

The Future of California's Environmental Self-Audit Policy

by Russ Naymark

Introduction

The environmental self-audit policy is an administrative tool at an early level of evolution. An environmental self-audit is "a regularized and formal self-generated inquiry" by businesses "to determine their own state of compliance" with either or both federal and state pollution regulations.¹ The federal government has drafted an administrative policy, and many state governments have drafted either legislation or administrative policies, which encourage businesses to self-audit and report any violations discovered by such self-audits to the appropriate regulatory agency. The self-audit legislation or policy typically provides two kinds of incentives for businesses to self-audit. These incentives include 1) offering businesses *immunity* in the form of decreased penalties for involuntary pollution violations than would normally apply if the violations were discovered by the government, and/or 2) offering businesses a general audit *privilege*, which prevents prosecutors from using certain documents created during a self-audit or the self-audit report itself as evidence in civil, criminal, and/or administrative proceedings.

Encouraging businesses to self-audit by promising varying degrees of audit immunity or privilege is one of a crop of recent changes in agency operations. Some feel these changes will decrease government bureaucracy in environmental regulation and increase discovery and remediation of pollution violations. Self-auditing policies purport to grant more autonomy, flexibility and security to businesses and corporations in reporting their polluting activities.²

Those who support granting audit immunity or privilege to businesses claim that without such protection, businesses will fear civil or criminal sanctions for reporting violations. If businesses are offered audit immunity and privilege, they will be more likely to report their pollution violations, more violations will be discovered and further environmental harm may be avoided.³

Opponents of audit immunity and privilege claim such protection lets polluting businesses off the hook for environmentally harmful activity. Prosecutors generally oppose these measures, claim-

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ing that an audit privilege will impede their ability to establish a business' knowledge of its polluting activity in environmental cases, thus decreasing their ability to establish business' intent and fight environmental crime.⁴

States that consider granting businesses audit immunity or privilege must consider more than just whether these protections help or hurt the environment. The federal government disfavors state audit privilege laws. The federal Environmental Protection Agency (EPA) now gives states the authority to administer federal pollution programs such as the Clean Air and Water acts. However, EPA has threatened to revoke this authority from states which have enacted audit privilege legislation EPA considers overly generous to polluting businesses.⁵ Thus, states must consider federal withdrawal of regulatory authority as a possible consequence of creating an audit privilege.

The Evolution of the Environmental Self-Audit

The self-audit has become a feature of the environmental policies of the federal government and of numerous states, including California. The self-audit program of the California Environmental Protection Agency (Cal/EPA)⁶ adopts the key provisions of the federal program; it has also implemented an increased level of audit immunity for polluting businesses.⁷ California, unlike some other states, has not adopted legislation which would grant a general audit privilege to documents used by companies in their self-audits.

Despite the risk of antagonizing the federal government, the California legislature did respond to the limitations of the state's administrative self-audit policy by proposing legislation earlier this year to instill in businesses more confidence in reporting pollution activity. Different bills would have provided either or both audit immunity and privilege. The legislature, however, deferred passage of the bills.

A question that remains unanswered is whether the self-audit policies and legislation at each level of government are serving the public as their drafters intended. The California policy is at present just that: a non-statutory policy which Cal/EPA may revoke without the procedural requirements that accompany a repeal of legislation. Without the assurance of actual legislation, businesses may have doubts about the actual legal protection they will receive after stepping forward with information about their unintentional pollution activity.⁸

Part of the controversy over self-audit programs stems from the distaste of some for a more lenient stance against polluters.⁹ Supporters of the self-audit program argue that who gets blamed isn't the important issue: if the policy encourages corporate awareness and decreases overall pollution, the policy is appropriate.

This article addresses three factors which the California legislature must consider if it attempts once more to pass audit privilege legislation:

- 1) Does Cal/EPA's current audit policy offer businesses sufficient incentives to report pollution violations?
- 2) If the policy is not sufficient, would audit privilege legislation increase or decrease pollution reports? and
- 3) What is the probability that the federal government would react to audit privilege legislation by revoking California's authority to administer federal programs such as the Clean Water and Clear Air acts?

This article will describe both the federal and California self-audit programs and analyze the effectiveness of these programs in relation to the programs of other states with greater audit protection. The article will then discuss the possible federal reaction if California did pass audit privilege legislation.

