Self-Audits, Disclosure of Environmental Liabilities, and Privilege Protection

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Is honesty always the best policy when dealing with environmental regulators?

ANY WELL RUN CORPORATION systematically reviews its business operations for compliance with the myriad of state and Federal regulatory programs and laws. That such reviews—commonly termed self-audits—regularly occur is in the public as well as the corporation's interest. The problem is that if the corporation discovers non-compliance, it may have created evidence against itself that could lead to ruinous civil or even criminal liability. Further, it had the dilemma of whether to report any violations to the authorities. Accordingly, Federal and state governments have enacted laws and regulations that provide privilege for qualified communications related to self-audits.

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FEDERAL LAWS AND POLICIES• A number of Federal laws require that instances of environmental contamination be reported. The laws have various requirements, but they almost always impose a penalty for non-disclosure.

Among the laws requiring reporting are:

- The Clean Water Act, 33 U.S.C. §1251 et seq.;
- The Superfund Amendments and Reauthorization Act ("SARA");
- The Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §9601 et seq. ("CERCLA"); and
- The Resource Conservation and Recovery Act, 42 U.S.C. §6901 et seq. ("RCRA").

President Clinton also issued an executive order requiring Federal agencies to conduct audits of their environmental management systems. Exec. Order No. 13,148, 65 Fed. Reg. 24,595 (April 21, 2000).

Clean Water Act Discharge Monitor Reports (Permit-Specific Periodic Status Reports)

Several programs under the Clean Water Act have reporting requirements. For example, the National Pollutant Discharge Elimination System ("NPDES") requires permits for discharge into U.S. waters. Among the reports required are "discharge monitoring reports," periodic reports detailing discharges. The Act also requires periodic reporting for discharges into "publicly owned or operated treatment works." Finally, under the Act, the EPA has authority to establish reporting programs or to approve state/local reporting programs.

Sara Title III Annual Reports

Title III to SARA includes the "Emergency Planning and Community Right-To-Know Act," 42 U.S.C. §11001 et seq. ("EPCRA"). This act provides for the periodic reporting, by facilities holding extremely hazardous substances above a certain base level, of emergency response plans. The act also requires "release forms" or annual reports of on-site use and release of specified toxic chemicals, if above a threshold level. Violation of these reporting requirements can include significant civil and criminal penalties.

CERCLA "Reportable Quantities" Releases

When a release of a "reportable quantity" (defined by EPA regulations) of a hazardous substance occurs, CERCLA requires EPA notification. CERCLA includes an exception for releases under permit. Penalties again can include severe civil or criminal penalties, including a felony charge.

RCRA "Cradle to Grave" Manifest System

RCRA requires reporting at all points of hazardous waste contact. Special recording and reporting requirements exist for generators (there are different requirements depending upon the periodic amount of hazardous waste generated), transporters, and treatment, storage, and disposal facilities. In addition to the submittal of manifests, biannual reports are required by the EPA. Penalties can be civil or criminal and can include third-party suits based on RCRA.

Executive Order 13,148

Each Federal agency is required to develop an agency-wide "self-assessment" of its environmental management by the end of October 2001. These self-assessments are to be based on the *Code of Environmental Management Principles for Federal Agencies* or other appropriate environmental management system framework. The agencies shall implement pilot projects that illustrate the adopted environmental management systems by May 2002. These systems should then be implemented agency-wide at all appropriate agency facilities by Dec. 31, 2005.

EPA Policies

The EPA has a number of reporting policies.

Environmental Auditing Policy Statement of 1986

The old 1986 EPA policy's purpose was "to encourage the use of environmental auditing by regulated entities to help achieve and maintain compliance with environmental laws…." 51 Fed. Reg. 25,004 (July 9, 1986). However, the old policy gave no tangible incentives to the regulated community to disclose.

At best, the policy recommended self-audits. It made explicit that the EPA did not require self-audits and would not routinely request audit reports. The EPA promised to "take into account" regulated entities' avoidance and correction efforts. However, it also reserved the right to seek audit data where needed. Further, it did not protect entities with self-audit programs against enforcement restraints.

The policy detailed the elements of an effective self-audit. These included:

- Management support and commitment to follow-up, which may include a written policy;
- An independent auditing function;
- Adequate training;
- Explicit scope and frequency of audits;
- Analysis of audited information;
- Implementation of audit recommendations; and
- Quality assurance procedures.

Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations

In May 1994, the EPA Administrator asked the Office of Enforcement and Compliance Assurance ("OECA") to review EPA policy. It conducted public meetings and analyzed public comments and data. The result was an interim policy statement in April 1995. 60 Fed. Reg. 16,875 (April 3, 1995).

The interim statement included penalty mitigation for an entity that disclosed a violation under certain conditions. Among the more problematic conditions were voluntary "reports" and voluntary "audits." Under the former, to gain penalty mitigation, the disclosure could not be already "required" under an environmental regulatory program such as previously described. The voluntary "audits" requirement for penalty mitigation excluded management programs that did not fit neatly into the EPA definition of an "audit." Beyond penalty mitigation, the EPA determined that entities in states with self-audit privilege laws in place would be scrutinized to a higher degree than others. Finally, the EPA did not provide for a self-audit privilege.

The Final 1995 Policy

After response from interested members of industry, EPA issued its final policy in December 1995. 60 Fed. Reg. 66,706 (December 22, 1995). EPA included penalty mitigation as it had in the earlier statement. However, it made explicit that nine conditions needed to be met for complete mitigation, and all but one of these conditions needed to be met for 75 percent mitigation. Further, the agency clarified the definition of "voluntary disclosure" and stated that certain monitoring efforts would not necessarily disqualify an entity under this requirement. "Due diligence" and compliance management programs were cited as allowable detection systems. In addition to these clarifications, the EPA also made it emphatically clear that it did not see the need for a self-audit privilege.

Despite the efforts of EPA, several issues remain unanswered. These include policy implementation issues and issues that fall outside the final policy, such as self-audit privilege and prosecutorial immunity.

Civil penalties in environmental law consist of a gravity-based, punitive component and an "economic benefit" component. EPA's final policy allows mitigation and satisfaction of the gravity component if certain conditions are met. For complete mitigation, all nine conditions must be met. These conditions are:

- Systematic discovery through audit or other due diligence;
- Voluntary discovery;
- Prompt disclosure to EPA within 10 days;
- Independent discovery and disclosure;
- Correction and remediation within 60 days;
- Written agreement to prevent recurrence;
- No repeat violations or pattern of violations;
- No serious actual harm results; and
- Full cooperation with EPA.

For 75 percent mitigation, all but the first condition must be met. For those entities that do not meet two or more of the conditions, the EPA would use any penalty-mitigation factors that exist in statute- specific penalties or its other policies. 60 Fed. Reg. 66,712 (1995) ("To the extent that existing EPA enforcement policies are not inconsistent, they will continue to apply in conjunction with this policy.").

EPA decided that only gravity-based penalties and not economic benefit penalties would be automatically mitigated. EPA reserved discretion to collect economic benefit penalties or to forgive these penalties when an "insignificant amount" of benefit is involved.

Gravity-Based vs. Economic Benefit Penalties

EPA distinguished between "gravity-based" and "economic benefit" penalties as follows:

A "gravity-based penalty" is that portion of a penalty over and above the economic benefit, i.e., the punitive portion of the penalty, rather than that portion representing a defendant's economic gain from non-compliance.

Despite this definition, the exact contours of an "economic benefit" penalty remain unclear. Under most current environmental laws, EPA uses the "BEN" model to determine economic benefit. Similarly, the policy does not determine what "insignificant amount" means, for which an economic-benefit penalty would not apply. Currently, individual environmental statutes contain "insignificant amount" exception to penalties, but even these statutes leave room for discretion. The bottom line is that the EPA still maintains discretion over the penalties assessed. Note that the cost to comply with disclosure requests, including attorney's fees, is not considered in the "economic benefit" calculus.

A recent illustration of EPA's economic benefit policy is provided by the Agency's decision to mitigate General Electric's penalty. GE reported its own violation of the Clean Air Act to EPA. The penalty imposed on GE was the amount GE saved by not initially installing the proper pollution control equipment. EPA decided not to pursue additional fines because GE "discovered, promptly disclosed to the government, and corrected the violations." 27 Env't Rep. (BNA) 883-84 (Aug. 16, 1996).

