1-1-1991

The Changing Intersection of Environmental Auditing, Environmental Law and Enforcement Policy

George Van Cleve

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INTRODUCTION

In writing this article for the Cardozo Law Review, I am mindful that the law school takes its name from the great jurist, Benjamin N. Cardozo, whose opinions most attorneys study from the beginning of their time in law school. Justice Cardozo took the view that trustees had broad responsibilities, and he regarded corporate directors and officers as subject to those fiduciary responsibilities. The breadth of his view of trusteeship in the corporate context is clearly expressed in *Globe Woolen Co. v. Utica Gas & Electric Co.*[1] In that case, plaintiff sued for specific performance of power supply contracts with defendant. Plaintiff's president was also a member of the board of the defendant corporation, and chairman of its executive committee. The defendant claimed that it should be relieved of its obligation because the contracts, which were entered into under the dominating influence of the common director, were unfair and oppressive. The plaintiff argued that the common director defense was irrelevant because plaintiff's president, the common director, had refrained from voting on the ratification of the contracts. Justice Cardozo disagreed, and invalidated the contracts, largely on the ground that the common director should have disclosed material inside information affecting the contract to the defendant corporation. He said:

> One does not divest oneself so readily of one's duties as trustee. . . . "[T]he great rule of law" which holds a trustee to the duty of constant and unqualified fidelity, is not a thing of forms and phrases. . . . A beneficiary, about to plunge into a ruinous course of dealing, may be betrayed by silence as well as by the spoken word.
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> . . . [The trustee] cannot rid himself of the duty to warn and to denounce, if there is improvidence or oppression, either apparent

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[1] 224 N.Y. 483, 121 N.E. 378 (1918).

> on the surface, or lurking beneath the surface, but visible to his practised eye.[2]

Although the problem of environmental audits differs from the problem in *Globe Woolen*, the broad conception of the trusteeship responsibilities of corporate officers and directors advanced by Justice Cardozo provides a valuable perspective for consideration of environmental auditing. The important question for trustees is not what the law demands today, but what the progression of the law, which mirrors the likely needs of society, means for tomorrow. It is in this spirit that corporations should consider the need for environmental auditing, which can be an important element in meeting present and future corporate environmental responsibilities.

As is the case with many potential tools for corporate governance, the actual value of environmental auditing to companies is to a considerable extent determined by the legal climate in which auditing occurs. Over the last few years that legal climate, established largely by Environmental Protection Agency (EPA) enforcement policy, has been relatively stable. Recently, however, there have been developments in Department of Justice and EPA enforcement policies which may affect the decision to audit. Also, in the Emergency Planning and Community Right-to-Know Act,[3] Congress has mandated a limited but significant form of environmental auditing. This may portend the fate of other pending legislative and administrative proposals on the audit issue. In my view, these changes significantly increase the value of environmental audits to companies, despite the risks such audits are sometimes thought to entail.

This article examines the changing intersection of environmental auditing, environmental law, and enforcement policy. It will begin by reviewing the concept of environmental auditing and will then discuss sources of existing legal authority to require or encourage audits and their limitations. Next, the article examines EPA's existing audit policies and the rationale behind them. It will consider the relationship between these audit policies, enforcement policy, and voluntary disclosures of environmental violations, which has recently been reviewed by the Department of Justice. The article will then consider two alternative models which might be used to establish the role of environmental auditing in environmental regulation. First, it will consider portions of the Community Right-to-Know legislation adopted by Congress in 1986,[4] which can be considered a limited form

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[2] *Id.* at 489, 121 N.E. at 379-80 (citation omitted).

[3] 42 U.S.C. §§ 11001-11050 (1988).

[4] *Id.*

of mandatory environmental auditing. Then, environmental auditing will be compared to the financial auditing process developed under the securities laws, which mandates broad financial auditing. The article will conclude by briefly describing recent legislative and U.S. Sentencing Commission proposals to broaden the use of environmental audits.

I. THE CONCEPT OF THE ENVIRONMENTAL AUDIT

It is useful to compare the environmental audit to the more established federal requirements for financial audits under the securities laws. The purpose of a financial audit is to give a true and complete picture of the financial standing of a business enterprise.[5] The purpose of an environmental audit should be to provide a similarly true and complete picture of the environmental consequences of the conduct of business operations of a given company, including its overall environmental practices and policies.[6]

Broadly speaking, there are two types of environmental audits—management audits, which test the nature of the company management systems controlling environmental risks faced by the company, and compliance audits, which test the status of environmental compliance by company operations. Similarly, there are two broad types of financial audits or audit issues—(1) issues surrounding the company's management controls to establish systems to provide for accurate and honest measurement and reporting of its financial performance, which might be described as the "fraud risk" faced by the company, and (2) issues surrounding the degree to which certain transactions should be reported, and in what amounts, i.e., decisions which affect the raw tally of company financial operations and are broadly analogous to judgments which must be made in determining compliance status.

In addition, financial and environmental audits might present certain common issues companies would need to confront—for example, whether the existence of a particular waste site will lead to financial liability for environmental contamination. There are, however, significant differences as well. One key difference[7] is that under current law, financial audits must comprehensively examine each aspect

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[5] This broad description is, of course, subject to the usual caveats concerning the limitations of generally accepted accounting principles.

[6] EPA's definition of environmental auditing, though clear, is narrower: "Environmental auditing is a systematic, documented, periodic and objective review by regulated entities of facility operations and practices related to meeting environmental requirements." Environmental Auditing Policy Statement, 51 Fed. Reg. 25,004 (July 9, 1986).

[7] Another difference is that the number of regulated entities under one or more of the environmental statutes is much larger than that under the securities laws.

of a company's operations—but an environmental compliance audit may be limited only to those aspects of company operations which are regulated under current law.[8] If an environmental audit is limited to reviewing compliance with existing laws and regulations, then management will be interested both in the substance of the information reported and in determining whether systems are in place to prevent false or inaccurate reporting. However, management may also be interested in conducting a comprehensive audit which provides additional environmental information concerning the consequences of activities which are not currently regulated, because such an audit may provide a means of avoiding future regulation or liability.[9]

II. THE SOURCES AND LIMITATIONS OF EXISTING LEGAL AUTHORITY TO REQUIRE ENVIRONMENTAL AUDITS

There are several sources of authority under existing federal law to require either management or compliance audits. These are: 1) as a condition of probation on conviction of a federal criminal environmental offense;[10] 2) as an element of injunctive relief following a judgment in civil enforcement proceedings;[11] 3) as a term in a judicially enforceable consent decree;[12] 4) to a certain extent under existing rec-

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[8] An environmental management audit is more likely to examine nonregulated aspects of a company's environmental activities, but it may also be limited to assessing management controls of environmental risks only under current environmental laws and regulations.

[9] *See, e.g.*, Priznar, *Trends in Environmental Auditing*, 20 ENVTL. L. REP. (ENVTL. L. INST.) 10179 (1990).

> [E]ven though the body of environmental laws and regulations is large, there are numerous practices and situations apparent to an experienced auditor that present environmental risks that are not regulated. In fact, regulatory compliance is no guarantee against liability. Thus, an audit that includes an identification of risks beyond compliance is a reasonable extension of the audit's scope.

