COMMENTS FOR THE EPA PUBLIC DOCKET ON "ENHANCING ENVIRONMENTAL OUTCOMES FROM AUDIT POLICY DISCLOSURES THROUGH TAILORED INCENTIVES FOR NEW OWNERS"

Docket ID No. EPA-HQ-OECA-2007-0291

Written on Behalf of:

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I. INTRODUCTION

The American Chemistry Council (ACC)[1] and the Corporate Environmental Enforcement Counsel (CEEC)[2] welcome this opportunity to contribute to EPA's thinking about the pros and cons of providing tailored incentives to encourage "new owners" of businesses or business assets to disclose and correct existing problems discovered at their recently-acquired facilities. According to the Notice that appeared at 72 Fed. Reg. 27116 (May 14, 2007), "Enhancing Environmental Outcomes from Audit Policy Disclosures through Tailored Incentives for New Owners," EPA envisions providing such incentives under a new pilot program to be created under the EPA Audit Policy.[3]

We believe that the Agency, the public, and the regulated community could all benefit from the appropriate use of tailored incentives. To be most productive, such a program should reflect the real-world conditions in which corporations and corporate assets are bought and sold, including the various mechanisms through which such transfers of ownership and management control take place.

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[1] The American Chemistry Council (ACC) represents the leading companies engaged in the business of chemistry. ACC members apply the science of chemistry to make innovative products and services that make people's lives better, healthier, and safer. ACC is committed to improved environmental, health, and safety performance through Responsible Care, a common sense advocacy designed to address major public policy issues, and health and environmental research and product testing. The business of chemistry is a $550 billion enterprise and a key element of the nation's economy. It is the nation's largest exporter, accounting for 10 cents out of every dollar in U.S. exports. Chemistry companies invest more in research and development than any other business sector. Safety and security have always been primary concerns of ACC members, and they have intensified their efforts, working closely with governmental agencies to improve security and to defend against any threat to the nation's critical infrastructure.

[2] The Corporate Environmental Enforcement Counsel (CEEC) is an organization of corporate counsel and environmental professionals representing thirty major companies from a wide range of industrial sectors. CEEC focuses exclusively on civil and criminal environmental enforcement policy issues and activities by providing a forum for review and discussion of such issues and developing constructive recommendations to executive and legislative environmental enforcement policymakers.

[3] 65 Fed. Reg. 19619 (2000).

In the Notice, EPA requested comments on "whether and to what extent the Agency should consider offering tailored incentives to new owners of regulated entities to discover, disclose, correct and prevent the recurrence of environmental violations."[4] On page 27121 of the Notice, EPA identified three major potential incentives that the Agency might be willing to provide to "new owners" as part of a pilot program:

- Reducing civil penalties beyond what the current Audit Policy provides, by reducing any economic benefit portion of the penalty;

- Allowing Audit Policy consideration of violations which would otherwise be ineligible, because their discovery is legally mandated and thus not discovered voluntarily; and

- Providing recognition from the Agency to new owners who self-audit and disclose under the Audit Policy.

The comments offered herein focus on the first of these incentives. We discuss several of the economic benefit issues identified in the Notice, including:

- Whether tailored incentives should take into consideration the extent to which environmental noncompliance liabilities are reflected in the purchase price of newly-acquired business assets.

- Whether environmental liability indemnification agreements should be taken into account in designing tailored incentives.

- When the clock should start running for new owners for purposes of calculating economic benefit under the pilot program.

- Whether any economic benefit calculation the Agency ultimately performs regarding a new owner should consider the extent to which the seller has indemnified the buyer.

To a lesser extent, our comments also address other issues identified in the Notice.

[4] 72 FR 27116.

II. OUR SUPPORT FOR THE PROPOSED PILOT PROGRAM

We agree with and commend EPA for its interest in establishing the pilot program. When businesses or assets are for sale, there is an opportunity for serious potential buyers to conduct environmental due diligence. After the deal is closed, there is an additional opportunity for the new owner to conduct more thorough compliance assessments of the purchased business or assets. Thus, these transactions present a unique opportunity for noncompliance to be identified, disclosed and corrected. Indeed, the private transactional market is one of the greatest drivers of environmental compliance.