The final policy stated that EPA generally would not recommend for prosecution to the Department of Justice or other authority a regulated entity that met all of the conditions. It is not clear, however, whether this would include those entities that receive a 75 percent mitigation since by definition they have not met one of the conditions.

The agency provided exceptions to this general rule of non-referral. If the violation demonstrates either a management philosophy that "concealed or condoned environmental violations" or high-level corporate officials were aware of the violations, EPA can recommend prosecution. Further, the acts of individuals are not protected by the general rule.

The final policy did not elaborate on how entities, without an audit privilege or immunity, would be protected from third-party suits. This is a significant concern because a toxic tort plaintiff or a citizen's group could use the information disclosed pursuant to a penalty mitigation procedure to pursue a personal or property damage action or a citizen suit enforcement and attorney fees lawsuit. Further, because the policy does not bind the agency, it is unclear whether it would be applied consistently across EPA regions.

EPA also makes explicit that it will not begin an enforcement investigation by asking for an audit report. However, it does reserve the right to request a report after a violation has been identified.

EPA reiterated its opposition to an evidentiary privilege from a self-audit. It cited six reasons for this opposition:

- The privilege would invite secrecy rather than build public trust in industry;
- There does not seem to be a need for the privilege, because audits were growing in popularity without the privilege and EPA rarely uses audits for its investigations;
- With a privilege, the term "audit" would be affixed to every piece of information related to a violation;
- An audit privilege would breed litigation;
- This policy is all the incentive that industry needs according to a 1995 Price Waterhouse survey; and
- Law enforcement and public interest groups oppose audit privileges.

The policy is not to be confused with a rule or other legal creature that creates rights. EPA made this explicit when it stated:

"This policy sets forth factors for consideration that will guide the Agency in the exercise of its prosecutorial discretion. It states the Agency's views as to the proper allocation of its enforcement resources. The policy is not final agency action, and is intended as guidance. It does not create any rights, duties, obligations, or defenses, implied or otherwise, in any third parties."

Thus, EPA maintains discretion to penalize regulated entities regardless of the text of the policy. This qualification is perhaps the greatest weakness in EPA's effort; simply put, what business desires most, certainly in a regulatory burden, is simply non-existent.

Fiscal 1998 Audit Policy in Practice

The Fiscal 1998 Audit Policy revealed that 96 companies disclosed violations at more than 927 facilities, of which 63 companies corrected violations at 390 facilities.

As of April 30, 1999, and since policy inception in 1995, EPA has reduced or forgiven penalties for 166 companies at 936 facilities.

Proposed Deadline Extension

The EPA issued a proposal to extend the deadline to report self-discovered violations from 10 days to 21 days dated May 11, 1999, and also, clarifications regarding FOIA and confidentiality, what is a "voluntary discovery," and penalty reduction for disclosures under other EPA programs.

Audit Policy Amended

In *Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations,* 65 Fed. Reg. 19,618 (April 11, 2000), the EPA Audit Policy was amended with input from the U.S. Department of Justice, States, public interest groups, and the regulated community. The 2000 Audit Policy maintains the basic structure and terms of the 1995 policy with a few minor revisions.

Of the nine factors required to be satisfied for complete mitigation, factors one and three have

been altered. Under factor one, the violation must have been discovered through either:

- An environmental audit; or
- A compliance management system that reflects due diligence in preventing, detecting, and correcting violations. The change from "due diligence" to "compliance management system" reflects the terminology used by industry and regulators.

The third factor now requires disclosure of the violation in writing to the EPA within 21 calendar days after the discovery. Newly acquired facilities will also have the 21-day window for disclosure, and the "no repeat violations" condition does not disqualify disclosure from newly acquired facilities. This 21-day disclosure period is triggered when any officer, employee, or agent of the facility has an objectively reasonable basis for believing that a violation has, or may have occurred.

The forth factor of independent discovery has been clarified. A facility may qualify for Audit policy credit even if another facility owned or operated by the same parent organization is already the subject of an inspection, investigation, or information request.

The EPA will not recommend prosecution for those who meet at least conditions two through nine. The systematic discovery requirement is not necessary if self-policing, discovery, and disclosure were conducted in good faith and the entity adopts a systematic approach to preventing the recurrence of the violation.

