

**SARBANES-OXLEY AND ENRON'S LEGACY:**

# **NEW ENVIRONMENTAL ACCOUNTABILITY**

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## **Executive Summary**

In the early 1980s, the SEC's adoption of environmental disclosure rules was greeted with applause from the environmental public interest community. Due to the lack of effective enforcement mechanisms, the bright hope that occasioned the applause has been largely unfulfilled until now. With the passage of the Sarbanes-Oxley Act, hope has been rekindled and networks are being established to assure that these requirements are finally taken seriously. These developments have major implications for corporate managers and corporate boards.

## Introduction

The catastrophic results of dubious accounting and disclosure practices at Enron, WorldCom, and Tyco have predictably engendered an aggressive response from the Congress. This response—the Sarbanes-Oxley Act—is widely recognized as having a pervasive and profound impact on the accounting profession, disclosure requirements, and corporate governance in general. Less well recognized and potentially even more significant, however, is the effect that this new body of law can have on companies' environmental management systems and executives' liability when those systems fail. This note explores the dynamics of those effects and suggests protective actions to avoid serious injury.

## Background—The Special Context of Environmental Liability

The SEC has recognized, at least since 1982, that financial disclosure includes disclosure about a company's environmental liabilities, and it is generally understood that the concept of environment is broad enough to include health and safety issues. As we will see, this Environment, Health, and Safety (EHS) context has a special culture and history, which will tend to magnify and intensify the effect of the Sarbanes-Oxley initiative. This context includes the following relevant elements.

### 1. Extreme Complexity and Difficult Compliance Challenges

Since its beginnings in the 1960s, the body of EHS laws, regulations, and related guidance documents has become increasingly complex and expansive. In a company of any complexity at all, it can be virtually impossible to be confident of full compliance with *all* applicable requirements at *all* times. Potential penalties for non-compliance are substantial and accrue daily. Sarbanes-Oxley's certification and governance provisions will add big teeth to compliance-related disclosure requirements, and the challenge of avoiding the bite will be more severe in the EHS context.

### 2. An Established Tradition of "Going After" Management

Perhaps because compliance costs in the EHS context are so substantial and because EHS issues are so deeply affected by the public interest, the EHS cases and statutes have long shown a tendency to supplement the traditional approach of fining the violating company by direct actions (usually criminal) against "responsible corporate officials" or "persons in charge" of violating facilities. In many cases, criminal prosecutions for violation of EHS statutes have been joined with counts for criminal violations of generic criminal laws, such as the Federal False Statement Prohibition, the Mail Fraud Statutes, etc. The Sarbanes-Oxley accountability provisions, providing major felony liability with relatively minimal showings of criminal intent, could magnify this tendency.

### 3. Established Principles for Imputing, Implying, or Otherwise Eroding Criminal Intent Requirements

EHS cases have long trended toward a position that managers in companies whose activities have the potential for significant environmental effects are engaged in "highly regulated

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industries” affected by the public interest, are presumed to know the law, and are subject to a duty of diligent inquiry regarding violations that do occur. A corporate executive who has the authority and responsibility to seek out and prevent violations of the EHS statutes but fails to do so may be subject to sanctions. Applied in the current context, the burden of proving “criminal intent” under Sarbanes-Oxley may be within easy reach of ambitious prosecutors. Thus, the threat of successful prosecution for violating Sarbanes-Oxley’s certification and disclosure requirements may be more serious in EHS contexts than in any others.

#### 4. Generally Accepted Standards for Internal Controls and External Validation

The increasingly widespread acceptance of ISO 14000 as a standard for Environmental Management Systems presents both advantages and disadvantages from a Sarbanes-Oxley compliance perspective. On the plus side is the fact that a company with an established ISO 14000 program may be in a better position to use that program to document fulfillment of diligence requirements as they pertain to environmental liabilities. On the other side, a company without an EMS or its equivalent may be at risk unless an alternative, highly credible validation approach is implemented.

