurement***—The FSP retains the requirement to recognize assets acquired and liabilities assumed in a business combination at the acquisition date at fair value, "*if the acquisition-date fair value of that asset or liability can be determined during the measurement period*." However, it qualifies this requirement: if the acquisition-date fair value cannot be determined, the asset or liability is recognized at the acquisition date in accordance with guidance in FAS 5 and FIN 14. Contingent consideration arrangements in a business combination are recognized initially at fair value in accordance with the guidance for contingent consideration arrangements already provided in FAS 141(R).

In effect, if an entity determines that it does not have sufficient information necessary to value assets and liabilities at fair value at the acquisition date, the accounting requirements revert to use of FAS 5 and FIN 14. Specific guidance, criteria or thresholds to define whether or when "sufficient" information may be available are not articulated in the FSP.

***Subsequent Measurement and Accounting***—The FSP requires entities to develop a systematic and rational basis to subsequently measure and account for assets and liabilities arising from contingencies. This requirement is consistent with that of Sarbanes-Oxley and the need for the existence and effectiveness of disclosure controls and procedures. Contingent consideration arrangements are measured subsequently in accordance with the guidance for contingent consideration arrangements provided in paragraph 65 of FAS 141(R). For changes in the fair value of contingent considerations that are not measurement period adjustments: contingent considerations classified as equity are not remeasured and subsequent settlement shall be accounted for within equity; contingent considerations classified as assets or liabilities are remeasured to fair value at each reporting date until the contingency is resolved.

***Disclosure of Assets and Liabilities***—The FSP requires that an acquirer disclose information that enables users of its financial statements to evaluate the nature and financial effects of a business combination. For assets and liabilities arising from contingencies recognized at the acquisition date, the following must be disclosed:

- The amounts recognized at the acquisition date and the measurement basis applied, thus whether recognized at fair value or at an amount recognized in accordance with FAS 5 and FIN 14;
- The nature of the contingencies; and
- For contingencies that are not recognized at the acquisition date, the disclosures required by FAS 5 if the criteria for disclosures in FAS 141R are met.

The FSP allows for aggregation of assets or liabilities arising from contingencies that are similar in nature in the required disclosures.

## Potential Implications

FAS 141R has the potential to fundamentally affect the manner in which companies address acquisition accounting for environmental exposures and liabilities. Alternatively, FASB's issuance of the FSP has provided an opportunity for companies to continue business as usual, with the exception of a few key attributes of the pronouncement. And, while the requirements are directed to acquisition accounting, to what extent should acquired companies understand the valuation of their environmental liability portfolios as they enter into a transaction? It would seem that it makes good business sense to have a clear understanding of such valuation regardless of which side of a transaction company occupies.

***Fair Value Accounting***—The most substantial requirements rest with the valuation of environmental-related assets and liabilities at fair value and accounting for these assets and liabilities at the acquisition date. This is a fundamental change, in that fair value is predicated on the mere existence of a legal obligation, and the potential use of expected value analysis and full lifecycle costing. It suggests the need to consider probabilistic uncertainties regarding alternative scenarios and the timing and amount of cash flows, and results in an estimate on a net present value basis.

Deferred recognition of pre-acquisition contingencies would no longer be possible and thus would require immediate estimation and disclosure of such liabilities.

The FSP provides the option for companies to use judgment to determine whether they have sufficient information to estimate fair value, but it does not provide tangible criteria to ascertain what is deemed "sufficient." When does a company have "sufficient" information to estimate fair value? What are its obligations to attempt to develop such information? Such a scenario has presented itself previously when FASB issued FIN 47—*Accounting for Conditional Asset Retirement Obligations*. While a company may not have in hand "sufficient" information to estimate fair value, what are its obligations to attempt to develop such information? The operative principle would be to consider whether obtaining such information requires "undue cost and effort." In the context of FAS 157—*Fair Value Measurements*, this principle is specifically cited in reference to "market participant assumptions" and "unobservable inputs." FASB articulates that FAS 141R can be applied without imposing "*undue costs*," with the principle not addressed in the FSP.

