
ENCOURAGING VOLUNTARY COMPLIANCE WITHOUT COMPROMISING ENFORCEMENT: EPA'S 1995 AUDITING POLICY

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SUMMARY

Environmental auditing has expanded rapidly in the United States over the past decade, in response to the complex and multiplying requirements of environmental law. The US Environmental Protection Agency has encouraged this trend by helping to define the concept of environmental auditing through policy and technical assistance, and through a strong enforcement program that discourages noncompliance. In December of 1995, the EPA announced for the first time that it would systematically reduce civil penalties and corporate liability for criminal prosecution for companies that voluntarily audit, disclose, and correct violations. This article examines the evolution in EPA's approach to environmental auditing, explains the criteria that shaped the new policy, and reviews its prospects for success.

1 THE FIRST STEP: EPA'S 1986 POLICY

1.1 EPA Policy Statement

By the mid 1980's, the accumulation of new regulatory standards and the federal government's commitment to their enforcement had made environmental auditing a practical necessity for many businesses. The EPA sought to encourage this trend with a 1986 policy statement that provided a common sense definition of auditing (ATTACHMENT 1), and recognized that auditing should remain a voluntary activity, to provide individual companies the flexibility to design their own systems for self-policing.

EPA also sought to reassure nervous corporate counsel, anxious to protect their clients' privacy, that environmental audits would not generally be the subject of routine government inspections.

US environmental law provides EPA inspectors with broad authority to request any evidence regarding a potential violation, including materials contained in an audit. This material may be requested prior to an investigation or during the course of the inspection request. While making clear that EPA would not request audit reports as a routine matter, the Agency reserved the right to request such documents (or portions thereof) for specific cause, e.g, where the information might be useful in determining whether a violation was intentional.

While auditing was identified as one factor the Agency might consider in assessing a penalty for violations, the policy declined to make specific promises to reduce inspections or enforcement in exchange for audits:

EPA will not promise to forgo inspections, reduce enforcement responses, or offer other such incentives in exchange for implementation of environmental auditing or other sound environmental management practices.

The Agency did indicate that it would take into account, on a case-by-case basis, the "honest and genuine efforts of regulated entities to avoid and promptly correct violations..." in determining the appropriate enforcement response.

1.2 Agency Practice Under 1986 Policy

Following issuance of the policy, EPA invested in numerous reports, case studies, bibliographic references, and training materials, designed to help guide the fledgling environmental auditing industry. EPA's internal surveys confirm that the Agency has kept its promise not to routinely request audit reports in inspections. The Agency also typically adjusted penalties downward for violations voluntarily discovered and reported by the regulated industry, although conflicting rules in different media programs made it difficult to establish a consistent and predictable pattern.

2 ENVIRONMENTAL AUDITING AFTER 1986

2.1 Importance of Deterrence to Self-Policing

The 1986 policy reflected three related principles that are fundamental to EPA's environmental enforcement program:

- 1) Frequent and thorough inspections and stiff penalties for noncompliance send a strong message of deterrence to would be violators;
- 2) Enforcement agencies should have the discretion to adjust penalties for good faith efforts to comply, but any limitations on that discretion (e.g., promises to reduce penalties for companies that audit) should be avoided because they undermine deterrence;
- 3) Environmental audits are their own reward, because they help companies to find and correct violations before they are brought to the attention of enforcers, as well as reduce potential liability for damage to surrounding communities.

2.2 Growth in Environmental Auditing

The explosion in environmental auditing since publication of the 1986 policy offers powerful testimony to the truth of these arguments. So does evidence from the regulated industry about the reasons for this growth.

Surveys of the private sector over the past two years have demonstrated that environmental auditing is now widely accepted as good business practice, at least by companies that are coping with significant regulatory requirements. A 1994 Price Waterhouse survey of major corporations found that 75% of respondents had already established environmental auditing programs, up from 40% in 1992. These findings were consistent with a 1994 survey by the Investor Responsibility Research Center (IRRC), which found that 85% of respondents had established such programs, with most conducting audits at U.S. facilities at least once every two years. A 1995 follow-up survey by Price-Waterhouse found that over 90% of respondents in heavily regulated sectors like petroleum refining and chemical manufacturing audited on a regular basis.

