

# EPA Proposes Additions To Its Audit Policy For New Corporate Owners

## EXECUTIVE SUMMARY

This Client Advisory discusses the Environmental Protection Agency's ("EPA" or "the Agency") recent proposed additions to its Audit Policy. EPA's proposal is designed to encourage new corporate owners of recently acquired regulated facilities to voluntarily disclose environmental violations at these facilities and avoid certain penalties. EPA's Audit Policy, and the evolving incentives for new owners, are important tools for companies involved in mergers or acquisitions (both buyers and sellers) to utilize to minimize environmental liabilities and maximize cost savings associated with business transactions.

## INTRODUCTION

EPA has both clarified and proposed new policies designed to encourage corporate entities that have recently acquired regulated facilities to take advantage of benefits under the existing Audit Policy.<sup>1</sup>

<sup>1</sup> See Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 60 Fed. Reg. 66,706 (December 22, 1995) as revised by 65 Fed. Reg. 19,618 (April 11, 2000) (commonly referred to as "the Audit Policy"). The Agency also published answers to frequently asked Audit Policy questions on April 30, 2007 (hereinafter "FAQs"). See EPA Memorandum, April 30, 2007, available at (<http://www.epa.gov/compliance/incentives/auditing/2007-faqs.pdf>). The FAQ's are significant guidance to the Agency's implementation of the Audit Policy and contain helpful insight into how

The Audit Policy, which has been quite successful, encourages regulated entities to voluntarily discover, disclose, correct, and prevent the recurrence of violations of federal environmental law by reducing or eliminating civil penalties and potential criminal charges for entities that make disclosures under the policy's terms. The Audit Policy generally extends benefits to those regulated entities that meet its nine conditions, which include voluntary discovery, prompt disclosure, correction and remediation, no repeat violations, and cooperation. The Agency's new proposal, published on May 14, 2007,<sup>2</sup> keeps the Audit Policy structure in place and proposes additional, specifically tailored incentives for new owners of regulated entities that are intended to encourage new owners to voluntarily disclose environmental violations and take advantage of the Audit Policy benefits.

EPA's focus on new owners stems from the Agency's recent experience with corporate-wide mergers and acquisitions and its recognition that new owners of regulated facilities may be particularly

the Agency is likely to implement the Audit Policy going forward; specifically as it relates to "new owners." Because the published Federal Register proposal focuses largely on soliciting comment (as opposed to actual Agency implementation strategies or rules), this Client Advisory draws substantially from the answers to the FAQs in discussing how new owners will likely be able to take advantage of the Audit Policy.

<sup>2</sup> 72 Fed. Reg. 27,116 (May 14, 2007).

well-situated, and motivated, to discover, disclose, and rectify environmental violations at recently acquired facilities (*i.e.* make a “clean start” for their new facilities and avoid potentially costly penalties in the future). For example, pre-acquisition environmental due diligence reviews often provide new owners with beneficial information related to potential noncompliance issues at newly acquired facilities. It is the Agency’s goal to increase voluntary disclosures by new owners by providing incentives that encourage them to take advantage of the information made available during the merger and acquisition process. In doing so, EPA has provided a unique opportunity for new owners that have acquired regulated entities to address environmental compliance violations, start with a clean slate, and avoid potentially significant penalties in the future.

### WHY NEW OWNERS

For several reasons, mergers and acquisitions provide a unique opportunity for new owners to take advantage of benefits available under the Audit Policy.

1. First, as noted above, pre-acquisition environmental due diligence reviews provide new owners with information regarding potential environmental issues at new facilities. Pre-acquisition environmental due diligence reviews alert new owners to potential environmental problems and provide information concerning environmental compliance that the new owner may use to “flag” problem facilities, further

investigate these facilities, and make voluntary disclosures.