There are large potential benefits that can be obtained by providing appropriate incentives to new owners to closely examine facility compliance and facility operations, correct violations, upgrade deficient equipment and practices, and disclose discovered noncompliance. The most obvious potential benefits of early detection and early correction are lower levels of pollution, fewer human health effects, and reduced environmental impacts. EPA and the regulated community have long recognized that environmental auditing can lead to significantly higher levels of environmental compliance.

Owners of new business assets should not be deterred from conducting environmental audits and disclosing the results due to the fear that what they discover might be used against them and trigger significant civil penalties, both (1) for the "economic benefit" attributable to, and the "gravity" (or seriousness) of, past violations and (2) for the same factors related to ongoing violations that occur until the new management is able to develop and fully implement improved compliance measures. As EPA correctly understands, under the most favorable circumstances, the existing Audit Policy might result in the "gravity component" of civil penalties being waived, but it would still leave the new owner liable for the full "economic benefit" that arguably it obtains during its period of ownership of the newly-acquired assets.

In order to maximize use of the Audit Policy in corporate transactions, therefore, EPA should remove the prospect that economic benefit-based penalties will be imposed in cases where new owners make timely disclosures of noncompliance and otherwise comply with the Audit Policy. As discussed below, EPA should do so in a way that reflects the real world context in which such transactions occur, and should not employ procedures or conditions that are overly intrusive or demanding. We explain these factors in the next section of our comments.

III. THE REAL-WORLD FRAMEWORK EPA SHOULD CONSIDER

When a new owner acquires an entire company, it inherits both the assets and liabilities of the predecessor corporation. In such circumstances, one might question whether such liabilities include the civil penalty liabilities of the previous owners. For example, some people might argue that the value of the ongoing concern includes the past economic benefits the predecessor corporation obtained due to noncompliance. Others might argue that the former shareholders of the predecessor corporation obtained those benefits through some combination of increased dividends and a portion of the price they were paid for their common stock when the firm was sold to the new owner. Even where a buyer purchases only the assets of another company, the terms of the deal may involve the buyer also assuming the liabilities associated with those assets, which may or may not include noncompliance liabilities.

We are well aware that EPA staff members have tried to grapple with this issue. Some of their concerns seem to be reflected in the following passages appearing on page 27120 of the Notice:

- "Providing tailored incentives to self-audit and disclose could potentially improve environmental compliance in these situations by encouraging in-depth auditing after purchase. On the other hand, providing such incentives could cause sellers to further delay or avoid compliance (i.e., a firm might be tempted to sell off a unit to another business in its noncompliant state rather than bring that unit into compliance), or could have the unintended effect of encouraging buyers to perform inadequate due diligence. EPA seeks comment on whether it would be appropriate to require that new owners have performed a certain level of pre-acquisition due diligence to qualify for tailored incentives, and if so, what that level should be?"

- "EPA seeks comment on the extent to which environmental noncompliance liabilities (as distinguished from environmental remediation liabilities) are reflected in the purchase price, and whether tailored incentives should take this into account."

- "The Agency is aware that, in acquisition situations, sellers may indemnify purchasers across a broad range of issues, including environmental liability. If a selling firm has indemnified the purchaser for violations which are ultimately disclosed by the new owner, are tailored incentives needed at all? On the other hand, the mere existence of an indemnification agreement does not insulate the purchaser from liability."

Reading between the lines, some EPA staff members seem to think that environmental noncompliance might result in a "purchase price adjustment" at the time of sale that could be viewed as an "economic benefit" to the acquiring corporation. Arguably, assuming such an economic benefit accrued to the new owner, to level the playing field among similar competing firms in the market place, EPA staff members might feel that such an economic benefit should be recaptured from the new owner through environmental enforcement activities, including but not limited to the assessment of civil penalties for noncompliance pre-dating the acquisition.

The following discussion is intended to clarify these issues for EPA, so that any changes to the Audit Policy are firmly grounded in real-world economics and practice

A. How People or Corporations Become New Owners of Business Assets

There are two basic ways a firm can become a "new owner" of a facility or other business assets: an asset acquisition, or a stock purchase. As discussed below, the latter can itself take several forms.

