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ENFORCEMENT

ECONOMIC BENEFIT

A recent decision by the Vermont Supreme Court found that the state's Agency of Natural Resources had been "improperly counting" gasoline sale profits as the defendant's economic benefit of noncompliance. The author of this article believes two recent articles published here have incorrectly concluded that the Vermont decision has doomed an entire concept to extinction or that the decision has self-contradictory outcomes and lacks sound philosophical underpinnings.

Wrongful Profits: Setting the Record, and the Concept, Straight

By JONATHAN S. SHEFFTZ

The Vermont Supreme Court's decision in *Agency of Natural Resources v. Deso*¹ does not, so to speak, throw the baby out with the bathwater, but rather sets forward what can be seen as constituting part of a helpful framework for distinguishing between the two. Nor does the decision contain any self-contradictory implications.

This article therefore aims to set the record straight on recent developments in economic benefit analysis and to show how the Vermont decision helps to clarify concepts in complex economic benefit cases.

Introduction

Many environmental requirements, both state and federal, entail significant capital investments in pollution control equipment, which in turn lead to ongoing operation and maintenance expenses. The benefits that offset these costs, however, are realized at the societal level, not at the facility level. Therefore, a significant financial incentive can arise to delay and/or avoid such pollution control costs.

In response to this situation, the Environmental Protection Agency has, quite sensibly, made the recapture

¹ 2003 VT 36, Supreme Court Docket No. 2001-532.

or disgorgement of this potential financial gain a cornerstone of its civil penalty policy.²

EPA has referred to this as “leveling the playing field,” even though the critical postscript should be “all else being equal.” That is, the recapture of the financial gain from environmental noncompliance returns the violator to the level it would have attained had the violations not occurred, but the competitive playing field between the violator and others may remain unlevel for an almost limitless number of factors, including wage differentials, transportation costs, and managerial expertise.

Somewhat unfortunately, the agency has termed this financial gain “economic benefit,” which often creates confusion with the societal benefit portion in a “benefit-cost” analysis of an environmental regulation. Despite the nomenclature difficulties, economic benefit in the context of environmental control noncompliance is commonly understood to represent the extent to which an alleged violator is financially better off because of its wrongful actions. (In other legal contexts, this is termed “unjust enrichment.”)

In the case of a for-profit violator, the extent to which an entity is financially better off manifests itself in higher or lower profits.³ The bottom-line issue in an analysis of an alleged violator’s economic benefit is how much additional profit resulted from the wrongful actions.

Economic Benefit Calculation—a Shortcut

Fortunately, an analysis of the violator’s entire profit during the noncompliance period is not needed in most cases. In the typical enforcement action involving economic benefit, a safe and reasonable assumption is that the violator’s level of production, output prices, and revenues are all unaffected by whether or not the violator purchased and subsequently operated the pollution control equipment. Therefore, to measure the incremental profits from the violations over the noncompliance period, the analyst need analyze only the lower costs, in the form of the delayed and/or avoided pollution control costs.

This simplified analysis has its near-perfect parallel in the field of commercial damages arising from breach of contract damages. There, the issue is the mirror image of economic benefit: the extent to which the plaintiff was harmed by the defendant’s alleged actions.⁴ For a relatively simple breach scenario under which the plaintiff has to resort to a higher-cost supplier, a safe and reasonable assumption is that the plaintiff’s level of

production, output prices, and revenues are all unaffected by whether or not the defendant breached the contract. Therefore, under such a “cost of cover” damages analysis, to measure the incremental loss in profits from the contract breach, the analyst need analyze only the higher costs, in the form of the higher production costs from having to resort to alternative input suppliers.

Because the environmental noncompliance equivalent of this “cost of cover” analysis arises so often in enforcement cases, EPA created the dedicated stand-alone “BEN” computer model in 1984 to allow laypersons to perform economic benefit calculations.⁵ The user need know only the delayed and/or avoided pollution control costs, as well as a few relevant dates, to determine the additional profits that resulted from the violator’s wrongful actions. The overall profits the violator earned during the noncompliance period can remain unknown, since profits would have remained the same, but for the additional pollution control costs during the noncompliance period, had the violator come into compliance.

