

Too Small to Fail: A New Perspective on Environmental Penalties for Small Businesses

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INTRODUCTION

In order for the US Environmental Protection Agency (EPA) to go about its business of regulating pollution, it needs a hammer to bring down on violators of environmental laws and regulations. The most important hammer it has is civil penalties, and the EPA has discretion over penalty amounts. Still, the environmental statutes that delegate enforcement authority to the EPA enumerate a number of factors that the EPA must consider in assessing civil penalties. These factors allude to the purposes of civil penalty authority: removing the economic benefits of pollution, approximating the environmental damage caused by pollution, and accounting for the polluter's unique circumstances.¹

The subject of this Comment is a more mysterious penalty factor: ability to pay. Almost all the major environmental statutes mandate that the EPA consider the violator's ability to pay when calculating penalties. The EPA implements this policy using financial models to predict polluters' profitability, which it then compares to penalty amounts, often leading to substantial penalty discounts. Other governmental actors—primarily judges—use their gut (rather than their computer) to assess penalties. Professor Colin Diver, one of the first scholars to describe ability to pay, was skeptical of the provision. He stated, “[T]he concept of ‘ability to pay’ is pregnant with a degree of ambiguity that invites arbitrary and capricious application. A set of administrative penalty standards that fails to resolve that ambiguity thus leaves a dangerous gap.”²

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¹ See, for example, Clean Air Act, 42 USC § 7413(e).

² Colin S. Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies*, 79 Colum L Rev 1435, 1469 (1979).

With its *Policy on Civil Penalties*,³ the EPA attempted to avoid leaving such a dangerous gap, but in the process it created a new problem. As currently interpreted, ability to pay erroneously mitigates otherwise-appropriate penalty amounts for certain types of businesses. These polluters enjoy discounts based on their limited ability to pay. Their richer competitors do not receive these discounts, resulting in an economic advantage that favors pollution. This advantage is significant: ability to pay has become the second-most-invoked defense to penalties in EPA enforcement actions.⁴ Despite its shortcomings, however, ability to pay pervades the US environmental regulatory regime.

This Comment argues that governmental actors incorrectly interpret and apply ability to pay. Part I provides a statutory and administrative background on ability to pay and shows that, while ability to pay's statutory landscape suggests a diversity of approaches, the EPA takes a uniform approach. Part I concludes by arguing that a uniformity model is superior. Part II discusses interpretations of ability to pay adopted by various governmental actors. It begins by describing penalty negotiations with the EPA and the agency's streamlining of ability to pay using its specialized computer program called ABEL. It then describes administrative litigation and concludes with federal court interpretations of ability to pay. Part III argues that the government's interpretation of ability to pay creates undesirable environmental and regulatory outcomes. These undesirable outcomes stem from a "penalty perspective" of ability to pay, which wrongly focuses on the polluter's future profitability without considering whether the polluter could have complied with environmental regulations in the first place. Part IV considers an alternative to the penalty perspective, arguing that the "compliance perspective" is superior because it disallows penalty mitigation for polluters that were financially capable of complying when they committed a violation. The compliance perspective examines whether the polluter could have afforded the cost of compliance with environmental regulations and mitigates penalties for only those businesses that could not afford to comply. Part

³ See generally US Environmental Protection Agency, *Policy on Civil Penalties* (Feb 16, 1984), online at <http://www2.epa.gov/sites/production/files/documents/epapolicy-civilpenalties021684.pdf> (visited Nov 3, 2014).

⁴ Ronald H. Rosenberg, *Doing More or Doing Less for the Environment: Shedding Light on EPA's Stealth Method of Environmental Enforcement*, 35 BC Env'r Aff L Rev 175, 212 (2008).

IV also argues that Congress should authorize the EPA to require environmental-penalty insurance in order to better effectuate the compliance perspective. Such a requirement protects polluters that are too poor to comply—those polluters that Congress intended ability to pay to protect—and closes loopholes for polluters that are able to comply.

I. THE STATUTORY AND REGULATORY BACKGROUND OF ABILITY TO PAY

Ability to pay's statutory language and regulatory implementation reveal a dichotomy. To highlight the dichotomy, this Part is organized in two sections. Section A reviews the statutory landscape, in which ability to pay exhibits variety; Congress enacted ability to pay using varying language at varying points in time. Section B reveals that the EPA's implementation of these varied provisions has become uniform. The EPA has distilled ability to pay into a unified doctrine through its promulgation of a single penalty framework. Section B also demonstrates that, despite the variety that characterized ability to pay's initial codification, Congress eventually adopted the uniformity model. This Part concludes that this adoption was wise.

A. Diverse Statutory Authority

This Section traces ability to pay's evolution over time. It begins with the provision's first appearance and follows its expansion into the entire federal environmental regulatory regime. This Section identifies how ability to pay's growth created numerous textual variations in the United States Code and highlights an interpretive dilemma that arises from that variety.

At its inception, ability to pay's precise purpose was unclear, and discussion of the penalty factor was sparse. Ability to pay first appeared in a statute designed to assign liability for environmental disasters: the Water Quality Improvement Act of 1970.⁵ It was passed one year after that generation's Deepwater Horizon: the Santa Barbara oil spill.⁶ Congress acted to ensure

⁵ Pub L No 91-224, 84 Stat 91. The Water Quality Improvement Act superseded the Oil Pollution Act of 1924, Pub L No 68-238, 43 Stat 604, and amended the Federal Water Pollution Control Act of 1948, Pub L No 80-845, 62 Stat 1155, codified as amended at 33 USC §§ 1251–1376. Neither of these statutes included ability to pay.

⁶ See Nicholas J. Healy and Gordon W. Paulsen, *Marine Oil Pollution and the Water Quality Improvement Act of 1970*, 1 J Marit L & Comm 537, 558 (1970) (explaining

that, should such a disaster happen again, taxpayers would not foot the cleanup bill. Congress's solution required oil shippers to demonstrate "financial responsibility" by purchasing insurance or proving self-insurance.⁷ During the political wrangling that ensued, the primary battles were waged over the choice of a strict liability or negligence standard and over statutory liability caps.⁸ Unsurprisingly, the insurance industry played an important role in the selection of the bill's final language.⁹ Meanwhile, committee reports hardly mention ability to pay.

The political environment surrounding the passage of the Water Quality Improvement Act informs ability to pay's original purpose. Industries beyond oil shipping faced threatening new financial-responsibility requirements and responded by seeking exemptions. These industries included fishing and tourism,¹⁰ resulting in a final bill that exempted ships under three hundred tons from the financial-responsibility requirement.¹¹ Thus, interest group politics played a role in carving out exemptions for industries comprised of businesses that were not "small businesses" but that operated boats that were physically smaller. At the same time, interest group politics aligned with limitations

that hearings on the Water Quality Improvement Act were conducted in 1969 as the Santa Barbara oil spill was still ongoing).

⁷ Water Quality Improvement Act § 11(p), 84 Stat at 97 ("Any vessel over three hundred gross tons . . . shall establish and maintain under regulations . . . evidence of financial responsibility.").

⁸ See Healy and Paulsen, 1 J Marit L & Comm at 553, 555–57 (cited in note 6).

⁹ See Water Quality Improvement Act § 11(p), 84 Stat at 97. See also Healy and Paulsen, 1 J Marit L & Comm at 556 (cited in note 6):

The House Committee invited representatives of the steamship, marine insurance, and petroleum industries, and of the Maritime Law Association of the United States (MLA) to assist in its efforts to draft workable oil pollution liability provisions. In response to this invitation, a special committee of the MLA was appointed to study the proposed legislation and present the views of the Association to Congress.

¹⁰ See *Bills to Amend the Oil Pollution Act, 1924, for the Purpose of Controlling Oil Pollution from Vessels, and for Other Purposes, Hearings before the Committee on Merchant Marine and Fisheries, House of Representatives, on HR 6495, HR 6609, HR 6794, and HR 7325*, 91st Cong, 1st Sess 391 (1969) ("Oil Pollution Hearings") (statement of J. Steele Culbertson, Director, National Fish Meal & Oil Association) ("We respectfully request that all of these fishing vessels be made exempt from the requirements of the bill, either as 'fishing vessels' or that the 300-gross ton exemption in section 5(a) be increased to 650 gross tons."); *Oil Pollution Hearings*, 91st Cong, 1st Sess at 459 (statement of Vincent A. Demo, Chairman, New York Committee, International Committee of Passenger Lines) ("[W]e must register our very deep concern over the proposal to impose an obligation to establish financial responsibility . . . by all operators of passenger vessels irrespective of their size.").

¹¹ Water Quality Improvement Act § 11(p), 84 Stat at 97.

on institutional capacity; Congress did not wish to limit the statute's focus to oil, and administrators did not want to regulate every ship on the sea. As pointed out in one hearing, Congress could have conditioned the financial-responsibility requirement on oil-carrying capacity rather than gross tons.¹² Presumably, Congress chose three hundred tons in order to balance regulatory inclusiveness and administrative feasibility.¹³

Thus, ability to pay struck a balance between two policy goals that were in tension with each other. Committee reports do not discuss ability to pay in depth, but the statute generally ensured that those responsible for high-liability events (oil spills) paid the cleanup costs. At the same time, Congress did not want onetime disasters to sink entire companies. Thus, while the financial-responsibility requirement prevented bankruptcy *ex ante*, ability to pay prevented bankruptcy *ex post*.

In the years that followed, Congress wrote ability to pay into numerous environmental statutes. By the time that Professor Diver wrote about civil penalties in 1979,¹⁴ Congress had included ability to pay in the Clean Water Act¹⁵ (CWA); the Clean Air Act¹⁶ (CAA); the Toxic Substances Control Act¹⁷ (TSCA); the Federal Insecticide, Fungicide, and Rodenticide Act¹⁸ (FIFRA); the Oil Pollution Act¹⁹ (OPA); the Comprehensive Environmental Response, Compensation, and Liability Act²⁰ (CERCLA); and fishery regulations.²¹ Ability to pay expanded even outside the environmental realm to areas such as horse protection, consumer product safety, and boating safety.²² Today, almost every major environmental statute lists ability to pay as a factor in assessing penalties for a wide variety of environmental violations. These statutes touch every part of daily life by regulating uses of

¹² See *Oil Pollution Hearings*, 91st Cong, 1st Sess at 10 (cited in note 10) (letter from Rear Admiral John Harlee, Chairman, Federal Maritime Commission).

¹³ See *id.* at 371 (statement of Rear Admiral John Harlee, Chairman, Federal Maritime Commission) (estimating that, with the 300-ton limit in place, the proposed legislation applied to approximately 13,200 vessels).

¹⁴ See generally Diver, 79 Colum L Rev 1435 (cited in note 2).

¹⁵ 33 USC § 1319(g)(3).

¹⁶ 42 USC § 7413(e)(1).

¹⁷ 15 USC § 2615(a)(2)(B).

¹⁸ 7 USC § 1361(a)(4).

¹⁹ 33 USC § 2716a(a).

²⁰ 42 USC § 9622(e)(3)(A).

²¹ 16 USC § 1858(a).

²² See 15 USC § 1825(b)(1) (addressing horse protection); 15 USC § 2069(b) (addressing consumer product safety); 46 USC § 2302 (addressing boating safety). See also Diver, 79 Colum L Rev at 1462 & n 163 (cited in note 2).

air, water, waste, chemicals, and energy, as well as a number of commercial transactions.

Ability to pay underwent a shift during this time, toward a new meaning as a small-business safeguard. During this expansion, Congress framed ability to pay as protecting businesses of all sizes from total annihilation by the EPA. The Clean Air Act Amendments of 1977²³ are a notable example of this change. When incorporating ability to pay into the CAA, the House Committee on Interstate and Foreign Commerce lamented what it considered to be a “regrettable choice”: either allow polluters to continue polluting, or shut down the offending source entirely.²⁴ The committee worried that this “all or nothing decision” undermined the credibility of its enforcement efforts.²⁵ Ability to pay provided regulators with a palatable middle ground.