Asset Purchases. The most straightforward way someone can become the new owner of a facility is through an asset purchase agreement based on either a direct sale of one or more facilities between two ongoing entities or a purchase of out of bankruptcy.[5] The buyers in an asset purchase agreement can be an individual, a corporation, or an Employee Stock Ownership Plan (ESOP).

Stock Purchases. An individual or entity can also purchase some or all of the common stock of a target company that is publicly traded. In such circumstances, it may be argued that there is new management, but there may not always be completely new ownership. Therefore, it is useful to distinguish among the various kinds of stock purchases and possible resulting ownership patterns.

Mergers. The term "merger" refers to an agreement between two entities to become one business through the purchase by the acquiring firm, with cash, of all outstanding shares of the acquired company. In many cases, the acquiring firm retains its name and identity, and the acquired business assets are owned outright by the acquiring firm's shareholders. This is a very clear case of "new ownership."

Less-than-complete takeovers. In other cases, some of the shareholders of the acquired company remain as owners of the relevant assets, because either:

- there was an exchange of common stock whereby the acquired firm's shares are exchanged for shares of stock in the acquiring corporation at some negotiated exchange ratio (so that the "old company" goes away, but its shareholders remain owners of the new company); or

- the "old company" remains in existence, with one or more prior minority owners remaining shareholders.[6,7,8]

[5] In the case of purchases of assets out of bankruptcy, it is hard to see how any pre-bankruptcy economic benefit due to noncompliance could be transferred to the new owner. Such assets are frequently sold at a deep discount from their pre-bankruptcy value. In any case, the purchase prices for such assets are set by competitive forces in the market place.

[6] Imagine, for example, that prior to the change in management, Company Y owns 45 percent of the shares in the target entity, Company X owns 30 percent, and the public at large owns the remaining 25 percent. In this scenario, let us further assume that Company Y, as the predominant shareholder, has been able (along with some other non-Company X shareholders) to elect the complete the Board of Directors and to select the senior management of the firm. Now suppose that Company X went to the stock market and succeeded in purchasing all the shares of the target entity except those owned by Company Y. Company X is now

The "new ownership" status of the resulting business is less clear in these less-than-complete takeover cases, because after the merger the old majority-owners of the target business may remain as part-owners of the new business. However, it should be noted that in all of these situations, management control has clearly shifted to the acquiring firm. There are good arguments for providing a "clean slate" in cases where individuals or entities who could not have been responsible for past noncompliance now take control of a business.

In the next section of these comments, we explain why it is impossible or unlikely, under any of these kinds of transactions, for any past benefit of noncompliance to inure to the new owners of a facility.

B. New Owners Are Unlikely to Receive any Benefit from Past Noncompliance

1. Direct Sales of Business Assets

In the case of a *direct sale of business assets* by one company to another, the seller has some idea of the value it might obtain from sale of the assets to alternative

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able to replace the Board of Directors and the senior management of the firm. Furthermore, assume that it now discovers or chooses to recognize noncompliant situations that existed under the prior management.

Since Companies X and Y previously may have obtained economic benefits due to noncompliance from their holdings in the target entity, it is not at all clear that they should be exempt from paying civil penalties for past violations of environmental requirements. However, if EPA wants to provide incentives to Company X to disclose the target entity's past violations, to perform an environmental audit that would be made available for EPA review, and to have resources invested as soon as possible in enhanced pollution controls, it should not let Company X's past, non-controlling minority interest in the entity serve as a disincentive to its possible participation in the pilot program. This situation requires a clear policy decision by EPA when it establishes the ground rules for the pilot program.

[7] In an alternative scenario, suppose that Company X was not a prior shareholder, and, through a stock tender offer, it obtained all or majority-ownership of the shares of the target enterprise. In this scenario, a much clearer case can be made that the previous shareholders received the economic benefit of past noncompliance; and Company X, as the new owner, should be held accountable for, at most, the economic benefit resulting from noncompliance that occurs during its period of ownership.