Id. at 10182. One side benefit of either a limited or a comprehensive environmental audit should be accurate information concerning a company's actual and projected costs of environmental compliance, which must be reported to the Securities and Exchange Commission if material. *See infra* pp. 1236-38. The similarities and differences between environmental and financial audits have been examined at some length because a later portion of this article will compare the auditing requirements of the securities laws with the requirements for environmental audits. In addition, as discussed below, it may be that environmental enforcement policy should also draw distinctions between different types of environmental audits.

[10] 18 U.S.C. § 3563(b)(12)(1988); *see also* United States v. General Wood Preserving, No. 89-6-01-CR-7 (E.D.N.C. Jan. 26, 1989); United States v. Unichem Int'l, No. DC-90-064J (D. Wy. May 31, 1990); H.R. 3641, 101st Cong., 2d Sess., 135 CONG. REC. 8350 (daily ed. Nov. 19, 1989).

[11] Most of the environmental statutes allow the United States to seek any "appropriate relief" from a district court. *See, e.g.*, Resource Conservation and Recovery Act of 1976 (RCRA) § 3008(a), 42 U.S.C. § 6928(a) (1988); Clean Water Act of 1977 (CWA) § 309(b), 33 U.S.C. 1319(b) (1988).

[12] *See supra*, note 11. The source of the court's authority is the same as that for injunctive relief awarded after an adversary disposition of the case.

ord-keeping and reporting provisions of the environmental statutes;[13] and 5) possibly as a condition of receiving a necessary permit or authority under an existing regulatory statute.[14] In addition, under existing law, environmental enforcement authorities have the discretion to modify enforcement policy in response to voluntary adoption of audit procedures by either altering inspection frequency or varying penalty assessments.

Obviously, there are limitations on the use of any of the mandatory authorities. For instance, there are important restrictions on authorities which flow from criminal or civil enforcement proceedings. Typical environmental enforcement proceedings do not usually apply to entire industries, or even always to an entire corporation, but rather to individual corporate facilities. Thus, environmental auditing by companies that are the targets of enforcement efforts is only a partial remedy. Unless it is our view that only those companies that are currently in violation of the law should be conducting environmental audits, a more systematic approach to requiring environmental auditing should be considered. Another limitation is the legal requirement that there be a close nexus between the nature of the violation which a prosecution or enforcement action seeks to cure and the nature of the proposed audit requirement. This limitation is inherent in the authority of courts to impose remedies.[15]

The ability to require audits in connection with the permitting process will usually be limited by the nature of the activity which gives rise to the permit requirement. It would probably be held to be subject to the further limitation that it must represent a reasonable extension of the "self-enforcement" character of a given statute.[16] As to this latter point, the authority may be limited to those discharges or emissions that are now subject to regulation. This result could, of course, be altered by statute.

Enforcement proceedings and permitting activity are the principal means through which audits can be required under existing law. Because enforcement proceedings and permitting activity are subject to enforcement discretion, it is apparent that enforcement discretion

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[13] *See, e.g.*, CWA § 308(a), 33 U.S.C. § 1318(a) (1988); RCRA § 3007, 42 U.S.C. 6927 (1988).

[14] *See, e.g.*, CWA § 402(a)(1), 33 U.S.C. § 1342(a)(1) (1988) (authorizing Administrator to set such conditions as "are necessary to carry out the provisions of this chapter" as conditions for issuance of permit). This could be interpreted to permit requiring an environmental audit.

[15] *See e.g.*, Public Interest Research Group v. Powell Duffryn Terminals, 913 F.2d 64 (3d Cir. 1990); *see also* EPA Clean Water Act Penalty Policy for Civil Settlement Negotiations 7 (Feb. 11, 1986).

[16] *See* CWA § 308, 33 U.S.C. § 1318 (1988); 40 C.F.R. §§ 122.41(j), 122.48 (1990) (requiring CWA permittee to submit discharge monitoring results to EPA).

could be used as an inducement to companies to conduct audits voluntarily. These audits might then be used to require environmental improvements or to provide enforcement information.

EPA has accordingly had occasion to consider the circumstances under which it should attempt to require environmental audits, and under which it should attempt to provide incentives for voluntary audits. The next section first reviews and comments on EPA's audit policy, a policy of limited incentives for voluntary adoption of audit programs. It then reviews alternative models for environmental auditing.

III. THREE MODELS FOR ENVIRONMENTAL AUDITING

A. *The EPA Voluntary Auditing Policy*

1. The Decision Not to Mandate Audits

EPA's Environmental Auditing Policy Statement[17] encourages regulated entities, including federal facilities, to implement environmental auditing programs and suggests a number of appropriate elements of an environmental audit. Although EPA's policy endorses the use of environmental audits, it does not mandate that any regulated entity perform an audit, it does not mandate anything about how an entity that does decide to undertake an audit should perform that audit, and it provides only limited incentives to encourage audits. In the main, EPA's policy was probably sound when adopted, given three considerations. First, there are some limits, just described, on its authorities under existing law. Second, there are severe limits on EPA's enforcement resources. Third, this is an issue "at the margin" for EPA because EPA has the ability to obtain most of the enforcement information it needs through its existing regulatory programs.

The policy statement gives two reasons for not requiring audits—"because environmental auditing systems have been widely adopted on a voluntary basis in the past, and because audit quality depends to a large degree upon genuine management commitment to the program and its objectives."[18] The factual basis for the first statement is unclear, but unless the suggestion is that most companies in fact have adopted comprehensive environmental audit programs, there is an obvious question left unanswered about the relative costs and benefits of creating an audit requirement for companies which have not acted voluntarily, and of requiring audits to be comprehensive.

The second reason for not reviewing audits would also be the

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[17] 51 Fed. Reg. 25,004 (July 9, 1986).

[18] *Id.* at 25,007.

subject of differing views. No one suggests that the success of a financial audit requirement depends on a "management commitment" to the requirement. Indeed, it is notable that the Securities and Exchange Commission (SEC) auditing programs discussed below rest on Congress' assumption that management would not always regard it as in their best interest to undertake or disclose the results of voluntary financial audits. Thus, to the extent environmental audits resemble financial audits, management commitment is not a prerequisite to a successful environmental audit. These comments on the reasoning supporting EPA's policy do not, however, support the argument that it would necessarily be desirable for EPA administratively to impose mandatory audit requirements, but rather show that this description of the issues involved is incomplete if the question were instead whether to broaden EPA's authority legislatively.

Several commentators have discussed EPA's rationale for its decision not to mandate environmental auditing. One article suggests that it was EPA's view that mandating environmental auditing was beyond the effective limits of "command-and-control" regulation for several reasons.[19] First, management was much more likely to develop an effective, meaningful program if it did so voluntarily. Second, the commentators suggest that EPA viewed it as difficult to develop uniform standards and regulations that would apply to the broad spectrum of regulated industries, especially given the diversity of approaches of management procedures within those companies generally.[20] In other words, according to these commentators, EPA's view was that, when left unregulated, an entity would develop an environmental auditing program that would improve accountability for that entity. EPA may have thought itself hard-pressed to mandate similarly effective audit programs for all regulated entities. Of course, similar arguments could probably have been made about financial auditing when requiring it was first proposed. The ultimate judgment Congress and the SEC made in that case, however, was that publicly available audits should be required for most major companies and that broad professional standards for an independent accounting profession were generally sufficient to ensure the efficiency and integrity of this process.