2. Second, EPA has recognized that bona-fide new owners (*i.e.* not new owners from corporate spinoffs) generally have no responsibility for past compliance violations at newly acquired facilities. Following the close of a merger or acquisition, new owners are more likely to thoroughly address, and rectify, environmental compliance issues for which they had no responsibility in creating—provided that EPA creates the incentive to do so.
3. Finally, although the proposed new owner incentives are not codified, EPA has sent a strong message that providing incentives to entice new owners of regulated facilities to voluntarily disclose environmental violations is key to improving the overall effectiveness of the Audit Policy program. As such, the Agency has expressly recognized that mergers and acquisitions provide a unique opportunity to discover, disclose and rectify environmental violations, and will likely be receptive to new owners that in good faith attempt to make voluntary disclosures.

### HOW MIGHT THE NEW OWNER INCENTIVES WORK?

EPA has signaled several ways in which it may provide incentives to new owners.

- The Agency has proposed to allow Audit Policy eligibility for new owners who voluntarily disclose Clean Air Act

(“CAA”) violations prior to a mandatory annual CAA Title V compliance certification. This is a significant step forward because CAA violations are required to be disclosed under Title V permits and, therefore, normally are not considered “voluntary” disclosures.

- Under the current Audit Policy, an entity generally must correct any violation within 60 days from the date of discovery. EPA has recognized that 60 days may not provide enough time for new owners to discover, disclose, and correct violations (especially in a large transaction with many facilities or where corrections will be capital intensive). Therefore, EPA is likely to grant new owners an extension. This extension must be negotiated with EPA, usually during the 60-day window.
- Normally, EPA will not allow an entity Audit Policy benefits where there is a corporate pattern of repeated noncompliance. The Agency has indicated that where an entity discloses numerous violations discovered as a part of a single audit or makes sequential disclosures from a single, comprehensive company-wide audit and takes appropriate actions to comprehensively address earlier violations, it will not exclude these types of noncompliance violations from the Audit Policy benefits under the “no repeat violations” or “corporate pattern” exclusion. The Agency’s revised position bodes well for new owners, who, in order to disclose in good faith, will often times be reporting multiple violations across many facilities, that perhaps have occurred over many years.
- In a similar vein, EPA has stated that it will generally consider successors that undertake examinations of newly acquired facilities to be eligible irrespective of the successor’s history of violations at their own facilities. Such a stance will go a long way towards encouraging new owners, even entities that have not had the most stellar compliance track record, to take advantage of the Audit Policy.
- Finally, EPA is considering changing its policy of civil penalty assessment. Under the Audit Policy program, the Agency can assess a “gravity-based” penalty and an “economic benefit” penalty. EPA will waive the “gravity” component if Audit Policy conditions are met, but has required payment of “economic benefit” penalties. The Agency now recognizes that, in the context of business acquisitions, economic gains from past noncompliance often will not, if ever, run to the new owners. Thus, in most cases it would be inequitable to assess economic benefit penalties on new owners. The Agency is seeking comment on this position, but it is likely that in the context of new owners, such a policy position will be adopted.

## CONCLUSION

EPA’s Audit Policy can provide significant benefits to companies that voluntarily discover and disclose environmental compliance violations. The Agency has recognized that corporate mergers and acquisitions provide regulated entities with a unique opportunity to voluntarily discover and disclose environmental compliance violations. To this end, EPA has developed an evolving set of principles and incentives, which ideally will

encourage new owners to take advantage of the benefits of the Audit Policy. EPA's effort is a win-win for all involved. For EPA's part, the improved policy will ultimately mean a cleaner environment. For regulated entities, the new policy provides great potential for costs savings and penalty avoidance. Kelley Drye environmental lawyers can advise companies engaged in acquisitions or mergers on how to benefit from the Audit Policy and EPA's recent proposed interpretations on the application of the Audit Policy to new business owners.

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### ENVIRONMENTAL LAW PRACTICE

Kelley Drye's Environmental Law Practice Group specializes in providing comprehensive solutions for complex problems to facilitate effective business strategies. We provide both advice and representation for clients participating in rule-making and policy-making activities by federal regulatory agencies, including the U.S. Environmental Protection Agency, the Occupational Safety and Health Administration, the U.S. Fish and Wildlife Service, and the U.S. Army Corps of Engineers.

### FOR MORE INFORMATION

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