[8] An altogether different situation might arise in the case of a corporate reorganization that leads to spin-offs of one or more corporate divisions as legally-independent, stand-alone entities. Since the shareholders of the parent corporation would be the initial owners of the spin-off entity, it would not be unreasonable to exclude such a spin-off from participating in the pilot program. In this situation, EPA must consider from a public policy standpoint whether it is more useful to provide tailored incentives or to rely on traditional enforcement approaches.

buyers. As a profit-maximizing firm, the seller wants to receive the highest price it can obtain in the market for the assets, net of whatever associated costs it must incur to do so. Similarly, an interested buyer will consider the cost of purchasing such assets from alternative suppliers, as well as the cost of and time required for replicating the assets at current market prices and in compliance with environmental requirements. The price the buyer is willing to offer the seller for its assets will reflect the buyer's desire to obtain similar business assets at least cost, including the cost of integrating such assets into its operations.

If an honest buyer learns that the business assets are noncompliant or otherwise "substandard," it may chose among the following options: (1) buy similar but compliant assets from an alternative supplier and pay "full price," (2) create compliant assets at current market prices, (3) negotiate a markdown in the purchase price based on the cost of bringing the business assets up to standard, or (4) negotiate an environmental indemnification agreement. As previously discussed, the possibility of a "markdown" (and maybe even an environmental indemnification agreement) may create some concerns for EPA staff members who fear that the ultimate buyer may receive a "benefit" from past noncompliance. However, we believe that such adjustments provide no potential for the transfer of past economic benefit from the seller to the purchaser where the new owner must invest funds to bring the newly-acquired assets into compliance.

Let us consider five possible scenarios.

In <u>Scenario 1</u>, the buyer is unaware of the noncompliant status of the business assets. After taking ownership of its new assets, the new owner discovers it must now invest $1 million dollars to bring them into compliance. Because it paid $1 million more than "fair market value," the buyer is worse off that it would have been if it had purchased compliant assets from an alternative seller for the identical price. Besides having now to incur the costs of installing pollution control equipment, it is now liable for civil penalties based on (i) gravity considerations and (ii) whatever amount of economic benefit it obtains due to noncompliance during its period of ownership. It may also be forced to curtail production for a period of time rather than violate environmental requirements.

The production curtailment issue is a profoundly important one that applies equally in each of the scenarios presented in these comments. A buyer runs significant risks of having to cease or restrict production when it discovers noncompliance with complex or obscure requirements – for example, under the Clean Air Act New Source Review or TSCA pre-manufacture notice programs -- that could not be identified during pre-acquisition due diligence.

In Scenario 2, let us assume the same fact pattern, except that the buyer becomes aware of the noncompliance through due diligence and negotiates a $1 million markdown to reflect the anticipated cost of correcting the noncompliance. In this scenario, the buyer has essentially paid "fair market value" for the noncompliant business. The buyer has the $1 million it needs to bring the assets into compliance, but it may still be worse off than it would have been if it had purchased fully-compliant business assets. For example, it runs the risk of having to pay civil penalties and/or reduce production for a period of time in order to not violate environmental requirements.

In Scenario 3, assume that the buyer was able to negotiate $1 million in environmental indemnification (or establish an escrow account in that amount) based on projected costs to remedy the noncompliance. In this case, the buyer is able to recoup compliance costs that it incurs, but only up to $1 million. Where compliance costs are less than or equal to $1 million, in essence the buyer has paid fair market value for the noncompliant business. However, if the compliance costs exceed the maximum allowable level (or if there is a non-recoverable deductible), the new owner is worse off than if it had purchased compliant assets. Additionally, in either situation the buyer may again be liable for ongoing delayed and avoided compliance costs and for gravity-based penalties, and risks having to curtail production.

In Scenario 4, assume that the known costs were $1 million but the buyer was only able to negotiate a markdown or an environmental indemnification for $800,000. The new owner is clearly worse off than if it had paid full market value to obtain compliant assets.

Finally, in Scenario 5, let us consider whether the seller would have agreed to a markdown in excess of $1 million; i.e., more than the estimated cost of compliance. This scenario is unlikely, as most sellers would choose to invest the $1 million to bring the business assets into compliance prior to the sale and receive the full market price for the assets. Some might argue that the seller might agree to a markdown in excess of the cost to comply because it feared that correcting ongoing environmental problems might lead EPA to focus on its past noncompliance. Assuming, however, that the new owner has an incentive to disclose, to perform an environmental audit that would be shared with EPA, and to fix the noncompliant situation, the seller – but not the buyer – in this situation faces an increased risk of discovery and having to pay a civil penalty to the U.S. Treasury for past noncompliance. Thus, a seller is not likely to agree to a markdown that exceeds the cost of compliance during the pendency of a new owner pilot program.