Other Federal Approaches

The Policy on Implementation of EPA Self-Disclosure Policy in Criminal Cases outlines several criteria that must be met in order for companies to be covered. Clearly, this recent policy parallels EPA's self-audit policy approach. The first is that the company must cooperate fully with EPA enforcement personnel, including giving them access to employees and documents. The policy memo does state, however, that "full cooperation does not require that the [company] waive legitimate legal privileges available to it, but does require that any privilege issues raised during the course of the criminal investigation be made in good faith."

Other criteria include disclosure of the violation must be made before EPA opens a criminal investigation; the disclosure must be made before the EPA begins investigating "promising leads"; the discovery must be made through voluntary actions on the part of the company, such as environmental audits; the violation must be disclosed with 21 days of the discovery; the company must state in writing that it will remedy the violation within 60 days of the disclosure; the company must agree in writing to prevent the future recurrence of the violation; and, the violation must not repeat a violation that has occurred in the previous three years and must not be a part of a pattern of noncompliance.

To ensure that all disclosures submitted to an agency are considered and administrated in a consistent and fair manner nationally, a Voluntary Disclosure Board was established which consists of members of EPA's Office of Criminal Enforcement, Forensics, and Training, and DOJ's Environmental Crimes Section. Guidance entitled "Implementation of the EPA's Self-Policing Policy for Disclosures Involving Potential Criminal Violations," Office of Criminal Enforcement, Forensics, and Training ("OCEFT"), October 1, 1997.

Department of Justice Policy

In *Department of Justice Policy: Exercise of Criminal Prosecutorial Discretion for Environmental Violations in the Context of Significant Voluntary Compliance or Disclosure Efforts by the Violator,* the DOJ did not jointly file EPA's self-audit policy. In a statement in 1991, however, DOJ stated that it would consider certain mitigating factors in

criminal environmental prosecutions. The purpose of the statement was to encourage self-auditing, self-policing, and voluntary disclosure of environmental violations.

DOJ's mitigation factors include:

- No prior history of violations;
- A compliance program that includes policies, training and an environmental violations "hotline";
- A self-audit program;
- Immediate correction of violations;
- Cooperation with the government including turning over related internal documents;
- A disciplinary program for individual violators; and
- Cooperation with the government in prosecuting these individuals.

The greater the number of factors that an entity meets, the more likely the DOJ will not prosecute. However, like the EPA policy, the DOJ policy offers little comfort to these entities because DOJ retains its full prosecutorial discretion and makes explicit that its statement does not grant any rights.

Federal Facilities and Contractors

In March 1997, a coalition of environmental groups urged President Clinton to bar Federal facilities and contractors from invoking state laws that treat environmental audits as privileged information. 27 Env't Rep. (BNA) 2351-52 (April 4, 1997).

EPA Final Policy on Compliance for Small Businesses

EPA Final Policy on Compliance for Small Businesses, 61 Fed. Reg. 27,984 (June 3, 1996), is "intended to promote environmental compliance among small businesses by providing them with incentives to participate in compliance assistance programs or to conduct environmental audits and then promptly correct violations."

The policy attempts to accomplish its goal in two ways:

- By setting forth guidelines for the EPA to reduce or waive penalties for small businesses that make good faith efforts to correct violations; and
- By providing guidance for State and local governments to offer these incentives.

A small business may qualify for the penalty waiver or mitigation as long as:

- The violation is the first violation of the particular requirement;
- The violation does not involve criminal conduct;
- The violation is not causing significant health, safety or environmental threat or harm; and
- The violation is remedied within the correction period.

The policy applies to a person, corporation, partnership, or other organization that employs 100 or fewer individuals. Small business industry sectors that are included in this policy include among others:

- Dry cleaners;
- Industrial organic chemical manufacturers;
- Chemical preparations industries; construction;
- Automotive service and repair shops;
- Landowners/farmers;
- Privately-owned drinking water systems;
- Electroplaters;
- Small quantity generators; and
- Fuel blenders.

In 1997, two dozen small steel mills in the Midwest were encouraged by EPA to conduct self-audits and disclose potential environmental violations. Approximately half of those mills

conducted the audits and several disclosed the violations; EPA has now inspected those facilities that did not comply.