Ability to pay’s evolving meaning and growing presence in the United States Code created textual variation among the environmental statutes. For better or worse, Congress failed to codify any two ability-to-pay provisions in precisely the same way. TSCA and the CAA exemplify this variation. TSCA civil penalty provision states, “[T]he Administrator shall take into account . . . with respect to the violator, ability to pay, [and] effect on ability to continue to do business.”²⁶ The CAA’s penalty-assessment criteria require the Administrator to “take into consideration (in addition to such other factors as justice may require) the size of the business, [and] the economic impact of the penalty on the business.”²⁷ The list of more minor variations continues: Some statutes—such as TSCA, the CWA, and CERCLA—explicitly reference “ability to pay.”²⁸ The CAA and

²³ Pub L No 95-95, 91 Stat 685.

²⁴ *Clean Air Act Amendments of 1977*, HR Rep No 95-294, 95th Cong, 1st Sess 72 (1977) (“Clean Air Act Amendments Report”), reprinted in 1977 USCCAN 1077, 1150. See also *Horse Protection Act Amendments of 1976*, HR Rep No 94-1174, 94th Cong, 2nd Sess 22 (1976), reprinted in 1976 USCCAN 1696, 1717:

The last sentence of new section 6(b)(1) would require the Secretary to take into account certain factors . . . including the effect of the penalty on the respondent’s ability to continue in business and the respondent’s ability to pay the penalty. . . . For example, if someone is unable to pay a penalty, and disqualification would put him out of business, the Secretary would not be precluded from taking such action . . . even though it may result in a violator being put out of business.

²⁵ *Clean Air Act Amendments Report* at 72, 78 (cited in note 24).

²⁶ 15 USC § 2615(a)(2)(B).

²⁷ 42 USC § 7413(e).

²⁸ 15 USC § 2615(a)(2)(B); 33 USC § 1319(g)(3); 42 USC § 9609(a)(3).

FIFRA reference the business's size.²⁹ The CAA, the SDWA, and the CWA each account for "economic impact" on the violator.³⁰ FIFRA and TSCA require the Administrator to consider the "effect on the person's ability to continue in business."³¹ As these examples demonstrate, many statutes employ a combination of these phrases.

Diversity in statutory text forces governmental actors to make an important interpretive choice. On the one hand, administrators and judges may interpret textual distinctions as a signal that Congress intended ability-to-pay provisions to have different meanings from one another. On the other hand, these statutes share a very similar history, subject matter, and even the same enforcement agency, suggesting that ability-to-pay provisions should be read similarly.

Indeed, the EPA reads these provisions similarly, reasoning:

[T]he distinctions between the two [ability to pay and effect on ability to continue to do business] are so narrow and artificial that they are treated as one. . . . Essentially, however, a firm can pay up to the point where it can no longer do business. . . . [Congress] did not intend that TSCA civil penalties present so great a burden as to pose the threat of destroying, *or even severely impairing*, a firm's business.³²

Before interrogating the EPA's ultimate choice, it is important to acknowledge the alternative: a diversity model. There are many reasons that statute-specific interpretations of ability to pay may be a superior paradigm.

Uniformity in interpretation runs the risk of textual overreach. After all, ability-to-pay provisions use different language. Particularly when juxtaposed in the same statute, ability to pay and ability to continue in business are temporally distinct. Ability to continue in business requires consideration of the violator's future competitive health. Ability to pay is present oriented, focusing on the moment of penalty assessment. Additionally, "size of the business" reflects the idea that penalties should vary depending on the subjective "pain" that they inflict on a

²⁹ 42 USC § 7413(e); 7 USC § 136l(a)(4).

³⁰ 42 USC § 7413(e); 42 USC § 300h-2(c)(4).

³¹ 7 USC § 136l(a)(4); 15 USC § 2615(a)(2)(B).

³² Environmental Protection Agency, Guidelines for the Assessment of Civil Penalties under Section 16 of the Toxic Substances Control Act; PCB Penalty Policy, 45 Fed Reg 59770, 59775 (1980) (emphasis added).

wrongdoer.³³ By engaging in statutory distillation, the EPA favors harmonization of environmental statutes over the plain meaning and structure of individual statutes. This does not mean that the EPA's position is textually irreconcilable with the statutes. Most statutes include the catchall phrase, "such other matters as justice may require,"³⁴ suggesting that these juxtaposed ability-to-pay factors should be read similarly. However, this phrase does not altogether eliminate the tension between plain meaning and the uniformity model.

Two policy arguments favor treating these provisions differently. First, diverse environmental problems require interpretive diversity. For example, regulations that require EPA-certified permits under the CAA involve bright-line rules.³⁵ If a permit requires a "Model X" gas tank and the actual product uses a "Model Y" gas tank, the violation is clear. This favors a less forgiving ability-to-pay policy because the violation was likely intentional. On the other hand, regulations that identify potentially responsible parties under CERCLA utilize flexible standards.³⁶ This may require a forgiving ability-to-pay policy because violations are likely accidental when the applicable legal standard is unclear.

The second policy argument for interpretive diversity is that environmental statutes regulate different types of risky events. OPA regulates low-risk, high-liability events: oil spills.³⁷ Ability to pay makes less sense in this context because it creates enormous moral hazard concerns for judgment-proof oil shippers. Meanwhile, ability to pay makes more sense in the CERCLA context, in which the EPA identifies many sites years after the initial pollution that require years of cleanup.³⁸ During that time, the site may change hands many times over. The moral hazard concern is smaller because businesses may have no idea

³³ Diver, 79 Colum L Rev at 1462, 1469 (cited in note 2).

³⁴ See, for example, 15 USC § 2615(a)(2)(B).

³⁵ See 42 USC § 7522(a) (requiring a certificate of conformity to import any new motor vehicle or motor vehicle engine).

³⁶ See US Environmental Protection Agency, *Finding Potentially Responsible Parties* (Mar 16, 2014), online at <http://www2.epa.gov/enforcement/finding-potentially-responsible-parties-prp> (visited Nov 3, 2014).

³⁷ See US Environmental Protection Agency, *Oil Pollution Act Overview* (Sept 8, 2014), online at <http://www.epa.gov/oem/content/lawsregs/opaover.htm> (visited Nov 3, 2014).

³⁸ See, for example, *K.C.1986 Limited Partnership v Reade Manufacturing*, 472 F3d 1009, 1013–15 (8th Cir 2007) (noting that the superfund site was not identified until seventy-five years after polluting operations started).

that they purchased a contaminated site. Ability to pay makes more sense because forcing these businesses into bankruptcy achieves no obvious policy goal.

B. The EPA Interprets and Distills the Environmental Statutes

This Section explores how the EPA departed from ability to pay's diverse statutory authority and adopted a uniform model. It also explains the EPA's interpretive methodology. Finally, it details Congress's eventual adoption of this methodology and argues that the EPA's uniform approach is superior.

Even within a single statute, regulators have wide discretion to impose penalty amounts. This discretion is apparent from most penalty provisions, which are essentially a laundry list of penalty factors:

In determining the amount of any penalty . . . the Administrator or the court, as appropriate, shall take into consideration (in addition to such other factors as justice may require) the size of the business, the economic impact of the penalty on the business, the violator's full compliance history and good faith efforts to comply, the duration of the violation as established by any credible evidence (including evidence other than the applicable test method), payment by the violator of penalties previously assessed for the same violation, the economic benefit of noncompliance, and the seriousness of the violation.³⁹

This provision illustrates two key takeaways. First, statutes do not provide guidance as to what penalty factors are most important. The result is that the EPA may consider and prioritize almost any factor that it deems relevant. Second, environmental statutes list numerous factors⁴⁰ but set no standards for how to calculate dollar amounts. Most environmental penalties are capped at a relatively high figure of \$25,000 per violation.⁴¹ Between the limited guidance on the factors that the EPA may consider and almost no guidance on how to calculate penalty amounts, the EPA retains extremely broad penalty discretion. Until 1984, regulators embraced this discretion: they used their

³⁹ 42 USC § 7413(e)(1).

⁴⁰ See, for example, 42 USC § 7413(e); 15 USC § 2615(a)(2)(B).

⁴¹ See, for example, 42 USC § 7413(b); 15 USC § 2615(a)(1).

gut instincts to calculate penalties, a process that some refer to as the “gestalt approach” to environmental-penalty assessment.⁴²

In 1984, the EPA cabined this discretion and standardized its process for calculating civil penalties by promulgating its *Policy on Civil Penalties*, which was intended to achieve the ends of “deterrence, fair and equitable treatment of the regulated community, and swift resolution of environmental problems.”⁴³ The *Policy on Civil Penalties* is not specific to any environmental statute.⁴⁴ It does not cite any statutory authority and disclaims itself as a basis for calculating any specific penalty.⁴⁵ Thus, the *Policy on Civil Penalties* is an *interpretive rule* relating to penalty provisions.⁴⁶ This interpretive rule took effect through the EPA’s subsequent creation of statute-specific penalty policies. Therefore, the *Policy on Civil Penalties* does not make specific penalty determinations but instead forms the basis for developing statute-specific penalty policies. Having crystallized its interpretive method, the EPA is able to pursue uniformity within a sea of environmental statutes that vary in structure, text, and medium of pollution.

The *Policy on Civil Penalties* (and, accordingly, the statute-specific penalty policies derived from it) requires a three-step calculation to reach the final penalty amount. In the first step, the EPA assesses the economic benefit of noncompliance.⁴⁷ This restitutionary calculation removes any advantage or unjust enrichment that the violator may have gained by failing to comply with environmental regulations. The second calculation involves assessing the gravity of the violation.⁴⁸ This factor alludes to a compensatory role, as it considers the amount of pollutant, toxicity of pollutant, and likelihood of harm. The likelihood of harm roughly equates to the amount of damage inflicted on

⁴² See, for example, Jonathan D. Libber, *Penalty Assessment at the Environmental Protection Agency: A View from Inside*, 35 SD L Rev 189, 191 (1990).

⁴³ US EPA, *Policy on Civil Penalties* at *1 (cited in note 3).

⁴⁴ See *id.*

⁴⁵ See *id.* at *1–2.

⁴⁶ The *Policy on Civil Penalties* is not in the Code of Federal Regulations and was not promulgated through notice-and-comment procedures pursuant to 5 USC § 553(b)(3).

⁴⁷ See US Environmental Protection Agency, *A Framework for Statute-Specific Approaches to Penalty Assessments: Implementing EPA’s Policy on Civil Penalties* *2 (Feb 16, 1984), online at <http://www2.epa.gov/sites/production/files/documents/epapolicy-civilpenalties021684.pdf#page=10> (visited Nov 3, 2014).

⁴⁸ See *id.* at *3.

the environment and human health.⁴⁹ Because penalties aggregate economic benefit and gravity, the preliminary deterrence amount (the penalty before any mitigation) will always be larger than the cost of compliance.⁵⁰

The third step involves a series of adjustment factors. Adjustment factors are part of the gravity calculation,⁵¹ but each plays a specific role in the penalty process. They include changes to the penalty amount for varying levels of mens rea (willfulness and negligence), cooperation with the EPA (including discounts for self-reporting), repeat offender multipliers (history of non-compliance), ability to pay, and the strength of the evidence (litigation risk factors).⁵² Notably, ability to pay applies only as a *mitigating* penalty factor. While a plausible interpretation of ability to pay might involve *increasing* a penalty amount for a particularly wealthy violator, EPA guidance focuses solely on ability to pay as a discount.⁵³

Ability to pay acts as a powerful cap on the total amount of the penalty. The EPA will not assess penalties that are above ability to pay absent some aggravating factor such as uncooperativeness, a willful violation, or a history of noncompliance.⁵⁴ The SDWA's statute-specific penalty policy translates this three-step calculation into a formula:

$$\text{Penalty} = \text{economic benefit} + (\text{gravity} \times \text{degree of negligence/willfulness} \times \text{history of noncompliance}) - \text{litigation consideration} = \text{ability to pay.}^{55}$$

This calculation appears as a formula only in the SDWA penalty policy, but its underlying logic parallels the *Policy on Civil*

⁴⁹ See *id.* (explaining that gravity should include the amount of pollutant, toxicity of pollutant, sensitivity of the environment, length of time of a violation, and size of the violator).