Why such high levels of participation? Not surprisingly, the same surveys report that environmental self-policing is driven by enlightened self-interest, as companies seek to reduce their exposure to fines and environmental damages and improve their efficiency. For example, over 96% of the respondents to the Price-Waterhouse survey said that one of their most important reasons for auditing was the need to uncover violations before they were identified by government inspectors. (ATTACHMENT 2). Interestingly, while companies responding to the IRRC survey reported auditing 75% of their U.S. facilities over the past two years, only half of their foreign

plants had been audited within that time. While there may be a number of explanations, stringent regulatory standards and their enforcement have undoubtedly created an incentive for industry self-policing in the United States.

3 EPA REEXAMINES ITS AUDITING POLICY

3.1 Regulated Industries Raise Concerns About Liability

As environmental auditing became more widespread, however, corporations began raising questions about their potential liability for violations uncovered during these self-evaluations. While fear of enforcement was identified as a major incentive to audit, the 1995 Arthur Andersen survey cited concern over potential exposure to fines and third-party claims for damage as a major impediment to the expansion of auditing programs.

At the same time, as inspection resources failed to keep up with the growth in new regulations, government agencies gained an even greater appreciation of the importance of voluntary auditing to compliance. By one estimate, at least 700,000 facilities are subject to one or more federal environmental laws, while the federal government and states together conduct fewer than 100,000 inspections every year. As discussed above, while different enforcement policies offered discretion to offset penalties by varying amounts for violations disclosed and corrected, these policies were not consistent and not perceived as offering a substantial incentive.

In July of 1994, EPA began a public reexamination of its auditing policy, to determine whether it should offer additional incentives to encourage companies to conduct environmental audits. The key issue was whether it was possible to reduce the risk of enforcement for companies that audited and corrected violations, without compromising the kind of deterrence-based enforcement that contributed to the growth of auditing in the first place.

3.2 Regulated Industry has Proposed Privilege and Amnesty for Environmental Audits

The Agency began by examining two concepts advanced by lawyers representing regulated industry.

The first proposed establishing a statutory privilege that would shield environmental audit documents from discovery by government agencies or other third parties, so long as any violations found were ultimately corrected. "Discovery" in this context refers to requests for evidence or testimony that occurs during the inspection process referred to above, as well as legal motions by either party to compel the disclosure of such material once the case is taken to court. Discovery rules under US law are quite broad, so long as the requests are relevant to the case, and subject to only a few narrow exclusions (such as confidential communications between a lawyer and his client).

The second alternative is to grant immunity from civil penalties or criminal prosecution for any violations found through audits which were disclosed to government agencies and corrected. At present, fifteen states have enacted either privilege or immunity laws, or some combination of the two approaches.

3.3 EPA Rejects Privilege

After careful consideration, the EPA has decided to reject the concept of a privilege protecting environmental audits from discovery for several reasons. Among the most important:

- The Agency is concerned about the effect a privilege might have on its ability to obtain evidence of wrongdoing, or assure that violations have been corrected. American law has traditionally placed a high value on fair access to the facts, best reflected in the Supreme Court's finding that, "*the public...has a right to every man's evidence.*" (CITATION)
- There is little to suggest that a privilege is needed or would encourage an increase in auditing, at least in those cases where the government is willing to offer limited amnesty to encourage disclosure. In practice, audits are rarely seized by government agents, while industry respondents in the Price-Waterhouse survey identified concerns about confidentiality as one of the least important barriers to auditing.

4 EPA OFFERS LIMITED AMNESTY TO ENCOURAGE AUDITS

4.1 Finding the Balance

While rejecting evidentiary privileges, the Agency came to appreciate the value that a limited penalty amnesty program might have in encouraging voluntary self-policing. Unconditional amnesty, which might excuse irresponsible behavior which caused real harm, was rejected outright as undermining the value of deterrence in preventing such misconduct. As an alternative, EPA worked with state agencies, the regulated industry, and public interest groups to develop a balanced approach that reduces civil penalties and the threat of criminal liability for companies that audit, but with conditions and exceptions to protect the public and provide a continued incentive for companies to prevent violations before they occur.