Self-Audits Under the Federal EPA

The federal EPA has an administrative self-audit policy which took effect January 22, 1996.¹⁰ The provisions of the policy create a remedial procedure for businesses to utilize upon discovery of an unintentional pollution violation. The key features of the policy are the forms of legal protection it grants businesses; the EPA intends the protection to provide incentives for businesses to initiate their own audits.¹¹ The EPA created the policy with the goal of reducing administrative costs and shifting the character of EPA from a "control" organization to one which provides guidance to businesses while allowing them a wider sphere of operational autonomy.¹² However, the federal government provides no privilege for a business' self-audit reports; hence, prosecutors who charge businesses with pollution violations may use self-audit reports as evidence against the polluting businesses.

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When the federal EPA determines a polluting business' self audit has conformed to the policy's provisions, the EPA may grant the businesses leniency in the penalties it imposes. The federal EPA policy treats polluting businesses differently depending on their methods of pollution discovery. A typical penalty for polluters is a gravity-based punitive penalty which the government determines based on the severity of the violation.¹³ For those businesses which have voluntary self-audit programs in place or whose self-audit efforts "reflect a regulated entity's due diligence" in discovering, disclosing and rectifying pollution violations, the EPA will usually decline to impose gravity-based penalties or recommend criminal prosecution.¹⁴ Businesses which have no self-audit programs and do not demonstrate due diligence, but which voluntarily disclose and correct violations in a timely fashion, will receive a 75 percent reduction of gravity-based penalties.¹⁵

The federal EPA requires businesses to comply with a list of nine pre-requisite actions to be eligible for the full range of self-audit incentives. These actions are:

- 1) Systematic discovery through an environmental audit or a procedure or practice reflecting due diligence;
- 2) Voluntary discovery, not through a legally mandated monitoring and sampling requirement;
- 3) Prompt disclosure in writing within 10 days (or such shorter period provided by law) unless shown to be impractical;
- 4) Discovery and disclosure independent of government or third party plaintiff prior to the commencement of an agency inspection or investigation, notice of a citizen suit, legal complaint, or "whistleblower" report;
- 5) Correction and remediation as expeditiously as possible;
- 6) Prevent recurrence by, for example, improving environmental auditing or due diligence efforts;
- 7) No repeat violations of the same provision within the past three years at the same facility under the same ownership or as part of a pattern of similar violations by the facility's parent organization within the past five years;
- 8) No actual or imminent injury to people or the environment; and
- 9) Cooperation as requested by the federal EPA and provision of information as is necessary and requested.¹⁶

These requirements address the conduct of businesses at the time of disclosure. In addition, they impose a pre-disclosure condition that businesses act independently from government, citizen or employee legal pressure; the business must make a proactive, not a reactive, effort. Businesses must also follow up their initial remedy with continued scrutiny of their operations to prevent repeat pollution incidents.

Self Audits under Cal/EPA

The Cal/EPA issued its current self-audit policy on July 8, 1996. The policy adopts the nine conditions set out in the federal EPA policy. The Cal/EPA policy, however, departs from the federal policy in four areas: 1) certification of a business' auditing system; 2) providing a list of criteria for "An Effective Environmental Auditing System"; 3) mitigation of gravity-based penalties and greater protection for management; and 4) limits to the requirements of document production.¹⁷ The Cal/EPA policy provides more protection to businesses than the federal EPA policy, but it falls short of the protection offered by other states that have passed audit immunity and privilege legislation.

Cal/EPA will consider certifying businesses which follow a self-audit or "due diligence" program as defined in the federal EPA policy. Once Cal/EPA certifies the

business, it assures the business that it will satisfy condition one of the nine conditions shared by the federal EPA and Cal/EPA. Businesses that comply with certification procedures will typically enjoy the advantages of the state's policy.¹⁸

The elements of "An Effective Environmental Auditing System" serve to assist smaller businesses in creating new audit programs. The elements include requiring management support for environmental auditing, audit program objectives, and specific auditing procedures. These elements "reflect attributes of auditing which Cal/EPA considers important to an effective program."¹⁹ The federal EPA policy provides no such assistance.

Also, in contrast to the federal policy which only reduces gravity-based penalties for businesses without audit or due diligence programs by 75 percent, the state policy allows penalties for such businesses to be reduced by 90 percent if the businesses adopt programs to prevent future violations.²⁰ Cal/EPA will, however, take any profits the company makes resulting from the lack of compliance with pollution laws.²¹

The Cal/EPA self-audit policy also offers businesses greater protection than the federal EPA policy by excepting those documents subject to a recognized privilege, such as the attorney-client or attorney-work-product privilege, from the cooperation requirement.²² This privilege is not as protective as the general audit privilege granted by legislation in some states, which protects all self-audit documents regardless of the presence of an attorney. However, it is more protective than the federal EPA policy.