⁵⁰ US Environmental Protection Agency, *New Public Water System Supervision Program Settlement Penalty Policy* *4 (May 25, 1994), online at <http://www2.epa.gov/sites/production/files/documents/sdwapen.pdf> (visited Nov 3, 2014) (“[T]he Agency should always seek a penalty that, at a minimum, recovers the economic benefit of noncompliance, plus some amount reflective of the gravity or seriousness of the violation.”).

⁵¹ US EPA, *Framework for Statute-Specific Approaches* at *3 (cited in note 47) (including the size of the violator in gravity).

⁵² *Id.* at *3–4.

⁵³ See Thomas L. Adams Jr., *Guidance on Determining a Violator's Ability to Pay a Civil Penalty* *2 (Dec 16, 1986), online at <http://www2.epa.gov/sites/production/files/documents/civilpenalty-violators.pdf> (visited Nov 3, 2014) (describing ability to pay only in terms of penalty reduction and not mentioning the possibility of penalty increases).

⁵⁴ See US EPA, *Policy on Civil Penalties* at *23 (cited in note 3).

⁵⁵ US EPA, *Settlement Penalty Policy* at *4 (cited in note 50).

Penalties (and therefore that of all the penalty policies). In the explanatory notes that follow, the *Policy on Civil Penalties* states, “[T]he Agency should always seek a penalty that, at a minimum, recovers the economic benefit of noncompliance, plus some amount reflective of the gravity or seriousness of the violation. Legitimate litigation considerations or ability-to-pay considerations, however, may preclude that goal in some specific instances.”⁵⁶

Two conclusions follow from this language: First, penalties exceed the cost of compliance, thereby disgorging the economic benefit of unlawful pollution. Second, when read together, the formula and its explanation indicate that final penalty amounts may only be less than or equal to the violator’s ability to pay.⁵⁷ Thus, a violator’s ability to pay places a ceiling on the violator’s penalties. Throughout this Comment, I refer to this form of liability cap as the “penalty perspective.” The EPA mitigates penalty amounts, intuitively, based on a comparison between the polluter’s ability to pay and the total penalty amount. This is unsurprising until one considers what this SDWA penalty formula omits: consideration of whether the polluter *could have* afforded to comply with environmental regulations in the first place.

The EPA’s departure from ability to pay’s diverse statutory authority is hardly a ploy to avoid problematic statutory text. If anything, Congress has refuted its own inexact and inconsistent codification of ability to pay and has blessed the EPA’s uniformity model in the context of CERCLA. In 2002, President George W. Bush signed into law the Small Business Liability Relief and Brownfields Revitalization Act⁵⁸ (“Small Business Relief Act”), which provides that the EPA “shall take into consideration the ability of the person to pay response costs and still maintain its basic business operations, including consideration of the overall

⁵⁶ Id. For a description of litigation considerations, see US Environmental Protection Agency, *Civil Penalty Policy for Section 311(b)(3) and Section 311(j) of the Clean Water Act* *17–19 (Aug 1998), online at <http://www2.epa.gov/sites/production/files/documents/311pen.pdf> (visited Nov 3, 2014) (describing litigation considerations as legal, evidentiary, or equitable considerations that make it likely that a judge would assess a penalty that is less than the preliminary deterrence amount).

⁵⁷ This formula is strikingly similar to Professors Kelly Lear and John Maxwell’s famous study of penalties and ability to pay. They argue that, when regulators seek to maximize penalties collected relative to resources used, “the optimal fine is either the maximum amount the firm can afford to pay or zero.” Kelly Kristen Lear and John W. Maxwell, *The Impact of Industry Structure and Penalty Policies on Incentives for Compliance and Regulatory Enforcement*, 14 J Reg Econ 127, 128 (1998). A fine of zero means that the industry should not be regulated. See *id.*

⁵⁸ Pub L No 107-118, 115 Stat 2356 (2002), codified at 42 USC §§ 9601–75.

financial condition of the person and demonstrable constraints on the ability of the person to raise revenues.”⁵⁹ This amendment indicates that the 107th Congress understood ability to pay as a way to keep small businesses running and to avoid negative economic and employment effects from overly burdensome liability.⁶⁰ While the EPA’s guidance following the amendments to CERCLA references ability to pay outside of de minimis violations,⁶¹ the bulk of the statute protects small businesses, as its name implies. The statute does not require companies to completely liquidate assets to meet penalty obligations, but it requires some liquidation to the extent that it does not constrain the business’s basic operations or ability to raise revenues. This understanding aligns with the EPA’s position. Finally, the statute frames ability to pay as a doctrine that protects small businesses from liability much greater than they can bear (keeping in mind the high statutory maximum of \$25,000 per violation for even the most minor offenses).⁶²

In the end, uniformity is the only administrable interpretation of ability to pay, particularly in light of the extremely broad penalty discretion that environmental statutes confer. Interpretive diversity simply invites regulators to dream up arbitrary penalty amounts. As noted above, there may be good policy reasons to interpret ability to pay more or less stringently. However, the minor textual distinctions between statutes do not achieve these ends. Rather, they appear to be random textual variations with no practical significance. By way of example, consider the textual distinctions between the penalty provisions of the CAA and the CWA. Both statutes reference “economic impact” on the violator.⁶³ However, the CAA also requires consideration of the business’s size, while the CWA requires consideration of the business’s ability to pay.⁶⁴ As mentioned above, however, an interpretive-diversity model might interpret the CAA as requiring that the EPA inflict financial pain proportional to the business’s size, while the CWA merely considers future solvency. If

⁵⁹ 42 USC § 9622(g)(7)(B).

⁶⁰ See Diver, 79 Colum L Rev at 1470 (cited in note 2).

⁶¹ See, for example, Susan E. Bromm, *Interim Guidance on the Ability to Pay and De Minimis Revisions to CERCLA § 122(g) by the Small Business Liability Relief and Brownfields Revitalization Act* *2 (May 17, 2004), online at <http://www2.epa.gov/sites/production/files/2013-09/documents/atp-demin-122g-04.pdf> (visited Nov 3, 2014).

⁶² See, for example, 42 USC § 7413(b); 15 USC § 2615(a)(1).

⁶³ 42 USC § 7413(e)(1); 33 USC § 1319(d).

⁶⁴ Compare 42 USC § 7413(e)(1), with 33 USC § 1319(g)(3).

the same business pollutes the air one day and the water the next, an interpretive-diversity model would require the EPA to calculate two separate figures for the business's ability to pay. Such a result is arbitrary because it reflects no qualitative judgment about the differences between air and water pollution. The EPA's *Policy on Civil Penalties* foreclosed this possibility and successfully ended gestalt penalty calculation, cabining regulators' broad discretion.

* * *

Many of ability to pay's characteristics favor interpretive diversity. The statutes' texts, subject matter, and policy goals vary on multiple dimensions. Additionally, ability to pay's legislative history and regulatory implementation reveal an evolving definition over time. At its origin, ability to pay did not necessarily protect the colloquial "small businesses"; it protected businesses of all sizes that posed small risk of catastrophe.⁶⁵ This definition changed in the 1970s, shifting toward protecting "small businesses" from devastating penalties.⁶⁶ Still, the legislative histories of all ability-to-pay statutes reference a generalized intent to avoid regulatory death in the presence of an effective environmental-penalty regime.

Hence, legislative history, statutory text, and EPA interpretations have converged toward an understanding of ability to pay as a means to prevent small-business death by penalties. However, as one among many factors that regulators must consider, ability to pay must not consume civil penalties entirely. With this realization in mind, one can align the diversity and uniformity models at a sufficiently high level of abstraction. From its creation, to the EPA's distillation, to the Small Business Relief Act, ability to pay reflects an attempt to balance two conflicting policy goals: protecting businesses from regulatory death while preserving the regulator's ability to penalize polluters. An effective ability-to-pay policy would balance *at least* these objectives. Having concluded that the EPA's uniformity model is good policy, this Comment turns next to substance, describing how governmental actors have applied ability to pay and considering whether regulators strike the proper balance between these two competing concerns.

⁶⁵ See text accompanying notes 10–14.

⁶⁶ See text accompanying notes 23–25.

II. ABILITY TO PAY: FROM THE EPA TO ARTICLE III

This Part addresses the substance of the EPA's ability-to-pay calculations. It also looks at other government agents who interpret ability-to-pay provisions. The EPA's uniformity model, despite its broad application, does not control every government agent. While the EPA's negotiations resolve most enforcement actions, administrative-law judges (ALJs) also decide cases. High-profile violations with large penalty amounts end up in federal courts as well. In order to highlight how the ability-to-pay analysis changes at various stages in litigation, this Part follows a hypothetical case through the process. It then demonstrates that all the major governmental actors adopt a penalty perspective when applying ability to pay.

A. Ability to Pay in EPA Negotiations

Imagine that the automobile company United Engines recently fell within the EPA's regulatory sights when independent testing revealed that the company's catalytic converters deviate from proposed design specifications. The EPA first issues a Notice of Violation, informing United Engines that the EPA believes that it has violated the CAA (this gives United Engines a clue as to the penalties that it may be facing). A Notice of Violation is not a final decision; it is an invitation to negotiate.⁶⁷ Because both the EPA and United Engines would prefer to settle the issue and move on, the EPA calculates its initial penalty assessment according to the applicable statute-specific penalty policy—in this case, the CAA Mobile Source Civil Penalty Policy⁶⁸—at a hypothetical amount of \$200,000.

At this stage, the EPA has not considered ability to pay because the EPA presumes ability to pay until it “is put at issue by a respondent.”⁶⁹ Should United Engines bring up its ability to pay, the EPA will require it to submit numerous financial documents, including income tax returns, internal financial documents, balance sheets and income statements, loan applications,

⁶⁷ See US Environmental Protection Agency, *What Is a Notice of Violation (NOV)?* (Mar 19, 2012), online at <http://compliance.supportportal.com/link/portal/23002/23009/Article/32970/What-is-a-Notice-of-Violation-NOV> (visited Nov 3, 2014).

⁶⁸ See generally US Environmental Protection Agency, *Mobile Source Civil Penalty Policy: Title II of the Clean Air Act Vehicle and Engine Certification Requirements* (Jan 2009), online at http://www2.epa.gov/sites/production/files/documents/vehicleengine-penalty-policy_0.pdf#page=2 (visited Nov 3, 2014).

⁶⁹ *In re New Waterbury, Ltd.*, 5 Envir Admin Dec 529, 541 (Envir App Bd 1994).

and bank records.⁷⁰ Consideration of an ability-to-pay discount is conditional upon receipt of these documents,⁷¹ and “[a] violator who raises the issue has the burden of providing information to demonstrate extreme financial hardship.”⁷² United Engines may balk at this intrusive request and abandon its ability-to-pay claim.

If United Engines returns the required documents, the EPA must translate the words “ability to pay” into a dollar amount. This is particularly important because many of the EPA’s enforcement actions never reach litigation.⁷³ Without a judge to decide the penalty amount, EPA attorneys need some mechanism to calculate fair and equitable penalties consistently. Penalty calculation requires the EPA to calculate the full penalty amount by summing its calculations of economic benefit and gravity.⁷⁴ If United Engines puts ability to pay at issue, the EPA must calculate how much money United Engines actually has. This calculation is not as simple as it seems. First, there are many ways to measure ability to pay. At one extreme, the EPA could calculate United Engines’ ability to pay up to its present liquidation value. At the other extreme, the EPA could require that United Engines pay only whatever cash it currently has on hand (its cash balance). There are numerous options between these extremes, including assessing United Engines’ capacity to raise debt, the total value of its short-term assets, or United Engines’ net profits. Instead, the EPA takes an approach that is popular among financial analysts: estimating future cash flows (the change in cash balance over a specified period).⁷⁵ This is no easy task: it is difficult to know how much cash a violator may have, let alone how much cash it will continue to make. Indeed, if the EPA could accurately predict future cash flows, it would be the envy of the financial world.