EPA may have also viewed enforcement of auditing requirements as overly burdensome. Such enforcement would require EPA to train employees in auditing procedures or hire auditing specialists

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19 Blumenfeld & Haddad, *The Responsibility of Regulators*, in THE MCGRAW-HILL ENVIRONMENTAL AUDITING HANDBOOK 5-3 (L. Harrison ed. 1984).

20 *Id.* at 5-9.

so that they could identify the flaws in mandated auditing procedures. This would be resource intensive. Furthermore, compliance monitoring for auditing requirements could require these highly trained individuals to engage in extensive examination of company files and to make prolonged visits to company headquarters and plants.[21] Given EPA's other obligations, it may have been reluctant to make such a major commitment of resources to mandate auditing when auditing is occurring voluntarily more and more frequently.[22]

Finally, it has been suggested that EPA decided not to mandate environmental auditing so as to give the regulated community some measure of privacy with respect to their internal affairs and to keep EPA out of making management decisions for companies. It is difficult to see how this type of audit requirement would be more intrusive than financial audit requirements and, in any event, this concern would apply principally to management rather than to compliance audits.[23]

In summary, then, given the possible limits on EPA's authority to require audits, and the fact that EPA already obtains substantial amounts of enforcement information through the regulatory process, EPA's decision not to mandate audits by regulation was probably the right decision at the time, given its responsibilities and resources. However, as shown, there are unanswered questions about whether legislation to provide for significantly broader audit requirements would be desirable. In addition, there are other questions, such as whether additional information would actually be useful to regulators or whether audit requirements should instead be limited to the criminal conviction context, as some have proposed, which would need to be addressed if legislation were considered. Later sections of this article consider two mandatory audit programs, the Emergency Planning and Community Right-to-Know Act and the SEC's audit requirements, as possible models for environmental audit requirements, as well as related pending legislative and U.S. Sentencing Commission proposals.

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21 *Id.* at 5-10.

22 However, EPA is now discovering that in at least key areas it is necessary for it to target its enforcement resources using auditing techniques, and since EPA is going to have to develop this capacity for the purpose of enforcement targeting, it could logically also be used for audit review.

23 However, the costs could be proportionately higher for smaller businesses, and, as noted, environmental regulations probably apply to many businesses which are not subject to SEC reporting requirements.

2. EPA's Analysis of Enforcement Incentives for Voluntary Audits

With respect to incentive programs for environmental audits, which might rely on matters such as altered inspection frequencies or penalty levels, EPA explained its decision not to adopt any specific incentives as follows:

> Based on earlier comments received from industry, EPA believes most companies would not support or participate in an "incentives-based" environmental auditing program with EPA. Moreover, general promises to forgo inspections or reduce enforcement responses in exchange for companies' adoption of environmental auditing programs—the "incentives" most frequently mentioned in this context—are fraught with legal and policy obstacles.[24]

In general, EPA's policy statement provides little reason for an entity that was not already predisposed to conduct an audit to do so now. The statement notes that the better an entity's compliance record, the less likely it is to be subject to inspections and enforcement actions,[25] but this has presumably always been the case. The only concession EPA makes to encourage environmental audits is to promise not to request the results of such audits routinely.[26] However, EPA preserves its right to request an audit (or relevant portion of an audit) whenever necessary for an enforcement action and particularly when pertinent to a criminal investigation.[27] Unless EPA has routinely requested environmental audits in the past, which does not appear to have been the case, the policy statement provides little or no additional incentive for an entity to conduct an environmental audit.

The implementation plan for the voluntary incentives approach to environmental auditing that EPA considered would have set up pilot projects with one or two states allowing voluntary industry participation. The incentives considered were less frequent inspections, waiver or suspension of penalties for violations identified and rapidly cured, and accelerated permit review or renewal. Several states indicated a reluctance to commit sufficient resources to such a nonregulatory program. Environmental groups expressed concern about any shift of resources from traditional enforcement. Industry was concerned that any voluntary program be flexible enough to allow participation by companies that already had environmental audit programs or that had specific ideas as to what they would want an audit pro-

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24 Environmental Auditing Policy Statement, 51 Fed. Reg. 25,004 (July 9, 1986).
25 *Id.* at 25,007.
26 *Id.*
27 *Id.*

gram to accomplish. Some companies saw the development of EPA guidance on audits as the first step in mandating environmental audits, and were opposed to it for that reason.[28] Finally, industry was very concerned about the confidentiality of an environmental audit program involving EPA or state environmental agencies. Even if no enforcement action resulted from audit findings of lack of compliance, industry expressed a concern that the publicity could be devastating in these environmentally-conscientious days (and apparently thought this would overshadow any good environmental press expected from participation in the voluntary audit program).[29]

As previously noted, EPA can already obtain most of the enforcement-related information it needs, at least with respect to currently regulated activities, through both the administrative information demand authority and self-reporting requirements of the federal environmental laws, which are being expanded as Congress reauthorizes environmental statutes such as the Clean Air Act. EPA's view, which I support, is that any reduction in enforcement efforts or inspections for those who perform environmental audits would eliminate the current incentive for them to perform effective audits and correct deficiencies.

EPA's rationale for not implementing an incentives approach in 1986 may have been in part due to the newness of the field of environmental auditing. Now that several more years have passed, it may be appropriate for EPA to give renewed consideration to voluntary incentives for audits. In addition, one must consider the connection between voluntary audits, disclosure of environmental violations identified in such audits, and subsequent enforcement action.

3. Voluntary Audits and Disclosure of Environmental Violations

Unlike certain other federal agencies, the Environment and Natural Resources Division of the Department of Justice has no formal voluntary disclosure policy.[30] The Rockwell matter recently considered by the division illustrates some of the issues necessarily implicated by such policies, and may contain potential implications for corporate audit decisions.

The federal government has recently begun coming to terms with

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28 Blumenfeld & Haddad, *supra* note 19, at 5-13 to 14.

29 *Id.* at 5-10 to 12; *see also* Palmisano, *Environmental Auditing as a Management Information System* in THE MCGRAW HILL ENVIRONMENTAL AUDITING HANDBOOK, *supra* note 19, at 5-23, 5-30 to 32.

