KIRKLAND ALERT
April 2009

EPA Offers Enhanced Incentives to Encourage Self-Reporting by Purchasers

The U.S. EPA recently announced an expansion of its Audit Policy aiming to encourage "new owners" of regulated facilities to voluntarily disclose and correct environmental violations in exchange for a mitigation of penalties.[1] Notably, eligible "new owners" include not only buyers of assets but also of stock, subject to certain conditions. The new policy presents a significant new opportunity to buyers of businesses and of regulated facilities, as well as new challenges for business transactions where one party seeks to make use of the new policy.

EPA's Evolving Audit Policy

The new initiative is crafted as a "pilot" expansion of the EPA "Audit Policy" first promulgated in 1995.[2] The original Audit Policy provided incentives, such as reduced penalties, to facility owners that self-audited their facilities and voluntarily disclosed and corrected environmental violations. EPA designed the original program to encourage companies to implement "systematic" in-house environmental auditing systems to proactively identify and correct violations, a key strategy in EPA's evolving mission to not only enforce the law but encourage compliance.

EPA's recent expansion of the Audit Policy was based on two factors. First was the realization that the vast majority of self-reported violations were "low value" disclosures of administrative reporting or record-keeping deficiencies, not violations involving serious environmental hazards or failure to install costly pollution control systems (which might not be eligible for full penalty waivers under the original program). Second, EPA came to recognize corporate mergers and acquisitions as a prime opportunity for environmental improvements, noting that "when a new owner takes control of a facility, a host of factors may make it feasible and attractive for a new owner to focus on, and invest in, assessing and addressing environmental compliance issues," and that "encouraging the new owners of regulated facilities to assess, disclose, and address environmental compliance at their newly acquired facilities presents a promising opportunity to achieve significant improvements to the environment."

The eligibility criteria in the original Audit Policy, however, made it ill-suited to the transactional context. For example, the requirement that violations be discovered in the course of a "systematic" environmental auditing system and be disclosed within 21 days of discovery virtually disqualified new owners. EPA's new initiative attempts to remove some of these obstacles by expanding the eligibility criteria. Additionally, in an effort to secure more "high value" disclosures, EPA is offering "new owners" a mitigation not only of "gravity-based" penalties but also "economic benefit" penalties, and has increased the range of violations eligible for penalty reductions.

Who Are "New Owners" Eligible for the Policy?

EPA defines "new owners" eligible for the benefits of the expanded Audit Policy with respect to three key concepts: corporate structure, timing, and responsibility. First, with respect to corporate structure, EPA defines

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a "new owner" as an entity that can certify that "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."[3] This is a significant development in that EPA has opted to allow both stock and asset buyers to be eligible so long as one party does not hold the "largest ownership share" of the other. Second, an owner is deemed to be "new" for a period of nine months from the date of the acquisition. Finally, the new owner cannot have been actually responsible for the violations being disclosed or otherwise in control of the facility in question prior to the acquisition.

What New Incentives Are Being Offered?

1. Reduction or Elimination of "Economic Benefit" Penalties. The new incentives include a significant reduction in civil penalties over and above the benefits offered in the original Audit Policy. Where the original policy provides only for the reduction of "gravity-based" civil penalties, "new owners" may be eligible for a waiver not only of "gravity-based" penalties but also a reduction in "economic benefit" penalties, a separate class of penalties that are based on the monetary gain resulting from non-compliance, such as the avoided costs of installing a piece of pollution control equipment. Specifically, new owners may be eligible for full waiver of all economic benefit penalties for the time period before the facility was acquired, and greatly reduced economic benefit penalties for the time period after the acquisition.[4]

2. Expansion of the Types of Violations That Will Be Excused. EPA's original Audit Policy did not cover violations that "resulted in serious actual harm, or may have presented an imminent and substantial endangerment, to human health or the environment" and violations that "violate the specific terms of any judicial or administrative order, or consent agreement." The new Audit Policy is more inclusive, and with respect to new owners, excludes a more limited set violations, those causing "a fatality, community evacuation, or other seriously injurious or catastrophic event." Similarly, the original Audit Policy did not cover violations that were detected by monitoring or other actions that are required by law, such as the monitoring prescribed in the NPDES program, auditing required by a consent decree, or activities related to a Clean Air Act Title V certification requirement. For new owners, EPA will not exclude such violations from the Audit Policy so long as the violations are disclosed, or an audit agreement entered into, before the time the monitoring or auditing is required by law. *See* 73 Fed. Reg. at 45000-01.

