

# Board Oversight of Environmental Management After Sarbanes-Oxley

## Hypothetical Illustrates Crisis Response

By Steven P. Solow and Karl R. Heisler

It's 5:30 p.m. on a Friday evening in August. Your plan was to leave the office early for a weekend with your family. As you are packing, your assistant tells you that the general counsel of the Acme Chemical Corporation is calling. You take the call. She sounds tense. "Sorry to

bother you," she says, "but I'm calling all the board members."

She reports that a small army of federal agents arrived at one of Acme's facilities that morning to execute a search warrant. They've been there all day. She found out a short time ago, when the plant manager finally thought to call her.

"What is this about?" you ask. She's not sure, but it appears to relate to a small release of chlorine gas from the facility that occurred a couple of weeks ago. This is the first you've heard of it.

Three years ago you joined the board of directors of Acme, a corporation with facilities in five countries. You

are proud of what you and the other directors have accomplished thus far in helping to streamline management and improve financial performance. When you accepted your seat, however, you hadn't focused on environmental issues. You were aware of some regulatory compliance issues in the past, but the corporation had an environmental compliance program that appeared sound and a vice-president for environment, health, and safety who appeared competent.

In light of Enron and the corporate accounting scandals, you were cautious about accepting a board seat, but not enough to decline such a prestigious invitation. In any

event, financial compliance, not environmental liabilities, was your main focus.

The general counsel tells you that the CEO has called a meeting of the board for the upcoming Monday. “Is it really that serious?” you ask.

She tells you that the search warrant alleges that the recent chlorine gas leak was due to “knowing or negligent” criminal intent, and that the release had allegedly endangered the employees and thousands of residents in the nearby town. She also notes that the investigators seized hundreds of boxes of records and interviewed dozens of employees.

“What kind of punishment can this lead to?” you ask.

The general counsel isn’t sure, but says that fines in other environmental cases have been in the tens of millions of dollars, and that managers could face up to fifteen years or more of prison time.

You discuss the potential for director liability. You’re aware that the WorldCom directors had to pay shareholders \$18 million and Enron directors had to pay shareholders \$13 million. You’ve also read that the SEC is increasing its efforts to find board members “unfit” under Section 305 of Sarbanes-Oxley, and bar them from ever serving on a public board again.

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How did this happen? What steps can you take to prevent a similar situation from ever happening again?

This article discusses some of the issues a director concerned with environmental liabilities may wish to consider. First, we’ll discuss recent developments in board responsibilities for environmental management. Second, we propose a response to the preceding hypothetical.

In the end, anticipating environmental management problems and planning for them rather than reacting to a crisis when it occurs is the key to effective board oversight.

### SOX ADDRESSES ENVIRONMENTAL COMPLIANCE

Board level oversight of environmental management appears to be increasing. Some directors now rely less on short briefings from corporate officers and more on their own active participation to reduce the risk of officer and corporate exposure to liability. Whatever the reason—shareholder pressure, media reports, or fear of criminal enforcement—more board involvement in environmental management may soon become routine.

Shareholder activism is beginning to focus on board level responsibilities for environmental management. The

number of resolutions aimed at environmental issues increased by nearly twenty percent in the past year. Sarbanes-Oxley itself was in part the product of pre-existing shareholder efforts to obtain more extensive disclosure of environmental matters. That effort merged with the response to Enron, and helped propel Sarbanes-Oxley through Congress.

EPA has begun its own environmental disclosure initiative as well. Two years ago the agency released the Enforcement and Compliance History Online (ECHO), a website that provides public access to facility-level compliance and enforcement information. Publicly-traded corporations are responding to these developments with enhanced environmental disclosures, either in SEC filings or in environmental shareholder reports.

Recent trends in criminal environmental enforcement may also be encouraging directors to take more assertive roles in corporate compliance. EPA is renewing its focus on criminal enforcement by, among other things, seeking to hire new criminal investigators. The agency has a long list of enforcement priorities including air toxics, new source review, mineral processing, “wet weather” (e.g., stormwater), tribal issues, petroleum refining, vessel pollution, and worker endangerment.