30 Compare, for example, Dept. of Defense Inspector General, Criminal Investigations Policy and Oversight, *The Dept. of Defense Voluntary Disclosure Program: A Description of the Process* (Sept. 1988).

the fact that there are substantial environmental problems at major federal facilities, among them facilities still under operation such as those of the Department of Energy which produce nuclear weapons materials. The United States has conducted one successful prosecution of federal employees for environmental crimes at a federal facility and, as is publicly known, is conducting a criminal investigation of activities at the Rocky Flats weapons plant in Colorado. At the same time, there is pending civil litigation and regulatory activity designed to force that facility to come into compliance. After the execution of a search warrant in aid of the Rocky Flats investigation, the contract operator of the Rocky Flats facility, Rockwell International Corporation, became concerned that by continuing to operate the Rocky Flats plant it would subject itself and its employees to criminal liability. Rockwell therefore sought assurances from the United States that its continued operation of the facility would not subject it to criminal liability.[31]

The Justice Department refused to make any blanket assurances with respect to Rockwell's potential criminal liability. However, the Department did write EPA and the Department of Energy a letter describing how it would normally exercise prosecutorial discretion in Rockwell's circumstances. As a precondition, the Justice Department insisted that there be full disclosure to the government of facility environmental violations and that the company enter into compliance agreements to correct them. The letter stated:

> In accordance with our general practices, summarized above, regarding the exercise of our discretion to prosecute, I can state the following on behalf of the Department of Justice and the United States Attorney for the District of Colorado:
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> Prompt, good-faith efforts by Rockwell and DOE to disclose environmental violations and reach environmental compliance agreements with the State of Colorado and the United States Environmental Protection Agency would be a significant factor in any decision whether to prosecute Rockwell, its employees, and DOE employees with respect to future violations of environmental laws that occur by reason of continued operation of the plant.
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> In addition, if (i) agreements are made between Rockwell and DOE and Colorado state authorities and EPA providing for corrective steps to achieve environmental compliance at Rocky Flats in accordance with a specific plan and schedule, (ii) the extent of violations of law at Rocky Flats has been fully disclosed to the

[31] Because Rockwell's disclosure was not made voluntarily before the execution of the warrant, there was no occasion to consider how voluntarily disclosed past violations would be prosecuted.

> relevant regulatory or other legal authorities, and (iii) corrective action is being undertaken in strict accordance with the terms of such agreements, our general practice would be not to prosecute DOE employees or Rockwell or its employees for conduct undertaken in accord with and authorized by such agreements.[32]

The letter then considered several potential issues of prosecutorial discretion. First, it drew a sharp distinction between liability for past conduct and liability for continued facility operations. As to past conduct, Rockwell received no assurance except that its environmental violations "would be on equal footing with other violations of environmental laws."[33] In addition, Rockwell was not given any guarantees as to the evidentiary use of any information it disclosed, voluntarily or otherwise, in a criminal prosecution. As to continued facility operations, however, the United States made clear that if Rockwell fully disclosed all violations, and entered into a compliance plan with respect to those violations, our general practice would be to take this into account as a "significant factor" in determining whether prosecution for continuing violations would be appropriate. The United States further stated that information as to any compliance agreements or conduct pursuant to them would not be used in grand jury proceedings or in the government's case-in-chief as evidence of past violations.[34]

Rockwell later sued the United States seeking a declaration that it could not be held criminally liable for continued operation of its facility and an injunction against prosecution. Rockwell's motion for a preliminary injunction was denied on the unsurprising ground that it would not be appropriate to enjoin a preliminary criminal investigation.[35]

By way of additional background, corporate management should be aware of two critical points about environmental enforcement. The first is that environmental enforcement officials typically can exercise discretion as to whether to proceed criminally or civilly against a violator, and that the frequency of criminal prosecutions is increasing. This trend is likely to continue. The second is that corporate management can, in certain circumstances, be held criminally liable

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32 Letter from Richard B. Stewart, Assistant Attorney General, Land & Natural Resources Division, Department of Justice, to Admiral James D. Watkins, Secretary of Energy, and William K. Reilly, Administrator of EPA (September 14, 1989).

33 *Id.*

34 *Id.*

35 Rockwell Int'l Corp. v. United States, 723 F. Supp. 176 (D.D.C. 1989). Rockwell later withdrew as DOE's contractor at this facility. It voluntarily dismissed its action against the United States.

as individuals for environmental violations even where those managers did not personally participate in, or direct, each of the actions which gave rise to criminal liability.[36]

The disposition of the Rockwell matter suggests that environmental audits can have substantial utility to a company in avoiding or limiting criminal liability. Properly directed audits, implemented on completion, can potentially shield corporate management from the type of "responsible corporate officer" liability discussed above by establishing that it took preventive steps to avoid the criminal conduct involved. In addition, disclosures made to prosecutors based on information discovered through an audit can potentially serve as the basis for mitigated penalties as to past conduct and to lessen or avoid liability for continuing conduct on the part of the company, though this is not assured.

However, it is fair to note that audits are sometimes regarded as a double-edged sword. The conventional wisdom among the defense bar holds that either it is unwise for companies to conduct audits at all, or that at the very least, it is unwise for a company to conduct an audit when it does not intend to act on the results.[37] The United States has used audit results to good effect in criminal prosecutions to prove that corporate management was aware of the existence of environmental violations and did not act to correct them when it could have done so.[38] The United States has consistently refused to limit access to audit results for criminal enforcement purposes.[39]

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[36] *See, e.g.*, United States v. Dotterweich, 320 U.S. 277 (1943); United States v. Johnson & Towers Inc., 741 F.2d 662 (3d Cir. 1984); United States v. International Minerals & Chem. Corp., 402 U.S. 558 (1971).

[37] Address by James Bruen, Boulder ALI-ABA Conference (June 1990); Reed, *Environmental Audits and Confidentiality: Can What You Know Hurt You As Much As What You Don't Know?*, 13 ENVTL. L. REP. (ENVTL L. INST.) 10303 (1983).

[38] *See, e.g.*, United States v. Ashland Oil, 705 F. Supp. 270 (W.D. Pa. 1989); United States v. Pennwalt, Crim. No. MS85-68(T) (W.D. Wash. 1988).

[39] *See, e.g.*, United States v. Eagle-Picher Indus., Civ. Action No. 87-5100-CV-SW-8 (W.D. Mo., Sept. 29, 1990) (1990 U.S. Dist. LEXIS 13206) (consent decree).

It is interesting to note that the Joint Explanatory Statement of the Committee of Conference for the Clean Air Act Amendments of 1990 contains hortatory language specifically intended to encourage owners and operators of sources subject to the Clean Air Act to conduct self-evaluations and self-audits. 136 CONG. REC. 13,101 (daily ed. Oct. 27, 1990). The Joint Statement provides in part:

> Nothing in subsection 113(c) is intended to discourage owners or operators of sources subject to this Act from conducting self-evaluations or self-audits and acting to correct any problems identified. On the contrary, the environmental benefits from such review and prompt corrective action are substantial and section 113 should be read to encourage self-evaluation and self-audits.
>
> Owners and operators of sources are in the best position to identify deficiencies and correct them, and should be encouraged to adopt procedures where internal compliance audits are performed and management is informed. Such internal

In deciding whether to voluntarily adopt an audit program, a company will likely take a series of factors into account. Among them certainly should be whether the liability resulting from uncorrected violations is likely to be manageable. Recent federal settlements and judgments for environmental violations have included multimillion dollar civil penalties, and these penalty levels are likely to increase.[40] In addition, EPA's consistent enforcement of the principle of joint and several liability in the Superfund program may mean that hazardous waste liability exposures are much larger than the exposure which companies traditionally would have faced in this area. The federal shift toward criminal enforcement makes audits and voluntary disclosure of continuing operations a course of action which deserves increasing and serious consideration. Whether a company is likely to face civil or criminal liability, it may be more beneficial to perform an audit and recommended compliance activities, or to disclose the results to the government with resulting penalties and compliance requirements, than to run the risk of prosecution without knowing in any detail what that risk actually looks like.[41]

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audits will improve the owners' and operators' ability to identify and correct problems before, rather than after, government inspections and other enforcement actions are needed.

