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Fraud Investigation Shakes Renewable Fuels Market

by

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As a result of fraud allegations against two renewable fuel producers, and subsequent Congressional inquiries into the Renewable Fuels Program, we expect the U.S. Environmental Protection Agency to increase inspections of Renewable Fuels Program renewable identification numbers and step up enforcement in that area. In response, we expect purchasers to demand greater supplier accountability and auditing measures in renewable identification number (RIN) transactions.

Allegations that Clean Green Fuels, LLC (“Clean Green”) and Absolute Fuels, LLC (“Absolute Fuels”) generated and sold more than 80 million fraudulent Renewable Identification Numbers (“RINs”) have undermined confidence in the renewable fuels market, led to court actions, congressional scrutiny, and an aggressive “Buyer Beware” policy at the U.S. Environmental Protection Agency (“EPA”). As a result, renewable fuel producers, RIN brokers, distributors, and other market participants face significant uncertainty in the RIN market, as well as heightened enforcement.

Renewable Fuels Program Background

The Energy Policy Act of 2005 (“EPAct”) sought to reduce U.S. dependence on foreign oil and promote the transition to alternative transportation fuels by directing EPA to implement a renewable fuels standard program (“RFS1”). RFS1 mandated the blending of 4 billion gallons (“bgal.”) of renewable fuel, primarily ethanol, into gasoline sold in the U.S. each year, with stepwise increases to 7.5 bgal. by 2012.¹

Section 202 of the Energy Independence and Security Act of 2007 (“EISA”) expanded the RFS1 program significantly by raising the renewable fuel mandate to 15.2 bgal. in 2012, with stepwise increases to 36 bgal. in 2022, and by expanding the types of fuel that would qualify as renewable (“RFS2”).²

Perhaps the most controversial aspect of RFS2 was a requirement that by 2015: (1) corn-based ethanol use would be capped at 15 bgal. per year; and (2) any renewable fuel production increases would be met entirely by “advanced biofuels,” defined as “renewable fuel, other than ethanol derived from corn starch,” with 50% less lifecycle GHG emissions than conventional gasoline.

Refiners and other commercial actors (“obligated parties”) are required to demonstrate compliance with their “renewable volume obligation” (“RVO”) through the use of RINs.³ RINs are 38-character alpha numeric codes that identify renewable fuel produced or imported into the U.S. by – among other descriptors – company, facility, batch, fuel, and feedstock type. RINs remain with the renewable fuel throughout its distribution and related transactions. Once the renewable fuel has been blended into transportation fuel, the RIN becomes available to demonstrate compliance or to be traded to other entities seeking to meet their RVO.

Uproar Over Invalid RINs

On November 7, 2011, EPA issued notices of violation (“NOVs”) to 24 companies for allegedly buying and using invalid RINs to meet their

RVO.⁴ The invalid RINs were purchased from Clean Green, a Maryland-based company, whose owner allegedly generated and sold over 32 million RINs (\$9 million) without ever producing or importing a single gallon of renewable fuel. The companies that received the NOVs had purchased and used approximately 18 million of these fraudulent RINs to meet their RVO, leaving 14 million invalid RINs unaccounted for and likely remaining in circulation.

Although the U.S. Department of Justice filed criminal charges against the owner of Clean Green on October 3, 2011,⁵ the Clean Green investigation had been proceeding for some time, and EPA provided no warnings or any notice to the RIN market before issuing its November 7 NOVs. In a news release issued the next day, EPA stressed that “buyer beware” applies in the RIN context, suggesting that the Agency has no obligation to warn of threats to the RIN market:

The EPA neither certifies the validity of RINs, nor does it make any provision for obligated parties who, despite their good faith, purchased invalid RINs. As the EPA explained when it created the RFS program, “[a]n underlying principle of RIN ownership is still one of “buyer beware.” Therefore, the regulated community is urged to exercise due diligence and use caution when conducting RIN transactions.”⁶

At issue is 40 C.F.R. § 80.1431(b)(2), which states:

Invalid RINs cannot be used to achieve compliance with the Renewable Volume Obligations of an obligated party or exporter, regardless of the party's good faith belief that the RINs were valid at the time they were acquired.

While it is certainly the case that “good faith” intent is not a defense under the strict liability scheme of the RFS program, the Agency’s hands-off approach to the RIN market likely aggravated the response to its second NOV announcement. On February 2, 2012, EPA issued a NOV against the Texas-based company, Absolute Fuels, for generating and selling over 48 million biodiesel RINs (\$62 million) without producing or importing any renewable fuel.⁷

The next day, House Energy and Commerce Committee Chairman, Fred Upton (R-MI), and Energy and Power Subcommittee Chairman, Ed Whitfield (R-KY), launched their own investigations into EPA’s

¹ Pub. L. No. 109-58 (codified at 42 U.S.C. § 7545(o)), available at <http://www.gpo.gov/fdsys/pkg/PLAW-109publ58/content-detail.html>.

² RFS2 expanded from on-road gasoline to include gasoline and diesel in on-road and off-road engines, as well as locomotives and marine vessels.

³ 40 C.F.R. §§ 80.1407 - 80.1408.

⁴ See EPA's enforcement alert, available at <http://www.epa.gov/compliance/civil/caa/fuel-novs.html>.

⁵ See U.S. Department of Justice Press Release (Oct. 3, 2011), available at http://www.justice.gov/usao/md/Public-Affairs/press_releases/press08/OwnerofCleanGreenFuelChargedinSchemetoSellover9MillioninFraudulentRenewableFuelCredits.html.

⁶ EPA EnviroFlash@epa.gov email alert (Nov. 8, 2011).