#### 5. Specific Standards for Disclosure of Environmental Liabilities

Unlike more generalized financial disclosure questions, which are to be resolved in accordance with “Generally Accepted Accounting Principles”, disclosure of environmental liability is the subject of specific SEC Rules setting out mandatory disclosure requirements.

- Regulation S-K 101 requires disclosure of material<sup>1</sup> costs associated with compliance with existing federal, state, and local environmental laws. S-K 103 requires disclosure of material pending legal actions<sup>2</sup>. S-K 303 requires disclosure of anticipated material<sup>3</sup> changes in financial conditions due to any known trends, demands, or commitments.
- Sarbanes-Oxley overlays these detailed disclosure requirements with mandatory, criminally enforceable CEO/CFO certification requirements not only going to the accuracy and adequacy of the disclosures themselves, but also to the effectiveness of the internal controls designed to assure adequate disclosure. Thus, the law has radically altered the context in which Regulation S-K will be interpreted and applied, and the consequences of failure to disclose accurately and in a timely manner. Diligent inquiry and assessment

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<sup>1</sup> threshold not quantified

<sup>2</sup> Non-enforcement proceedings are material when claims for damage, and/or expenditures, potentially exceed 10 percent of a company’s current assets. Enforcement proceedings (in which the government is the plaintiff) are “material” if there is a reasonable potential for sanctions exceeding \$100,000.

<sup>3</sup> Here again, materiality is not quantified.

will be required in order to confidently certify that environmental disclosure is accurate and defensible, and, by so doing, to protect the certifying officers against criminal liability.

These elements, and potentially a number of others, suggest the need for specialized Sarbanes-Oxley compliance approaches where EHS-related disclosure, internal controls, or corporate governance is at issue. The following outline of the Act's functions, purposes, and mechanisms may be of assistance in designing those approaches.

## Foreground—Primary Elements of Sarbanes-Oxley

The Sarbanes-Oxley Act of 2002 seeks to restore investor confidence by: (1) Increasing the accuracy and reliability of public disclosures; and (2) Improving corporate governance.

### Increasing Transparency, Accuracy, and Reliability: Holding Executives Responsible

The Act's primary mechanism for improving public disclosure is a requirement for certification, by the Chief Executive Officer and the Chief Financial Officer, of periodic reports filed with the SEC under the securities laws. These certification requirements are broad, extending not only to the accuracy of the disclosure but also to the internal controls in place to assure accuracy, and are enforceable by severe criminal penalties.

Under the Act, the Chief Executive Officer and Chief Financial Officer (or the equivalent) of any company required to submit periodic reports must certify, based on personal knowledge, that:

- They have reviewed the report;
- The report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which the statements were made, not misleading;
- The financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations as of, and for, the periods presented in the report;
- The company has designed and maintained internal controls to ensure that material information is made known to such officers, and the certifiers have evaluated these internal controls as of a date 90 days prior to the report, and have reported conclusions about their effectiveness based on this evaluation.

Certification of untrue statements, omission of material facts, or otherwise misrepresenting the company's condition is subject to criminal penalties—fines up to \$5,000,000 and/or imprisonment up to 20 years. We should expect that, in EHS contexts, courts will imply knowledge of the law, duties of diligent inquiry, management system norms and so forth and will place firm mandates on certifiers to take diligent actions to assess conformity with

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EHS laws, regulations, and standards of care, and to determine and disclose material nonconformities and liabilities resulting therefrom.

In sum, at least in EHS contexts, the Sarbanes-Oxley certification requirement presents daunting liability exposure for the certifying officers. That liability warrants great care and diligence in issuance of the required certification, as well as careful documentation of that diligence and care.

### Enhanced Corporate Governance Requirements

The Act attempts to strengthen the policing of accountability to shareholders by increasing the board of directors' independence from management and by providing systems to assure board access to relevant EHS compliance and liability information.