The criminal penalties available under subsection 113(c) should not be applied in a situation where a person, acting in good faith, promptly reports the results of an audit and promptly acts to correct any deviation. Knowledge gained by an individual solely in conducting an audit or while attempting to correct any deficiencies identified in the audit or the audit report itself should not ordinarily form the basis of the intent which results in criminal penalties.

Id.

[40] *See, e.g.*, United States EPA v. Environmental Waste Control, Inc., Nos. 89-1865, 89-2197 (7th Cir. Oct. 31, 1990)($2.7M RCRA penalty); United States v. Shell Oil Co., Civ. No. C-89 4220 (N.D. Cal. Mar. 26, 1990)($4.2 million in federal and state CWA and other civil penalties); United States v. Menominee Paper Co., Civ. No. M-88-108 CA2 (W.D. Mich. July 20, 1990)($2.1 million CWA penalty).

[41] Companies can maintain the option of not disclosing the legal conclusions of audits if they can structure the audit process to protect it under applicable privileges against disclosure. Reed concludes that properly structured audits can be protected from discovery. Reed, *supra* note 37, at 10308. To the same effect, though noting the limits of privileges, see Bird, Marella & Drooks, *Preserving Confidentiality in Corporate Internal Investigations*, 1 Corp. Crim. Liability Rep. 1 (Spring 1987); Price & Danzig, *Environmental Auditing: Developing a "Preventive Medicine" Approach to Environmental Compliance*, 19 LOY. L. A. L. REV. 1189 (1986). The decision to conduct an audit under the claim of protection of the attorney-client privilege is, however, one which the United States has challenged. The United States will seek to limit the scope of the privileged material to its proper extent, and to challenge the privilege if it is not clearly available or has been waived by the claimant. In addition, the decision not to disclose audit results which demonstrate that criminal liability may exist for continuing conduct may well raise substantial ethical problems for the attorney involved in the decision. Van Cleve, *Environmental Law in the 1990s and its Principal Implications for Professional Responsibility*, address to the Environmental Law Section of the Michigan Bar (May 18, 1990) (on file with the Cardozo Law Review).

4. EPA's Use of Auditing Provisions in Enforcement Settlements and Recent Decrees

In the past several years, EPA enforcement officials have increasingly focused on audit requirements in connection with the settlement of enforcement matters. This section reviews EPA's policy, and provides recent examples of its implementation.

On November 14, 1986, EPA issued a policy statement on including environmental auditing provisions in enforcement settlements.[42] The policy promotes the use of audits in settlements to (1) address compliance at an entire facility or at all facilities owned or operated by a party, rather than just the violations that are the subject of the lawsuit, to the extent permitted by law; (2) focus the attention of the party's top-level management on environmental compliance; and (3) provide assurance that existing environmental management practices are adequate.[43] The basic policy of EPA is to suggest auditing as part of a settlement (in addition to any other necessary corrective action) when heightened management attention could lower the potential for recurrence of noncompliance.[44]

EPA guidance distinguishes between compliance audits and management audits. A compliance audit is an independent assessment of the current status of a party's noncompliance with environmental requirements.[45] EPA's guidance defines a management audit as an independent evaluation of a party's environmental compliance policies, practices, and controls.[46] EPA's guidance suggests that a compliance audit is appropriate where the discovered violations suggest that environmental noncompliance exists elsewhere within that party's operations.[47] EPA encourages settlements which include a management audit when a major contributing factor to noncompliance is inadequate managerial attention to environmental policies, procedures, and staffing.[48]

Some settlements including audits have involved simply a party's agreement to perform an independent audit, correct any deficiencies identified, and certify to EPA that it has done so.[49] Other settlements, however, have required a party's full disclosure to EPA of findings of

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42 EPA Policy on the Inclusion of Environmental Auditing Provisions in Enforcement Settlements (Nov. 14, 1986)[hereinafter EPA Environmental Audit Settlement Policy].

43 *Id.* at 1.

44 *Id.* at 2.

45 *Id.* at 3.

46 *Id.*

47 *Id.*

48 *Id.*

49 *See, e.g.*, *In re* Owens-Corning Fiberglas Corp., No. TSCA-V-C-101 (EPA Reg. V, June

its independent auditor, sometimes followed by a compliance plan to address identified problems, and/or stipulated penalties for violations identified by the audit and promptly remedied.[50] EPA's guidance on the use of environmental audits in settlements reiterates the position stated in its Environmental Auditing Policy Statement that, in setting a penalty, a party's willingness to conduct an audit may be considered as evidence of good faith efforts to remedy noncompliance, but EPA is not required to view it as such.[51]

Some of the more recent federal judicial consent decrees requiring environmental audits demonstrate that EPA and the Department of Justice have approached the question of the proper scope of the audit provisions, and the disclosure requirements connected to them, on a case-by-case basis. A few examples follow.

(1) *United States v. Eagle-Picher Industries:*[52] The defendant was alleged to have discharged wastewater without a valid National Pollutant Discharge Elimination System (NPDES) permit as is required under the Clean Water Act (CWA) and also to be in violation of its pretreatment requirements. In addition to a penalty of $1.5 million and a compliance schedule, the consent decree requires the defendant to conduct a multimedia in-house environmental compliance audit of the facilities that were the subject of the complaint and to correct promptly any conditions of noncompliance discovered. Eagle-Picher is required to certify to EPA its completion of these requirements, but is not required to disclose the results of the audit to the United States, unless Eagle-Picher raises the audit in defense or mitigation in any future proceeding or the audit is material to a future criminal investigation.

(2) *United States v. Menominee Paper Company Inc. and Bell Packaging Corp.:*[53] Defendants were alleged to be in violation of their NPDES permits under the Clean Water Act as well as Clean Water Act pretreatment regulations. Under the decree, Menominee is required to hire an outside consultant approved by the United States to perform a multimedia environmental compliance audit and to provide the results of that audit to the United States. The auditor is required

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8, 1984) (Consent Agreement and Final Order) (polychlorinated biphenyl compliance audit for sixty-three facilities).

[50] *See, e.g., In re* Chemical Waste Management, Inc., Nos. RCRA-09-84-0037, TSCA-09-0009 (EPA Reg. IX, Nov. 7, 1985) (Consent Agreement and Final Order). This consent agreement is described in some detail in Price & Danzig, *supra* note 40, at 1208-09.

[51] EPA Environmental Audit Settlement Policy, *supra* note 41, at 6.

