

October 2008

## Environmental and Utilities Legal Update

### EPA's Audit Policy - A New Approach for New Owners

In an effort to encourage new owners of facilities to make a "clean start," and to promote investment in maintenance and equipment likely to improve environmental health and safety, EPA has proposed an "Interim Approach to Applying the Audit Policy to New Owners."<sup>1</sup> Comments on the Interim Approach are due November 1, 2008. EPA will then determine whether the policy should become a permanent program, be refined or discontinued based on whether the program has resulted in increased self-disclosures and investment in controls to protect human health and the environment.

Under EPA's Audit Policy, new owners who self-disclose are not treated any differently than existing owners, except to the extent that disclosed violations involve Title V compliance discovered during the process of completing annual certification. By way of contrast, the Interim Approach would not assess penalties against qualifying new owners for the economic benefit or gravity of those disclosed violations that began before the new owner acquired the facility, and it would also alter the way EPA applies five of the nine Audit Policy conditions to new owners allowing more violations to be eligible for penalty relief. Buyers and sellers should consider this change in approach when negotiating for the purchase and sale of environmentally impacted facilities and businesses, particularly the scope of pre-transaction due diligence, representations and warranties regarding compliance, and indemnities for past violations.

#### **Who is a "New Owner" under the Interim Approach?**

An entity seeking to disclose violations under the Interim Approach must meet the criteria of a "new owner." Specifically, it must certify that it meets the following:

- Prior to the transaction closing date, the new owner: (1) was not responsible for environmental compliance at the facility(ies) where the relevant violations occurred; (2) did not cause the violations; and (3) could not have prevented the violations;
- The violations being disclosed originated with a prior owner; and
- Prior to the transaction, the buyer and seller did not have a common corporate parent, and neither owned the largest ownership stake in the other.

EPA will exclude from the definition of "new owner" any entity that, prior to the transaction, had the largest pre-transaction ownership interest in the facility. Buyers with the same corporate parent as the seller are also excluded. An entity that, prior to the transaction, was a "silent or inactive partner in a joint venture" and whose ownership stake was less than the largest owner will also qualify as a "new owner."

New owners are only considered "new" for up to nine months after the transaction closing date. New owners wishing to self-report may either enter into an audit agreement with EPA that specifies the facility(ies) to be audited, the scope of the regulatory programs to be included, and the dates for completion and disclosure, or they may make individual disclosures as violations are discovered; however, during that nine-month period, individual disclosures would have to be made within 21 days of discovery or within 45 days of the transaction closing date, whichever is longer.

#### **What are the benefits of disclosure under the Interim Approach?**

Under the Interim Approach, new owners will not be subject to economic benefit or gravity-based penalties for violations that took place under the previous owner's watch, provided the new owner was not in a position to prevent the violations. Disclosing new owners will, however, be subject to economic benefit penalties arising out of "avoided operation and maintenance costs" enjoyed as a result of not having improved controls from the date of the acquisition until such time as the

necessary improvements are made. New owners who correct the violations within 60 days of discovery (or other reasonable time frame to which EPA has agreed) will not incur economic benefit penalties for such capital expense delays.

### **Audit Policy Conditions will be applied differently to cover more types of violations**

In addition to the economic benefits provided to "new owners" that self-report, the Interim Approach treats new owners differently under five of the nine Audit Policy conditions to allow more types of violations to be eligible for penalty relief.

- **Systematic discovery** : Because pre-transaction due diligence is a one-time event, EPA will waive the requirement that the review leading to the discovery of the violations be "periodic."
- **Voluntary discovery** : Under the Audit Policy, EPA does not provide protection for violations discovered through a legally mandated process, such as permit-required monitoring, sampling or auditing. The Audit Policy made an exception for Title V requirements. The Interim Approach extends this exception to violations found under all permits or other legal requirements to monitor, sample, and audit, provided they are disclosed before the first instance such monitoring, sampling, and auditing would be required.
- **Prompt disclosure** : Under the Audit Policy, companies making voluntary disclosures must do so within 21 days of discovery of a violation or reason to believe a violation has occurred. Under the Interim Approach, new owners may enter into an audit agreement, including a schedule for disclosure within 9 months of closing, or it must disclose individual violations within 21 days of discovery or 45 days of closing, whichever is longer.
- **Discovery and disclosure independent of the government or a third-party plaintiff** : There is no change under the Interim Approach.
- **Correction and remediation within sixty days from the date of discovery** : There is no change under the Interim Approach.
- **Agreement in writing to prevent recurrences** : There is no change under the Interim Approach.
- **No repeat violations** : As under the Audit Policy, the existence of a violation prior to the new owner's acquisition of a facility does not trigger the repeat violations exclusion.
- **Other violations excluded** : the Audit Policy excludes violations that result in serious actual harm or that may present an imminent and substantial endangerment to human health and the environment. Under the Interim Approach, such violations may be disclosed provided they began pre-closing and did not cause any fatalities, community evacuation, or other serious injuries or a catastrophic event.
- **Cooperation** : Under the Interim Approach, cooperation also includes the requirement that a new owner provide the necessary information to demonstrate it meets the criteria of a new owner.

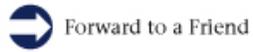
### **What impact will the Interim Approach have on transactions?**

EPA is hopeful that the Interim Approach will increase the number of self-disclosures made, reduce the amount of pollutants released to the environment, and encourage investment in better maintenance and controls by providing new owners the protection of the Audit Policy. EPA has affirmatively stated that it has not instituted a new enforcement priority focused on newly acquired facilities. Regardless, it is likely that the Interim Approach will bring to light compliance issues that might have remained undiscovered, as buyers and sellers focus more on pre-transaction due diligence, requirements to address violations pre-closing, escrow money for improved controls, and or broader indemnities for disclosure or failure to disclose compliance issues. Furthermore, as the Securities and Exchange Commission and the Financial Accounting Standards Board revise and tighten rules associated with estimation and disclosure of loss contingencies, the Interim Approach may provide another significant issue for buyers and sellers to negotiate how they allocate post-closing risk for environmental issues.

### **Need More Information?**

At Robinson & Cole, we have experienced environmental attorneys who also understand that environmental compliance is but one aspect of the complex, multifaceted, and sometimes competing demands made on businesses. For more information, please call any of our environmental attorneys or call Pamela Elkow ([pelkow@rc.com](mailto:pelkow@rc.com)) in our Metro-New York office at (203) 462-7548, Earl Phillips ([ephillips@rc.com](mailto:ephillips@rc.com)) in our Hartford office at (860) 275-8220, or Christopher Foster ([cfoster@rc.com](mailto:cfoster@rc.com)) in our Boston Office at (617)557-5908.

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