EPA Small Business Compliance Policy

EPA Small Business Compliance Policy, 65 Fed. Reg. 19,630 (April 11, 2000), The 2000 Small Business Compliance Policy extended the amount of time entities have to disclose a violation from 10 to 21 days after discovery. The 2000 policy also is broadened to apply to violations uncovered by small businesses through any means of voluntary discovery, such as by using a checklist or another tool obtained from a Compliance Assistance Center.

Recent Developments

EPA announced in April of 2002 that, for that year, it waived penalties totaling $539,653 for six firms in Pennsylvania and Virginia that voluntarily disclosed and corrected violations of several environmental laws. The potential penalties were waived for violations of TSCA, EPCRA, and the CWA. These are among the first audit disclosures resolved in 2002 by EPA Region III, which reduced or waived $350,900 in potential penalties against 18 companies in the agency's mid-Atlantic region during 2001, under the self-auditing policy. *EPA Region III Waives $539,000 in Penalties After Six Firms Disclose Violations to Agency*, BNA Daily Environment Report, April 26, 2002, at A-3.

On January 31, 2002, EPA released data on its enforcement and compliance assurance results for FY 2001.

- Enforcement actions required violators to reduce an estimated 660 million pounds of pollutants and treat and safely manage an estimated 1.84 billion pounds;
- Violators being required to invest $4.3 billion in pollution control and cleanup measures—the highest-ever such investment; 222 civil judicial cases were settled and 3,228 administrative orders and field citations issued;
- A vigorous criminal program resulted in prison sentences totaling 256 years—an increase of more than 100 years over FY2000—for criminal violations; such violations also resulted in nearly $95 million in fines and restitution;
- Supplemental environmental projects totaled at $89 million—up 60 percent from $55.8 million in FY2000; these involve actions a violator agrees to undertake to protect the environment and human health beyond required injunctive relief in exchange for a penalty reduction; and
- Compliance assistance for more than one million individuals and businesses by direct assistance or through Compliance Assistance Centers.

EPA Achieves Significant Compliance and Enforcement Progress in 2001, at http://www.epa.gov/compliance/planning/results/press//2001eoy/2001eoy.html

EPA is developing a voluntary program under which independent firms would audit industrial facilities' plans for managing chemical risks. These audits would not automatically or permanently take the place of required EPA audits, but the EPA is considering: allowing the third-party audits to temporarily exempt participating facilities from EPA inspections.

According to the program, described in a January 25, 2002 article in BNA "Daily Environment" report, after the audit is performed, the auditor would submit the results of the audit to the facility only and the facility would have the option of submitting the results to the EPA. The only exception being if the auditor found an "imminent hazard." If the facility chooses not to submit the audit it would not be eligible for any of the incentives for completing the outside audit, which may include a temporary exemption from future EPA risk manage-

ment plan inspections, a waiver of enforcement penalties for most non-serious violations and a policy that third-party audits would satisfy the existing requirement for prevention program compliance audits.

EPA announced in June 2001 that it would waive nearly $350,000 in potential fines for seven companies that voluntarily reported violations of EPCRA. The potential violations were all reporting violations, not releases of toxic substances, and were discovered in part through self-audits. Additionally, EPA reported that 35 companies in the mid-Atlantic region alone had avoided approximately $3,000,000 in potential fines for reporting violations under EPA's audit policy. *EPA Waives $350,000 in Potential Fines After Alleged EPCRA Violations Disclosed*, BNA Daily Environment Report, June 8, 2001, at A-10.

In December 2000, EPA reported that 10 cheese companies conducting self-audits of 32 facilities in 11 states had corrected 264 environmental violations under the audit policy. The self-disclosed violations involved EPCRA reporting requirements. In applying the audit policy, the EPA waived 100 percent of the potential penalty, based on the severity (gravity-based punitive element) of the violation. Of the 10 companies, only one was subject to a fine, even though the companies discovered violations that could have resulted in fines of up to $100,000 per violation over a four-year period. *Cheese Companies Correct Violations Using EPA Audit Policy; No Penalty for Most*, BNA Daily Environment Report, Dec. 27, 2000, at A-2.

An EPA spokesman announced on June 22, 2001 that EPA would release a plan intended to improve its rulemaking process, which would likely encourage the agency to employ voluntary or other non-regulatory means to reduce pollution and address other environmental issues. *Plan to Improve Regulatory Process at EPA May Urge Voluntary, Nonregulated Options*, BNA Daily Environment Report, June 25, 2000, at A-1.