This compromise is reflected in EPA's new policy, announced on December 22 of 1995. The policy is best explained by examining:

- how the violation must be discovered and disclosed;
- what the company must do after the violation is reported to EPA;
- the specific benefits EPA is offering for those who meet the policy's conditions; and
- the circumstances in which these benefits are not available.

4.2 Discovery and Disclosure

Discovery of the violation must be voluntary, that is it must not be detected through monitoring equipment or sampling protocols that are required in the company's permit. It should be independent, e.g., before the company has been notified of the problem through an inspection or by a third party. To receive full credit from EPA, the discovery should arise from either an environmental audit, or a compliance management program that demonstrates due diligence. Finally, once identified, disclosure of the violation must be prompt, generally within 10 days of discovery.

These conditions make clear that the incentives offered under the audit policy are for companies that take the initiative, without requirements or prompting from the government, to assess their compliance status. Disclosure of the violation is important, because it allows EPA to determine that the problem has been corrected and not allowed to linger.

An effective compliance program requires not only periodic auditing, but a comprehensive system that engages both managers and employees in the day-to-day task of both preventing and responding to noncompliance. The Agency's policy recognizes the value of both approaches. Environmental audits are defined according to the 1986 policy as encompassing a periodic, etc.

To receive credit for violations found through a compliance management program, a company must be able to demonstrate due diligence according to criteria for corporate compliance adapted from the 1991 Sentencing Guidelines. (ATTACHMENT 3). These criteria are designed to be flexible and consistent with emerging ISO 14001 standards for environmental management systems, while providing more specific guidance for compliance than are contained in ISO.

4.3 Correction and Prevention

Once the company has reported the violation it must, of course, agree to return to compliance. EPA may require a written agreement binding the company to keep its commitment, and to take specified actions to prevent the violation from recurring. The company is expected to cooperate with the Agency in supplying whatever documentation is needed to determine that the problem has been corrected. Any compliance agreements reached under the policy will be made public, to avoid any appearance of collusion between EPA and the regulated industry.

4.4 Incentives for Self-Correction

A company with an aggressive auditing or compliance management program to identify, report, and correct violations can virtually eliminate its potential for significant civil or criminal penalties. These incentives are particularly valuable under US environmental law, which establishes stringent sanctions for noncompliance.

In general, a company or individual that knowingly violates the law risks not only monetary penalties, but incarceration for those responsible. For purposes of establishing criminal liability, "knowledge" means awareness that the act was committed, not necessarily that it was illegal. Under the Clean Water and Clean Air Acts, even negligence may be charged as a criminal misdemeanor. These seemingly strict standards are consistent with liability for other types of "general welfare" offenses, and reflect the common-law maxim that "ignorance of the law is no excuse." In practice, criminal prosecutions are reserved for the most serious types of misconduct, but there is no question that the potential penalties — particularly the prospect of jail time for corporate officials — has caught the attention of senior management and their counsel.

Where conditions of the audit policy are met, however, EPA will not recommend criminal prosecution of the corporation. Neither will corporate managers be charged with the illegal acts of their employees, unless they were consciously involved in, or wilfully blind to, the violation. In other words, companies may audit, disclose and correct compliance problems without fearing that these actions may expose them to criminal liability. Not surprisingly, EPA's new policy reflects common sense practice, as the Agency's criminal program has never recommended criminal prosecution in such circumstances. Putting this practice in writing, however, may help to reassure the most risk-averse corporations that their good faith efforts will be rewarded, not punished.

Corporations are also strictly liable for environmental violations, without regard to whether the violation is knowing or negligent. Strict liability allocates the cost of correcting the problem to responsible parties, without regard to fault. Federal environmental law also promotes deterrence through civil penalties that reflect both the "gravity" of the offense, and any economic benefit gained through noncompliance.

