



UNITED STATES ENVIRONMENTAL PROTECTION AGENCY

WASHINGTON, D.C. 20460

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GM # 56

OFFICE OF
ENFORCEMENT AND
COMPLIANCE MONITORING

MEMORANDUM

SUBJECT: Guidance on Determining a Violator's
Ability to Pay a Civil Penalty

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TO: Assistant Administrators
Regional Administrators

I. PURPOSE

This guidance amplifies the discussion in the Uniform Civil Penalty Policy on how to adjust a penalty target figure when a violator claims paying a civil penalty would cause extreme financial hardship. This guidance was developed to meet the commitment made in the Uniform Civil Penalty Policy issued February 16, 1984, and in response to Regional Office requests for amplification of the "Framework for Statute-Specific Approaches to Penalty Assessments" (GM-22).

II. APPLICABILITY

This guidance applies to the calculation of civil penalties under medium-specific policies issued in accordance with the Uniform Civil Penalty Policy that EPA imposes on:

1. For-profit publicly or closely held entities; and
2. For-profit entities owned by not-for-profit entities.

This guidance does not apply to:

1. The calculation of civil penalties that EPA imposes on municipalities and other not-for-profit entities; or
2. A violator who files for bankruptcy or is in bankruptcy proceedings after EPA initiates the enforcement action.

III. SCOPE

This guidance only gives a general evaluation of the financial health of a violator and the possible effects of paying a civil penalty for the purpose of settlement negotiations. It describes when to apply the ability to pay factor and provides a methodology for applying the factor using a computer program, ABEL.

The guidance does not prescribe the amount by which EPA may reduce a civil penalty if the ability to pay factor is applied. The methodology in this guidance will not calculate a specific dollar amount that a violator can afford in civil penalties nor does it provide a way to predict whether paying a certain amount for a civil penalty will cause an already financially troubled firm to go out of business.

For an ability to pay analysis, EPA needs specific financial information from a violator (see section V). EPA includes the financial data in a litigation report only when the data are requested by the Department of Justice or offered by the violator.

IV. THE ABILITY TO PAY FACTOR

Under the Uniform Civil Penalty Policy, EPA may consider using the ability to pay factor to adjust a civil penalty when the assessment of a civil penalty may result in extreme financial hardship. Financial hardship cannot be expressed in absolute terms. Any limitation on a violator's ability to pay depends on how soon the payments must be made and what the violator has to give up to make the payments. A violator has several options for paying a civil penalty:

1. Use cash on hand;
2. Sell assets;
3. Increase debt by commercial borrowing;
4. Increase equity by selling stock;
5. Apply toward a civil penalty for a period of time what would otherwise be distributed as profit; or
6. Use internally-generated future cash flows by deferring or eliminating some planned future investments.

Each of these options will affect a for-profit violator's operations to some degree. EPA must decide whether to adjust

a proposed penalty amount and by how much, taking into account the gravity of the violation and other criteria in medium-specific guidance.

V. INFORMATION TO DETERMINE ABILITY TO PAY

If ability to pay is at issue, EPA may request from a violator any financial information the Agency needs to evaluate the violator's claim of extreme financial hardship. A violator who raises the issue has the burden of providing information to demonstrate extreme financial hardship.

Financial information to request from for-profit entities may include the most recent three to five years of:

1. Tax returns;
2. Balance sheets;
3. Income statements;
4. Statements of changes in financial position;
5. Statements of operations;
6. Retained earnings statements;
7. Loan applications, financing agreements, security agreements;
8. Annual reports; or
9. Business services, such as Compustat, Dun and Bradstreet, or Value Line.

Tax returns are the most complete and in the most consistent form for analysis. Tax returns also provide financial information in a format for direct input into ABEL. Annual reports are the most difficult to analyze and may require the assistance of a financial analyst.

When requesting information informally or through interrogatories or discovery, EPA should ask for three to five years of tax returns along with all other financial information that a violator regularly maintains as business records. If a violator refuses to give EPA the information to evaluate the violator's ability to pay, EPA should seek the full calculated penalty amount under the assumption that the violator can pay.

VI. CONFIDENTIALITY OF FINANCIAL INFORMATION

A violator can claim confidentiality for financial information submitted to EPA. In accordance with the regulations on confidential business information, 40 CFR 2.203, EPA must give notice to a violator that the violator may assert a business confidentiality claim. EPA's notice must contain the information required in 40 CFR 2.203. The notice must include a statement that if the violator submits financial information without a confidentiality claim, EPA may release the information without further notice to the violator.

The violator can make a claim of confidentiality for financial information in a cover letter accompanying the information. Information in published annual reports would not be entitled to confidential treatment.