In total, the Cal/EPA policy provides businesses with greater immunity and privilege protection than the federal EPA policy, but less than states with legislated immunity and privilege protection. However, no business which intentionally violates a pollution law will receive the benefits of either the federal or state self-audit policy.²³

The California legislature attempted to expand the protection of the state's administrative self-audit policy by proposing legislation earlier this year to instill in businesses more confidence in reporting pollution activity. The two chambers of the legislature, however, could not agree on a compromise. The Senate Judiciary Committee refused to pass Senate Bill 1432,²⁴ self-audit legislation proposed by Senator Charles Calderon, which would have created audit privilege for voluntary environmental audit reports.

The Senate did approve Senate Bill 1752,²⁵ a bill proposed by Senator Byron Sher which was based on the Cal/EPA self-audit policy and stopped short of creating

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the audit privilege sought by businesses. Sher's bill offered some immunity to businesses that reported non-serious pollution violations found through an audit process. The bill also established an affirmative defense against prosecution in criminal cases that businesses could assert if they met all necessary conditions. However, the Senate Judiciary Committee failed to approve a counterpart measure which the Assembly had passed, Assembly Bill 856²⁶ by Assemblyman Louis Caldera, even though it and Senate Bill 1752 were "nearly identical."²⁷ The proposed self-audit legislation "was more narrowly drafted than environmental audit legislation proposed and enacted elsewhere."²⁸

Federal-state conflict

The Cal/EPA self-auditing policy is not a mere replica of its federal analogue. The California policy expressly notes in its preamble that, despite the similarities, "there are areas where the U.S. EPA policy is vague or fails to adequately address concerns of stakeholders. . . . The Cal/EPA policy endeavors to ameliorate these problems."²⁹ California, which has no audit privilege legislation, has avoided conflict with the federal EPA on the subject of self-audits. However, as of October 28, 1996, twenty states had passed audit privilege legislation for self-audit documents.³⁰ In fleshing out the enigmas of the federal policy, some states which have adopted a legislative audit privilege have hit a nerve at the federal level that has provoked a protective reflex.

The federal EPA has openly expressed dismay over what it considers overly-generous self-audit protection laws of certain states. The federal government has responded to several states' audit laws with disapproval, threatened withdrawals of support, or, in certain instances, sanctions.

The situation in Idaho may indicate how audit privilege legislation would affect California's environmental regulatory powers. Idaho has encountered federal resistance to its privilege and immunity legislation, which grants audit privilege for voluntary environmental audits and offers immunity from administrative, civil and criminal violations when the business discloses the information voluntarily and the business makes efforts to comply with state law.³¹ The federal EPA has warned Idaho that to retain regulatory powers under Title V, Section 502(b) of the federal Clean Air Act,³² Idaho must maintain a minimum level of enforcement authority, the power to recover all penalties due for criminal conduct of businesses, and the authority to issue emergency orders and issue injunctive relief. The federal EPA claimed that Idaho's legislation impedes its authority required by federal law, and must either change the law to conform to federal standards or prove the EPA wrong.³³

On March 18, 1996, New Hampshire Governor Stephen Merrill signed a bill to increase the number of environmental self-audits by privileging self-audits in any civil, criminal, or administrative proceeding and waiving certain penalties. Prior to that, the federal EPA informed Merrill it opposed the measure. The agency noted its concerns that the state law would hinder compliance, discourage the dispersal of environmental information, protect criminal acts, and increase lawsuits.³⁴

These examples of federal-state conflicts foreshadow the impediments the California legislature might face in passing and successfully maintaining audit privilege legislation.

Does self-auditing increase reports of pollution violations?

California intends its self-audit policy to increase the incidence of business' reporting of their involuntary pollution violations. Supporters of self-audit legislation for California claim that the current policy is ineffective, noting 1) it is substantively inadequate because it does not provide self-reporting California businesses enough protection, and 2) even if the promised protection were sufficient, the tentative nature of the California self-audit policy fosters confusion among businesses in determining the level of legal protection that applies to them.³⁵ Brian White, Director of Air and Waste Management at the California Chamber of Commerce, notes that management at most California businesses feel the protections offered by the policy are too limited to be effective.³⁶