Many companies are concerned that the information they provide to EPA under the audit policy rule has been used against them in subsequent proceedings. In January 2001, Colorado Congressman Joel Hefley introduced a bill (similar to a bill he introduced in 1997) entitled the "Voluntary Environmental Self-Evaluation Act" (H.R. 352) that would provide partial protection to companies discovering violations of an environmental law during self-audits. H.R. 352 would make information contained in any voluntary environmental self-evaluation and any related testimony inadmissible in Federal or state judicial or administrative proceedings under a Federal law, unless the information were required to be reported, developed or maintained under the law or if the company's violation of the law were intentional or willful.

Under the proposed bill, the protections from prosecution would only apply if the company disclosing the violation did so promptly and also initiated remediation. Moreover, the immunity from prosecution provided by the bill would not be available if the violation were part of a pattern of significant violations.

H.R. 352 was jointly referred to five House committees. *Rep. Hefley Reintroduces Legislation On Corporate Immunity for Voluntary Efforts*, BNA Daily Environment Report, Feb. 5, 2000, at A-1. The bill never became law.

STATE APPROACHES • Many states have adopted their own auditing incentives—some through policy and others by legislation. The Clinton Administration adamantly opposed Federal and state environmental audit privilege and immunity legislation on the grounds that the environmental audit privilege laws promote secrecy, interfere with law enforcement, impede the public right-to-know, and can penalize employees who report illegal activity to law enforcement authorities.

Although EPA supports penalty mitigation as an incentive for self-policing, EPA believes that to immunize serious violations—including those where there is criminal conduct, imminent and substantial endangerment, or actual harm—is wrong. Because of this stand, the EPA has been working with several states to modify their state audit privilege and immunity laws to conform with Federal law and many states have reached an agreement on needed changes to the laws.

With all the audit laws, "cooperation" is a necessary prerequisite, condition, or factor in receiving all or some of the benefits conferred. The DOJ Criminal Prosecution Policy describes "cooperation" as one of the key mitigating factors to be considered in deciding "whether to bring a criminal prosecution for a violation of an environmental statute even though it is not actually defined in the policy. All the other policies actually define cooperation and agree that it is a necessary condition and/or element of "good faith" that may determine the whether gravity-based penalties should be mitigated or eliminated.

EPA Response to State Approaches:

Under EPA Response to State Approaches: *Statement of Principles, Effect of State Audit Immunity/Privilege Laws or Enforcement Authority for Federal Programs* (OECA February 14, 1997)

- EPA prefers states to have body policies, not legislation:
- Immunity must be limited to minor violations and exempt Federal programs;
- Information-gathering authority must not be compromised;
- Right of public to obtain information must not be compromised; and
- EPA (sanctions: withdrawal of delegation, over-filing).

In handling civil and criminal disclosures, the Revised 2000 EPA Audit Policy Clarifies that the EPA will defer to states that have audit policies that meet minimum requirements for Federal delegation.

PRACTICE CHECKLIST

Self-Audits, Disclosure of Environmental Liabilities, and Privilege Protection

Corporate self-audits may disclose infractions of environmental laws and regulations. Counsel must decide whether disclosure is in the interest of the corporation. Disclosure may be required, or it may be privileged under evidentiary or special regulatory privileges. Practical concerns, such as public reaction, will also influence this decision.

- Is a violation reportable?

__ Check to see whether there is a statutory obligation to report the violation via permit, monitoring report, or spill reporting;

__ In deciding whether to report a discovered infraction, remember that the disclosure will only be privileged if it is voluntary;

__ Determine whether there will be exoneration against later "knowledge" claim;

__ Evaluate the public relations aspect of reporting a violation;

__ If the violation is reported, determine whether the fine will be minimal.

- Is an audit disclosable?

__ Does the audit enjoy a litigation privilege?

__ Regulatory subpoena;

__ CERCLA §104(e), 42 U.S.C. §9604(e) information request;

__ Consent decree obligation.

- Transactional considerations:

__ Look for protection for buyer and lender against pre-existing conditions;

__ Determine whether the transaction will cause a loss of "privilege."