

SEC ENFORCEMENT ACTION AGAINST ASHLAND INC. HAS IMPLICATIONS ON ENVIRONMENTAL REPORTING REQUIREMENTS

December 22, 2006

While there's been a lot of noise about the Securities and Exchange Commission (the "SEC") more closely scrutinizing environmental reserves in the wake of the Sarbanes-Oxley Act of 2002, 15 USC § 7201 *et seq.* ("Sarbanes-Oxley") and the Government Accounting Office Report, until recently, the SEC appeared to be all bark and no bite. On November 29, 2006, the SEC issued a cease-and-desist settlement order (the "Settlement Order") against Ashland, Inc. ("Ashland" or the "Company"), a Kentucky-based Fortune 500 chemical company, and William C. Olatin, Ashland's former Director of Environmental Remediation, in connection with alleged misstatements of Ashland's environmental reserves associated with the remediation of several active and non-active sites. In its Settlement Order, the SEC found that Ashland violated the reporting, books and records, and internal controls provisions of the Securities Exchange Act of 1934 and that Olatin caused those violations and individually violated Securities Exchange Act Rule 13b2-1 (17 C.F.R. § 240.13b2-1). Specifically, the Settlement Order states that Olatin improperly reduced remediation estimates used to determine environmental reserves and, as result, Ashland *materially understated* its environmental reserves and *overstated* its net income in periodic reports filed with the SEC from 1999 through 2001. The Ashland Order reinforces the need to for companies to closely scrutinize environmental reserves and implement management systems to ensure that benchmarking, accuracy, and reliability are part of the environmental reserves setting process.

SEC Determines Adjustments without Documentation Constitute a Violation of the Exchange Act

The SEC determined that between 1999 and 2001, Olatin made multiple reductions to the environmental remediation reserve cost estimates that had been determined by a team of engineers and an independent consultant retained by Ashland. Olatin had no reasonable basis and no supporting documentation for the reductions, according to the SEC. In particular, significant reductions were applied at various sites, thereby reducing Ashland's environmental reserves by over \$25 million and, as a consequence, increasing the Company's net income by the same amount. In making the adjustments, Olatin reduced the engineers'/consultant's estimates for sites by anywhere from 3% to 44% per site and kept no documentation to support the reductions. The SEC stated that Olatin had considered additional reserve reductions for 2002, but abandoned that plan when Ashland's internal auditors commenced an audit at approximately the time the reductions would have been finalized.

Ashland learned of Olatin's adjustments to the environmental reserves from an internal whistleblower and conducted an audit in response, but failed to discover most of Olatin's improper reductions. Shortly after Ashland's internal audit, the whistleblower, believing he was being subjected to retaliation, filed a complaint with the U.S. Department of Labor under the whistleblower protection provisions of Sarbanes-Oxley.

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During the time period when Olatin was making the reductions, Ashland's internal controls for setting the company's environmental reserves depended upon detailed, documented support for the engineers' estimates, as well as a peer critique session led by the independent consultant. The SEC Settlement Order stated, however, that Ashland's controls were inadequate because the controls did not establish guidelines for, or require documentation or review of, adjustments made by Olatin to the engineers' cost estimates.

Settlement Order with the SEC Imposes No Fines, but Results in Significant Costs

Pursuant to the SEC Settlement Order, Ashland must "cease and desist" from committing or causing future violations. While the SEC did not assess a monetary penalty, it did require Ashland to implement significant, and potentially costly, internal controls, including:

- (1) conducting an annual best practices review with an independent outside auditor for the purposes of discussing and modifying the company's policies and procedures for determining its environmental reserves;
- (2) retaining an auditor to review Ashland's policies, procedures, and internal controls with respect to the company's determination of environmental reserves and prevention of retaliation against complainants; and
- (3) additional document and records retention requirements including retaining records relating to environmental remediation for a period of seven years.

For his violations, Olatin was ordered to cease and desist from committing any future violations of the Securities Exchange Act and was precluded from participating in the determination of Ashland's environmental reserves, the creation and maintenance of Ashland's books and records and the preparation of Ashland's financial statements.

Implications of the Ashland Enforcement Action

The Ashland enforcement action sheds some light on the SEC's current views about environmental accounting matters, in particular as to reporting and reserve determination. The action suggests that the SEC may be increasing its focus on environmental reporting and is willing to hold companies accountable for failure to accurately report and document environmental reserves decisions, including changes to prior determinations. Accordingly, companies and the individuals involved with environmental reserve setting will be well served by more closely scrutinizing their decision-making with respect to establishing or changing reserves and must be extremely diligent in documenting such efforts (and retaining such documentation for appropriate periods of time). Not only will such decisions potentially be scrutinized by the SEC, independent financial auditors/certifiers will no doubt recognize the signal sent by the SEC's findings in Ashland and continue to be circumspect in reviewing reserves as well before providing certifications.

Moreover, the SEC's reliance on the Sarbanes-Oxley whistleblower provision suggests that the SEC views Sarbanes-Oxley as applying to environmental reporting. While Sarbanes-Oxley does not directly address the issue of environmental disclosures, it appears that the SEC is taking a hard look at how environmental disclosure requirements should be implemented in practice in the larger disclosure framework driven by Sarbanes-Oxley. Such practical application of Sarbanes-Oxley principles already has occurred in practice by many financial auditors/certifiers.

The Ashland action may indicate that the SEC is taking an interest in financial accounting standards on environmental issues. If this is indeed the case, then

companies should be on the lookout for future enforcement actions concerning not only environmental reserves, but also environmental disclosures and decisions made pursuant to Financial Accounting Standard ("FAS") 5 (regarding reporting for loss contingencies), FAS 143 as clarified by Financial Interpretation Number 47 (regarding reporting for obligations associated with the retirement of tangible long-lived assets). Given the expectation that the SEC likely will continue to scrutinize environmental reserve decisions, companies and environmental managers may realize significant benefits by retaining independent consultants to help address reserve and other environmental accounting issues (to help clarify/maintain appropriate documentation, to assist in more accurately defining future remediation estimates and

to avoid a potential enforcement action that directs control measures to be taken on a timeline set by regulators) in light of the SEC's Ashland decision. Finally, it is becoming increasingly prudent for companies, when setting environmental reserves, to consider whether Phase I environmental site assessments are sufficient to accurately estimate and document appropriate reserve amounts and whether uncertainty surrounding future remediation costs can (and should) be best addressed through the use of environmental insurance.

If you have any questions regarding the legal and business implications of the SEC's enforcement action, please contact your LeBoeuf Lamb relationship partner.

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