[52] Civ. Action No. 87-5100-CV-SW-8 (W.D. Mo. July 12, 1990), 55 Fed. Reg. 28,694 (July 12, 1990). The United States filed a motion for entry of the decree on September 7, 1990.

[53] 727 F. Supp. 1110 (W.D. Mich. 1989). The consent decree was entered on July 20, 1990.

to develop a remedial action plan for any violations discovered as a result of the audit, including a date-specific timetable for remedying those violations. The defendant is required to implement its remedial action plan after approval of the plan by the United States.

(3) *United States v. Browning Ferris Industries*:[54] The consent decree in this case requires Browning Ferris (BFI) to conduct environmental compliance and management audits of its facility in Calcasieu Parish, Louisiana. That facility was alleged to be in violation of certain operating regulations applicable to interim status hazardous waste facilities under the Resource Conservation and Recovery Act. Under the decree, BFI is required to hire an outside auditor, subject to the approval of the EPA, who will prepare a compliance report and plan and a corporate management report and plan. Each of these reports must be made available to EPA upon request. The United States and Louisiana agree not to use the auditing reports as direct evidence in civil or administrative enforcement actions if BFI corrects any violations discovered within the time frame specified in the consent decree, but the reports may be used in any circumstance in a criminal enforcement action.

B. *Community Right to Know Legislation as a Model for Environmental Auditing*

In the wake of the Bhopal disaster,[55] Congress passed the Emergency Planning and Community Right-to-Know Act of 1986 (EPCRA).[56] The law was intended to prevent future Bhopal-like incidents.[57] EPCRA requires facilities to determine whether they are using more than minor quantities of certain extremely hazardous substances and, if so, to communicate this information to state and local emergency response authorities for planning purposes.[58] It requires the development of emergency response plans for handling contingen-

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54 Civ. Action No. 88-0718-LC (W.D. La. March 6, 1990). The consent decree was entered on August 16, 1990.

55 In December of 1984 there was a toxic gas leak from the Union Carbide plant insecticide plant in Bhopal, India. New York Times, Dec. 4, 1984, at 1, col. 6. As a result, over 2,000 people were killed. Fin. Times, Limited, Dec. 18, 1984, sec. 1 (overseas news) at 3. The disaster resulted in a call for a reevaluation of procedures. Arters, *Carbide Chairman Testifies Company 'Overwhelmed' by Bhopal Disaster*, United Press International, Dec. 14, 1984 (LEXIS, Nexis library, wires file). The incident also raised questions about the role multinationals should play when they operate in less developed countries. New York Times, Dec. 16, 1984, at 1, col. 2.

56 42 U.S.C. §§ 11001-11050 (1988).

57 Yost & Schultz, *The Chemicals Among Us*, THE WASHINGTON LAWYER 24 (Mar./Apr. 1990).

58 EPCRA § 303, 42 U.S.C. § 11003 (1988).

cies related to the use of these hazardous materials.[59] The Act also requires facilities that have accidental releases of acutely toxic chemicals to report those releases to local emergency planning committees and the public.[60] EPCRA requires manufacturers to inventory the quantities of toxic chemicals they are using or storing at their facility and to report those findings to the public.[61] Finally, EPCRA requires facilities to estimate the amounts of toxic chemicals that they are releasing to the environment both intentionally and accidentally on an annual basis. This information must be provided to EPA and the state in which the facility is located.[62]

EPA has been aggressively enforcing the basic notification and emergency planning requirements of this statute using its administrative authorities.[63] Of particular interest, though, are the toxic chemical reporting provisions. These provisions represent a focused, limited, congressionally-mandated auditing requirement with respect to certain environmental effects of manufacturing facility operations. Congress was obviously prompted by the specific concern about a repetition of the Bhopal incident, but it is apparent that this mandatory reporting and disclosure provision goes further, since this type of reporting and disclosure is not necessary to effective emergency planning and response. Instead, it would more likely be justified by proponents as a valuable tool for public decision making about various issues such as facility location and development of residential areas near industrial facilities.

It appears that an unintended but very significant consequence of this legislative requirement has been an alteration in company decisions concerning environmental control of unregulated activities.[64] According to Yost and Schultz:

> The substance of the EPA toxic release inventory for 1987 is based on 74,000 reports filed by more than 19,000 manufacturing facilities on 328 toxic chemicals. These reports reveal that in 1987 more than 18 billion pounds of these toxic chemicals were released di-

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59 *Id.*

60 EPCRA § 304, 42 U.S.C. § 11004 (1988).

61 EPCRA §§ 311, 312, 42 U.S.C. §§ 11021-11022 (1988).

62 EPCRA § 313, 42 U.S.C. § 11023 (1988).

63 Yost & Schultz say that EPA recently levied $1.65 million in fines against 42 firms for failure to file the required reports and announced it was going after 1,500 more violators. Yost & Schultz, *supra* note 57, at 26.

64 W. Reilly, *Aiming Before We Shoot: The Quiet Revolution in Environmental Policy*, Address to the National Press Club, Washington, D.C. (Sept. 26, 1990)("Based on the industry response so far, it is clear that one of the most effective instruments for reducing toxic air emissions has been the Community Right-To-Know law requiring industries to estimate and publicly announce them, by plant and by chemical.")

> rectly into air, surface waters, land, or underground injection wells, and an additional 4.6 billion pounds were transported off-site for disposal or waste treatment.[65]

The public reaction to these disclosures has been substantial. Major chemical manufacturers such as DuPont and Monsanto have clearly altered their environmental control strategies in response to the public perception of environmental harm rather than in response to any specific regulatory requirement. DuPont announced, for example, that it was ending chlorofluorocarbon production before it was legally required to do so. Monsanto pledged to reduce hazardous air emissions from its facilities substantially even though they met the requirements of current law.[66]

It is particularly significant that Congress chose to require reporting of largely unregulated emissions of toxic chemicals in EPCRA, since this represented a decision that the public and EPA would benefit from obtaining information about unregulated activities. It seems clear from the immediate response that companies have benefited as well, since they are adjusting their plans for controlling such emissions even without mandatory decisions by government regulators. These decisions are probably based on the companies' view that they are thereby limiting their ultimate compliance and liability costs.

With respect to audits of unregulated activities not subject to EPCRA, further consideration should be given to the proper enforcement policy with respect to disclosure and access to audit materials.

C. *Financial Auditing and Mandatory Environmental Liability Disclosures as a Model for Environmental Auditing*

1. General Comparison

In order to sell securities to the public, companies must file a registration statement with the SEC pursuant to the Securities Act of 1933,[67] and must make annual and quarterly filings of audited financial statements pursuant to the Securities Exchange Act of 1934.[68] Under these statutes and their implementing regulations, audits must be performed by an independent public or certified accountant in conformance with generally accepted auditing standards.[69]

The audited financial statements required by the SEC normally

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65 Yost & Schulz, *supra* note 57, at 54.

66 *Id.* at 55.

67 15 U.S.C. §§ 77a-bbbb (1988).

68 15 U.S.C. §§ 78a-ll (1988).