VII. APPLYING THE ABILITY TO PAY FACTOR

Under the terms of a consent decree, a violator pays a civil penalty in addition to making any capital investment necessary to come into compliance. EPA considers the costs of attaining compliance when applying the ability to pay factor to a civil penalty calculation.

EPA determines whether to apply the ability to pay factor using a four-step process:

1. Determine, if possible, whether a violator plans to claim extreme financial hardship;
2. Determine whether criteria in the Uniform Civil Penalty Policy and medium-specific guidance require consideration of ability to pay;
3. Evaluate the overall financial health of a violator's operations by analyzing financial information provided by a violator or from other sources, such as business services; and
4. Project the probabilities of a violator having future internally-generated cash flows to evaluate how paying a proposed civil penalty may affect a violator's financial decisions.

VIII. FINANCIAL COMPUTER PROGRAM

EPA's computer program, ABEL, assists in evaluating the financial health of for-profit entities, based on the estimated strength of internally-generated cash flows. ABEL uses financial information on a violator to evaluate the overall financial health of a violator (step 3 above). The program uses standard

financial ratios to evaluate a violator's ability to borrow money and pay current and long-term operating expenses.

ABEL also projects the probable availability of future internally-generated cash flows to evaluate some of a violator's options for paying a civil penalty (step 4 above). EPA is developing a user's manual to provide self instruction in the use of ABEL in addition to the documentation and help aids in the computer program.

Exhibit 1 is a hypothetical use of ABEL to evaluate a violator's financial health. If the ABEL analysis indicates that a violator may not be able to finance a civil penalty with internally-generated cash flows, EPA should check all available financial information for other possible sources of cash flows for paying a civil penalty.

For example, in corporate tax returns, item 26 of Schedule A (cost of goods sold) sets forth deductions for entertaining, advertising, and professional dues. Schedule E shows the compensation of officers. In Schedule L (balance sheets), item 8 sets forth investments that may include certificates of deposit or money market funds. These types of assets and expenses do not directly affect operations and may vary considerably from year to year without adversely affecting the violator's operations. Because a civil penalty should be viewed as a one-time expense, these kinds of assets and expenses could be sources of cash for a civil penalty.

Using the sources of financial information from the example above, liquid assets such as certificates of deposit and money market funds could be used to pay a penalty. Expenses for advertising, entertaining, or professional dues could be reduced for a short period to pay a civil penalty. A corporate officer might even be willing to take less compensation for a short period. A combination of options like these may produce enough cash flow to pay a civil penalty without causing the violator extreme financial hardship in meeting operating expenses.

Attachment

EXHIBIT 1

Assumption that Violator is Financially Healthy

Assume that EPA has calculated an economic benefit for Company X of \$140,000 and a gravity component of \$110,000 for a total proposed penalty of \$250,000. EPA presents the proposed penalty after several negotiation sessions, and the CEO for Company X then claims that the company cannot afford to pay that much. In support of the claim, the CEO produces accounting statements showing that the firm paid no income taxes for the previous three years and had less than \$100,000 in net income for those years.

EPA requests tax returns and other financial information for the most recent three years of Company X. EPA enters the tax return information in ABEL and receives the output in Attachment A. The Phase 1 analysis from ABEL is not dispositive of the issue, so EPA performs a Phase 2 analysis.

The Phase 2 analysis indicates that Company X can finance a civil penalty of \$250,000 from internally-generated cash flows, even after planning for \$400,000 in pollution control investments and \$50,000 for annual O&M expenses. The table in Phase 2 shows a 99 percent probability that Company X will have future cash flows with a net present value of \$370,061 available to pay a civil penalty.

Assumption that Violator Is Not Financially Healthy

Assume again that EPA has calculated a total penalty amount of \$250,000. Company Z claims extreme financial hardship. If the ABEL analysis indicates that Company Z would have little probability of generating \$250,000 in cash flows during the next five years, EPA would go back to the financial data supplied by the violator and look for items that may indicate a source of cash, including loans outstanding to corporate officers, entertainment expense deductions, company cars or airplanes, amount of compensation for corporate officers, compensation for relatives of corporate officers who do not have clearly defined duties.

If the ABEL Phase 1 analysis indicates that Company Z may have additional debt capacity (debt/equity ratio), EPA would look in the tax returns for the amount of long term debt the violator is carrying and analyze any loan applications the violator submitted in response to EPA's request for financial information. Frequently, firms can borrow additional money for operations and free up cash flow to pay civil penalties.

Even a firm on the verge of bankruptcy may choose to settle an enforcement action with a civil penalty provision in the consent decree. EPA should always seek some civil penalty. ABEL and other financial analysis provide a range of penalty amounts for the purpose of settlement negotiations.

