HERCULES INC
Form 10-Q
November 03, 2005

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**Quarterly Report**

**Pursuant to Section 13 or 15(d)**

**of the Securities Exchange Act of 1934**

**For the quarterly period ended September 30, 2005**

**Commission file number 1-496**

# HERCULES INCORPORATED

**A Delaware Corporation**

**I.R.S. Employer Identification No. 51-0023450**

**Hercules Plaza**

**1313 North Market Street**

**Wilmington, Delaware 19894-0001**

**Telephone: 302-594-5000**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes: ý No: o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes: ý No: o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes: o No: ý

As of October 31, 2005, 112,760,397 shares of registrant s common stock were outstanding.

**Hercules Incorporated**

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**PART I FINANCIAL INFORMATION**

**Item 1. Consolidated Financial Statements**

**HERCULES INCORPORATED**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

*(Dollars in millions, except per share)*

| | (Unaudited) | | | |
|---|---|---|---|---|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Net sales | $ 522.9 | $ 500.5 | $ 1,566.6 | $ 1,485.9 |
| Cost of sales (Note 4) | 357.5 | 327.0 | 1,054.3 | 957.6 |
| Selling, general and administrative expenses (Note 4) | 92.8 | 94.7 | 292.5 | 290.5 |
| Research and development | 10.1 | 10.4 | 30.5 | 32.6 |
| Intangible asset amortization (Note 5) | 2.0 | 2.0 | 6.0 | 6.0 |
| Other operating expense, net (Note 7) | 11.1 | 1.4 | 31.5 | 23.0 |
| Profit from operations | 49.4 | 65.0 | 151.8 | 176.2 |
| Interest and debt expense | 22.5 | 25.1 | 67.5 | 84.9 |
| Gain on sale of CP Kelco ApS | | | | (26.0) |
| Other expense, net (Note 8) | 0.2 | 49.8 | 47.1 | 93.6 |
| Income (loss) before income taxes and equity loss | 26.7 | (9.9) | 37.2 | 23.7 |
| Provision (benefit) for income taxes (Note 16) | 2.6 | 41.2 | (1.3) | 44.3 |
| Income (loss) before equity loss | 24.1 | (51.1) | 38.5 | (20.6) |
| Equity loss of affiliated companies, net of tax | (0.1) | (0.2) | (0.4) | (0.3) |
| Net income (loss) | $ 24.0 | $ (51.3) | $ 38.1 | $ (20.9) |
| Basic and diluted earnings (loss) per share (Note 6) | | | | |
| Basic earnings (loss) per share | $ 0.22 | $ (0.47) | $ 0.35 | $ (0.20) |
| Diluted earnings (loss) per share | $ 0.22 | $ (0.47) | $ 0.34 | $ (0.20) |
| Weighted-average number of shares basic (millions) | 108.9 | 107.7 | 108.7 | 107.2 |
| Weighted-average number of shares diluted (millions) | 110.7 | 107.7 | 110.5 | 107.2 |