69 *See* 17 C.F.R. §§ 210.2-01 to 2-02 (1990).

include consolidated balance sheets, consolidated statements of income and changes in financial position.[70] Additionally, the SEC encourages registrants to include management's projections of future economic performance of the registrant.[71]

Thus, in a financial audit required by the SEC, the SEC and public are informed of each publicly traded company's current and projected financial condition for their use in making investment and regulatory decisions. Although companies may use the information obtained by the auditing process to improve internal controls and to plan their business strategy, the purpose of the audit from the regulator's standpoint is not to improve the management of the audited company, but rather to ensure that the public is informed of the relevant information in making investment decisions (in order to perfect capital markets).

The impetus for the adoption of the SEC audit requirements was the sense that the audits were a socially efficient way to protect prospective investors against widespread securities fraud, and thus to counter demands for government control of corporate decisions or financial bailouts of defrauded investors. In short, the SEC audit requirements were a recognition that certain corporate decisions had externalities, *i.e.*, harmful effects on investors, which needed to be controlled through disclosure. Since financial audits must be performed to support the goal of financial disclosure, it makes sense to mandate audits and then require disclosure of the results.

In contrast, a principal purpose of an environmental audit from EPA's traditional perspective was to improve management of the regulated entity's environmental activities and increase compliance. From this traditional EPA perspective, since management resistance to an externally-imposed environmental audit requirement might well frustrate its principal purpose, such resistance is a more weighty consideration against requiring audits or disclosure than it would be in the case of financial auditing. However, the validity of this perspective implicitly depended on the flawed premise that the company's activities either have no external effects on the environment or that these externalities are fully controlled.

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[70] *See generally id.* § 229 (1990). The statements must include a description of the business, *id.* at § 229.101, the property, *id.* at § 229.102, any material pending legal proceedings, *id.* at § 229.103, and the securities of the registrant, *id.* at § 229.201. A registrant also must include an analysis of the registrant's financial condition and results of operations, identification of the management and certain security holders. They would also include a number of specialized financial statements to reflect acquisitions, reorganization, or other major changes in the form of the business. *See generally id.* § 210 (1990).

[71] *Id.* at 210(b).

If there were no uncaptured environmental externalities from a company's production activities, because one assumed a perfect regulatory or tax system for capturing these costs and imposing them on the company and hence on the consumer, then it could be argued that information on the environmental effects of company activities is private corporate information which should not be subject to disclosure. However, it is clear that no such perfect system to control environmental externalities presently exists.

Disclosures of environmental audit data may, accordingly, significantly influence company activity, private and public investment, enforcement, and regulatory activity, as the experience of EPCRA has shown. In addition, our unhappy experience with the necessity for programs such as Superfund makes us aware that both taxpayers and specific industries, particularly those in later generations, may be asked to pay for failures to control environmental externalities. Thus, the public and regulatory authorities might have a dual interest in broadened disclosure of the environmental effects of company activities.[72] However, as discussed below, it is not at all clear that this public interest in environmental disclosure is adequately met by the current SEC financially-based environmental disclosure requirements.

Another important difference between financial audits and environmental audits is the present lack of generally accepted professional standards for the conduct of environmental audits as compared to the generally accepted accounting principles which underpin SEC-required financial audits. If EPA were to mandate environmental audits at this time, it could not rely upon generally accepted environmental auditing practices, but would instead have to specify certain practices itself. There are promising signs that this problem of a lack of professional standards may be remedied. There are now several organizations studying the professionalization of environmental auditing, including the Institute for Environmental Auditing, the Environmental Auditing Roundtable, and the Environmental Forum.[73] It may eventually be possible for EPA to rely, at least in substantial part, upon the environmental auditing profession to set its own standards, as the SEC now does with its accountants.

2. Environmental Disclosure Requirements of the Securities and Exchange Commission

Since 1971, the SEC has required publicly held firms to disclose

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[72] Of course, some public disclosures are provided for under current law, *e.g.*, Discharge Monitoring Reports (DMRs) under the Clean Water Act, and EPCRA disclosures.

[73] These are discussed in Priznar, *supra* note 9.

certain information concerning their environmental activities.[74] Registrants are required to disclose the material economic effects that compliance with federal, state, and local environmental laws may have on the registrant. Publicly held companies have a continuing legal obligation, under SEC regulations, to disclose any and all environmental information that is financially material to investors and shareholders. As discussed below, the SEC also appears to have lessened its traditional materiality standard in some circumstances with respect to environmental activities, thus broadening disclosure obligations beyond customary securities law requirements.[75]

a. *Item 101 of Regulation S-K: Disclosure of Economic Effects of Compliance with Environmental Laws*

Regulation S-K is the integrated disclosure system applicable to SEC registrants. Item 101 of regulation S-K requires companies to make appropriate disclosure "as to the material effects that compliance with Federal, State, and local provisions . . . regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries."[76] In addition, the registrant is required to disclose any material estimated capital expenditures for environmental control facilities for at least the next two years and for such further periods as the registrant deems material.[77]

These regulations were interpreted expansively by the SEC in *In re United States Steel Corp.*,[78] in which the SEC issued its findings and accepted a consent judgment requiring U.S. Steel to conduct an extensive environmental audit and report its results to the SEC. In *U.S. Steel*, the SEC took the position that U.S. Steel's projected capital

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[74] *See generally* T. TRUITT, ENVIRONMENTAL AUDIT HANDBOOK 17-18, 124-35 (1981); Hamilton, *Environmental Disclosure Requirements of the Securities and Exchange Commission* in THE MCGRAW HILL ENVIRONMENTAL AUDITING HANDBOOK, *supra* note 19, at 2-109 to 119.

[75] This departure may have been prompted by concerns raised by environmental groups and litigation pursued by the Natural Resources Defense Council (NRDC), in which they advocated that companies have an obligation to disclose "socially significant" information as well as financially material information. Natural Resources Defense Council, Inc. v. SEC, 432 F. Supp. 1190 (D.D.C. 1977); *see also* Hamilton, *supra* note 73, at 2-110. Note, however, that NRDC ultimately lost this litigation on appeal. Natural Resources Defense Council, Inc. v. SEC, 606 F.2d 1031, 1062 (D.C. Cir. 1979).

[76] 17 C.F.R. § 229.101(c)(1)(xii) (1990).