Gravity-based penalties can reach as high as \$25,000 per violation per day under some federal environmental laws; long-term noncompliance can, and has, cost companies tens of millions of dollars in civil fines.

EPA has agreed to waive these gravity-based penalties altogether where companies audit, disclose and correct violations. In the 1995 Price-Waterhouse survey, two-thirds of corporate respondents said they would expand the scope of their auditing programs in exchange for reduced penalties. The Agency's policy offers this incentive in the hope that it will improve the extent and quality of corporate self-policing.

4.5 Maintaining Deterrence

While reducing the potential for criminal and civil penalties to encourage auditing, EPA wanted to maintain the deterrent effect of a strong enforcement program, which gave birth to the environmental auditing movement in the first place. The conditions for discovery, disclosure, and correction described above are meant to limit the benefits of the policy to good actors. But the Agency also believes that whether or not they audit, corporations ought to remain liable for certain kinds of behavior and exclude the following from the terms of the policy:

- Repeat Violations, where either the same violation has occurred at the same facility within the past three years, or the corporation has demonstrated a pattern of noncompliance over the past five years. Audits should be designed to prevent violations, not to license their repeated occurrence.
- Violations which Result in Serious Harm or Imminent and Substantial Endangerment; The corporation should remain liable not only for putting its neighbors at such risk, but because such events signal a serious failure in its corporate self-policing program.
- Significant Economic Benefit, where a company has gained a competitive advantage over its competitors by delaying its investment in compliance. Several trade associations, including the Chemical Manufacturers Association, have recognized the importance of retaining some ability to recover economic benefit even for violations discovered through auditing, although the CMA does not agree with EPA's definition of economic benefit;
- Individual Criminal Conduct, as auditing should not shield individuals from their personal responsibility for knowing violations of the law;
- Violations of a Compliance Order are excluded. Specific orders to correct violations are generally treated as contractual agreements between EPA and the regulated agency, and companies would have little incentive to meet their commitments if the failure to do so carried no penalty.

EPA has retained its discretion to penalize the worst types of noncompliance, so that auditing remains focused primarily on preventing violations, rather than providing an excuse for misconduct.

5 FROM THEORY TO PRACTICE

While it is too early to determine whether the policy will achieve its goals, preliminary signs are encouraging¹. Disclosures have increased as both the Agency and the regulated community learn that at least some compliance problems can be resolved more quickly without adversarial,

expensive, and time consuming enforcement actions. State environmental agencies, which retain substantial responsibility for environmental enforcement under the US federal system, have begun to adapt the policy for use in their own compliance incentive programs.

Further expansion of environmental auditing, which has become standard business practice for many US companies, may depend on factors beyond changes in EPA's penalty policy. As discussed above, industry's own surveys show that a significant enforcement presence, through frequent inspections, for example, provide an obvious motivation for self-auditing. What happens to this incentive if budget limitations force a cutback in inspections? EPA is exploring whether independent third-party audits, subject to stringent standards, can supplement scarce inspection resources. The Agency is also working through trade associations and state programs to simplify rules and provide direct assistance for the many small businesses that will never be able to audit on a regular basis.

Whether or not it substantially expands auditing, EPA's new policy offers fair play for those who take the initiative to correct violations and stay in compliance. And by helping to distinguish responsible companies from bad actors, it should preserve a solid foundation for a strong and credible enforcement program.

ENDNOTE

1. Under the new audit policy, 105 companies disclosed violations at more than 350 facilities. Of these disclosures, violations were settled against 39 companies and 47 facilities. Most cases settled without penalty, although some paid economic benefit.