*See accompanying notes to consolidated financial statements*

**HERCULES INCORPORATED**

**CONSOLIDATED BALANCE SHEETS**

*(Dollars in millions)*

| | (Unaudited) September 30, 2005 | December 31, 2004 |
|---|---|---|
| **ASSETS** | | |
| Current assets | | |
| Cash and cash equivalents | $ 73.2 | $ 126.5 |
| Accounts receivable, net (Note 4) | 336.0 | 346.7 |
| Inventories (Note 4) | 191.8 | 189.4 |
| Deferred income taxes | 88.8 | 44.8 |
| Asbestos-related assets (Note 13) | | 6.3 |
| Other current assets | 53.6 | 58.6 |
| Total current assets | 743.4 | 772.3 |
| Property, plant, and equipment, net (Note 4) | 636.6 | 695.4 |
| Deferred income taxes | 125.0 | 121.9 |
| Asbestos-related assets (Note 13) | 129.3 | 162.5 |
| Deferred charges and other assets | 220.2 | 245.5 |
| Intangible assets, net (Note 5) | 156.4 | 162.3 |
| Goodwill (Note 5) | 528.0 | 550.3 |
| Total assets | $ 2,538.9 | $ 2,710.2 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities | | |
| Accounts payable | $ 197.1 | $ 197.8 |
| Accrued expenses | 209.6 | 217.2 |
| Asbestos-related liabilities (Note 13) | 46.8 | 46.8 |
| Current debt obligations (Note 10) | 23.2 | 29.8 |
| Total current liabilities | 476.7 | 491.6 |
| Long-term debt (Note 10) | 1,117.3 | 1,210.3 |
| Deferred income taxes | 70.0 | 77.2 |
| Pension obligations | 252.6 | 241.4 |
| Other postretirement benefits | 70.2 | 80.5 |
| Deferred credits and other liabilities | 296.7 | 298.9 |
| Asbestos-related liabilities (Note 13) | 189.3 | 213.4 |
| Total liabilities | 2,472.8 | 2,613.3 |
| Commitments and contingencies (Note 13) | | |
| Stockholders equity | | |
| Series preferred stock | | |
| Common stock, $25/48 par value (shares issued at both 2005 and 2004 - 160.0 million) | 83.3 | 83.3 |
| Additional paid-in capital | 549.5 | 569.2 |
| Unearned compensation | (69.1) | (77.9) |
| Accumulated other comprehensive losses | (359.0) | (276.4) |
| Retained earnings | 1,559.6 | 1,521.5 |

| | | | | |
|---|---|---|---|---|
| | | 1,764.3 | | 1,819.7 |
| Reacquired stock, at cost (2005 47.2 million shares; 2004 47.8 million shares) | | 1,698.2 | | 1,722.8 |
| Total stockholders equity | | 66.1 | | 96.9 |
| Total liabilities and stockholders equity | $ | 2,538.9 | $ | 2,710.2 |

*See accompanying notes to consolidated financial statements*

**HERCULES INCORPORATED**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

*(Dollars in millions)*

| | (Unaudited) Nine Months Ended September 30, 2005 | 2004 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income (loss) | $ 38.1 | $ (20.9) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation | 59.6 | 56.1 |
| Amortization | 19.0 | 19.6 |
| Deferred income tax provision | 9.4 | (8.7) |
| Gain on disposals | (11.3) | (26.3) |
| Impairment charges | 0.5 | 6.7 |
| Write-off of debt issuance costs | 1.7 | 17.6 |
| Other non-cash charges and credits | 7.4 | 8.5 |
| Accruals and deferrals of cash receipts and payments: | | |
| Accounts receivable, net | (7.4) | (14.9) |
| Inventories | (11.4) | (5.2) |
| Asbestos-related assets, current | 6.3 | (9.3) |
| Other current assets | (2.2) | 24.9 |
| Asbestos-related assets, non-current | 35.6 | (9.4) |
| Accounts payable and accrued expenses | 9.9 | 1.0 |
| Income taxes payable | (30.1) | (36.5) |
| Pension and postretirement benefits | (23.4) | (22.5) |
| Asbestos-related liabilities | (24.1) | 44.6 |
| Non-current assets and liabilities | (1.8) | 30.5 |
| Net cash provided by operating activities | 75.8 | 55.8 |
| | | |
| **Cash Flows from Investing Activities:** | | |
| Capital expenditures | (45.7) | (53.1) |
| Proceeds from sale of minority interest in CP Kelco ApS | | 27.0 |
| Proceeds from fixed asset disposals | 15.6 | 0.4 |
| Other, net | | (0.1) |
| Net cash used in investing activities | (30.1) | (25.8) |
| | | |
| **Cash Flows from Financing Activities:** | | |
| Long-term debt proceeds | | 650.0 |
| Long-term debt repayments and repurchases | (100.5) | (707.3) |
| Change in short-term debt | 2.5 | 0.3 |
| Payment of debt issuance costs and underwriting fees | | (7.8) |
| Treasury stock issued | 2.4 | 3.0 |
| Other | (0.3) | 5.0 |
| Net cash used in financing activities | (95.9) | (56.8) |
| Effect of exchange rate changes on cash | (3.1) | (0.4) |
| Net decrease in cash and cash equivalents | (53.3) | (27.2) |
| Cash and cash equivalents beginning of period | 126.5 | 126.3 |
| Cash and cash equivalents end of period | $ 73.2 | $ 99.1 |
| | | |
| **Supplemental Disclosures of Cash Flow Information:** | | |
| Cash paid during the period for: | | |
| Interest and debt expense | $ 59.1 | $ 67.8 |