Proponents of self-audit legislation point to Texas, where regulators and industry representatives herald their state's self-audit law as a victory for encouraging business' compliance with state environmental laws. The Texas law encourages self-audit reporting by providing penalty immunity and audit privilege to businesses that report pollution violations, a higher degree of protection than California's self-audit policy. As of May 1996, 165 Texas firms had alerted the Texas Natural Resource Conservation Commission that they planned to conduct environmental self-audits under the 1995 law. Of that number, over 20 had disclosed their audit results.³⁷

Texas Commission litigation director John Riley noted that one benefit of the self-audit program is that "[t]he companies are doing their own inspections for us, and they know where to look."³⁸ Riley suggests that more instances of non-compliance are surfacing under the new law than would have surfaced under the Commission's limited inspection efforts. While the Commission is usually restricted to single-media, low frequency inspections, companies can utilize different self-audit strategies on a more consistent basis.³⁹

Without the audit privilege, companies would fear government "green-mail" demands to see their audit documentation, according to Brian White of the California Chamber of Commerce.⁴⁰ An audit privilege would be most helpful to smaller companies, White contends. These smaller companies may not be able to reap the benefits of an attorney-client privilege - a privilege recognized in the Cal/EPA self-audit policy - used by larger companies because they can't afford attorneys to study their pollution situations. White likens the business self-audit to a personal tax self-audit - one shouldn't be penalized for voluntarily informing the government of one's accidental wrongdoing.⁴¹ These examples support the argument that the California legislature should pass audit legislation to increase self-reporting of pollution.

The argument that a legislated self-audit program would have teeth that a bare policy lacks has not been embraced universally. After the Arizona Senate passed an environmental self-audit bill that would have given companies immunity from criminal or civil prosecution upon reporting the violation of pollution laws, Arizona Attorney

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General Grant Woods asserted that legislation would not encourage environmental cleanup since "companies already have plenty of incentives to police themselves, including avoidance of costly regulatory proceedings arising out of violations and preserving of their land for future marketability."⁴²

Some have pointed to the situation in Wyoming, which passed a law - the "Environmental Protection Initiative" - that shielded Wyoming companies from penalties upon admission of environmental violations. A year after its passage, the law "has gone unused," and environmentalists say this failure is proof that the bill is a "smoke screen" to give polluting companies an escape hatch from liability.⁴³

Others claim the audit privilege is unnecessarily broad and hurts the efforts of prosecutors in their quest to punish polluters. Edwin Lowry, Environmental Project Director of the California District Attorneys' Association, calls the audit privilege a "line in the sand for prosecutors," noting that the criminal justice system is generally opposed to suppression of evidence.⁴⁴

The judicial process for decreasing pollution violations, according to Lowry, encourages businesses to comply with pollution laws without the audit privilege. Lowry adds that prosecutors already are averse to punishing self-reporting businesses even without the audit privilege, and that prosecutors do not abuse the self-audit system.⁴⁵ Lowry also notes that "there are no instances . . . where information contained in an environmental audit has been used to prosecute a company."⁴⁶

The National District Attorneys Association has voiced similar concerns about proposed audit privilege legislation at the federal level. The Association has noted that a business' documents may constitute the only indication of a company's intent and knowledge with regard to pollution violations, both primary elements the government must prove in prosecuting many environmental offenses. Privilege legislation could deprive federal prosecutors of a potent tool for proving what and when a business knew about its pollution activity.⁴⁷ These views, in contrast to legislation supporters, illustrate the potential pitfalls of legislation in California that would grant audit immunity or privilege to self-reporting polluters.

Conclusion

It is difficult to state any certainties about the effectiveness of self audit programs because of their relatively recent adoption. Evaluations of the programs are dependent upon the interests of the group doing the evaluation: businesses approve of the self-audit programs and hope state legislatures will strengthen the protection the programs offer; prosecutors and environmental groups generally oppose giving polluters any more advantages in dodging liability for their violations.

The California legislature may once again attempt to strengthen the state's self-audit policy with legislation giving businesses greater incentives to self-report pollution violations. However, even if the legislature successfully passes new proposed legislation, it must consider the ramifications such legislation would have on state-federal relations and the chance that the federal government would attempt to revoke some of the regulatory powers of the state.

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Notes

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² Landels Ripley & Diamond, *Cal/EPA Issues Final Policy on Environmental Auditing*, CALIFORNIA ENVIRONMENTAL COMPLIANCE MONITOR, August 5, 1996.

³ Lowry, *supra* note 1 at 5.

⁴ Lowry, *supra* note 1 at 5.

⁵ Robert Ankeny, *State: EPA Is Impeding Incentives For Biz Cleanups*, CRAIN'S DETROIT BUSINESS, October 28, 1996.