In a fast-paced transactional environment, many companies can be hard-pressed to perform basic Phase I environmental due diligence let alone Phase II and subsequent investigations to better inform the potential nature and extent of contamination that may create an environmental liability at acquired sites. Identification of plausible options to address potential issues would be difficult at best, except in circumstances where a company has appreciable experience with remediation of similar issues at comparable sites. The impetus to go beyond basic environmental due diligence is not provided in FAS 141R or the FSP.

Furthermore, an acquirer could readily anticipate that an acquisition target who includes environmental exposures and liabilities as part of its public financial disclosures would have available the underlying data necessary to support its disclosure of such liabilities. The key consideration may be access to such information, not whether or not it exists.

However, there is another side to this coin. While the existence of potential transaction-related environmental liabilities often would not derail a transaction, there are companies that choose to more thoroughly understand the risks and opportunities inherent to a transaction. Even though former requirements may not have required immediate disclosure of *probable* and *reasonably estimable* environmental liabilities, there are companies that have been estimating such liabilities on an expected value basis and considering alternatives for future management of these liabilities as part of prudent risk management practices. Such liabilities and associated assets are disclosed as required, and the company is better informed of the future risks associated with the acquisition.

***Expensing Transaction Costs When Incurred*** — Because transaction costs are no longer included in the transaction pricing and are expensed as incurred, an immediate impact to net income will be realized during period(s) prior to and including the transaction. For a significant transaction, will this have a material effect on the acquiring company's earnings? May this requirement result in sending an early signal to the market, due to short-term increases in such expenses?

***Post-acquisition Reconciliation of Assets and Liabilities***—Post-transaction, accounting for assets and liabilities is performed on a FAS 5 basis, which may have potential future adverse impacts to net income for transaction liabilities recorded at fair value. With new information available, environmental liabilities (and assets) are now estimated on a FAS 5 basis and adjusted only if the estimated liability is higher (or asset is valued lower) than that recorded at the transaction date. Any increase to environmental liabilities (or decrease to assets) would translate into a future charge to net income.

***Inconsistencies between FAS 141R and IFRS 3R***—While the objective of this article is not to provide an analysis between these companion pronouncements, there are two considerations worth noting. The most obvious is that each is applicable on different dates. IFRS 3R does not come into effect until fiscal years beginning after July 1, 2009 (and subsequent transactions). Consequently, as much as a year may transpire between implementation of these

| FAS 5 Accounting | Fair Value Accounting |
|---|---|
| *Early lifecycle environmental remediation project* | |
| ▪ Initial recorded liability consists of site investigation, remedial planning and possibly interim remedial measures<br>▪ Future recorded liability adjusted as triggering events occur during the project | ▪ Likelihood for larger recorded 'fair value' liability due to consideration of full lifecycle remediation alternatives and associated costs, even accounting for time value of money |
| *Mature environmental remediation project* | |
| ▪ Remediation in progress and being monitored for effectiveness<br>▪ Remediation program and associated costs are reasonably well defined | ▪ Potential for no significant difference in 'fair value' liability due to maturity of project, shorter term costs and associated impact of time value of money |
| *Long-term operations, maintenance and monitoring (OM&M) project* | |
| ▪ May include groundwater pump and treat, landfill monitoring, closure monitoring, with cost and timeframe defined<br>▪ Environmental liability recorded on a current value basis | ▪ Likelihood for decrease in recorded 'fair value' liability due to impact of time value of money |

**Table 1.** Comparison of Environmental Remediation Cost Estimates: FAS 5 v. Fair Value.

new accounting requirements between U.S. and non-U.S. based companies.

Furthermore, the latitude for utilizing expected value methods and discounting to estimate environmental liabilities already exists under IFRS through International Accounting Standard (IAS) 37—*Provisions, Contingent Liabilities and Contingent Assets*. As such, U.S. companies considering the acquisition of companies located in jurisdictions governed by IFRS need to be mindful of the basis in which IFRS-governed companies are reporting and disclosing such environmental liabilities.

***Impact of Fair Value on Estimation of Environmental Liabilities***—What may be the impact of fair value accounting on the valuation of environmental liabilities? It depends! The following simple scenarios are presented to illustrate some of the potential differences, with the specific cases outlined in Table 1.

