Client Alert

EPA Implements Audit Policy for New Owners

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In an effort to encourage new facility owners to self-disclose environmental violations, EPA is implementing its new "Interim Approach to Applying the Audit Policy to New Owners." 72 Fed. Reg. 27 (8/1/08) ("Interim Self-Disclosure Policy"). Under the new Policy, new owners who self-disclose environmental violations within nine months of the acquisition (or who enter into "audit agreements" providing for self-disclosure) will be free of pre-acquisition penalties and certain post-acquisition penalties.

The Interim Self-Disclosure Policy modifies an April 11, 2000 policy on "Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations" (the "Audit Policy") by expanding penalty mitigation and tailoring certain Audit Policy conditions to recognize the unique position of new owners. EPA states that, through September 2007, it has resolved violations involving over 3,500 entities and at nearly 10,000 facilities as a result of the Audit Policy. EPA believes that new owners may be well-situated and motivated to use the Audit Policy because they were not responsible for the facility when the noncompliance began, they may already be assessing and auditing new facilities to manage and reduce risk, and they have funding available to correct non-compliance conditions. While EPA is implementing the new policy now, it is also soliciting further public comment for 90 days (initial comments were solicited in May 2007).

Definition of New Owner. In order to qualify as a "new owner" under the Interim Self-Disclosure Policy, a purchaser must certify that:

1. Prior to the transaction, they were not responsible for environmental compliance at the subject facility, did not cause the violations being disclosed and could not have prevented their occurrence;
2. The violation at issue originated with the prior owner; and
3. Prior to the transaction, neither the buyer nor the seller had the largest ownership share of the other entity, and they did not have a common corporate parent.

Under this definition, stock purchasers, asset purchasers, and new owners by merger are all eligible for "new owner" status as long as they meet the above criteria.

Penalty Mitigation. The Interim Self-Disclosure Policy provides for penalty mitigation for new owners that, within nine months of the transaction closing, promptly disclose violations to EPA, enter into an audit agreement with EPA, and meet all the conditions of the Audit Policy as modified for new owners:

1. No penalties will be assessed against the new owner for the period before the date of acquisition;
2. Penalties for "economic benefit" (operation and maintenance costs which would have been incurred to comply with applicable law) will be assessed against the new owner, but only from the date of acquisition; and
3. No penalties for economic benefit associated with delayed capital expenditures or with unfair competitive advantage will be assessed against the new owner if the violations are corrected in accordance with the Audit Policy (i.e., within 60 days of discovery or another reasonable timeframe acceptable to EPA).
4. As with the Audit Policy, the Interim Self-Disclosure Policy offers 100% "gravity-based" penalty mitigation to entities that meet EPA' s nine conditions (discussed below).

Conditions Applicable to New Owners. The Audit Policy requires disclosing entities to meet nine conditions in order to be eligible for penalty mitigation. For new owners, EPA has modified five of the nine conditions of the Audit Policy (1, 2, 3, 8, and 9) in order to enhance applicability of Audit Policy penalty mitigation. The conditions are as follows:

- *Systematic Discovery - Condition 1*: This condition of the Audit Policy requires that the violation at issue be discovered as part of a periodic audit. Recognizing that a new owner's pre-closing due diligence is by its nature a one-time event, EPA will waive the "periodic" element of this condition for violations discovered through pre-acquisition due diligence, and allow such disclosures to be considered for full penalty mitigation
- *Voluntary Discovery- Condition 2*: The Audit Policy requires that the violation at issue was not detected as a result of a legally required monitoring, sampling, or auditing procedure. The Interim Self-Disclosure Policy modifies this requirement in the new owner context to allow consideration of all violations which would otherwise be ineligible for Audit Policy consideration because they are already required to be identified through a legally mandated monitoring, sampling or auditing protocol, and thus not "voluntarily discovered."
- *Prompt Disclosure-Condition 3*: The Audit Policy provides that violations must be promptly disclosed in writing, within 21 days of discovery. For violations discovered pre-closing, a new owner would have up to 45 days after closing to disclose violations. For violations discovered post-closing, a new owner would have to disclose violations within 21 days after discovery or within 45 days after the transaction closing, whichever time period is longer.
- *Discovery and Disclosure Independent of Government or Third Party Plaintiff-Condition 4*: The Audit Policy provides that violations must be discovered and disclosed before EPA or another government agency likely would have identified the problem either through its own investigative work or from information received through a third party. The Interim Self-Disclosure Policy does not modify this condition.

- *Correction and Remediation - Condition 5*: The Audit Policy provides that a self-disclosing entity must correct the disclosed violation within 60 calendar days from the date of discovery, certify in writing that the violation has been corrected, and take appropriate measures as required by law to remedy any environmental or human harm due to the violation. EPA recognizes that not all violations can be corrected in the 60-day time frame, and may allow for an extension of time for corrections that require significant expenditures, involve technically complex issues, or involve decisions for which an entity seeks or is required to obtain EPA, state or local input or approval. The Interim Self-Disclosure Policy does not modify this condition.
- *Prevent Recurrence - Condition 6*: The Audit Policy provides that the disclosing entity must agree in writing to take steps to prevent a recurrence of the violation after it has been disclosed and corrected. The Interim Self-Disclosure Policy does not modify this condition.
- *No Repeat Violations - Condition 7*: For a self-disclosure to receive Audit Policy consideration, the same or closely-related violation must have not occurred at the same facility within the past three years. When the facility is part of a multi-facility organization, the Audit Policy is not available if the same or closely-related violation occurred as part of a pattern of violations at one or more of these facilities within the last five years. If a facility has been newly acquired, the existence of a violation prior to the acquisition does not trigger the repeat violations exclusion as to the new owner.
- *Other Violations Excluded - Condition 8*: The Audit Policy excludes violations that resulted in serious actual harm or may have presented an imminent and substantial endangerment. Where violations that gave rise to serious actual harm or an imminent and substantial endangerment began before the new owner acquired the facility, EPA will allow such violations to be eligible under the Interim Self-Disclosure Policy, absent a fatality, community evacuation or other seriously injurious or catastrophic event.
- *Cooperation Condition - Condition 9*: The Audit Policy requires that the disclosing entity cooperate with EPA and provide it with the information it needs to determine the applicability of the policy. EPA is modifying the cooperation condition of the Audit Policy only to make clear that the disclosing entity must cooperate with EPA in determining whether all Audit Policy conditions - as they have been modified by the Interim Self-Disclosure Policy - have been met.

Affected businesses should consider whether they can benefit under the Interim Self-Disclosure Policy by conducting a compliance audit in connection with transactions currently contemplated and those completed in the last nine months. A few words of caution are in order, however: (1) EPA has not to date been prepared to recognize a "self-evaluative" privilege in conjunction with audits, and can request a copy of self-audits during the enforcement process,[1] so confidentiality is not ensured; (2) the Interim Self-Disclosure Policy does not shield the self-disclosing entity from criminal enforcement, although it is EPA's policy to not refer matters for criminal enforcement if Conditions 2 through 9 (and certain other requirements) are met, and; (3) self-disclosure under the federal policy does not necessarily bar enforcement action by state and local authorities. Parties negotiating a transaction should also keep the new policy in mind during the diligence and documentation process. Where non-compliance is apparent, parties may wish to modify traditional "non-disclosure" provisions to permit such disclosure as may quality for penalty mitigation.

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[1] 60 Fed. Reg. 16875 (April 3, 1995). Note that several states have established immunity for self-audits by law.

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