⁷ See Notice of Violation, File No. AED/MSEP # 7994 (Feb. 2, 2012), available at <http://www.epa.gov/compliance/civil/caa/fuel-novs.html>.

management of the RIN cases.⁸ Senator James Inhofe (R-OK), Ranking Member of the Senate Committee on Environment and Public Works, soon followed suit, demanding a hearing into EPA's Buyer Beware policy.⁹

To date, the Agency is upholding the application of "buyer beware" to all RIN transactions, and has expressed no interest in seeking to understand or address the burdens and implications for good faith RIN-purchasers.¹⁰ Frustrated by the Agency's apparent inflexibility, a New York energy broker, OceanConnect, LLC, which purchased \$6.7 million worth of Clean Green RINs, filed a lawsuit against the EPA in the U.S. District Court for the District of Columbia.¹¹

OceanConnect's Suit Against EPA

OceanConnect's action challenges EPA's failure to timely inform the public of the RIN fraud. Specifically, OceanConnect alleges that EPA's failure to suspend or revoke the renewable fuel producer registrations of Clean Green and Absolute Fuels amounts to: (1) conduct that is arbitrary and capricious and an abuse of discretion under the Administrative Procedures Act ("APA");¹² and (2) a breach of EPA's duty to ensure the integrity of the Renewable Fuels Program. The complaint also alleges that EPA is prohibited from causing others to violate RFS2 requirements¹³ and that EPA's failure to act resulted in a Fifth Amendment deprivation of property without due process of law. The complaint also raises the common law doctrine of equitable estoppel as prohibiting the government from penalizing an individual when the government itself induces the wrongful conduct.¹⁴

OceanConnect seeks declaratory and injunctive relief, and asks that the court set aside EPA's actions invalidating the RINs the company purchased from Clean Green to the tune of \$6.7 million.

RINs Market, Transactional Risk, and EPA

The uncertainty surrounding EPA's response to the RIN fraud is likely to continue in the absence of any definitive statement about the scope of EPA's investigation. Indeed, individual RIN prices have fallen sharply since EPA released news of the investigation. In response, the market has certainly taken EPA's due diligence mantra to heart. Obligated parties and brokers increasingly are seeking to purchase RINs from a core group of large and reputable producers. Critical to such relationships will be the producer's willingness and ability to indemnify the purchaser should the RINs prove to be invalid. We also understand that RIN purchasers are increasingly demanding that brokers disclose the identity of the RIN generator prior to completing a RIN transaction.

EPA is encouraging these increased due diligence efforts and has specifically suggested that RIN purchasers visit renewable fuel production facilities to ensure actual production of renewable fuel. We would expect RIN purchasers conducting such visits to also confirm that the appropriate D Codes are being assigned to each fuel pathway. In turn, companies responding to such due diligence requests should ensure that their

responses are handled under a confidential disclosure agreement that ensures the protection of confidential business information, trade secrets, and other intellectual property. Any agreement also should address the preservation of any and all legal defenses available to both parties. Biofuel producers should also consider the sufficiency of their internal procedures and auditing practices as a confidence assurance measure.

Potentially confidential RIN information is also the subject of a recent Freedom of Information Act ("FOIA") request to EPA, which seeks:

- (1) the names of all companies that have generated biomass-based diesel RINs since RFS2's inception;
- (2) the number of biomass-based diesel RINs generated by each RIN producer, identified by production or importation and year, since RFS2's inception; and
- (3) the names of obligated parties and the number of biomass-based diesel RINs each obligated party has retired, identified by production year, since RFS2's inception.¹⁵

Pursuant to its FOIA procedures,¹⁶ EPA has notified regulated parties of the request and their right to assert business confidentiality protection for the information sought. Protection from FOIA disclosure likely does not apply to the first information request, as this information is already publicly available through EPA's "RFS2 Registered Renewable Fuel Producer List."¹⁷ The other two information requests, however, constitute the type of proprietary commercial information that could adversely affect the competitive position of transacting companies, if disclosed to the public. Accordingly, companies receiving EPA's notice of the FOIA inquiry should consider objecting to the release of such information.

For more information about the Keller and Heckman Fuels Practice, please contact fuels@khlaw.com or visit the [Fuels Practice Website](#).

⁸ See House Energy and Commerce Committee Press Release (Feb. 3, 2012), available at <http://republicans.energycommerce.house.gov/News/PRArticle.aspx?NewsID=9266>.

⁹ See Inhofe Press Release (Feb. 14, 2012), available at http://epw.senate.gov/public/index.cfm?FuseAction=Minority.PressReleases&ContentRecord_id=7d4e8198-802a-23ad-49b2-b116a7805906.

¹⁰ See EPA-Inhofe Questions and Answers, available at http://epw.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=3c6883aa-e07b-4714-bc15-18b142f22917.

¹¹ *OceanConnect, LLC v. Environmental Protection Agency*, No. 1:12-cv-00408-ESH (D.D.C. Mar. 15, 2012).

¹² 5. U.S.C. § 706.

¹³ 40 C.F.R. § 80.1460(e).

¹⁴ Complaint at 8-10, *OceanConnect, LLC v. Environmental Protection Agency*, No. 1:12-cv-00408-ESH (D.D.C. Mar. 15, 2012).

¹⁵ FOIA Request No. HQ-FOI-02231-11.

¹⁶ 40 C.F.R. Part 2, available at <http://www.epa.gov/foia/foiaregs.htm>.

¹⁷ EPA, RFS2 Registered Renewable Fuel Producer List (Mar. 15, 2012), available at <http://www.epa.gov/otaq/fuels/reporting/documents/rfs2producerlist.xls>.