DATA FOR ABEL EXAMPLE

ANALYSIS DATE: NOVEMBER 24, 1986

DEBT EQUITY RATIOS

1985 0.58 A RATIO LESS THAN 1.5 INDICATES THE FIRM
MAY HAVE ADDITIONAL DEBT CAPACITY

1984 2.91 A RATIO GREATER THAN 1.5 INDICATES
THE FIRM MAY HAVE DIFFICULTY BORROWING

1983 1.59 A RATIO GREATER THAN 1.5 INDICATES
THE FIRM MAY HAVE DIFFICULTY BORROWING

PLEASE ENTER A CARRIAGE RETURN TO CONTINUE

CURRENT RATIOS

1985 1.10 A RATIO LESS THAN 2.0 MAY INDICATE
LIQUIDITY PROBLEMS

1984 1.20 A RATIO LESS THAN 2.0 MAY INDICATE
LIQUIDITY PROBLEMS

1983 1.05 A RATIO LESS THAN 2.0 MAY INDICATE
LIQUIDITY PROBLEMS

PLEASE ENTER A CARRIAGE RETURN TO CONTINUE

BEAVER'S RATIOS

1985 0.22 A RATIO GREATER THAN 0.20 INDICATES
HEALTHY SOLVENCY

1984 0.20 A RATIO BETWEEN 0.10 AND 0.20 IS
INDETERMINATE

1983 0.30 A RATIO GREATER THAN 0.20 INDICATES
HEALTHY SOLVENCY

PLEASE ENTER A CARRIAGE RETURN TO CONTINUE

TIMES INTEREST EARNED

1985 1.02 A RATIO LESS THAN 2.0 MAY INDICATE
SOLVENCY PROBLEMS

1984 1.64 A RATIO LESS THAN 2.0 MAY INDICATE
SOLVENCY PROBLEMS

1983 1.30 A RATIO LESS THAN 2.0 MAY INDICATE
SOLVENCY PROBLEMS

PLEASE ENTER A CARRIAGE RETURN TO CONTINUE

ABEL INTERPRETS THE OVERALL RESULTS OF THE FINANCIAL RATIOS AS FOLLOWS:

ALTHOUGH THE FIRM MAY FACE CURRENT CASH (OR LIQUIDITY) CONSTRAINTS, ITS LONG-TERM PROSPECTS ARE GOOD AND IT SHOULD BE ABLE TO FINANCE PENALTIES AND INVESTMENTS. A PHASE TWO ANALYSIS IS RECOMMENDED.

ABEL NOTES THAT THE FIRM'S MOST RECENT DEBT-EQUITY RATIO IS SUBSTANTIALLY BETTER THAN ITS HISTORIC AVERAGE.

ABEL NOTES THAT THE FIRM'S MOST RECENT TIMES INTEREST EARNED IS SUBSTANTIALLY POORER THAN ITS HISTORIC AVERAGE.

DO YOU WISH TO CONTINUE WITH THE PHASE TWO ANALYSIS (Y OR N)?

DO YOU WISH TO ANALYZE A CIVIL PENALTY (P) OR A NEW INVESTMENT (I)?

PLEASE INPUT THE INITIAL PROPOSED SETTLEMENT PENALTY AMOUNT IN CURRENT DOLLARS (E.G., 5000); IF THERE IS NO TARGETED PENALTY, ENTER 0.

250000

BEFORE PROCEEDING WITH THE CIVIL PENALTY ANALYSIS, ABEL WILL REQUIRE CERTAIN ADDITIONAL INFORMATION REGARDING ANY INVESTMENTS WHICH MAY BE REQUIRED IN ORDER FOR THE FIRM TO ACHIEVE COMPLIANCE.

ENTER THE DEPRECIABLE CAPITAL COST OF THE NEW INVESTMENT (E.G., 1000.00); IF THERE IS NO NEW INVESTMENT, ENTER 0.

200000

PLEASE ENTER WHAT YEAR DOLLARS THIS IS EXPRESSED IN (E.G., 1984)

1985

ENTER ANY NON-DEPRECIABLE, NON-TAX DEDUCTIBLE COSTS ASSOCIATED WITH THE NEW INVESTMENT. IF THERE IS NO COST THAT MEETS THIS REQUIREMENT PLEASE ENTER 0.

100000

PLEASE ENTER WHAT YEAR DOLLARS THIS IS EXPRESSED IN (E.G., 1984)

1985

ENTER ANY NON-DEPRECIABLE, BUT TAX DEDUCTIBLE COSTS ASSOCIATED WITH THE NEW INVESTMENT. IF THERE IS NO COST THAT MEETS THIS REQUIREMENT PLEASE ENTER 0.