In recognition of the fact that EPA staff attorneys are not expert financial analysts, the EPA created a computer program

⁷⁰ Adams, *Determining a Violator’s Ability to Pay* at *3 (cited in note 53).

⁷¹ See *New Waterbury*, 5 *Envir Admin Dec* at 542.

⁷² Adams, *Determining a Violator’s Ability to Pay* at *3 (cited in note 53).

⁷³ See US Government Accountability Office, *Superfund: Litigation Has Decreased and EPA Needs Better Information on Site Cleanup and Cost Issues to Estimate Future Program Funding Requirements* *23 (July 2009), online at <http://www.gao.gov/assets/300/292299.pdf> (visited Nov 3, 2014).

⁷⁴ See Part I.

⁷⁵ Adams, *Determining a Violator’s Ability to Pay* at *4 (cited in note 53).

called ABEL to aid regulators in calculating ability to pay.⁷⁶ After a few hours of training with the ABEL interface, EPA staff attorneys can input United Engines' financial information into the ABEL program.⁷⁷ ABEL automatically does what many Finance 101 students learn to do: it calculates free cash flow.⁷⁸ From this, ABEL creates a statement of net present value cash flows.⁷⁹ By analogy, if corporations are cash-making machines, the statement of cash flows defines the machine's cash *outputs*; it measures how much cash a given cash-making machine makes per year after paying taxes, salaries, and all other cash expenses.

The EPA uses ABEL to calculate the likelihood that a polluter will meet its penalty obligations. This is relevant to both the firm's long-term survival and its ability to service penalties levied on a payment plan.⁸⁰ ABEL generates a probabilistic projection of various levels of cash flow, including a graph that illustrates the specific likelihoods of each level of future cash wealth.⁸¹ If the odds that cash flow will exceed the penalty amount are 70 percent or higher, then ability-to-pay discounts are deemed inappropriate.⁸² If the firm is less than 70 percent likely to meet its penalty obligations through cash flow, ability-to-pay reductions *may* be appropriate.⁸³

ABEL is not perfect. Just because ABEL reports inability to pay does not mean that the EPA automatically reduces the penalty. For example, United Engines may be small and closely held. In this situation, the company has strong tax incentives to report zero net income on its annual filings. Rather than paying out profits as dividends or keeping them as retained earnings, the owners may instead opt to pay themselves bonuses that they

⁷⁶ See US Environmental Protection Agency, *Evaluating Claims of Inability to Pay from Corporations and Partnerships* *2 (July 11, 2011), online at http://cfpub.epa.gov/crem/knowledge_base/crem_report.cfm?deid=74996&view=PDF (visited Nov 3, 2014).

⁷⁷ US Environmental Protection Agency, *ABEL User's Manual* 3-1 (2002).

⁷⁸ That is, the program adds or subtracts various types of expenditures that do not represent cash transactions during the relevant period (typically one year). Depreciation, amortization, and changes in long-term debt amounts are added back into net income, while capital expenditures and changes in working capital are subtracted from net income (obtained from the company's balance sheet). *Id.* at 4-3.

⁷⁹ See *id.* at 3-13, 4-1.

⁸⁰ See *id.* at 3-12.

⁸¹ See US EPA, *ABEL User's Manual* at 4-1, 4-10 (cited in note 77).

⁸² See *id.* at 4-11.

⁸³ See *id.*

declare salary expenditures.⁸⁴ In this way, United Engines avoids double taxation through an accounting practice that is both legal and in its interest. ABEL does not account for this situation, but its creators were aware of ABEL's limitations. The ABEL manual lays out a number of similar scenarios that create artificially low net income, including extravagant officer compensation, high dividend payouts, and expenditures on assets that do not relate to the business's core operations.⁸⁵ Also, violators can raise debt or reach out to parent entities for the necessary funds.⁸⁶ For these reasons, a "negative or inconclusive" finding from ABEL is followed up by "additional analysis."⁸⁷ This required follow-up illustrates the difficulties inherent in company valuation. A "negative or inconclusive" finding is so unguided that it undermines the purpose of the *Policy on Civil Penalties*, which is to cabin regulatory discretion.

Reducing the penalty amount is a last resort that the EPA will not permit unless the polluter has exhausted its ability to raise capital. The EPA may first request that United Engines liquidate nonessential assets, raise additional debt, sell equity to raise cash, or acquire funds from parent or subsidiary companies.⁸⁸ But this raises another concern. While the EPA is cognizant of ABEL's shortcomings, it offers no standard for assessing which of United Engines' assets are nonessential, how much compensation is extravagant, or how much additional debt is appropriate. This issue recurs in any ability-to-pay regime that assesses the polluter's finances—inexact valuation methods force the EPA to make sensitive business decisions on a polluter's behalf. Like the "inconclusive" finding mentioned above, mandatory capital-raising procedures undermine the *Policy on Civil Penalties'* limitations on regulatory discretion.

B. Ability to Pay in Administrative Court

If negotiations do not resolve the EPA's enforcement action, either United Engines or the EPA may bring a claim in

⁸⁴ See id at 4-12.

⁸⁵ See US EPA, *ABEL User's Manual* at 4-12 (cited in note 77).

⁸⁶ See id at 4-13.

⁸⁷ Id at 4-12.

⁸⁸ See id at 4-12 to -13; US Environmental Protection Agency, *Revisions to the 1990 RCRA Civil Penalty Policy* *40 (June 23, 2003), online at <http://www2.epa.gov/sites/production/files/documents/repp2003-fnl.pdf> (visited Nov 3, 2014) (stating that staff attorneys should "consider straight penalty reductions as a last recourse," and only after installment plans or delayed payment).

administrative court. United Engines may pursue this option if it is unhappy with its ability-to-pay assessment. After all, it released a great deal of internal information to the EPA and has nothing to show for it. Under the Administrative Procedure Act⁸⁹ (APA), United Engines has the right to a hearing before an ALJ.⁹⁰ ALJs apply the EPA's published rules, and their decisions are subject to review by the Environmental Appeals Board (EAB).⁹¹

Administrative courts assessing ability to pay follow the burden-shifting procedure outlined in *In re New Waterbury, Ltd*⁹² which, in its normal operation, affords EPA penalty calculations a presumption of reasonableness when the EPA follows the *Policy on Civil Penalties*.⁹³ Although the standard for invoking ability to pay is the same as in negotiations—ability to pay must be “put at issue” by the respondent⁹⁴—the burden is on the EPA to establish that its proposed penalty is reasonable.⁹⁵ The EPA need not *prove* each statutory penalty factor but instead must only present some evidence to show that it considered each factor.⁹⁶ A showing that the EPA performed an ABEL analysis should satisfy this low standard, which, along with similar showings for the remaining statutory factors, establishes a *prima facie* showing of reasonableness.⁹⁷

New Waterbury's procedure prevents an ALJ from second-guessing ABEL unless United Engines puts the calculation at issue. Since the statute-specific penalty policies direct EPA staff attorneys to consider these factors, an ALJ will presume that United Engines is able to pay. To rebut this presumption, United Engines must show, through the introduction of new evidence, one of two possibilities: first, “that the penalty is not appropriate because the [EPA] . . . failed to consider all of the statutory factors,”

⁸⁹ 5 USC §§ 551–59.

⁹⁰ See 5 USC §§ 554(c), 556(c).

⁹¹ 5 USC § 557. See also Richard R. Wagner, *Administrative Decisionmaking by Judges in the United States' Environmental Protection Agency Administrator's Civil Penalty Assessment Process: Whatever Happened to the Law?*, 32 Wm & Mary Envir L & Pol Rev 57, 59 (2007).

⁹² 5 Envir Admin Dec 529 (Envir App Bd 1994).

⁹³ See id at 539.

⁹⁴ Id at 540.

⁹⁵ 5 USC § 556(d) (“[T]he proponent of a rule or order has the burden of proof.”).

⁹⁶ *New Waterbury*, 5 Envir Admin Dec at 538.

⁹⁷ Although *New Waterbury* was decided before the EPA instituted ABEL, the court's analysis suggests that ABEL would satisfy the requirements of the burden-shifting framework. See id at 543.

or second, “that despite consideration of all of the factors the recommended penalty calculation is not supported and thus is not ‘appropriate.’”⁹⁸ If United Engines “fails to produce any evidence to support an inability to pay claim,” then any ability-to-pay claim is waived.⁹⁹ If the ALJ accepts United Engines’ additional evidence, however, the burden of persuasion regarding ability to pay rests on the EPA.¹⁰⁰ Apparently, ABEL alone does not persuade ALJs, because the *ABEL User’s Manual* advises attorneys to hire financial experts when litigating ability to pay in administrative court.¹⁰¹ Thus, despite the fact that the EPA rarely introduces ABEL analyses in administrative court, ABEL establishes a portion of the EPA’s prima facie case of reasonableness and sets the EPA’s proposed penalty amount. Put another way, ABEL occupies an odd administrative niche in which its quantitative output substantially impacts penalty amounts yet also evades review.

The ALJ must make his or her own finding as to an appropriate penalty, which may differ from the EPA’s penalty calculation.¹⁰² In doing so, however, the ALJ must consider the applicable penalty policy of the EPA Administrator.¹⁰³ In addition, ALJ penalty determinations that differ significantly from the Administrator’s penalty policy receive heightened scrutiny from the EAB.¹⁰⁴ Nonetheless, because of these provisions, ALJs have discretion to impose penalties that are not only different from the EPA’s proposed amount but that are also in tension with the Administrator’s official penalty policies.

⁹⁸ Id at 538–39. Under EPA rules governing the answer to the complaint, 40 CFR § 22.15(d), a respondent must raise ability to pay and offer supporting evidence in its complaint. Otherwise, it waives the claim. The standard of review is also unclear. However, the EAB’s quoted language parallels arbitrary-and-capricious review of agency action in the administrative law context; it implies both procedural and substantive elements. See *Motor Vehicle Manufacturer’s Association v State Farm Mutual*, 463 US 29, 41–42 (1983), citing *Citizens to Preserve Overton Park v Volpe*, 401 US 402, 414 (1971). At the same time, however, ALJs must consider the EPA’s penalty policies. See Wagner, 32 Wm & Mary Envir L & Pol Rev at 59 (cited in note 91).

⁹⁹ *New Waterbury*, 5 Envir Admin Dec at 542.

¹⁰⁰ See id.

¹⁰¹ US EPA, *ABEL User’s Manual* at 1-2 (cited in note 77).

¹⁰² 40 CFR § 22.27(b) (providing that, when determining “a penalty different in amount from the penalty proposed by complainant,” the ALJ “shall set forth in the initial decision the specific reasons for the increase or decrease”).

¹⁰³ 40 CFR § 22.27(b). See also Wagner, 32 Wm & Mary Envir L & Pol Rev at 59 (cited in note 91); 5 USC § 706.

¹⁰⁴ *New Waterbury*, 5 Envir Admin Dec at 546.

C. Ability to Pay in Federal Courts

Ability to pay appears at the federal level only under limited circumstances, including appeals from administrative decisions, interventions by the DOJ, and ability-to-pay settlements. United Engines may turn to federal court only after it exhausts its administrative remedies, which include appeals to the EAB.¹⁰⁵ Federal courts reverse the EPA if they believe that its decision was arbitrary and capricious or not supported by substantial evidence.¹⁰⁶ Because of these deferential standards of review, United Engines' case is likely doomed at the outset.

Although rare, some cases avoid deferential standards of review when the DOJ exercises jurisdiction. These cases avoid administrative courts entirely. In cases in which the penalty exceeds \$200,000, the DOJ must authorize the EPA to bring an enforcement action.¹⁰⁷ DOJ cases rarely include ability-to-pay claims because the DOJ likely prefers to litigate high-stakes and high-profile issues in federal court. Thus, no procedural rule estops litigants from raising ability-to-pay claims in federal court, but the DOJ's prosecutorial preferences filter out many violators with legitimate ability-to-pay claims.