1. ***Early Lifecycle Site Investigation/Remediation Project***—A fair value estimate of this liability is likely to be higher than that on a FAS 5 basis. On a fair value basis, the estimated liability could include the site investigation and remedial planning cost, as well as preliminary consideration of potential scenarios for site remediation. Such cost could be in the millions of dollars. However on a FAS 5 basis, the site investigation and remedial planning costs would comprise the *probable* and *reasonably estimable* components of this cost and would be appreciably less, likely by an order of magnitude or more. Post-transaction, the initial fair value estimate recorded at transaction close would remain in place until such time that remedial alternatives are better defined and estimated, or the obligation has been completely discharged.

2. ***Mature Environmental Remediation Project—*** The fair value estimate may compare well with that on a FAS 5 basis. Ideally, the magnitude of these costs

would decrease during the completion of the remediation project and would be removed from the balance sheet once the regulatory obligations have been met. This estimated liability has the potential to increase post-transaction if circumstances result in the discovery of additional contamination or changes to the remedial plan should the original plan prove not to be effective.

3. ***Long-term Operations, Maintenance and Monitoring (OM&M) Project***—A fair value estimate of this liability is likely to be lower than that on a FAS 5 basis. Consider a project where a consistent cost is anticipated for a period of N years. On a fair value basis, the environmental liability would be less than N times the estimated annual cost due to the effect of discounting. Post-transaction and on a FAS 5 basis, the estimated environmental liability would be N times the annual cost, unless the company has sufficient evidence to confirm that the cost and timing is fixed or reliably determinable and would choose to discount the liability.

While these simplified examples may provide a sense of how a FAS 5 and fair value estimate may compare, the exact circumstances associated with an environmental remediation project will dictate the required actions to fulfill all technical, regulatory and financial requirements.

The extent to which estimates of environmental liabilities would be higher (or lower) on a fair value versus *probable* and *reasonably estimable* basis requires consideration of the tradeoff between uncertainty and timescale for the subject liability. Higher certainty (i.e., mature project) and longer timeframes would favor a FAS 5 estimate being higher than one at fair value. The certainty of project costs combined with the affect of discounting on future costs favors such an outcome. Alternatively, lower certainty (i.e., project in an early stage) and a shorter timeframe would favor a fair value estimate being higher than one on a FAS 5 basis. In this instance, lower certainty leads to addressing other and potentially more costly alternatives, with a lower impact of discounting due to the shorter timescale for the estimated cash flows.

As we proceed through the present economic turmoil and into a more robust transaction market, we will have the opportunity to observe how companies approach the requirements of FAS 141R. Similarly, we will have the opportunity to observe the extent of the SEC's scrutiny of acquisition accounting practices and any associated response.

***John P. Fillo, Ph.D., CPEA*** *is an Independent Business Advisor who specializes in the areas of EHS compliance and risk management, business process/performance improvement, environmental financial reporting and disclosure, sustainable development, and climate change. He has been involved for over 12 years in the auditing, reporting and disclosure of environmental exposures and liabilities, and the evaluation and improvement of associated processes/internal controls. He is a Certified Professional Environmental Auditor through the Board of Environmental, Health and Safety Auditor Certifications. He can be reached at docfillo@embarqmail.com.*

## MANAGEMENT AND PROTECTION OF ENVIRONMENTAL CONTINGENT LIABILITY INFORMATION UNDER FAS 141R-1

**Edward B. Witte**
**Natalia Minkel-Dumit**

### Introduction

Financial Accounting Standard 141R (FAS 141R), as clarified by 141R-1 (summarized below), presents challenges for reporting companies and their legal counsel to manage information on contingent liabilities, including environmental liabilities, that is both relevant for financial disclosure, but which is also potentially protected by attorney-client privilege or the work product doctrine. Companies and their counsel should understand these challenges and be prepared to utilize the best practices identified in this article as they begin to operate under FAS 141R-1.