Profits From Wrongful Actions v. ‘Wrongful Profits’

If even the most simple application of the relatively simple BEN model is an analysis of the additional profits from wrongful actions, then what is the meaning of the term “wrongful profits”? The answer is that “wrongful profits” is somewhat invalid (or at least potentially misleading) term for a valid concept, i.e., economic benefit that goes beyond the BEN model’s simplifying paradigm of delayed and/or avoided pollution control costs. Even though the assumption of unaltered revenues is safe and reasonable for the typical enforcement action, atypical cases do still exist.

In such atypical cases, estimating the additional profit from noncompliance via estimating the delayed and/or avoided pollution control costs does not yield an accurate or even meaningful result because too many factors differ between the on-time and delayed compliance scenarios. Therefore, the violator’s entire profit during the noncompliance period must be estimated, and compared to the profit that would have prevailed had the violator been in full and timely compliance during this same time period. From this perspective, an analysis that goes beyond the BEN model is simply a more complete analysis of the economic benefit. At the other end of the spectrum, a BEN-type analysis is a convenient shortcut toward the result that a more complete analysis would provide in the typical straightforward case involving delayed and/or avoided pollution control costs (and nothing more).

Almost 20 years ago, EPA provided some illustrative examples of economic benefit scenarios that go beyond the BEN Model’s capabilities:⁶

- selling banned products;

⁵ The current version of the BEN model and its accompanying user’s manual are available at <http://www.epa.gov/compliance/civil/programs/econmodels/benproj.exe> and <http://www.epa.gov/compliance/civil/programs/econmodels/ben.pdf> on the World Wide Web.

⁶ See *A Framework for Statute-Specific Approaches to Penalty Assessments* (PT.1-2) Feb. 16, 1984. This document is available at http://www.indecon.com/iec_web/practice/SAB.asp on the World Wide Web.

² For an overview of federal environmental penalty policy, see EPA’s *Policy on Civil Penalties* (PT.1-1) Feb. 16, 1984; and *A Framework for Statute-Specific Approaches to Penalty Assessments* (PT.1-2) Feb. 16, 1984. These documents are available at http://www.indecon.com/iec_web/practice/SAB.asp on the World Wide Web.

³ In commercial litigation of any type where an analysis of profitability is at issue, a significant difference can arise between economic measures of cash flow and accounting measures of net income. Nevertheless, for the purposes of this article, a generic reference to “profits” can suffice.

⁴ The author believes that the different focus in an economic damages case as compared to an economic benefit case can argue for different values for certain financial parameters. However, the close similarities between the two analyses still make for a useful analogy for the purposes of this article.

- selling products for banned uses;
- selling products without required labeling or warnings;
- removing or altering pollution control equipment for a fee (e.g., tampering with automobile emission controls); and
- selling products without required regulatory clearance (e.g., pesticide registration or premanufacture notice under the Toxic Substances Control Act).⁷

What unites all of these examples is that the violations allowed the violator to realize higher revenues than would have prevailed under a compliant state. Therefore, the BEN model's simplifying paradigm of analyzing delayed and/or avoided pollution control costs, simply does not apply under such non-simple conditions.

Despite the rather sensible identification of these examples, EPA somewhat less sensibly termed them "competitive advantage" (and a later date, "illegal competitive advantage"), which although less misleading than "wrongful profits" has nevertheless created considerable confusion.

Invalid Applications of a Valid Concept

EPA had identified (albeit also confusingly named) pertinent examples of economic benefit (i.e., financial gain or unjust enrichment) that go beyond the BEN Model's simplifying paradigm of delayed and/or avoided pollution control costs all the way back in 1984. But its enforcement staff did not seem to pursue such analyses very often. Based on the collective experience of this author and his colleagues, when EPA or Department of Justice attorneys were advised that a prospective case analysis involved factors that went far beyond the limitations of the BEN Model (and, moreover, required significant resources devoted to the necessary research and analysis), that was often the end of the economic benefit calculation (with a quick and simple BEN Model run substituting for a full and accurate estimate of the actual economic benefit).