Federal courts adopt no uniform ability-to-pay standard analogous to the EPA's use of ABEL, so ability to pay often becomes a battle of the experts. In *United States v Gulf Park Water Co.*,¹⁰⁸ both the government and the defendant hired independent financial experts to analyze ability to pay.¹⁰⁹ While each expert used his own methodology, the standard that the court applied was whether the violator met "the burden of showing that the impact of a penalty would be ruinous or otherwise disabling."¹¹⁰ Similarly, in *Chesapeake Bay Foundation v Gwaltney of Smithfield*,¹¹¹ the court rejected a claim of inability to pay because the violator did not show that the proposed penalties

¹⁰⁵ 40 CFR § 22.27(d).

¹⁰⁶ 5 USC § 702; 5 USC § 706(2)(A); *Diehl v Franklin*, 826 F Supp 874, 880–82 (D NJ 1993).

¹⁰⁷ 42 USC § 7524(c)(1) ("[T]he maximum amount of penalty sought against each violator in a penalty assessment proceeding shall not exceed \$200,000, unless the Administrator and the Attorney General jointly determine that a matter involving a larger penalty amount is appropriate for administrative penalty assessment.").

¹⁰⁸ 14 F Supp 2d 854 (SD Miss 1998).

¹⁰⁹ *Id* at 866.

¹¹⁰ *Id* at 868.

¹¹¹ 611 F Supp 1542 (ED Va 1985)

“would jeopardize [the defendant’s] continued operation.”¹¹² Yet another court made its ability-to-pay determination without articulating a standard.¹¹³ Despite these disparate lines of reasoning, one factor is common to all three decisions: they adopt the penalty perspective.¹¹⁴ In other words, they make ability-to-pay determinations based on whether the polluter can currently afford the total penalty amount.

Ability to pay also arises in CERCLA settlement cases. Congress passed CERCLA to properly allocate civil liability for environmental damages.¹¹⁵ CERCLA settlements often involve the filing of a consent decree for a stipulated liability amount. In the process of developing these settlements, both the DOJ and the EPA figure ability to pay into the final settlement amount.¹¹⁶ When the violators are small businesses, the DOJ and the EPA often enter into an “ability-to-pay decree.”¹¹⁷ Here, the court’s only role is to ensure that the settlement was reasonable, fair, and consistent with CERCLA’s goals.¹¹⁸ Under this standard, the court will review ability-to-pay decisions only to ensure that the government made reasonable efforts to collect and analyze financial data.¹¹⁹ ABEL finds its way to federal court with ability-to-pay settlements. Parallel to EPA penalty negotiations, policies on CERCLA’s ability-to-pay provision specifically reference

¹¹² Id at 1562.

¹¹³ See *United States v M. Genzale Plating*, 807 F Supp 937, 939–40 (EDNY 1992) (determining that the defendant could pay after simply comparing the amount of the benefit to the violator’s assets, loans to shareholders, and salaries).

¹¹⁴ See *Gulf Water Park*, 14 F Supp 2d at 868; *Gwaltney*, 611 F Supp at 1562; *M. Genzale Plating*, 807 F Supp at 940.

¹¹⁵ See US Environmental Protection Agency, *CERCLA Overview* (Dec 12, 2011), online at <http://www.epa.gov/superfund/policy/cercla.htm> (visited Nov 3, 2014) (“CERCLA . . . provided for liability of persons responsible for releases of hazardous waste.”).

¹¹⁶ Bromm, *Interim Guidance on the Ability to Pay* at *5 (cited in note 61).

¹¹⁷ Id at *3.

¹¹⁸ *United States v Cannons Engineering*, 899 F2d 79, 85 (1st Cir 1990), citing *Superfund Amendments of 1985*, HR Rep No 99-253, 99th Cong, 1st Sess 19 (1985), reprinted in 1986 USCCAN 3038, 3042.

¹¹⁹ See *United States v Montrose Chemical Corp of California*, 50 F3d 741, 746 (9th Cir 1995); *United States v Bay Area Battery*, 895 F Supp 1524, 1529 (ND Fla 1995). Often, the only inquiry that courts will perform is whether an expert analyzed the violator’s financials. See, for example, *United States v Hecla Ltd*, 2011 WL 3962227, *3 (D Idaho) (“[I]n this case, the ability to pay settlement has been evaluated by many experts and found to be reasonable based upon the financials of Hecla, its future operating plans and the volatility of the mineral markets.”).

ABEL as a helpful tool for screening and prioritizing ability-to-pay claims.¹²⁰

The circumstances under which governmental actors litigate ability to pay in federal courts are narrow. The result is twofold: First, federal courts lack a unified ability-to-pay doctrine analogous to the EPA's reliance on the *Policy on Civil Penalties* and ABEL. Instead, courts' standards vary based on the case's procedural posture—whether it is an appeal from administrative court, a DOJ intervention, or an ability-to-pay settlement. Second, federal court opinions barely engage with ability to pay's meaning beyond mere fact-finding relating to expert analysts' testimony. Thus, very little judicial analysis of the ability-to-pay provision's meaning exists.

D. The Penalty Perspective

All the major interpreters—the EPA, ALJs, and federal courts—adopt a penalty perspective of ability to pay in that they base penalty amounts on present and future solvency. This stands in contrast to a compliance perspective, which considers the company's finances at the time that the company chose to unlawfully pollute. In the contexts of EPA negotiations and administrative litigation, ABEL guides ability-to-pay outcomes. While these calculations address penalty negotiations, they also carry through to administrative litigation because the EPA uses the relevant statutory penalty policy (which includes ABEL) when calculating its proposed penalty amount.¹²¹ ALJs presume this calculation to be correct absent additional evidence presented by the violator.¹²² ABEL takes the penalty perspective; it uses past financial information to predict future cash flows and then compares the predicted cash flows to penalty amounts.

Federal courts may diverge in their methods of reviewing ability to pay, but they uniformly analyze ability to pay by comparing

¹²⁰ US Environmental Protection Agency, *General Policy on Superfund Ability to Pay Determinations* *6–7 (Sept 30, 1997), online at <http://www2.epa.gov/sites/production/files/2013-09/documents/genpol-atp-rpt.pdf> (visited Nov 3, 2014). ABEL plays a more limited role in ability-to-pay settlements than in other enforcement actions. The ability-to-pay guidance states that computer models “lack the capability to evaluate the quality of the financial information and to consider all aspects of a [potentially responsible party's] financial condition.” Id at *7.

¹²¹ See US EPA, *Policy on Civil Penalties* at *1 (cited in note 3) (“The Agency will make every effort to urge administrative law judges to impose policies consistent with this policy and any medium-specific implementing guidance.”).

¹²² See text accompanying notes 93–95.

present or future solvency to penalty amounts. In the battle-of-the-experts scenario, the court simply chooses between competing expert opinions of current and future ability to pay.¹²³ Under the “ruinous effect” standard, the court must look at the polluter’s future competitive viability.¹²⁴ This interpretation is not without merit. Some statutes specifically contemplate future business viability.¹²⁵ One of the two cases that adopts the ruinous-effect standard does stem from a statute that includes such language.¹²⁶ Thus, it is clear that judges are not adopting a diversity model that is attentive to minute variations in statutory text. Finally, under the method adopted in *United States v M. Genzale Plating, Inc.*,¹²⁷ the court determines ability to pay based on the polluter’s financial position at the time of litigation.¹²⁸ None of these techniques asks whether the polluter could have complied at the time of violation. They look into past financial performance only to the extent that it is predictive of future ability to pay penalties.

The penalty perspective is an intuitive interpretation of ability to pay. As Professor Diver notes, ability to pay appears to refer to the polluter’s practical ability to pay the penalty.¹²⁹ If Congress intended to protect all businesses from regulatory death, penalty-oriented interpretations of ability to pay are effective. Not every business is worthy of protection, however—many businesses can afford to comply with environmental regulations.

III. ABILITY TO PAY’S SHORTCOMINGS

This Part compares Part I’s conclusions about ability to pay’s purpose with ability to pay’s real-world operation, as described in Part II. Recall ability to pay’s purpose: it prevents small-business death from penalties but does not consume civil penalties entirely. In practice, the EPA, ALJs, and federal judges calculate ability to pay from a penalty perspective; they compare a company’s future profitability to the penalties that it must pay.

There are four major shortcomings of the current interpretations of ability to pay, all of which stem from the status quo’s

¹²³ See, for example, *Gulf Park Water Co*, 14 F Supp 2d at 868.

¹²⁴ *Chesapeake Bay Foundation*, 611 F Supp at 1562.

¹²⁵ See Part I.A.1.

¹²⁶ See *Gulf Park Water Co*, 14 F Supp 2d at 868.

¹²⁷ 807 F Supp 937 (EDNY 1992).

¹²⁸ See *id.* at 939–40.

¹²⁹ Diver, 79 Colum L Rev at 1470 (cited in note 2).

reliance on the penalty perspective. First and foremost, the current interpretation does not sufficiently balance Congress's goals of protecting businesses from regulatory death while preserving the penalty regime's effectiveness. Instead, it inappropriately undermines the penalty regime by giving ability-to-pay discounts to polluters that are financially capable of complying with environmental regulations. Second, the penalty perspective exacerbates inexact valuation methods that are inherent to any ability-to-pay regime. Third, the penalty perspective creates a moral hazard. Finally, the penalty perspective requires the EPA to make sensitive business decisions that are beyond its institutional competence. Section A begins by illustrating the penalty perspective's fundamental flaw—its failure to balance Congress's goals—in terms of three classes of violators. While only one of these violators has a meritorious ability-to-pay claim, the EPA discounts penalties for two classes of violators. Section B describes the three additional failures of the penalty perspective.

A. Three Types of Polluters

Polluters fall into three categories, only one of which has a meritorious ability-to-pay claim. A CAA-penalty-policy hypothetical helps define these three categories: The EPA's emission standards in effect require some manufacturers of gasoline engines to install catalytic converters,¹³⁰ which are devices that use precious metals to remove pollutants from engine emissions. A manufacturer that violates these emission requirements by installing phony catalytic converters that lack rare earth materials can save about \$80 per engine. Applying the EPA's CAA *Mobile Source Civil Penalty Policy*, however, the gravity calculation alone would result in a fine of \$2,725 per engine.¹³¹ The penalty policy adds this amount to the economic benefit, which is *at least* \$80—the avoided cost of a catalytic converter. The paragraphs that follow apply three different levels of ability to pay to these underlying calculations.

¹³⁰ US Environmental Protection Agency, Control of Air Pollution From New Motor Vehicles: Tier 2 Motor Vehicle Emissions Standards and Gasoline Sulfur Control Requirements, 65 Fed Reg 6698, 6704 (2000) (implementing more-stringent emissions standards that are achievable through installation of catalytic converters). See also US Environmental Protection Agency, *What You Should Know about Using, Installing, or Buying Aftermarket Catalytic Converters* *7 (Sept 2000), online at <http://www.epa.gov/otaq/cert/factshts/catcvrts.pdf> (visited Nov 3, 2014) (noting that it is against the law to use an incorrect catalytic converter).

¹³¹ US EPA, *Mobile Source Civil Penalty Policy* at *11–23 (cited in note 68).

The meritorious ability-to-pay claimant is a “poor polluter.” Poor polluters’ claims are meritorious because these firms are the class of businesses that Congress intended to protect with ability to pay. Poor polluters lack the resources to comply with burdensome environmental regulations but wish to remain in business. In this hypothetical, the poor polluter’s ability to pay is less than \$80—say \$50. Under these circumstances, the polluter will never choose to comply with environmental regulations, because doing so would result in bankruptcy.

From an efficiency perspective, some might argue that the EPA *should* bankrupt these poor polluters because they cannot produce value greater than their environmental costs—costs that penalty amounts approximate. Congress has rejected this argument with ability to pay, opting instead to avoid destroying small businesses and creating secondary unemployment. That is, if ability to pay is to mean anything at all, it must mitigate penalties for businesses that truly cannot afford environmental compliance. At the same time, it is difficult to imagine a real-world case of the perpetually poor polluter—a business so unprofitable that it is repeatedly excused from penalties on a theory of ability to pay.¹³² That is because this continually poor polluter is likely a fiction.