## Background

On April 1, 2009, the Financial Accounting Standards Board (FASB) issued FAS 141R-1 to clarify and simplify the earlier drafts of FAS 141R. FAS 141R initially contemplated that every "business combination" (or merger, acquisition, or divestiture) would require companies to identify loss contingencies of an acquired business at "fair value," as of the date of acquisition. "Fair value" means 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. In many cases, fair value will be a dollar figure greater than the number that current standards (FAS 5) would require companies to identify, if they identify any number at all. FAS 141R-1 softened these obligations, to a degree, but the new standard, effective for companies in their first annual reporting period beginning on or after Dec. 15, 2008, will still require companies acquiring assets to identify and report liabilities assumed in a business combination at fair value, if fair value can be determined within a year following acquisition. If the fair value cannot be determined within a year following acquisition, the company must utilize the customary FAS 5/FIN 14 process to disclose liabilities that are "probable" and that can be "reasonably estimated." Thereafter, however, the company must develop and implement a systematic and rational basis to subsequently measure and account for such liabilities, including potentially transitioning FAS 5 estimates to fair value estimates, if ascertainable.

For companies and their clients, FAS 141R-1 compounds the tension that has existed between the transparency sought through robust financial disclosure, on the one hand, with the traditional confidences and privileges associated with effective legal representation of companies, on the other. FAS 141R-1 expands the scope of contingent liabilities that must be reported on financial statements, as of the acquisition date, and at "fair value." There is therefore an increased concern that companies will be forced to or will inadvertently waive attorney-client privilege or work product protections, especially with respect to litigation-related contingencies when they adhere to the FAS 141R-1 requirements. There is also a concern that the amendments to FASB Statement No. 5 and 141R-1 will further undermine the 1975 "Treaty," described below, between the American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA) which generally governs communications between attorneys and auditors.

The attorney-client privilege and the work product doctrine are two fundamental cornerstones of legal representation. The attorney-client privilege enables companies to communicate openly and freely with counsel to facilitate a full dialogue without the fear that the matters discussed will be disclosed to third parties, either through regulatory requirements or in litigation. In addition, the work product doctrine protects documents prepared "in anticipation of litigation or for trial" and, in particular, an attorney's conclusions, opinions, and legal theories which are included in those documents, from being disclosed to adversaries. If companies fear that any communication to or from attorneys or prepared by the company or its attorneys for litigation will be subject to FASB disclosure and subsequent discovery, the companies will rely less on communication with counsel, and a critical aspect of sound legal representation will have been compromised.

## The ABA/AICPA Treaty

Following the promulgation of FASB Statement No. 5 in the mid-1970s, the ABA and the AICPA recognized the "Treaty" to address concerns regarding the impact of financial disclosure requirements on the attorney-client relationship. Under the Treaty, when directed by the client, a lawyer should respond to an auditor's request for information concerning loss contingencies, including overtly threatened or pending litigation, contractually assumed obligations and unasserted possible claims or assessments. A lawyer should disclose to the auditor/accountant "probable claims and reasonable evaluations of unfavorable outcome." According to the Treaty, the lawyer should share essential facts regarding the claim or proceeding, but should refrain from speculating on any unfavorable outcome, unless the lawyer's observations are a result of that outcome being probable or remote.

The common ground established by the "Treaty" remained in place until the late 1990's and early 2000's when public and governmental confidence in accurate disclosure was shaken by the Enron scandal. The Enron implosion and the ensuing Sarbanes Oxley Act of 2002 (SOX) pushed the level of scrutiny deeper into corporate board rooms and into the communications between corporations and their outside counsel. SOX put an added burden on the auditors of companies to verify and attest to the sufficiency of internal controls and to call attention to areas of deviation. Therefore, a persistent question exists as to how much a lawyer must disclose in order to comply with FASB rules and verify the accuracy of required financial disclosures, and the circumstances in which such disclosures constitute a waiver of attorney-client privilege or work product protection.

## Recent Case Law

Although most courts have found that disclosure of financial information to third parties, including independent auditors, constitutes a waiver of attorney-client privilege, there is a lack of consistency among the circuits on the standards for work product protection and the circumstances in which disclosure of financial information to an independent auditor constitutes a waiver of work product protection. *Compare U.S. v. Textron, Inc.*, 507 F. Supp. 2d 138, 151 (D.R.I Aug. 28, 2009) (finding waiver of the attorney-client privilege but not work product privilege for disclosure of tax accrual work papers), *vacated* 577 F.3d 21 (1st Cir. 2009) (finding that work product privilege did not protect tax accrual work papers) *and Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 229 F.R.D. 411 (S.D.N.Y. 2004) (finding no waiver of work product protection; although, Merrill Lynch conceded waiver of attorney-client privilege) *with Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113 (S.D.N.Y. 2002) (finding waiver of work protection).