This aversion to complicated and resource-intensive economic benefit calculations appears to continue to this day, but with a twist that arises out of the U.S. District Court for the Middle District of Pennsylvania's decision in *United States v. Municipal Authority of Union Township; Dean Dairy Products d/b/a Fairmont Products*.⁸ As Kenneth T. Wise and M. Alexis Maniatis summarize in their July 8, 2003 article, "The Life Cycle of a Flawed Concept: Wrongful Profits Rejected in Vermont," given the generally agreed-upon facts of Dean Dairy's noncompliance, the company clearly did not gain any economic benefit from its noncompliance.⁹ That is, had the company installed and operated the pollution control pretreatment equipment, the consequent savings in effluent surcharges would have more than offset the cost of installing and operating the pollution control equipment.

Therefore, the company essentially lost out on a profitable opportunity, i.e., timely environmental compliance. However, despite this particular business mis-

take, the company was otherwise profitable during the period of noncompliance. Moreover, an internal company memorandum had documented that a compliance alternative to pretreatment would have been to cut back on production, which would have lowered the company's profits.¹⁰

The Justice Department case team latched onto this memorandum, arguing that although Dean Dairy had not gained financially by delaying and/or avoiding pollution control costs (i.e., since the surcharge savings would have more than offset the pollution control costs), it had still somehow accrued "wrongful profits." Both the trial court and appeals court found favor with this line of reasoning:

The parties stipulate that [Dean Dairy] did not realize any economic benefit from delaying the capital investments necessary to achieve compliance with its [industrial users] permit. [Dean Dairy] did, however, realize an economic benefit during the period of violations by producing at a volume above that which would have allowed it to operate within its [industrial users] permit.

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The memorandum's figure for losses from potential production cutbacks was then used as the basis for the economic benefit of noncompliance. The appeals court concluded that "the district court's method of calculation of the penalty was within its discretion."

But as Wise and Maniatis point out in their article, this finding is anything but reasonable. Assume that two alternative yet equally satisfactory means of achieving the same outcome are identified (and both are known and feasible at the pertinent time periods), yet one is essentially costless while the other is prohibitively costly (and the company indeed eventually chose the costless option). Why then should the costly one be the focus of the analysis?

In other words, there is a time and a place (quite a few times and places, e.g. see previous discussion of limitations of BEN Model) for pursuing economic benefit analyses that go beyond the simplifying paradigm of delayed and/or avoided expenditures, but *Dean Dairy* simply was not that time and place.

Dean Dairy Versus Deso

The *Dean Dairy* decision did seem to generate increased enforcement interest in "aggressive" approaches that would entail "going for wrongful profits." A considerable amount of education was necessary to convey that just because a company is profitable during the noncompliance period did not necessarily mean that its profit has arisen from the noncompliance. In other words, the typical company's overall profitability is almost entirely unrelated to the noncompliance, since the company could have generated almost exactly the same profit and yet still complied with environmental regulations. Indeed, the profit gained from the noncompliance in a typical case is already represented by the

¹⁰ The memorandum, as well as the Justice Department's citation of it and the court decision's use of it, was rather vague on whether the cited figure represented gross revenues, revenues net of variable operating costs, or something else entirely. Nevertheless, for the purposes of this discussion, the main point is that the memorandum referred to a dollar amount that had clear implications for profitability.

¹¹ 929 F. Supp. at 805.

⁷ Framework document, *supra* at p. 10.

⁸ 929 F. Supp. 800, 43 ERC 1377 (M.D. Pa. 1996) affirmed 150 F.3d 259, 46 ERC 1977 (3rd Cir. 1998).

⁹ (34 ER 1569, 07/11/03).

present value of the delayed and/or avoided pollution control expenditures.

Perhaps the Vermont *Deso* decision will assist in this educational process, as the Vermont Supreme Court quite sensibly ruled the lower court had erred by “improperly counting” gasoline sale profits as the economic benefit of noncompliance.

Deso could have complied by spending \$13,070 to install a vapor recovery system. The lower court had instead added on \$161,264 for the profit from gasoline sales during the period of noncompliance. Had *Deso* spent the \$13,070 for the vapor recovery system, however, it still would have been able to earn the \$161,264 in gasoline sale profits. In the supreme court’s words:

Economic principles, normal business behavior, and common sense suggest that a rational business would choose to install the required equipment. Thus, the unfair economic advantage *Deso* gained over his competitors is the savings gained by not installing an approved Stage II vapor recovery system.