The primary mechanism to achieve the "independence" goal is an audit committee to exercise oversight on the board's behalf. This requirement is designed to increase transparency by providing an independent, and thus objective, assessment of financial condition. To this end, the audit committee is structured to process and discover material information on behalf of the board of directors, and more importantly, the shareholders.

The audit committee must consist of independent board members. Audit committee members may not be otherwise affiliated with the company, beyond duties with the committee and board of directors, *and* may not accept any compensation from the company beyond that associated with the board and committee.

The obligation to exercise oversight requires that the audit committee actively engage in the affairs of the company. While management remains responsible for self-evaluation, the audit committee must appoint, and serve as the point of contact for, the company's public accounting firm(s), and any other advisor it deems necessary to retain. This includes any independent counsel, environmental expert, or consultant hired to validate all or part of the disclosed information.

As to the "access to relevant information" goal: CEOs and CFOs of companies subject to periodic reporting requirements must certify that adequate systems are in place to ensure accurate and material information is made known and properly disclosed to certifying officials. Specifically, the CEO and CFO are required to establish, maintain, and evaluate internal controls and disclosure procedures, and certify in each periodic report that they have performed an evaluation within the previous 90 days. Signing officers are further obligated to report their conclusions based on this evaluation. These conclusions must include any material deficiencies in internal controls and significant changes that could affect internal controls, including corrective actions. This information must also be disclosed to the audit committee, and disclosure made to the SEC confirming this action.

This process should assure and document that the board and audit committee receive complete information on the company's compliance and risk exposure. Failure to act prudently in response to this information can have liability consequences for both the board and audit committee as well as for management.

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## Protective Actions

To summarize, then, Sarbanes-Oxley criminalizes failure to disclose material costs of environmental law compliance, material environmental liability, the pendency of significant enforcement actions or material changes in financial condition due to known trends. It requires the establishment and certification of systems and internal controls appropriate to insure that both senior management and the board receive the information necessary to enable adequate and complete disclosure and certification thereof and provides backstops to insure that such certifications are properly issued and communicated. This system operates against a backdrop of EHS laws, such as the Clean Air and Clean Water Acts, which impose on responsible corporate officials affirmative duties to seek out and prevent violations and hold them individually liable for failure to do so.

The pincer effect of this duty to know and disclose and the correlative duty to correct and comply can demand of top management and boards extraordinary, and perhaps inordinate, vigilance in order to protect themselves against serious, possibly inordinately serious, consequences.

Imagine, for example, the consequences for executives of National Gypsum, Johns-Manville, or W. R. Grace had this system been in effect at the time of a failure to timely disclose the potential for Asbestos-related liability. What about tobacco company executives, top management of PCB manufacturers, or companies that used target agricultural chemicals? Conversely, consider the very real dilemma of a CEO in identifying and considering whether to disclose the cost of compliance with EHS laws when knowledge of such non-compliance places upon him or her individually an enforceable duty to bring the company into compliance or face consequences. The risks inherent in these circumstances, and many similar ones that may be predicted in the context of the Sarbanes-Oxley/EHS law combination, mandate scrupulous efforts to do that which is necessary not only to comply with the applicable requirements but also to have a system in place to document that this has been done. Though the elements of such systems may vary from organization to organization, commonalities might include:

### **1. Use the Audit Committee Effectively; Integrate with the EHS System**

Sarbanes-Oxley requires independent audit committees empowered with the authority required to police and validate internal controls and the CEO/CFO certification process. If this asset is effectively utilized to address EHS issues and to engage the EHS managers in the audit process, it can shield the certifiers and can also assure a more effective EHS management program. This special role for the audit committee, of course, suggests that its members will need to be actively engaged and will have some liability exposure. Presumably, over time, these factors will be reflected in increased compensation for this special class of directors.