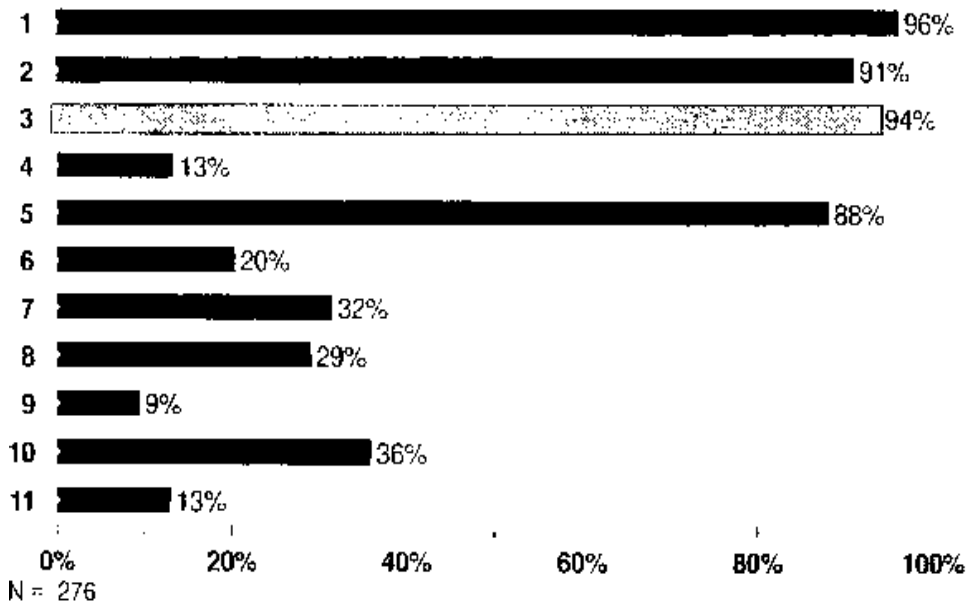
Attachment 1. The voluntary Environmental Audit Survey of U.S. Business**Reasons why companies audit can be referenced with the following codes:**

1. Problems can be identified internally and corrected before they are discovered by an agency inspection.
2. Assurance can be provided to management that control systems are functioning.
3. To improve the company's overall environmental program and make it proactive.
4. It is a requirement of a permit, consent orders, etc.
5. To decrease the company's operating and financial risks.
6. Auditing program was instituted upon the recommendation of counsel.
7. The proposed "Sentencing Guidelines" state that enforcement actions might be more lenient if an effective audit program is in place.
8. The U.S. DOJ " Factors Document states that criminal enforcement might be averted if an effective audit program is in place.
9. In response to the issuance of the 1986 EPA Policy Statement.
10. To meet requirements of special due diligence audits required reduced risk during real property transactions.
11. Other.

Attachment 2. Reasons why Companies Audit'

Reasons Why Companies Audit'

Percentage for Companies That Audit



In terms of importance, the most frequently cited reason

Note:

Reason #1 "Problems can be identified internally and corrected before they are discovered by an agency inspection" was the most frequently cited reason why companies audit.

Reason #3 "To improve the company's overall environmental program and make it proactive" was the most frequently cited "Primary" reason for auditing.

* From "The Voluntary environmental Audit Survey of U.S. Business" Price Waterhouse (1995)

Attachment 3. Due diligence**“Due Diligence” is defined in EPA Audit Policy as follows:**

“Due Diligence” encompasses the regulated entity’s systematic efforts, appropriate to the size and nature of its business, to prevent, detect, and correct violations through all of the following:

1. Compliance policies, standards and procedures that identify how employees and agents are to meet the requirements of laws, regulations, permits and other sources of authority for environmental requirements.
2. Assignment of overall responsibility for overseeing compliance with policies, standards, and procedures, and assignment of specific responsibility for assuring compliance at each facility or operation.
3. Mechanisms for systematically assuring that compliance policies, standards, and procedures are being carried out, including monitoring and auditing systems reasonably designed to detect and correct violations, periodic evaluation of the overall performance of the compliance management system, and a means for employees or agents to report violations of environmental requirements without fear of retaliation.
4. Efforts to communicate effectively the regulated entity’s standards and procedures to all employees and other agents.
5. Appropriate incentives to managers and employees to perform in accordance with the compliance policies, standards and procedures, including consistent enforcement through appropriate disciplinary mechanisms.
6. Procedures for the prompt and appropriate correction of any violations, and any necessary modifications to the regulated entity’s program to prevent future violations.