2. Acquisitions or Mergers Based On Purchases of Stock

EPA staff members evidently fear that in a merger or other stock acquisition the ultimate buyer may receive an economic benefit from past noncompliance. In fact, this is unlikely to happen, for several reasons:

- First, the prior company may have passed on any benefits of noncompliance to its customers (by reducing prices) or to its prior shareholders (through increased dividends).

- Second, in a true merger where all prior shareholders are paid in cash for their stock, any accumulated benefits of noncompliance redounded to the benefit of the prior shareholders when they were paid for their stock.

- Third, but perhaps most important, we seriously doubt that the economic benefit from past noncompliance can transfer to an acquiring firm in any form of stock transaction because that firm necessarily will have to pay a premium above and beyond the intrinsic, stand-alone value of the target business assets in order to bring about the merger. This point is explained below.

By implication, the current owners of the common stock of a company prefer to retain their shares at the current market price, or they would have already sold their shares when the share price reached its current value. For someone to induce a current owner to sell shares, that person or corporation must be willing to pay a premium over the current market price. That is why stock tender offers always involve offering to pay a premium over the current market price.

Put another way, the minimum price that would be paid in a merger of two publicly-trade corporate entities is the current market value of the target entity, which is assumed to be the discounted present value of the entity's anticipated free cash flows as viewed by participants in the stock market. According to the principles of corporate finance, that value can be obtained for a stand-alone entity by multiplying its current share price by the number of outstanding shares of common stock in that company. If the market believes that the target entity might soon be acquired by someone or some firm willing to pay a premium, the market value of the firm will be greater than its "intrinsic," stand-alone value.[9] In effect, the market price will reflect a premium.

The reason a potentially acquiring firm is willing to pay a premium to acquire new business assets is fairly obvious.[10] It is to obtain the present value of the benefits

[9] Richard A. Brealey and Stewart C. Myers, Principles of Corporate Finance, sixth edition (2000), pages 952-953.

[10] In cases where the target firm is not publicly-traded, its market value can be calculated using other valuation techniques, such as direct comparisons with publicly-traded firms using price-earnings ratios and discounting future anticipated free cash flows to present value. In each case, the acquiring firm will pay a premium over the target firm's stand-alone value. See, Bradford Cornell, Corporate Valuation: Tools for Effective Appraisal and Decision-Making, 1993, pages 87-88 and Chapter 8; and A.A. Groppelli and Ehsan Nikbakht, Finance (2006), pages 499-507.

that it thinks will result from the acquisition or merger.[11] Companies engage in mergers and acquisitions for many different reasons, e.g., to obtain synergistic effects, such as tax advantages, reductions in the overall risk of the acquiring firm, improvements in the acquiring firm's capital structure, talent or managerial skills, the technology owned by the target firm, or some combination of possible benefits.[12] Hoped-for synergistic effects, including increased efficiencies, economies of scale or distribution, and reduction in the size of the combined workforce, may be real or illusory. Nonetheless, they provide the basis for paying a premium over the stand-alone value of the targeted entity.

Based on the recognition by participants in the stock market that the target entity may not be priced at its full post-merger value to a would-be acquiring firm, the price of the price of the target company's stock may be competed upward until a deal satisfactory to both the existing owners and the proposed new owner(s) is consummated.

The same market dynamics occur regardless of whether the merger or acquisition is based on a stock-for-cash transaction or replacement of shares of stock in the target entity by shares of stock in the merged or acquiring entity.[13] In either case, the "new owner" is paying more for the target business assets than their stand-alone value. For this reason, it is difficult to see how the economic benefit of past noncompliance can be said to be transferred to a new owner in a stock transaction.

The only exception to the foregoing might be in cases where the "new owner" of a business also had control of the prior business. Aside from corporate spin-offs (see footnote 8 above), such cases would seem to be rare and EPA should not try to design the pilot program specifically around anticipating and/or preventing this scenario.