Ability to pay is better justified by a more realistic version of the poor polluter: the small *new entrant* to a market. Burdensome regulations are widely regarded as anticompetitive because they impose numerous barriers to entry and require higher pollution standards for new technology than for existing technology.¹³³ Regulatory exclusions and reduced enforcement actions for small businesses may be an incentive to new-firm entry.¹³⁴ New entrants fail to comply not only because they are undercapitalized, but also because they do not understand complex environmental regulations and are often subject to higher environmental standards than are their incumbent competitors.¹³⁵ Therefore, reducing barriers to entry through provisions like

¹³² This is especially true given that the EPA is intolerant of repeat violations. See generally US EPA, *Framework for Statute-Specific Approaches to Penalty Assessment* (cited in note 47).

¹³³ See, for example, Thomas J. Dean and Robert L. Brown, *Pollution Regulation as a Barrier to New Firm Entry: Initial Evidence and Implications for Future Research*, 38 *Acad Mgmt J* 288, 288–93 (1995).

¹³⁴ *Id.* at 293.

¹³⁵ See *id.* at 292 (explaining that many environmental regulations place a heavier burden on new sources of pollution than existing ones).

ability to pay provides two benefits: it fosters competitive markets and gives new entrants a fair shot at market entry. For these reasons, poor polluters are worthy of protection.

The second type is the “poor-on-paper polluter.” The poor-on-paper polluter does not have a meritorious ability-to-pay claim. It is financially capable of *complying* with environmental regulations but cannot afford a large civil *penalty*.¹³⁶ The polluter is poor on paper because financial analysis reveals that future cash flows do not meet future penalty obligations. In this situation, ability to pay could be \$500, well below the penalty amount of \$2,805, yet well above the \$80 cost of compliance. The EPA currently mitigates penalties for these polluters under its penalty-perspective version of ability to pay. However, poor-on-paper polluters do not fall into the class of businesses that Congress sought to protect because they are financially capable of complying. For these polluters, an ability-to-pay determination is erroneous. Predicting that it will nonetheless receive an ability-to-pay determination, the rational poor-on-paper polluter will continue to pollute if future cash flows do not appear to meet penalty obligations.

The final polluter is the “rich polluter,” or one that is wealthy enough to comply *or* pay civil penalties. The rich polluter does not have a meritorious ability-to-pay claim. Perhaps its ability to pay is \$500,000. The rational rich polluter will choose the least expensive option between penalties and compliance. When civil penalties exceed economic benefit—as they do in all the EPA’s civil penalty policies, which disgorge economic benefit and impose an additional sanction for gravity¹³⁷—the rational actor will choose to comply.

To summarize, the current ability-to-pay doctrine misses poor-on-paper polluters that actually could afford compliance, but it generates reasonable outcomes for poor and rich polluters. This occurs because all the governmental interpretations calculate ability to pay by comparing the polluter’s current and future financial position to pay penalty amounts, rather than its *ex ante* ability to comply.

¹³⁶ See US EPA, *Mobile Source Civil Penalty Policy* at *27 (cited in note 68) (explaining that the EPA tries to avoid requesting penalties that are clearly beyond the means of the violator, but noting that the EPA also avoids giving discounts when doing so might encourage companies to try to gain a competitive advantage through noncompliance).

¹³⁷ See text accompanying note 50.

B. Additional Failures

Penalty-oriented calculations generate erroneous mitigations for three additional reasons: First, although company valuation is necessary to any ability-to-pay regime, accurate and efficient valuation is exceedingly difficult. Second, the penalty perspective creates avoidable moral hazard. Finally, the penalty perspective requires the EPA to make sensitive business decisions that are beyond its institutional competence.

Company valuation is difficult because financial data from the past are often not reliable bases for predicting future finances. One example is the small, closely held violator (or, similarly, a small subsidiary of a larger parent company) that is financially capable of compliance but cannot afford a penalty for noncompliance. These violators are undercapitalized and will rarely keep cash on hand, making them appear perpetually unable to pay.¹³⁸ A savvy polluter may even structure its business to appear unprofitable in the shadow of ability to pay.¹³⁹ This problem intensifies in parent-subsidiary relationships, in which a parent company sets up a smaller and intentionally unprofitable subsidiary that violates environmental regulations. The subsidiary protects the parent from liability for environmental violations through ability-to-pay defenses. For ABEL, this is the problem of bad data in, bad data out. When the EPA inputs this business's information into ABEL, it will get an output that indicates insolvency. In reality, however, the owners of the company may be enriching themselves, directing funds to another entity, growing their business through the unfair competitive advantage of environmental noncompliance, or all of the above. Corporate veil piercing is available under CERCLA and in Article III courts, but not in penalty negotiations because it requires a judgment.¹⁴⁰ This, in addition to a high evidentiary burden

¹³⁸ See text accompanying notes 86–87. See also James Parker and Claire Y. Nash, *Compensation Planning: Concerns Differ for C and S Corporations*, 10 *Bus Entities* 34, 38 (2008) (“Shareholder/employees of closely held C corporations have generally controlled the corporate income that is subject to double taxation by paying themselves bonuses, commissions, or salaries sufficient to reduce their corporation’s taxable income to some targeted amount.”).

¹³⁹ See, for example, *In re 1836 Realty Corporation*, 1998 WL 846758, *3 (EPA) (explaining that the owner of several closely held companies engaged in a complex series of real estate conveyances that made the defendant company appear to have less money available to pay an EPA penalty than was truly at its disposal).

¹⁴⁰ See Gregory P. O'Hara, *Minimizing Exposure to Environmental Liabilities for Corporate Officers, Directors, Shareholders and Successors*, 6 *Santa Clara Computer & High Tech L J* 1, 4–5 (1990).

concerning the closeness of the relationship between parent and subsidiary, makes veil piercing an ineffective check on complex corporate structures.

While one might argue that criminal penalties deter intentional pollution, criminal penalties do not deter the accounting tricks mentioned above.¹⁴¹ These complex corporate structures are legal. Others may argue that polluters avoid penalties by simply evading detection entirely. This is not a problem of ability to pay; it is a problem of adjusting penalty amounts and criminal sanctions to reflect detection rates.¹⁴²

Perhaps most importantly, money hiding need not occur intentionally. Polluters that are unaware of their violations will not save money for future penalties. Many small firms are neither sophisticated nor wealthy enough to hire an environmental-compliance officer. Environmental laws can be too opaque or complicated for laypeople to understand. Meanwhile, a small business that unknowingly accumulates penalties is likely re-investing the economic benefits of noncompliance back into the company's polluting activities. The penalties then become analogous to a balloon payment mortgage, in which the pollution's cost (in terms of penalty amount) does not fully amortize over the term of pollution, thus leaving the full cost of pollution due when the EPA levels penalties.

Finally, problems arise with businesses that have unpredictable cash flows from year to year. Unpredictable cash flow undermines the assumption that past cash flows are predictive of future ability to pay. This criticism applies to all ability-to-pay regimes because some form of company valuation is inherent in calculating ability to pay. However, unpredictable cash flows acutely impact ABEL's mechanical approach. Because valuation is so difficult, an effective ability-to-pay regime should minimize reliance on ex post valuation techniques and instead promote ex ante opportunities to internalize pollution costs.

The penalty perspective also creates moral hazard. If ability to pay is an absolute cap on penalty amounts as implied by the

¹⁴¹ See, for example, 42 USC § 7413(c)(1). Criminal liability for false statements made on CAA documents deters polluters from cooking their books by criminalizing misinformation in documents that they submit to the EPA. 42 USC § 7413(c)(1).

¹⁴² See 42 USC § 7413(c)(1) (requiring a mens rea of "knowingly"). See also Mark A. Cohen, *Optimal Enforcement Strategy to Prevent Oil Spills: An Application of a Principal-Agent Model with Moral Hazard*, 30 J L & Econ 23, 29 (1987) (stating that penalty functions include the probability of detection).

Policy on Civil Penalties and the SDWA penalty policy's formula,¹⁴³ then firms whose ability to pay is less than the penalty amount face no increased liability for increased pollution. In effect, they are judgment proof.¹⁴⁴ In this situation, the incentive is to continue to pollute and reap the economic benefit of noncompliance. Poor polluters also face this type of moral hazard, which generates a fair criticism of ability-to-pay discounts for *any* polluter. It is less controversial, however, to assert that, given ability to pay's existence in the United States Code, interpretations of ability to pay should *at least* reduce moral hazard for poor-on-paper polluters, which do not deserve discounts in any state of the world.

The final problem is that the penalty perspective requires regulators and courts to make sensitive business decisions about how much a firm must cut back in order to pay a civil penalty. Penalties will necessarily hinder a polluter's continued growth because money paid to the US Treasury is money unavailable for capital investments. Penalties also hinder a firm's ability to raise debt.¹⁴⁵ Under the current regime, a business's true ability to pay the penalty is somewhere between zero and the full penalty amount. At the very least, the EPA expects the polluter to forfeit future cash flows toward penalties. But the EPA may still require a business seeking ability-to-pay discounts to sell non-essential assets or raise additional funds by taking on debt, selling equity, cutting salaries, limiting benefits, or withholding dividends.¹⁴⁶ The EPA and courts do not possess the institutional expertise to make sensitive business decisions that firms would otherwise make in a competitive market. Ability-to-pay penalty policies should instead pursue opportunities to force businesses to internalize the cost of compliance *ex ante*, forcing the *polluter* to make sensitive business decisions involving trade-offs between salaries, dividends, assets, and investments.

¹⁴³ See US EPA, *Policy on Civil Penalties* at *23 (cited in note 3). See also text accompanying note 55.

¹⁴⁴ See S. Shavell, *The Judgment Proof Problem*, 6 Intl Rev L & Econ 45, 45–46 (1986).

¹⁴⁵ See *Gulf Park Water Co*, 14 F Supp at 866 (“[T]he borrowing power of the defendants, while once substantial, is now virtually non-existent.”).

¹⁴⁶ See text accompanying notes 85–86.

* * *

Sections A and B illustrated two problems associated with the penalty perspective. Section A showed that the penalty perspective is a fundamentally unsound interpretation of ability to pay. The penalty perspective's protection is overinclusive to the point that it undermines civil penalties' deterrent effects, thus striking an inappropriate balance between protecting small businesses while preserving the regulatory regime's integrity. Simply put, the penalty perspective gives a pass to polluters that could have complied with environmental regulations. It is true that poor polluters receive a pass as well. However, applying ability to pay to poor polluters invigorates markets and curbs the unfairness inherent in many technology-forcing regulations. Applying these same discounts to poor-on-paper polluters does not further these goals. Section B added to the list of administrative headaches that stem from the penalty perspective. These headaches vary in kind but are avoidable through a new perspective on ability to pay. First, an effective ability-to-pay regime should protect poor polluters and penalize poor-on-paper polluters. Second, an ability-to-pay regime should be administratively feasible and minimize bureaucrats' roles in running the day-to-day operations of the regulated community.

IV. PROMOTE COMPLIANCE, PENALIZE POLLUTION

Ability to pay should avoid giving erroneous penalty reductions to poor-on-paper polluters and rich polluters but should continue to protect poor polluters. This Part will demonstrate that ability to pay should be calculated based on the polluter's ability to pay *at the time of the violation in relation to the cost of compliance*. This compliance perspective would reduce the incidence of false negatives in granting ability-to-pay mitigations. At the same time, it presents little risk of false positives and economic disjuncture due to bankruptcy.