## **2. Have a Risk Assessment Process, and Clear Lines of Communication About Risks**

Though on-site managers and EHS staff probably have a fair grasp of the risks, liabilities, compliance issues, and trends facing their operations, there is often no process, akin to the budgeting process, for identifying and quantifying those exposures and communicating them up the chain. Recognize that Sarbanes-Oxley is not just about traditional financial disclosure, and install a system, preferably a simple one, to demonstrate a diligent effort in this regard.

## **3. Monitor Public Information Sources**

Over the past few years, the EPA has significantly increased public access to its collection of compliance data. The agency, pursuant, in part, to its Disclosure Initiative, has begun publishing detailed information about pending enforcement actions and companies' compliance status on its web site and plans to increase this openness. Public interest groups will likely monitor this information, and distribute it to a wider audience. If information is published in this manner, certifying officers obviously should be aware of it, and take this into account in their certifications.

## **4. Be Careful with Internal Committees**

Though the SEC, in its regulations implementing Sarbanes-Oxley, encouraged the use of internal "management committees" to assure appropriate materiality determinations and disclosures, such "in-house" review may be less effective in shielding the certifiers than review by the audit committee or other outside independent auditors. Keep in mind also that this function, even done properly, can divert resources from other important management functions and will also tend to increase the number of key managers with individual exposure under the "responsible corporate official" provisions of the EHS statutes.

## **5. Make Wise Use of Independent Counsel and Consultants**

The audit committee must be empowered to retain consultants. An independent reviewer or the independent audit committee should be able to provide a certifier with more comfort than directly retained or previously involved consultants with respect to the adequacy of systems in place and the matters required to be disclosed under the Act. Keep in mind, also, that the traditional "comfort letter" approach, under the Sarbanes-Oxley regulations, will subject the signer of letters used in SEC filings to new direct disclosure obligations. This erosion of the security and confidentiality that has until now existed in these relationships may warrant restructuring the comfort process to preserve its confidentiality by keeping it separate from the work done in preparing SEC filings.

## **6. Consider Environmental Annual Reporting**

An environmental reporting system in conformity with the Global Reporting Initiative or some other widely accepted reporting protocol will provide firm support for the CEO/CFO's certification of internal controls and reporting systems, thereby effectively insulating against liability in this connection.

## 7. Don't Assume

Certifiers whose companies have certified Environmental Management Systems may, understandably, assume that those systems as they stand are sufficient to assure that they will be advised of any matters requiring disclosure under the securities laws. That assumption, unfortunately, is not necessarily accurate. Until we plug into our EHS system our Sarbanes-Oxley related expectations on matters such as materiality, risk analysis, and risk communications, an ISO 14000 certification will not assure that the CEO/CFO receive the information and comfort that they need. Fine-tuning, even of advanced systems, may well be appropriate.

All of these steps can, and should be, accomplished in a simple, non-document-intensive way that will be compatible with company culture, protect top management, and achieve Sarbanes-Oxley objectives with minimal disruption of management functions or diversion of company resources. Up-front attention can pay significant long-term dividends, both in the effectiveness of the company's EHS management systems and in the comfort and security of its very highest officers.

## Conclusion

Sarbanes-Oxley provides the Environmental Law System with new big teeth, and the System provides Sarbanes-Oxley with the definition, focus, and context necessary to determine what and where to bite. Properly focused, this symbiosis can result in enhanced EHS management systems and a better standard of care in environmental contexts. Improperly focused, it will result in increased bureaucracy and paperwork, inefficient expenditures of time and money, and unjust punishment of the wrong people. Careful planning and management can maximize the good potentials and minimize the bad ones.

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## About the Author

Gordon Arbuckle has been advising clients on environmental issues for over 35 years. He wrote some of the earliest articles and classic texts on environmental law and management. In recent years, he has represented a number of major clients in the steel, utilities, oil and gas, and food industries in matters involving significant environmental compliance, management, and enforcement matters. He has served on numerous boards and committees including the Colorado Governor's Pollution Prevention Advisory Board and the EPA's National Advisory Committee on Compliance Assistance. He divides his time between Boulder, Colorado and Washington, DC.