Yet this state court decision is not binding precedent on federal district courts or administrative tribunals.

The Vermont decision, though, does set a common-sense precedent for the limits on going beyond the BEN model’s simplifying paradigm of the delayed and/or avoided pollution control expenditures. At the same time, it affirms that such an approach is appropriate where it is merited. If the facts in *Deso* had supported going beyond the BEN approach, the Vermont Supreme Court was perfectly willing to go in that direction, citing instances of facilities that operate before receiving final permits, and concluding that “when the violation gives the violator a competitive advantage, such profits are an economic benefit subject to penalty by confiscation.”

Furthermore, the *Dean Dairy* decision still affirms the validity of going beyond the BEN model (even if the *Dean Dairy* case circumstances did not merit its application). In addition, there are now a series of EPA administrative decisions that apply this approach in a way that does make sense. For example, *In re Lawrence John Crescio III*, No. 5-CWA-98-004, 2001 WL 537494 (May 17, 2001); *In re Chempace Corp.*, No. 5-IFRA-96-017, 1999 EPA ALJ 110 (March 25, 1999), affirmed 9 E.A.D. 119 (May 19, 2000).

Contradictions Versus Confusion

Whereas the Wise article overstates the importance and repercussions of the *Deso* decision, the article by Sunil K. Garg, “‘Wrongful Profits’ or Unfair Competitive Advantage: Evaluating Economic Benefit in Environmental Penalty Cases,”¹² merely adds confusion to the issue by asserting contradictions in the decision where none exist.

In brief, Garg finds that:

The *Deso* decision turns more on evidentiary issues than on sound philosophical underpinnings based on an interpretation of what does or does not constitute sound economic policy or rational business behavior.

But evidentiary issues are precisely what is at issue in whether the BEN Model’s simplifying paradigm of delayed and/or avoided expenditures accurately reflects

the economic benefit in any particular case. It is not a question of philosophical musings. Rather, it is a question of whether a violator’s level of production, output prices, and revenues are all unaffected by whether the violator is in compliance. If these are all unaffected, then the economic benefit analysis can safely focus exclusively on the avoided and/or delayed pollution control costs. If they are instead significantly affected, then the analysis must go beyond the inherent limits of the BEN model’s simplifying paradigm.

In most cases, the answer to this question is obvious. In other cases, detailed information may be necessary to make this determination. Garg, however, finds this prospect troubling:

Nonetheless, this is a development with continuing negative repercussions for regulated entities. It could encourage the government, in a bid to develop the evidence to “level the playing field,” to demand sensitive business, competitive, and financial information from alleged violators to help evaluate whether they have gained an unfair competitive advantage.

But such a demand for evidence is par for the course in commercial litigation. For example, an antitrust lawsuit could never proceed if discovery were not allowed to delve into financial evidence. And if the sensitivity of such information is the main concern, then confidentiality agreements in such litigation are a well-established practice.

Having started off by bringing further confusion to an already complex issue, Garg concludes with a call for adding irrelevant information to a legal proceeding on financial economic issues:

Clearly, if, in addition, the government wants to introduce evidence of economic benefit of noncompliance, defending entities should be able to present evidence of overall competitive economic detriment to their businesses as an offset.

Garg appears to be confusing EPA’s “level playing field” analogy in the economic benefit context with something it quite clearly is not. The recapture of economic benefit is intended to level the playing field between compliant and noncompliant companies, all else being equal, which of course it is not on a one-by-one basis. The competitive positions of companies vary widely, depending upon many factors, with their environmental compliance/noncompliance being only one. The contention that a company should be allowed to offset its financial gain from environmental noncompliance by, say, the wage differential accruing to its Chinese competitor, makes even the overturned economic benefit calculation by the Vermont Agency of Natural Resources seem sensible.

Conclusion

Shortcuts can be helpful, but only if they do not obscure the occasional need for the longer, more complete route. The BEN model’s simplifying paradigm of delayed and/or avoided expenditures constitutes such a shortcut in the context of the economic benefit of environmental noncompliance. Taking the longer route does present the danger of wandering off course, such as in the *Dean Dairy* decision. Fortunately, the *Deso* decision should serve as a helpful roadmap for future journeys.

¹² (34 ER 1905, 08/22/03).