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[11] A.A. Groppelli and Ehsan Nikbakht, ibid.
[12] A.A. Groppelli and Ehsan Nikbakht, ibid., page 525.
[13] Ibid., page 504.

C. The Relative Insignificance of Noncompliance Savings in the Pricing of Business Assets

It is hard to imagine the circumstances in which the new owner's necessary investment to bring the acquired facilities into compliance would approximate more than a small percentage of the market value of the assets being acquired. In most situations, the costs to achieve compliance are not large enough to drive deals or to significantly affect the price of transactions. However, such costs could be substantial enough to lead to indemnification or escrow agreements whereby the buyer demands to be compensated for the cost of bringing specific facilities or processes into compliance. Such agreements are frequently structured with both a deductible amount that must be reached before coverage is triggered and a maximum limitation on liability.

Given that there may be multiple buyers and multiple sellers of similar business assets, and that a would-be buyer might also be able to produce compliant assets "from scratch," we believe that the sales price in most situations will reflect fair market value based on competitive market forces. Such "fair market value" may be defined as the cost of obtaining compliant assets, with either an appropriate markdown in the purchase price or an environmental indemnification agreement designed to make the buyer whole (i.e., to put it in the same situation in which it would have been if it had purchased compliant assets).

Major acquisitions are usually facilitated by intermediaries, such as investment bankers who attempt to put together such deals, lawyers who are employed to conduct or lead due diligence reviews, and technical consultants. Separate sets of lawyers, financial analysts, and consultants support each side in a potential transaction. Intermediaries for the seller may develop a confidential memorandum describing the attributes of the assets that are for sale and providing relevant financial information. Such memoranda may be shared only with potential buyers who are carefully screened. Intermediaries for potential buyers may also attempt to shop for similar deals with alternative potential sellers to develop alternatives. In many cases, buyers insist on the performance of environmental due diligence prior to agreeing to make acquisitions.

The notion that buyers may benefit from purchasing a noncompliant business seems to be without foundation, as shown in Scenarios 1-5 above. If the business was purchased at a markdown or with total indemnification for noncompliant operations, the buyer must still pay to bring the business, facility, or process back into compliance. If the business was not purchased at a markdown or with an indemnification due to future expenditures necessary to bring about compliance, as stated before, the buyer may be worse off because it purchased noncompliant assets. And the likelihood that a seller would provide a discount exceeding the cost of compliance seems small, and would be smaller yet under the proposed pilot program.

D. Two Important Questions

Within this real-world framework, two questions are relevant:

- Under what circumstances would it be correct, as a matter of economic theory, to say that the new owner may receive an economic benefit in the sense of (a) the purchase price and (b) future delayed and avoided compliance costs?
- How likely is it that business deals can be unraveled so that outside observers, such as EPA staff members, Department of Justice attorneys, or outside contractors, could determine after-the-fact whether in a given case the buyer and seller colluded to share past noncompliance benefits between themselves?

1. When Can a New Owner Obtain an Economic Benefit Due to Environmental Noncompliance?

We have already stated that most transactions occur at fair market value, including those that occur with an appropriate markdown or with an environmental indemnity to compensate for the noncompliant status of the business or assets at the time of sale. In such circumstances, we do not perceive any potential for the previous owner to transfer to the new owner any economic benefit obtained through past noncompliance. However, there is a perception that the new owner may obtain economic benefit from delayed and/or avoided compliance costs from the time when it started to own the new assets until when it has brought them into compliance.

Under the current Audit Policy and without any program of tailored incentives such as the one EPA envisions in its Notice, the new owner may be subject to civil penalties at least equal to the amount of money it saved from delayed or avoided compliance costs during its period of ownership. The new owner therefore has an incentive to try to bring the facility into compliance without attracting EPA's attention. With the proposed pilot program, that incentive could be eliminated. Also, a new owner pilot program would provide additional incentive for a new owner who was unable to conduct full environmental due diligence prior to the closing to promptly conduct an environmental audit and promptly remedy any noncompliance.

We have also stated that in any sale above fair market value, the new owner has been injured and has not obtained any economic advantage due to past noncompliance.