There are two ways to operationalize the compliance perspective. The first is a mere interpretive switch whereby the EPA and courts reinterpret ability to pay as requiring an assessment of the polluter's financial ability to comply with environmental regulations at the time of violation, as opposed to an assessment of the ability to pay penalties once the violation has occurred. The second is a mandatory-insurance requirement of

the type enacted in the Water Quality Improvement Act.¹⁴⁷ Recall that this Act—which first established ability to pay—required vessels over three hundred tons to either purchase liability insurance or provide proof of self-insurance.¹⁴⁸ Insurance applies the compliance perspective because it similarly forces polluters to internalize the costs of their unlawful pollution through insurance premiums. This Part will argue that a mandatory-insurance requirement, in addition to the interpretive switch, is the preferable solution.¹⁴⁹

A. The Compliance Perspective

If the penalty perspective interprets ability to pay by comparing the penalty amount to the business's future ability to pay, then the compliance perspective interprets ability to pay by comparing the violator's ability to pay at the time of violation to the cost of compliance. That is, while the current approach to ability to pay considers a company's ability to pay *the penalty*, the compliance approach considers the company's ability to pay *the cost of environmental compliance ex ante*—the company's financial ability to avert an environmental violation in the first instance.

The catalytic converter example illuminates this distinction. Under the penalty perspective, an engine manufacturer faces a \$2,805 penalty for failing to install an \$80 catalytic converter. For simplicity's sake, assume that the EPA investigates violations and levies fines immediately when the violation occurs. Under the penalty perspective, if the firm generates cash flows of \$500 when it sells an engine, it would pay only a \$500 penalty, making it a poor-on-paper polluter because it could have afforded the \$80 cost of compliance. If one relaxes the assumption that the polluter pays penalties at the time of violation, the penalty perspective would require payment of only however much money the polluter *kept* until the EPA arrived and levied penalties. In other words, the polluter would pay only the amount of

¹⁴⁷ Water Quality Improvement Act § 11(p), 84 Stat at 97.

¹⁴⁸ See text accompanying notes 10–13.

¹⁴⁹ This solution draws on an established law-and-economics literature comparing methods of deterring risky behavior. This literature describes how deterrence arises from ex post tort liability, ex ante regulation through penalties, and markets for risk. Particularly in the context of ex post tort liability, private and social insurance can manage judgment-proof injurers. See Steven Shavell, *Economic Analysis of Accident Law* 240–42 (Harvard 1987).

money that it has on paper. By the time the EPA is involved, the polluter may have paid out dividends, reinvested in the company, or directed its profits to a corporate parent. A rational polluter might do these things intentionally to obtain ability-to-pay protection, while the unsophisticated polluter might do this unaware of the large penalties that loom.¹⁵⁰

The compliance perspective, on the other hand, disallows penalty mitigation in this situation. It completely ignores the fact that, because of the violation, the polluter made only \$500 (which is less than the \$2,805 penalty amount). In fact, the compliance perspective ignores the possibility that, by the time the EPA shows up, the polluter may have \$0. The compliance perspective asks only how much money the polluter had when it chose to violate the law. If the polluter had enough money to comply with environmental regulations at that time, it would face the full penalty amount.

This occurs without any adjustment to the underlying calculations of penalty amount. The only change is that the EPA calculates the polluter's ability to pay compliance costs using information on the polluter's profitability at the time of violation. In the foregoing example, the EPA assesses the full penalty amount of \$2,805 because the \$500 ability to pay at the time of the violation exceeded the \$80 cost of compliance. If the business had saved this unjust enrichment, the EPA would take the money. If not, then the business would go into bankruptcy. At first glance, the compliance perspective fails to achieve one purpose of ability to pay because it permits the regulatory death of some businesses. Nevertheless, the compliance perspective is still desirable because the EPA's assessment of the full penalty amount would change the polluter's behavior *ex ante*, minimizing the bankruptcies that occur. Moreover, the polluter that could have afforded to comply in the first place should answer for the environmental harm that it has caused.

Part III explained that the penalty perspective creates four problems: First and foremost is that it creates false negatives. Second, the penalty perspective requires the EPA to engage in complex predictive valuations. Third, it generates moral hazard. Fourth, it offers no guidance as to the appropriate amount of mitigation. Reinterpreting ability to pay under the compliance perspective resolves many, but not all, of these problems.

¹⁵⁰ See text accompanying notes 135–39.

Calculating ability to pay based on the cost of compliance would reduce the incidence of false negatives because it would change the poor-on-paper polluter's behavior. Knowing that the full penalty amount would apply without ability-to-pay mitigations, the poor-on-paper polluter would foresee the possibility of bankruptcy. This would force the rational poor-on-paper polluter to choose between compliance and bankruptcy. In this situation, compliance is the clear winner.

More subtly, the compliance perspective creates a distinction between two types of poor-on-paper polluters: those that appear too poor to pay a penalty and those that appear too poor to pay the cheaper costs of compliance. The distinction is merely one of degree. The latter polluter has simply managed to cook its books more extensively. However, neither polluter has a meritorious ability-to-pay claim because both can afford to comply. But while the compliance perspective fully captures the former, the current regime captures neither. As to the latter poor-on-paper polluter, the compliance perspective offers a more modest improvement. Very-poor-on-paper polluters may still benefit from erroneous ability-to-pay mitigations, but such a determination requires that the polluter hide a great deal more money than the status quo requires.

The compliance perspective would not be superior if, in exchange for the reduction in false negatives, it failed to protect poor polluters. Recall that poor polluters may invigorate markets with new competition, and that environmental regulations may unfairly favor established businesses. Fortunately, the compliance perspective does not affect the behavior of a poor polluter at the time of the violation because the poor polluter's ability to pay at that time is below the cost of compliance. The poor polluter does not care what bankrupts it. It goes without saying that a \$2,805 penalty would bankrupt a company whose ability to pay is only \$50. Alternatively, however, compliance costs of \$80 are greater than the company's \$50 ability to pay, also forcing the business under. Regardless of whether it attempts to comply or pay the penalty, the poor polluter would fold. Only in this instance would ability to pay take effect as an absolute cap on the penalty amount. The EPA levels a mitigated penalty of \$50 per engine based on inability to pay the cost of compliance. Thus, the compliance perspective continues to protect poor polluters.

The delay between violation and enforcement raises a potential problem. A poor polluter will probably grow in a marketplace

in which it gets a free lunch on penalties. While some might consider this growth to be unfair, such growth is more likely just a sign that ability to pay is working—reducing barriers to entry and giving new entrants a fair shot at market entry. Additionally, the compliance perspective is not static. As the company grows in profitability, so too will its ability to pay. Thus, the greater the market penetration that the new entrant achieves, the greater a portion of the full penalty amount that it will have to pay.

The compliance perspective also fails if it creates false negatives by granting ability-to-pay mitigations to rich polluters. Again, the compliance perspective does not affect the rich polluter's behavior *ex ante*. This polluter's ability to pay is above both the cost of compliance (\$80 per engine) and the penalty amount (\$2,805 per engine). Because its ability to pay is greater than the cost of compliance, the EPA would reject the ability-to-pay claim under either approach. The rational rich polluter merely chooses the least expensive option, which is compliance. In a regime in which penalties increase proportionally to the amount of pollution, incremental deterrence eliminates moral hazard.¹⁵¹

One can contemplate a "rich-on-paper" polluter as well. This polluter—for which the compliance perspective requires imposition of the full penalty amount—appears wealthy at the time of violation but cannot afford costly penalties in the present. Though the rich-on-paper polluter's situation is regrettable, rich-on-paper polluters are not businesses that ability to pay should protect. Not only are rich-on-paper polluters neither small businesses nor new entrants, but they also had the money to comply at the time of the violation. Even in the event that the rich-on-paper polluter's violation occurs during its economic slump, it is not a compelling defense that the rich-on-paper polluter's solution to its economic woes was to violate environmental regulations.

The compliance perspective is also superior because it does not require the government to predict future profitability. The regulator need know only the company's finances at the time of the violation and the cost of compliance. No predictive calculations are necessary. Certainly, similar problems of company

¹⁵¹ See Cohen, 30 *J L & Econ* at 43 (cited in note 142) (arguing that pollution controls should equate marginal costs with marginal benefits).

valuation remain because the EPA must judge whether the polluter is profitable enough to afford the cost of compliance. Fortunately, the compliance perspective mitigates the fuzziness of valuation by removing the need to predict the future. The benefit here is obvious: predictive valuations typically exhibit greater variance than purely descriptive valuations.

The compliance perspective also mitigates the problem of moral hazard for poor-on-paper polluters by introducing the punishment of bankruptcy. Under the penalty perspective, the violator's penalties are capped at its ability to pay on paper, but the business continues in operation. Thus, the poor-on-paper polluter benefits from a competitive advantage, yet it is never fully accountable for the violation once caught.¹⁵² The new cap on penalties under a compliance perspective would force poor-on-paper polluters to internalize the opportunity cost of future revenues lost in bankruptcy, resulting in incremental deterrence.

Similarly, the compliance perspective does not exacerbate moral hazard for poor polluters; it merely maintains the status quo. Because the EPA caps penalties at \$500 in the example above, increased pollution on the poor polluter's part would not result in greater penalties. This is the case under current law, the only distinction being that the EPA caps ability to pay under the penalty perspective at the violator's future profitability.¹⁵³ Thus, the penalty's size under the penalty perspective does not correlate to pollution, but rather to the polluter's intentional or accidental financial situation. Thus, moral hazard may be an argument against ability to pay *in general*, but it is not an argument against the compliance perspective *in particular*.

This interpretive method is not perfect, however. It still leaves regulators and courts with the task of making intrusive business decisions about whether the polluter could have truly afforded to comply at the time of violation. It also does little to protect the unsophisticated polluter, which may not be aware or capable of understanding complex environmental regulations. In fact, the unsophisticated polluter is at an acute risk of regulatory death regardless of whether it is poor or merely poor on paper. Fortunately, an interpretive switch need not act alone in effectuating a compliance-oriented–ability-to-pay regime. This

¹⁵² See Shavell, 6 *Intl Rev L & Econ* at 45–46 (cited in note 144).

¹⁵³ See text accompanying notes 143–45.

Comment proposes the use of mandatory insurance to complement a compliance-perspective approach to environmental penalties.

B. Mandatory Insurance

The best answer is to return to the Water Quality Improvement Act's mandatory-insurance requirement. It requires that a regulated entity either purchase liability insurance or prove that it can bear the full cost of an environmental disaster.¹⁵⁴ Regulation by insurance is widely discussed in law-and-economics literature.¹⁵⁵ This Section provides a brief description of existing mandatory-insurance requirements. It then argues that insurance both implements and improves on the interpretive switch to a compliance perspective for several reasons: First, differentiated insurance premiums implement the compliance perspective's elimination of false negatives by pricing risky behavior ex ante, operating similarly to a Pigouvian tax.¹⁵⁶ Second, a mandatory-insurance requirement protects unsophisticated businesses from regulatory death, and it does not require the government to make sensitive business decisions that are best left to competitive markets. Finally, environmental-insurance markets are not only viable and competitive, but they also outperform government regulation in many instances.¹⁵⁷

Mandatory-insurance regimes already exist in many forms and share some basic similarities. First, regulators promulgate rules detailing the regulated facilities and the amount and type of financial instrument that qualifies as insurance.¹⁵⁸ They also include an enforcement mechanism for failure to obtain insurance and allow wealthy, stable companies to insure themselves.¹⁵⁹ A detailed proposal for the optimal insurance regime is

¹⁵⁴ Water Quality Improvement Act § 11(p), 84 Stat at 97.

¹⁵⁵ For a discussion of "surrogate regulation" performed by insurers—that is, the use of private insurers to effect public policy goals—see Kenneth S. Abraham, *Distributing Risk: Insurance, Legal Theory, and Public Policy* 57 (Yale 1986).

¹⁵⁶ See Omri Ben-Shahar and Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 Mich L Rev 197, 206–07 (2012).

¹⁵⁷ See *id.* at 203–05 (arguing that superior information and competition cause insurance to outperform government regulation by pricing risk and inducing efficient behavior).

¹⁵⁸ James Boyd, *Financial Assurance Rules and Natural Resource Damage Liability: A Working Marriage?* *19 (Resources for the Future Discussion Paper 01-11, Mar 2001), online at <http://www.rff.org/rff/Documents/RFF-DP-01-11.pdf> (visited Nov 3, 2014).