In the recent case, *United States v. Textron, Inc.* (*Textron*), the Internal Revenue Service (IRS) filed a petition to compel Textron to produce certain "tax accrual work papers," which included notes and memoranda written by in-house counsel regarding items that should be included on Textron's tax reserve spreadsheet and estimates for each item of the likelihood that the item will be subject to litigation. 507 F. Supp. 2d 138 (D.R.I Aug. 28, 2009), *vacated* 577 F.3d 21 (1st Cir. 2009). Textron asserted that the work papers were protected by attorney-client privilege and the work product doctrine. The IRS argued that even if the work papers were protected, Textron had waived attorney-client and work product protections by disclosing the work papers to its independent auditor, Ernst & Young. The district court agreed with the IRS that Textron had waived its attorney-client privilege by disclosing the work papers to Ernst & Young; however, the court found that the work papers were subject to work product protection and that Textron had not waived such protection.

The district court in *Textron* applied the "because of test" (as an opposed to the "primary purpose" test adopted by other circuits) to analyze whether the work papers were protected under Federal Rule of Civil Procedure 26(b)(3) as documents prepared "in anticipation of litigation or for trial." The district court found that since Textron's work papers had been prepared "because of" anticipated litigation with the IRS, the work papers were subject to work product protection. In addition, the district court held that since Textron's disclosure of the work papers to Ernst & Young did not "substantially increase the opportunity for potential adversaries to obtain the information," Textron had not waived work product protection.

On appeal, the First Circuit vacated the district court's decision, in a 3-2 *en banc* decision, issued on Aug. 13, 2009, and held that Textron's work papers were not subject to work product protection because they were not "prepared for" litigation, but rather to support financial filings and obtain auditor approval to comply with securities and auditing requirements. In a persuasive twenty-six-page dissent, Judges Torruella and Lipez criticized the majority's opinion as departing from the First Circuit's prior use of the "because of test," which provides work product protection for documents prepared for "dual" litigation and non-litigation purposes. The dissent argued that instead of following the "because of test," the majority had established a new "prepared for litigation" test, which

is inconsistent with the plain language of Federal Rule of Civil Procedure 26(b)(3). Corporate attorneys who oversee financial disclosures should be familiar with the *Textron* case, especially if the First Circuit's reasoning is adopted by other circuits or if the Supreme Court grants a petition for *certiorari*.

Another leading case on protection of information used for financial disclosures is the 2004 case *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.* from the Southern District of New York. 229 F.R.D. 411 (S.D.N.Y. 2004). In this case, Allegheny Energy argued that two reports produced by Merrill Lynch in connection with an internal investigation were subject to discovery because Merrill Lynch had provided the reports to its auditor, Deloitte & Touche, and had thereby waived any applicable privileges. Merrill Lynch conceded that it had waived its attorney-client privilege. So, the issue before the court was whether Merrill Lynch had also waived work product protection. After reviewing approaches taken by other courts on this issue, the court determined that the critical inquiry was whether Deloitte & Touche was an adversary or a conduit to a potential adversary. Since the court found that Deloitte & Touche was not an adversary or a conduit to a potential adversary, the court held that Merrill Lynch had not waived protection under the work product doctrine.

It is important to note that the court in *Merrill Lynch* declined to follow the approach taken by the court in *Medinol, Ltd. v. Boston Scientific Corp,* a similar case decided in the Southern District of New York. *See* 214 F.R.D. 113 (S.D.N.Y. 2002). *Medinol* is often cited to support the position that a disclosure to third parties constitutes a waiver of work product protection; however, this decision seems have been limited following the court's decision in *Merrill Lynch* and similar decisions from other circuits. *See e.g. In re Raytheon Sec. Litig.*, 218 F.R.D. 354 (D. Mass. 2003); *In re JDS Uniphase Corp. Sec. Litig.*, No. C-02-1486, 2006 U.S. Dist. LEXIS 76169, at *12 (N.D. Cal. Oct. 5, 2006).