Now let us deal with the situation – Scenario 5 above -- where a seller and a buyer are alleged to have colluded to divide between themselves economic benefit due to past noncompliance. Although we believe that such a situation is very unlikely to occur (because the economic benefit of past noncompliance is such a small item in most transactions when compared to the overall economics of the deal), we would like briefly to contemplate this situation.

How likely is it that the new owner in this situation would apply to EPA for the benefits of the proposed pilot program, particularly its potential to shield the new owner from having to pay a civil penalty for noncompliance while it is trying to get the new business unit into compliance as soon as possible? If the buyer discloses under the pilot program and performs an environmental audit, EPA's attention might be immediately focused on the noncompliance that occurred prior to the date of the transaction. Would the buyer be willing to run the risk of disclosing to EPA ongoing violations if it does not itself have clean hands? We think not.

Under the proposed pilot program, on the other hand, we believe that the incentives would drive both potential sellers and potential buyers away from any inclination to engage in devious behaviors related to environmental noncompliance.

2. How Likely Is It that EPA Could Unravel Past Transactions to Identify Situations In Which a Buyer and Seller Colluded?

As noted earlier, environmental compliance costs are rarely so material that they affect the price of a deal, and it would be highly unlikely that two parties would enter into a sham transaction to use the Audit Policy to avoid potential penalties for noncompliance.

Nonetheless, for the sake of argument, let us assume that some or all of the economic benefit obtained by the previous owner was somehow conveyed to the new owner. In this circumstance, can EPA delve into the details of the business deal sufficiently well to be able to prove that this was the case?

Asset purchase agreements, acquisitions, and mergers all are codified in written documents. What these documents do not convey is (a) what additional deals may have been struck orally, (b) the exact terms of the competitive deals offered by other potential buyers or sellers, (c) whether past economic benefit savings had been distributed to shareholders through dividends, and (d) whether a portion of the past economic savings were shared with the buyer at the time of sale. All of these are complex matters to investigate and prove. In a sufficiently egregious case, any one of them might warrant EPA's (and potentially DOJ's) time and effort. Absent highly suggestive evidence of significant misdoing and collusion, however, we recommend that EPA not attempt to do so.

Rather, we suggest that if EPA wants to use tailored incentives to obtain environmental benefits it needs to put aside its accustomed "policeman" perspective. If participation in the pilot program leads to fishing expeditions into legitimate corporate activities, we suspect that few firms will be willing to participate.

IV. POSSIBLE UNINTENDED CONSEQUENCES OF THE PROPOSED PILOT PROGRAM

The unfortunate truth is that regulatory acts based on good intentions sometimes lead to unintended consequences. Economics is all about incentives. If the incentives change, behavior may also be expected to change.

Participants in business transactions always try to maximize their leverage and their returns. A proposal to promote disclosures by giving new owners tailored incentives, while not likely to change the nature of a deal or the way it is priced, could still lead to some unintended behaviors regarding environmental compliance assessment, correction or disclosure. We do not recommend that EPA design its pilot program to anticipate or prevent these problems because we do not know how frequently they might occur, how important they might be, or whether in the long run the hoped-for benefits will be outweighed by unanticipated costs. Rather, we simply want to identify things that could occur, and to urge EPA and the regulated community to be observant during the pilot program so that consequential behaviors can be documented.

A. Possible Effects on Sellers' Behavior

We fear that sellers might try to write into sales agreements that buyers are prohibited from participation in the new pilot program if potential disclosures by the new owner might cause EPA to look to the seller for recapture of its historically-obtained economic benefit due to noncompliance. A seller might also try to require the buyer to indemnify it for potential claims that regulatory authorities may bring against the seller due to the buyer's disclosures to EPA, or to refrain from researching the compliance status of the newly-acquired business assets for a set period of time.

We think that these types of behavior by sellers should be "red flags" to buyers that they need to pay close attention to the compliance status of the assets they are trying to acquire. Perhaps such behaviors by sellers will create lower demand for their business assets, thereby giving the sellers a strong incentive to bring their business assets into compliance prior to concluding the sale.

B. Possible Effects on Buyers' Behavior

A new owner who is contemplating participation in the proposed pilot program may also think about reopening its discussions with the previous owner prior to making disclosures to EPA. In effect, the new owner could suggest that the seller pay the new owner some amount of money or otherwise induce the new owner to not participate in the pilot program. We do not think that such behavior would be in the public interest.