3. Increase in the Period of Time for Discovery and/or Reporting. Under the original Audit Policy, companies were required to disclose a violation within 21 days of discovery. New owners, however, need not report violations until 45 days after the date they acquire a facility (closing date), even if they discovered the violation before closing. After the 45-day mark, the traditional 21-day reporting requirement again applies. *See* 73 Fed. Reg. at 45001. In addition, companies may negotiate an individual schedule for conducting audits and reporting identified violations if the acquired facilities present additional complexity or scope that is not readily addressed in the 21-day or 45-day periods.

4. New Owners Not Subject to "Systematic Discovery" Condition. Under the original Audit Policy, companies could not reap the full benefits of penalty reduction unless its discovery of the violation was made pursuant to a "systematic, documented, and periodic" review of the facilities. In light of the impracticality of imposing such a requirement on buyers in the transactional context, however, EPA has concluded that new owners may receive the full 100% penalty reduction for violations discovered during the buyer's pre-closing environmental due diligence, even though this due diligence is a one-time (and thus not periodic) review. *See* 73 Fed. Reg. at 45449-45000.

Transactional Pitfalls and Opportunities

While offering new incentives, the policy also creates new challenges for parties to a transaction. For example, EPA's new policy in essence asks buyers to disclose violations committed by their sellers, but does not offer sellers any sort of "safe harbor" from prosecution. As a result, sellers could potentially object and seek to impose contractual restrictions on self-reporting by the buyer. Although EPA has indicated that it believes contractual non-disclosure terms may be "contrary to public policy," sellers could

alternatively limit the buyer's indemnification rights for losses occasioned by buyer's voluntary self-reports, or require the buyer to indemnify and defend the seller should the government take action against the seller as a result of buyer's report. The parties' relative exposures to such risks will also varying depending on whether the deal is structured as an asset or a stock transaction. The new policy does offer potentially significant benefits, but both buyers and sellers will need to adopt a thoughtful approach to negotiations, deal structure and drafting of contract terms to limit their respective exposures in light of the new policy.

Recent Events Confirm EPA's Commitment to Reinvigorate Use of the Audit Policy

Two recent and high-profile consent decrees highlight the willingness of EPA to apply its audit policies to significantly reduce penalties to entities that self-report violations, particularly where a "new owner" is involved. On April 13, 2009, EPA announced that *Invista* will pay a $1.7 million civil penalty in connection with its discovery and self-disclosure of over 680 environmental violations at 12 facilities it acquired from Dupont in 2004. Considering that *Invista* must spend $500 million to correct the violations, "gravity-based" and "economic benefits" penalties could have totaled tens of millions of dollars had *Invista* not acted under the Audit Policy. Similarly, on April 17, 2009, EPA announced a settlement with six energy companies, two of which self-reported their violations. The two companies that self-reported their violations (Dominion Exploration and Production, and Miller Dyer) were provided Audit Policy treatment, reducing the likely penalties they would have incurred without the Audit Policy.

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1 Interim Approach to Applying the Audit Policy to New Owners," 73 Fed. Reg. 44991 (Aug. 1, 2008).

2 Formally titled "Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations," the EPA Audit Policy was first issued in 1995 and was reissued in its current form in 2000. *See* 65 Fed. Reg. 19618 (April 11, 2000); www.epa.gov/oecaerth/resources/policies/incentives/auditing/auditpolicy51100.pdf

3 *See* 73 Fed. Reg. at 44995-96. Whether a particular entity in a given transaction constitutes a "new owner" may warrant a more detailed legal analysis, particularly where there is some commonality of interests among the parties. Kirkland & Ellis can assist with this analysis.

4 "Economic benefit" penalties are usually based on the following: (1) delaying compliance, which allows an entity to avoid incurring costs such as capital improvements for pollution control, (2) avoiding ongoing operation and maintenance costs that it would have incurred had it made the improvement, and (3) the unfair competitive advantage gained as a result of non-compliance. "New owners" may be eligible to avoid all "economic benefit" penalties other than the those based on the operation and maintenance costs that the entity would have incurred had its predecessor made the improvement. *See* 73 Fed. Reg. at 44998.

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