Notwithstanding these priorities, Granta Nakayama, head of the EPA’s Office of Enforcement Compliance and Assurance, recently assured an audience comprised largely of industry representatives that EPA will “maintain a criminal enforcement presence across the spectrum” of environmental laws.

It is no surprise, then, that directors are taking a more active role in environmental management. The board bears ultimate responsibility for the corporation’s accounting practices—including those that address environmental liabilities. Sarbanes-Oxley increased the board’s audit committee responsibilities to oversee work performed by outside public accounting firms, and that includes work that covers the environmental disclosures in SEC filings. Accordingly, directors are wise to provide audit committees with guidance or counseling on what constitutes adequate environmental disclosure controls and procedures.

Sarbanes-Oxley’s CEO/CFO certification requirement reinforced the “information and reporting systems” requirement set forth in the landmark 1996 Delaware Court of Chancery decision in the Caremark case. The court instructed the board of directors to ensure there are internal reporting systems that are reasonably designed to provide senior management and the board with timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning the corporation’s compliance with the law and its business performance.

Many corporations fulfill this requirement through an environmental management system designed, in part, to identify, evaluate, and report environmental risks and liabilities. But many directors have been given little in the way of

guidance or training to evaluate what makes such systems succeed or fail.

Sarbanes-Oxley has contributed to enhanced environmental disclosures in SEC filings, a development that takes on added significance in light of a 1980 SEC rule that requires a majority of the board of directors to sign the 10K.

In issuing this rule, the SEC noted that it anticipates that directors will be encouraged to devote the needed attention to reviewing Form 10-K, and to seek the involvement of other professionals if necessary in order to make themselves comfortable signing. In the Commission's view, this added measure of discipline is vital to the disclosure objectives of the federal securities laws, and outweighs the potential impact, if any, of the signature on legal liability.

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Specific board responsibilities differ depending upon the size and nature of the corporation, but below is a list of four general recommendations for responsible environmental management:

- **Know your corporation.** Familiarize yourself with the ECHO reports, recent SEC disclosures, and internal records to identify noncompliance trends. Visit some facilities and speak with the managers. Environmental compliance efforts and overall metrics of performance should be regularly provided. Ask to be kept informed of government or citizen enforcement actions, civil or criminal, that face your corporate peers.
- **Ask questions.** As Caremark recognized, "relevant and timely information is an essential predicate for satisfaction" of the duty of care. When you are speaking with corporate management, counsel, or managers in the field, never hesitate to ask for more information or a clearer explanation.

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- **Be Independent.** The "Thompson Memo," a 2003 Department of Justice guidance document, cites independent review over proposed corporate actions as a critical factor when the government is determining whether or not to prosecute a business organization based on the level of the corporation's compliance efforts.
- **Trust but verify.** Seek routine and clear reporting on the integrity of your corporate compliance policies, particularly with respect to your environmental disclosure controls and procedures. Is the corporation prepared to respond to a crisis? In the hypothetical above, why did it take hours for the general counsel to learn about the search warrant?

These approaches can help support management's effort to obtain compliance, and help satisfy the post- Sar-

banes-Oxley fiduciary duty of care. They may mitigate or eliminate related personal and corporate exposure. However, a specific instance of potential noncompliance may warrant a more comprehensive or more specific response.

### RESPONSE TO THE HYPOTHETICAL

If this were a financial problem, you would know what to do. You would even know whom to recommend to help guide the corporation. Now, you are in new territory. You don't recall anything about environmental management issues aside from a fifteen-minute briefing that focused on "sustainable development."

The board has several options. The first is to hire an experienced environmental lawyer who is familiar with such issues. This attorney would be retained by the board itself, the audit committee, or a special committee of the board. Counsel can help the board assess the corporation's possible exposure relating to the investigation and evaluate the corporation's environmental compliance efforts overall. Counsel can also work with the audit committee to ensure that the proper disclosures are made.

The corporation's defense counsel should focus on responding to the criminal investigation. The board's counsel would advise on how to assess board responsibilities for taking measures to prevent problems in the future.

There are several reasons why the board would hire its own counsel, not the least of which is the fact that failure to respond adequately to the investigation may lead to director liability if the situation develops into a material matter. For example, nothing could undermine the board's credibility with the shareholders more than an indictment for false statement or obstruction of justice.