100000

PLEASE ENTER WHAT YEAR DOLLARS THIS IS EXPRESSED IN (E.G., 1984)

1985

ENTER THE ANNUAL O&M COST OF THE NEW INVESTMENT. IF THERE IS NO O&M COST, ENTER 0

50000

PLEASE ENTER WHAT YEAR DOLLARS THIS IS EXPRESSED IN (E.G., 1984)

1985

THE FOLLOWING STANDARD VALUES ARE USED IN THIS SECTION OF ABEL:

1. REINVESTMENT RATE = 0.0
2. NOMINAL DISCOUNT RATE = 13.69%
3. INFLATION RATE = 4.41%
4. MARGINAL INCOME TAX RATE = 50.00%
5. INVESTMENT TAX CREDIT = 10.00%

DO YOU WISH TO HAVE THESE ITEMS EXPLAINED (Y OR N)?

N

DO YOU WISH TO CHANGE ANY OF THESE INPUTS (Y OR N)?

N

ABEL IS READY TO PROVIDE OUTPUT. YOU HAVE THE CHOICE OF THREE OUTPUT OPTIONS:

1. PRINT ONLY THE POSSIBILITY OF THE PRESENT VALUE OF THE FIRM'S FIVE YEAR PROJECTED CASH FLOW EXCEEDING EITHER AN INITIAL PROPOSED SETTLEMENT PENALTY OR A REQUIRED INVESTMENT.
2. PRINT A TABLE SHOWING THE NET AVAILABLE CASH FLOW WITH AN ANALYSIS OF THE TABLE.
3. PRINT A DETAILED TABLE SHOWING THE COMPONENTS OF THE FIRM'S CASH FLOWS. THIS OPTION MAY BE HELPFUL TO FINANCIAL ANALYSTS BUT IS NOT RECOMMENDED FOR MOST USERS. PLEASE ENTER YOUR CHOICE (1, 2 OR 3).

2

THERE IS A 99.9 % CHANCE THAT THE FIRM CAN FINANCE THE PROPOSED SETTLEMENT PENALTY OF \$ 250000.00 BASED ON THE STRENGTH OF INTERNALLY GENERATED CASH FLOWS FOR THE NEXT FIVE YEARS. THE ANALYSIS AT THIS POINT DOES NOT DEMONSTRATE CONCLUSIVELY THE FIRM'S ABILITY TO PAY THE PROPOSED PENALTY. TO MAKE A DETERMINATION, ONE MUST LOOK AT THE FIRM'S OTHER OPTIONS, INCLUDING INCREASING EQUITY, SELLING ASSETS, OR LEVERAGING UNLEVERED ASSETS.

ABEL IS READY TO BEGIN OUTPUT. IF YOU WISH, PLEASE POSITION YOUR PRINTER TO THE START OF A NEW PAGE. PLEASE ENTER A CARRIAGE RETURN TO CONTINUE

DATA FOR ABEL EXAMPLE

ANALYSIS DATE: NOVEMBER 24, 1986

PROBABILITY	NET PRESENT VALUE AVAILABLE	EQUIVALENT ANNUAL CHARGE
50.0	716944.31	280891.31
60.0	679230.25	266115.37
70.0	633832.69	250298.00
80.0	591428.81	231715.82
90.0	525839.50	206018.06
95.0	471726.56	184817.56
99.0	370061.81	144986.37

THE ABOVE DATA ARE PRESENTED IN CURRENT-YEAR DOLLARS

PLEASE ENTER A CARRIAGE RETURN TO CONTINUE

THIS TABLE SHOWS THE PROBABILITY THAT THE VIOLATOR CAN FINANCE CIVIL PENALTIES OF A GIVEN AMOUNT. FOR EXAMPLE, THERE IS A 95.00 % CHANCE OF FINANCING A LUMP SUM PENALTY OF UP TO \$ 471726.56 BASED ON THE STRENGTHS OF PROJECTED INTERNALLY GENERATED CASH FLOWS. THIS IS EQUIVALENT TO ALLOWING THE FIRM TO MAKE THREE EQUAL ANNUAL PAYMENTS OF \$ 184817.56. THE ANALYSIS AT THIS POINT DOES NOT DEMONSTRATE CONCLUSIVELY THE FIRM'S ABILITY TO PAY THE PROPOSED PENALTY. TO MAKE A DETERMINATION, ONE MUST LOOK AT THE FIRM'S OTHER OPTIONS, INCLUDING INCREASING EQUITY, SELLING ASSETS, OR LEVERAGING UNLEVERED ASSETS.

DO YOU WISH TO PERFORM THE PHASE TWO ANALYSIS FOR THIS CASE AGAIN (Y OR N)?

N

DO YOU WISH TO ANALYZE ANOTHER CASE (Y OR N)?

N