[77] *Id.*

[78] Exchange Act Release No. 16,223 [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,319, at 82,376 (Sept. 27, 1979)(reporting U.S. Steel's consent to entry of order finding company failed to make inadequate disclosure of environmental matters).

outlays of up to $1.6 billion for environmental compliance were material future expenditures that should have been reported pursuant to regulation S-K. Moreover, in *U.S. Steel*, the SEC expresses its view that registrants may be required to develop compliance cost estimates that have not previously been made and to disclose those estimates to the SEC if the registrant reasonably expects that costs for any future year will be materially higher than the costs disclosed for the mandatory two-year period.[79] The SEC said that such estimates could be required in order to describe adequately the material effects of complying with environmental regulations and in order to prevent the mandatory disclosures of capital expenditures from being misleading.[80]

In *In re Occidental Petroleum Corp.*,[81] the SEC explained that adequate disclosure of the effects of environmental regulation upon a company's financial condition includes not only the cost of bringing facilities into compliance, but also the cost of any remedial activity that may be required to compensate for past noncompliance. These costs include penalties that may be incurred as well as the cost of cleanup, plant shutdowns, and other costs to remedy past violations.[82]

b. *Items 103 and 303 of Regulation S-K: Disclosure of Legal Proceedings Relating to the Environment*

Item 103 of regulation S-K requires the registrant to disclose legal proceedings to which it is subject, "other than ordinary routine litigation incidental to the business."[83] Instructions to that rule provide that an administrative or judicial proceeding arising under any federal, state, or local environmental laws shall not be deemed "ordinary routine litigation incidental to the business" if (1) the proceeding is material to the financial condition of the registrant; (2) the proceeding involves claims for damages or penalties that exceed ten percent of the current assets of the registrant; or (3) a governmental entity is a party unless the registrant anticipates that the potential monetary sanctions, if any, will not exceed one hundred thousand dollars.[84]

Item 303 of Regulation S-K requires that among the financial information filed with the SEC in a registration statement must be a

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79 *Id.* at 82,383.

80 *Id.*

81 Exchange Act Release No. 34-16,950, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,622, at 83,346 (July 2, 1980)(reporting settlement of SEC charges of failure to disclose matters involving environmental protection and compliance).

82 *Id.* at 83,356.

83 17 C.F.R. § 229.103 (1990).

84 *Id.*

management's discussion and analysis of financial condition and results of operations.[85] This requires a discussion of liquidity, capital resources, results of operations, and material changes in financial condition.[86] The regulation pertaining to liquidity requires the registrant to discuss "known trends or any known demands, commitments, events, or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way."[87] The SEC has issued an interpretative release that discusses how this requirement applies to the designation of a registrant as a potentially responsible party (PRP) under the Comprehensive Environmental Response, Compensation, and Liability Act.[88] It advises that designation as a PRP does not in and of itself trigger a disclosure requirement; however, upon such designation, if "management is unable to determine that a material effect on future financial condition or results of operations is not reasonably likely to occur," disclosure is required.[89]

Under regulations 103 and 303 of S-K, therefore, a publicly held company has a greater obligation to report environmental litigation than any other type of litigation, since liabilities which are not material in traditional terms must be recognized in some cases, and in other cases liabilities must apparently be disclosed sooner than they might be required to be disclosed under generally accepted accounting principles.

c. *Impact on Environmental Auditing*

Because of these reporting requirements, managers must have in place reliable procedures that enable them to identify and highlight potentially reportable environmental developments. The company should be equipped to develop required estimates and supporting data when necessary. Thus, publicly held companies must maintain adequate internal controls to monitor environmental compliance and must be able to anticipate the future costs of such activities. For some companies, an ongoing environmental audit program may help to accomplish such objectives. In addition, financial auditors must be aware of the potential liability of a publicly held company in all pending environmental litigation and contemplated environmental litigation of which the company is aware. Unless management has reliable

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[85] *Id.* § 229.303.
[86] *Id.* § 229.303(a).
[87] *Id.* § 229.303(a)(1).
[88] 42 U.S.C. §§ 9601-9675 (1988).
[89] 54 Fed. Reg. 22,427, 22,430 (May 24, 1989).

information regarding environmental activities and problems, a company will run a substantial risk of violating SEC disclosure requirements.[90]

Although SEC disclosure requirements for environmental matters somewhat exceed those for other business developments in certain respects, it seems unlikely that they provide the same level of disclosure provided by a statute such as EPCRA within its sphere of application. First, the entity coverage of the securities laws is much narrower. Second, even where the entity coverage overlaps, SEC disclosure requirements in the environmental area generally depend either on government or private party intervention (for example, disclosure triggered by an environmental penalty claim against a company) or on a developed legal regime such as Superfund which gives rise to calculable liabilities.[91] EPCRA, on the other hand, provides for environmental disclosure with respect to both regulated and unregulated activities where future liability is completely inchoate, incalculable, or even potentially nonexistent. In the specific area of its coverage, therefore, it appears to require significantly broader disclosure than the SEC requirements.

D. *Pending Legislative and Sentencing Commission Proposals*

During the 101st Congress, a subcommittee of the House Judiciary Committee held hearings on H.R. 3641, the Environmental Crimes Act of 1989,[92] which proposed a substantial broadening of environmental criminal liability and sharp increases in criminal sanctions for certain types of environmental offenses. The bill also contained a provision providing for mandatory auditing of persons convicted of "knowing endangerment" in federal environmental criminal offenses.[93] The mandatory audit provision would have provided for independent audits conducted by an auditor whose recommendations would have been required to be implemented by court order unless the court found clear and convincing evidence that certain conditions were met.

In testimony presented to the Judiciary Committee, the Depart-

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[90] Violators of the Securities Act of 1933 and the Securities Exchange Act of 1934 are subject to civil actions for damages pursuant to 15 U.S.C. § 77k and 15 U.S.C. § 78r, respectively. Individuals who willfully violate these statutes are subject to criminal sanctions of up to $10,000 in fines or five years imprisonment or both. 15 U.S.C. §§ 77x, 78ff (1988).

[91] This is because generally disclosure is not required unless the claim would have a "material effect" on company operations. *But see* Item 303 of Reg. S-K, 17 C.F.R. § 229 (1990).

[92] Hearing before the Subcom. on Criminal Justice to Consider H.R. 3641, 101st Cong., 1st Sess. (1989).

[93] H.R. 3641, *supra* note 10, at § 734.

ment of Justice endorsed the concept of formalizing the authority that courts already have to require a defendant to conduct an environmental audit upon conviction. The Justice Department pointed out, however, that it had difficulties with specific provisions of the bill as introduced. In particular, the Department criticized the lack of discretion available to the sentencing court on several major issues and the lack of EPA involvement in the audit process. The Department also expressed the view that the provision as written was quite possibly unconstitutional as a limitation on the power of an article III court.

Somewhat analogous issues are presented by some of the proposed provisions of the Organizational Sentencing Guidelines under consideration by the United States Sentencing Commission. The United States supports the concept that the courts should have clear authority on conviction of an environmental crime to require properly structured audits which will improve the regulatory and enforcement process, but great care needs to be taken as to how this requirement is effectuated.

At this writing, it is not clear what form future legislative or Sentencing Commission proposals will take, but the developments reviewed in this article suggest it is reasonable to expect that the issue will return in the near future.

CONCLUSION

This article has shown that environmental enforcement policy can significantly influence the decision to conduct environmental audits. As presently structured, federal environmental enforcement policy provides limited incentives for such audits. In view of the increased emphasis on criminal enforcement, and the consideration now being given to related voluntary disclosure issues, these incentives may increase significantly. At the same time, Congress has expressed substantial interest in broadening the use of environmental audits by adopting EPCRA and considering legislation such as H.R. 3641. It is likely that both Congress and the Sentencing Commission will give further consideration to such requirements in the near future. A change in the intersection of environmental audits with environmental law and enforcement policy is underway.