Prosecutors often pursue these types of "traditional" offenses in lieu of what is afforded in more complex environmental statutes. Counsel well-versed in these and other aspects of criminal law may provide both the board and the corporation with an additional layer of protection.

Some boards allow their outside counsel to retain environmental consultants. There is a good reason for this. The mechanism by which the board employs the consultant is critical. The consultant should be retained by the outside counsel for purposes of assisting in providing legal advice to the board. This is necessary to protect the work of the lawyer with the consultant under the attorney/client privilege.

The driver behind this "derivative privilege" doctrine is that the communication – i.e. the consultant's work – is made for the purpose of obtaining legal advice from the lawyer. Otherwise, the board/consultant relationship would lack the protection of the privilege, making the consultant's work a subpoena away from immediate disclosure to the government.

This is critical. Defense counsel across the country are reporting consistent efforts by the government to obtain internal corporate documents created in response to governmental investigations.

Working with the technical assistance of an environmental consultant, counsel can evaluate the corporation's environmental compliance efforts against governmental policies, rules, and requirements that define (to the government) what constitutes an effective compliance program. These include:

- The U.S. Sentencing Commission's Organizational Sentencing Guidelines.
- EPA's Audit Policy.
- EPA's Policy on the Exercise of Investigative Discretion.
- EPA's EMS guidance.
- DOJ's Policy on the Principles of Federal Prosecution of Business Organizations.
- DOJ's "Policy on the Factors in Decisions on Criminal Prosecutions for Environmental Violations in the Context of Significant Voluntary Compliance or Disclosure Efforts by the Violator."
- ISO 14001 EMS Standard.
- The Commission for Environmental Cooperation's 10 Elements of Effective Environmental Management Systems.

An environmental enforcement action can result in an environmental compliance program that is designed and imposed by the government – not a desirable outcome. If the board takes the steps discussed above, it will help prevent the costs, inefficiencies, and other problems associated with a compliance program designed by an outsider who does not understand the business plan or corporate culture.

Finally, the board's counsel and the audit committee can work together to ensure that the proper environmental liability disclosures are made in the corporation's SEC filings. Before Sarbanes-Oxley, boards often lacked the accounting expertise necessary to oversee work performed by either in-house or outside public accounting firms. Post-Sarbanes-Oxley, boards are taking less deferential approaches to financial accounting practices. Outside counsel could, for example, monitor other corporations in Acme Chemical's industrial sector to assess how similar environmental liabilities are disclosed, in keeping with the idea behind EPA/SEC coordination to maintain a "level playing field for environmentally responsible companies."

Retaining counsel with expertise in these matters may mitigate the shareholder exposure caused by the chlorine gas release, while ensuring the future financial health of the corporation.

### HAVE A PLAN

Abundant evidence suggests corporations that address environmental compliance issues affirmatively have fewer operational problems overall and enhance their bottom line.

Although the efforts outlined above should help, perhaps the most important imperative is to be informed. Find out what's happening directly. Visit a plant and meet with your compliance team. Your interest in their efforts will make others more interested in helping them succeed. Are inspections on the rise? If so, they may be a precursor to a full-blown regulatory enforcement initiative.

Make sure your corporation has a clear environmental policy, not one that only covers health and safety, and that the policy is communicated to all employees clearly and unequivocally, by the highest-level corporate managers.

If an environmental compliance problem does arise, be prepared to respond. While instituting your plan, take the opportunity to address any deficiencies in the structural or managerial commitment to the corporation's compliance efforts. Doing so should minimize the impact of compliance problems with enforcers, shareholders, and the public.

Corporations need strong directors, but many potential directors are simply declining the invitation to serve. According to a recent study by Korn/Ferry International, 58 percent of U.S. board directors surveyed believe that Sarbanes-Oxley regulations have made boards "overly cautious, and should be repealed or overhauled." The study also reported that 59 percent of U.S. board directors surveyed have declined a board seat due to the associated risks.

But those willing to serve can arm themselves to succeed. Directors can take steps to help publicly-traded companies avoid liabilities and related personal liabilities that can result from undetected, uninsured, or undisclosed environmental violations.



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