Overall, the cases discussed above highlight the continuing tension between a company's need to comply with disclosure requirements and the importance of maintaining attorney-client privilege and work product protections. This tension will increase due to the requirement under FAS 141R-1 for companies to provide financial disclosures, preferably at fair value, as of the date of acquisition.
Some states have responded to concerns regarding disclosure of protected information by establishing "auditor privilege" standards. These "auditor privilege" laws essentially extend the attorney-client privilege to communications with accountants which are made in preparing financial disclosures. However, as exemplified by a 2005 dispute between the Shaw Group and AES Corporation, even in states that have "auditor privilege" laws, companies have been exposed to waiver claims for disclosing otherwise protected information to auditors. *See* Lynnley Browning, *What the Corporate Auditor is Told, a Plaintiff Could Exploit*, N.Y. TIMES, Nov. 23, 2007, *available at* http://www.nytimes.com.

## Recommendations for Best Practices

Every internal and outside counsel who oversees liability management and FASB disclosure should consider the following best practices:

- Review the 1975 "Treaty" between the ABA and the AICPA, which sets forth a lawyer's responsibilities in responding to auditors' requests for information.

- Review and become familiar with relevant FASB documents, especially FAS 5/FIN 14 and FAS 141 R-1/FAS 157.

- Determine whether there are any unique privilege laws at issue, such as state auditor privilege laws.

- Understand the distinctions between the attorney-client privilege and the work product doctrine, and keep in mind that, potentially, neither the attorney-client privilege nor the work product doctrine protects the underlying facts of the communications at issue.

- Documents, communications, and work product that are subject to attorney-client privilege or work product protection should be

marked as such and carefully managed—but resist the temptation to mark every document as such, for fear of diluting the protection.

- Utilize outside counsel for actions and communications with the company and with outside parties, accountants, consultants, engineers, to maximize the attorney-client privilege. The risk of relying too heavily on internal counsel for these communications is that the work may be characterized as unprotected "business communication."

- Execute confidentiality agreements with accountants and auditors to ensure that information disclosed during an audit remains confidential, to the greatest extent possible, or to ensure that the company is notified if there is a threatened disclosure.

- Develop and implement sound practices and response mechanisms to prepare for and anticipate challenges to attorney-client privilege and work product protection issues.

- Be aware of a risk that the Buyer's communications with the Seller may establish a waiver of any privilege the Buyer is seeking to establish.

- Anticipate that fair value may not be estimable for loss contingencies arising out of a business combination, because the buyer of assets probably has less knowledge about than the seller, who likely has been using a FAS 5 approach to setting reserves for financial disclosures.

- Be prepared for some adjustment to reserves for liabilities before and after a business combination and the move, potentially for the first time, from a FAS 5 valuation to "fair value" assessment—same loss contingency, but new owner and new fair value.

- The process of discovering known and potential loss contingencies during a transaction will likely change. Most companies are accustomed to detailed environmental due diligence of target businesses and operations. With FAS 141R-1, purchasers will see a need for greater "loss contingency and reserve setting due diligence." This process will enable an acquiring company to know what sort of shape the reserves and supporting documentation of the target company are in, how feasible it will be to transition that valuation to fair value, and how that transition will potentially affect the overall valuation of the target company.

- Anticipate that target companies will probably be cautious with transactional disclosures if the information it is divulging to a buyer weakens any right it has to claim that that information or related communications were privileged in any later lawsuit between the buyer and the seller of those assets.

The coming years will be critical for companies that are required to manage and disclose loss contingencies, including environmental contingencies, under FAS 141R-1. Companies that are better prepared now will handle the changes that FAS 141R-1 will bring more effectively and decrease the risk of waiving attorney-client privilege and work product protection in complying with the requirements of FAS 141R-1 .

***Edward (Ned) B. Witte*** *is the head of the Environmental Law Team at Gonzalez Saggio & Harlan LLP. His practice includes advising clients on environmental due diligence and liability allocation in corporate transactions, environmental disclosures, and reserve setting for environmental liabilities. Ned Witte can be reached at ned_witte@gshllp.com.*

***Natalia Minkel-Dumit*** *is an associate on the Environmental Law Team at Gonzalez Saggio & Harlan LLP. Natalia Minkel-Dumit can be reached at natalia_minkel@gshllp.com.*