¹⁵⁹ James Boyd, *Financial Responsibility for Environmental Obligations: Are Bonding and Assurance Rules Fulfilling Their Promise?* *13, 20–21 (Resources for the Future Discussion Paper 01-42, Aug 2001), online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=286914 (visited Nov 3, 2014).

beyond the scope of this Comment. However, since insurance regimes currently vary greatly depending on the medium of pollution and the nature of the financial obligation insured (uncertain or defined), the EPA is well positioned to create and administer mandatory-insurance regimes.¹⁶⁰ One can imagine a structure similar to that of ability to pay: the EPA promulgates a unified, abstracted document analogous to the *Policy on Civil Penalties*, followed by statute-specific insurance requirements. Such a regime would map well onto the existing regulatory framework.

Because poor polluters in this regime cannot afford insurance,¹⁶¹ the EPA must protect them in some way to preserve ability to pay's statutory mandate. After all, a mandatory-insurance regime that applied equally to every polluter would contradict ability to pay's purpose of protecting small businesses from overly burdensome regulation. It would bankrupt polluters that were too poor to purchase insurance—polluters that Congress intended to protect with ability to pay. It also would be an anticompetitive barrier to entry. To combat these effects, the EPA can either exempt poor polluters from the insurance requirement, or it can simply require the poor polluter to purchase affordable, subsidized insurance. The choice between these two is a policy decision based on the availability of resources and administrative feasibility.¹⁶²

In contrast to the poor polluter, the poor-on-paper polluter should not be eligible for an ability-to-pay insurance exemption or subsidized insurance. It cannot show that its ability to pay is less than the cost of compliance.¹⁶³ Mandatory insurance's role for poor-on-paper polluters, then, is to prevent the polluter from cooking its books and expending the economic benefits of non-compliance in the interim between a violation and EPA enforcement. If violators have insurance, they cannot claim inability to pay because the violators are not paying—the insurance companies are. At the same time, insurance companies are not

¹⁶⁰ See *id.* at *13–17, 19 (noting that many environmental regulations already involve some form of insurance rule).

¹⁶¹ Shavell, *Economic Analysis of Accident Law* at 240 (cited in note 149) (detailing a scenario in which an injurer is “worse off with any positive amount of coverage than with none at all”).

¹⁶² The latter is an approach that many states have already taken. See US Environmental Protection Agency, *Guidance for Regional Office Review of State Underground Storage Tank Financial Assurance Funds *2* (Jan 2012), online at <http://www.epa.gov/oust/states/state-fund-soundness-guidance1-26-2012.pdf> (visited Nov 3, 2014).

¹⁶³ See text accompanying notes 150.

foolish. They will monitor their clients' behavior and include contractual provisions requiring them to take cost-benefit-justified precautions.¹⁶⁴ Because penalties greatly exceed the economic benefits of noncompliance,¹⁶⁵ the most obvious cost-benefit-justified precaution is to comply with environmental regulations. To determine whether a polluter is poor or merely poor on paper (for the purposes of a compliance-oriented–ability-to-pay exemption), the EPA will still need to value the company's ability to pay the cost of compliance *ex ante*. This raises the penalty perspective's line-drawing issues between business expenditures that are essential and those that should be sacrificed to pay penalties (or compliance costs, for that matter). Perhaps this is why many existing insurance regimes have pursued subsidized insurance rather than small-business exemptions.¹⁶⁶ Insurance mitigates these valuation concerns because it subjects the cost effectiveness of pollution controls to competitive forces in the insurance market.

Mandatory insurance reduces false negatives by using differential premiums to price pollution. The compliance perspective requires poor-on-paper polluters to anticipate, *ex ante*, the EPA's imposition of the full penalty. An insurance regime operates the same way but converts predictions of *ex post* liability to *ex ante* insurance premiums.¹⁶⁷ Polluters internalize the costs of their pollution in both regimes, but the mandatory-insurance regime achieves this effect without requiring polluters to predict the possibility of bankruptcy ahead of time (which a mere interpretive switch requires polluters to do). Instead, insurers dictate the cost of pollution from the top down.

A mandatory-insurance requirement protects unsophisticated poor-on-paper polluters by providing them with actuarial information (through premium prices), regulatory expertise, and legal services. Insurers price risky activities by collecting information about polluters' behaviors. Applicants fill out detailed insurance applications and insurers perform site surveys.¹⁶⁸ Insurers communicate compliance expertise not only through

¹⁶⁴ See text accompanying notes 170–71. See also Ben-Shahar and Logue, 111 Mich L Rev at 206 (cited in note 156).

¹⁶⁵ See text accompanying notes 53–57.

¹⁶⁶ Boyd, *Financial Responsibility for Environmental Obligations* at *22 (cited in note 159).

¹⁶⁷ Insurers set premiums to reflect the relative riskiness of an insured's behavior—in this case, the likelihood that environmental penalties will be imposed. *Id.* at *20.

¹⁶⁸ See Ben-Shahar and Logue, 111 Mich L Rev at 206 (cited in note 156).

differential premium prices, but also through explicit education of policyholders by insurance companies.¹⁶⁹ Additionally, policyholders receive legal representation when the EPA brings enforcement actions.¹⁷⁰ Finally, insurance premiums force polluters to amortize the costs of their pollution, while subsequent insurer payouts to the EPA prevent polluters from going bankrupt. This resolves the “balloon payment” problem discussed in Part III.B.

Mandatory insurance leaves sensitive business decisions to competitive forces. As mentioned above, the Pigouvian tax function allows polluting companies to price their environmental activities, thereby enabling fair competition in primary markets. Competition in the insurance market causes insurers to identify efficient risk-reduction measures and attract customers through lower premiums.¹⁷¹ Insurers even privately monitor their policyholders’ activities *more stringently* than does the government; insurers offer discounts of up to 30 percent for participation in private Environmental Management Systems with *heightened* standards of environmental compliance, and they set requirements for on-site auditing—an aggressive form of oversight that even the EPA does not always pursue.¹⁷²

Mandatory insurance in environmental regulations is not new. The EPA has established and maintained mandatory-insurance regimes before, and mandatory insurance already plays a significant role in many of the industries that the EPA regulates, including hazardous-materials transportation, waste storage, offshore drilling, nuclear power, and mining.¹⁷³ In fact, the EPA has rolled out greater financial-assurance requirements (which are essentially mandatory-insurance regimes) in select industries since 2010.¹⁷⁴ State insurance requirements also complement and sometimes exceed federal regulations.¹⁷⁵ Mandatory requirements aside, markets for environmental insurance are generally robust, flexible, and tailored to specific environmental

¹⁶⁹ See *id.* at 226.

¹⁷⁰ *Id.* at 214–15.

¹⁷¹ *Id.* at 201–02.

¹⁷² See *How to Open Pollution Coverage Market—Make Policy Contingent on Obeying Environmental Code*, 108 *Ins Advocate* 10, 10 (Apr 5, 1997).

¹⁷³ See Boyd, *Financial Responsibility for Environmental Obligations* at *12–17 (cited in note 159).

¹⁷⁴ US Environmental Protection Agency, *Upgrading Implementation of the Financial Assurance Program* *6 (2010), online at <http://www.epa.gov/osw/hazard/tsd/td/ldu/financial/documents/upgrade.pdf> (visited Nov 3, 2014).

¹⁷⁵ See Boyd, *Financial Responsibility for Environmental Obligations* at *17–18 (cited in note 159).

statutes.¹⁷⁶ Broader assessments of financial assurance indicate that it is an effective up-front strategy to ensure ongoing compliance with environmental regulations.¹⁷⁷

One criticism of insurance generally is that, once purchased, it reduces the policyholder's incentive to prevent damage. In other words, insurance creates moral hazard.¹⁷⁸ Countering this presumption, Professors Omri Ben-Shahar and Kyle Logue promote environmental liability insurance as a “[s]triking example[] of how insurance minimizes rather than exacerbates moral hazard.”¹⁷⁹ Insurers write exceptions into their policies that preclude coverage for the most egregious and unpredictable violations, including deliberate noncompliance.¹⁸⁰ They also utilize deductibles and copayments to force polluters to share the cost of ex post penalties.¹⁸¹ Finally, they disclaim liability when policyholders make material misrepresentations in their insurance applications.¹⁸²

To initiate a mandatory-insurance requirement, Congress need not make any sweeping changes to the major environmental statutes; it need only pass statutes authorizing the EPA to promulgate regulations requiring proof of financial responsibility. For example, OPA and CERCLA require financial-responsibility coverage for damages up to a specified liability limit.¹⁸³ The EPA, as enforcer of these statutes, promulgates rules governing the types of polluters to which the rules apply and the financial instruments that constitute coverage.¹⁸⁴ These instruments include insurance policies, surety bonds, self-insurance, or financial guaranty by another firm.¹⁸⁵ Finally, the EPA must create a regime for monitoring ongoing coverage. The

¹⁷⁶ See David J. Dybdahl, *A User's Guide to Environmental Insurance* *27 (American Risk Management Resources Network), online at <http://www.erraonline.org/usersguide.pdf> (visited Nov 3, 2014). See also Boyd, *Financial Responsibility for Environmental Obligations* at *30 (cited in note 159) (“In every regulatory context to date, private financial markets have developed to provide . . . [financial instruments] at reasonable cost.”).

¹⁷⁷ See Boyd, *Financial Assurance Rules* at *43 (cited in note 158).

¹⁷⁸ See Steven Shavell, *On Moral Hazard and Insurance*, 93 Q J Econ 541, 541 (1979).

¹⁷⁹ Ben-Shahar and Logue, 111 Mich L Rev at 225 (cited in note 156).

¹⁸⁰ See Dybdahl, *A User's Guide to Environmental Insurance* at *30–33 (cited in note 176).

¹⁸¹ See Ben-Shahar and Logue, 111 Mich L Rev at 208–09 (cited in note 156).

¹⁸² See *id* at 213–14.

¹⁸³ See Boyd, *Financial Assurance Rules* at *2 & n 4 (cited in note 158).

¹⁸⁴ *Id* at *12–17, 22–27.

¹⁸⁵ See *id* at *22–27.

regime need only attach to preexisting permitting programs, such that self-reporting is the major mechanism for enforcing financial-responsibility requirements. Rules regarding self-reporting must at least assure that firms maintain the appropriate levels of insurance over time, from policy to policy.¹⁸⁶ Modest civil penalties for failure to maintain financial responsibility allow the regime to be largely self-regulated.

CONCLUSION

This Comment has demonstrated that ability to pay is not only common among environmental laws but has also achieved a common interpretation among many governmental actors. This interpretation has changed over time, from its roots in the Santa Barbara oil spill to its expansion during the 1970s. The EPA nonetheless distilled the mass of ability-to-pay statutes into an intuitive and streamlined doctrine with its *Policy on Civil Penalties* in 1984. The EPA's effort to unify ability to pay is laudable; the unification avoids the pitfalls presented by minute textual variations while also cabining the regulator's discretion. The EPA's *Policy on Civil Penalties* and Article III judges come up short, however, in their interpretation of ability to pay. Together, they adopt the penalty perspective and, in doing so, shield polluters unworthy of protection. This inhibits the goals of protecting the environment and enabling fair competition.

The compliance perspective addresses this shortcoming because it prohibits penalty mitigation when compliance is financially feasible. At heart, the penalty perspective takes a page out of Tony Baretta's book: "Don't do the crime if you can't do the time." This is a hard rule that ability to pay aims to temper. But if ability to pay incentivizes pollution when compliance is possible, the penalty regime's deterrent effects diminish.

Administrative feasibility and the market's cost-internalizing superiority favor a compliance perspective of ability to pay, complemented by a mandatory-insurance regime. Mandatory insurance best protects the small, unsophisticated violators that the ability-to-pay doctrine seeks to protect. For this reason, Congress should authorize the EPA to promulgate new regulations requiring that polluters purchase environmental-penalty insurance. Under this regime, the market may decide the

¹⁸⁶ See Boyd, *Financial Responsibility for Environmental Obligations* at *22–27 (cited in note 158).

means of compliance while the EPA decides the appropriateness of penalties, rather than the other way around.