C. Conclusion

Since it seems very hard in the abstract to consider all the potential unintended consequences of the pilot program, it is very important for EPA to gather data, whether through surveys or simply anecdotal information, during the pilot program to ascertain whether there are identifiable unintended consequences. It may be difficult to obtain demonstrable evidence of unintended consequences, but we think it is very wise of EPA to hold an additional public comment period seeking input from the various stakeholders prior to making any long-term change in the Audit Policy or to the manner in which the Agency implements the Audit Policy.

V. QUESTIONS AND ANSWERS

We would like to offer some conclusions in the form of questions and answers.

A. Should EPA Offer Tailored Incentives to Encourage New Owners To Self-Audit and Disclose Existing Noncompliance?

Yes, for the reasons stated above, we believe this would be good public policy.

B. Who Should Qualify as a "New Owner"?

We agree with the following passages that appear on page 27120 of the Notice:

- "The Agency believes that, in the context of eligibility for tailored incentives, only 'arm's length' transactions can produce new owners."
- "[T]he Agency does not have the resources necessary to delve into complex corporate structures and histories to make determinations about the authenticity of new ownership in the context of such Audit Policy disclosures. The Agency seeks comment on a clear, straightforward and easily administered approach to determining 'new ownership' and eligibility for tailored incentives."

In this context, we suggest that "new ownership" should apply to the following situations: asset purchase agreements between ongoing entities; asset purchases out of bankruptcies; acquisitions through tender offers or stock purchases where the new owner was not previously a "controlling shareholder" of the corporation (however EPA may define choose to define that); and mergers through cash payments to or exchanges of stock with the owners of the target entity. We suggest that, at least for the present time, EPA exclude only corporate spin-offs and situations where "new owner" firms previously held a controlling interest in the target entity.

C. Should an ESOP Be Treated as a New Owner?

We see no reason for EPA to exclude ESOPs from participation in the pilot program. Employees who may become new owners are not responsible for the past episodes of noncompliance. We do not see any basis for believing that they may have received a share of noncompliance benefits from past situations.

D. Should Tailored Incentives Consider Whether Purchase Prices Reflected Noncompliance Liabilities?

No. We believe that markdowns in recognition of the noncompliant status of business assets reflect considerations of fair market value. If and when such markdowns are paid, their intension is to enable the new owner to bring the assets into compliance, not to share some past economic benefit obtained through noncompliance.

E. Should Tailored Incentives Consider Whether Environmental Indemnities Were Provided?

No. Environmental indemnities do not cover future civil penalty liabilities. They are not an appropriate consideration in providing tailored incentives.

F. Does EPA Have the Ability and the Resources to Screen Past Business Transactions to Determine Whether a Buyer and Seller Have Colluded?

We doubt it.

G. When Should the Clock Start Running for Calculating Economic Benefit for Qualifying New Owners?

For the pilot program to be successful in achieving its goals, we believe that the new owner who chooses to participate should be given a reasonable period of time to discover problems, conduct an audit, and achieve compliance. The time required will be different from case to case. We suggest that EPA establish reasonable timetables based on case-specific factors, and agree that it is reasonable to hold that unnecessary periods of delay may leave the new owner liable for civil penalties.

H. Should An Economic Benefit Calculation Consider the Extent of Environmental Indemnification?

Under EPA's program of recapture of economic benefit, economic benefit is calculated on the basis of (a) avoided costs (usually pollution control operations and maintenance expenses) and (b) returns allegedly related to such costs and to delays in incurring capital and one-time expenses necessary for compliance. When the new owner ultimately pays for the necessary pollution control costs, whether they were covered by an environmental indemnity agreement, a markdown in the purchase prices, or paid for by the new owner in cash or stock is usually irrelevant to the calculation of economic benefit.

VI. CONCLUDING REMARKS

The American Chemistry Council and the Corporate Environmental Enforcement Counsel appreciate the effort and insights that went into the drafting of the Notice. We are very pleased with its content and welcome the opportunity to share our views on this very important topic. We look forward to working with the Agency as its thinking develops regarding the details of the pilot program.