⁶ California Environmental Protection Agency Policy on Incentives for Self-Evaluation, issued July 8, 1996.

⁷ Tiffany Schauer, *Will Government Policies Frustrate Environmental Auditing?*, LEGAL BACKGROUNDER, July 12, 1996.

⁸ Telephone Interview with Brian White, Director of Air and Waste Management of the California Chamber of Commerce, in Sacramento, Cal. (November 15, 1996)

- ⁹ See Christopher Bedford, *DIRTY SECRETS: THE CORPORATIONS' CAMPAIGN TO CREATE AN ENVIRONMENTAL AUDIT PRIVILEGE*, Environmental Action Foundation, 1996.
- ¹⁰ 60 Fed. Reg. 66706, Dec. 22, 1995.
- ¹¹ JAMES E. MCCARTHY, *ENVIRONMENTAL AUDIT PRIVILEGE: STATE LAWS AND FEDERAL POLICY*, CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS, THE LIBRARY OF CONGRESS, April 11, 1996, at 11.
- ¹² *A Kinder, Gentler EPA?*, MANUFACTURING ENGINEERING, May 1996, at 14-16.
- ¹³ Viven Lou Chen, *Know Thy-Self*, S.F. DAILY J., Environmental Law supplement, October 24, 1996, at 14.
- ¹⁴ Schauer, *supra* note 7.
- ¹⁵ *Id.*
- ¹⁶ *Id.*
- ¹⁷ Landels Ripley & Diamond, *supra* note 2.
- ¹⁸ *Id.*
- ¹⁹ *Id.*
- ²⁰ Schauer, *supra* note 7.
- ²¹ Julia E. Richards and William S. Waller, *State's Cleanup Carrot*, S.F. DAILY J., Environmental Law supplement, October 24, 1996, at 8.
- ²² Schauer, *supra* note 7.
- ²³ *California: Final Version of State Audit Policy Issued; Only Minor Changes Made in Draft, Official Says*, ENVTL. REP., July 26, 1996.
- ²⁴ 1995 California Senate Bill No. 1432, California 1995-1996 Regular Session (Ca. 1996)
- ²⁵ 1995 California Senate Bill No. 1752, California 1995-1996 Regular Session (Ca. 1996)
- ²⁶ 1995 California Assembly Bill No. 856, California 1995-1996 Regular Session (Ca. 1996)
- ²⁷ Landels Ripley & Diamond, *Environmental Audit Incentive Bills Whither in Legislature's Final Days*, CAL. ENVTL. COMPLIANCE MONITOR, September 16, 1996.
- ²⁸ Lowry, *supra* note 1 at 5.
- ²⁹ Cal/EPA Policy, *supra* note 6.
- ³⁰ Robert Ankeny, *State: EPA Is Impeding Incentives For Biz Cleanups*, CRAIN'S DETROIT BUS., October 28, 1996.
- ³¹ 1995 Idaho Sess. Laws 359.
- ³² 42 U.S.C. § 7401.
- ³³ *Idaho: EPA Says State Audit Privilege Law Results In Only Interim Approval of Title V Program*, ENVTL. REP., June 28, 1996.
- ³⁴ *Audit Legislation Signed Into Law Despite EPA Opposition*, TOXICS L. REP., April 17, 1996, at 1327.
- ³⁵ Schauer, *supra* note 7.
- ³⁶ Telephone Interview with Brian White, *supra* note 8.
- ³⁷ *Immunity, Privilege Law Reveals Violations That State Would Not Detect, Officials Say*, TOXICS L. REP., May 1, 1996, at 1390.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ Telephone Interview with Brian White, *supra* note 8.

⁴¹ *Id.*

⁴² *State Senate Passes Self-Audit Measure: Attorney General Faults Bill's Leniency*, TOXICS L. REP., March 6, 1996, at 1118.

⁴³ *Wyoming: No Penalty Waivers Sought Under Self-Audit Law*, AMERICAN POLITICAL NETWORK GREENWIRE, September 26, 1996.

⁴⁴ Telephone Interview with Edwin Lowry, Environmental Project Director with the California District Attorneys Association, in Sacramento, Cal. (November 15, 1996).

⁴⁵ *Id.*

⁴⁶ Lowry article, *supra* note 1 at 5.

⁴⁷ *House Panel OKs F97 EPA Budget; No Riders - And Little Extra Money*, AIR/WATER POLLUTION REPORT'S ENV. WEEK, June 21, 1996.