| | | |
|---|---|---|
| Income taxes | 17.9 | 42.1 |
| Non-cash investing and financing activities: | | |
| Incentive and other employee benefit stock plan issuances | 12.0 | 14.2 |

*See accompanying notes to consolidated financial statements*

**HERCULES INCORPORATED**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

*(Dollars in millions)*

| | (Unaudited) | | | |
|---|---|---|---|---|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Net income (loss) | $ 24.0 | $ (51.3) | $ 38.1 | $ (20.9) |
| Foreign currency translation | (2.2) | 14.3 | (67.1) | (0.1) |
| (Increase) decrease in additional minimum pension liability due to: | | | | |
| Remeasurement adjustments | (20.2) | (41.4) | (20.2) | (41.4) |
| Foreign currency translation | 0.9 | 0.1 | 4.7 | |
| Comprehensive income (loss) | $ 2.5 | $ (78.3) | $ (44.5) | $ (62.4) |

*See accompanying notes to consolidated financial statements*

**HERCULES INCORPORATED**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Dollars and shares in millions, except per share amounts)*

*(Unaudited)*

## 1. Basis of Presentation

The interim consolidated financial statements and the notes to the consolidated financial statements of Hercules Incorporated ( Hercules or the Company ) are unaudited as of and for the three and nine months ended September 30, 2005 and 2004, but in the opinion of management include all adjustments (consisting only of normal recurring adjustments) necessary for a fair statement of Hercules financial position and results of operations for the interim periods. These consolidated financial statements should be read in conjunction with the accounting policies, financial statements and notes included in Hercules Annual Report on Form 10-K for the year ended December 31, 2004. Certain prior period amounts have been reclassified to conform to the current period presentation.

## 2. Stock-based Compensation

Pursuant to the disclosure requirements of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ), as amended by Statement of Financial Accounting Standards No. 148, Accounting for Stock-Based Compensation Transition and Disclosure ( SFAS 148 ), the following table presents the pro forma effect on net income and earnings per share assuming the Company had applied the fair value recognition provisions of SFAS 123 to all stock-based employee compensation on a retroactive basis.

| | Three Months Ended September 30, 2005 | Three Months Ended September 30, 2004 | Nine Months Ended September 30, 2005 | Nine Months Ended September 30, 2004 |
|---|---|---|---|---|
| Net income (loss), as reported | $ 24.0 | $ (51.3) | $ 38.1 | $ (20.9) |
| Add: Stock-based compensation, net of tax, included in reported results | 0.8 | 0.6 | 5.0 | 2.3 |
| Deduct: Stock-based compensation, net of tax, determined under the fair value based method for all awards | (0.8) | (1.0) | (5.6) | (3.9) |
| Pro forma net income (loss) | $ 24.0 | $ (51.7) | $ 37.5 | $ (22.5) |
| Earnings (loss) per share: | | | | |
| Basic as reported | $ 0.22 | $ (0.47) | $ 0.35 | $ (0.20) |
| Basic pro forma | $ 0.22 | $ (0.48) | $ 0.35 | $ (0.21) |
| Diluted as reported | $ 0.22 | $ (0.47) | $ 0.34 | $ (0.20) |
| Diluted pro forma | $ 0.22 | $ (0.48) | $ 0.34 | $ (0.21) |

### 3. Recent Accounting Pronouncements

On December 16, 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment ( SFAS 123R ). On April 14, 2005, the Securities and Exchange Commission issued an amendment to Rule 4-01 of Regulation S-X that allows companies to implement SFAS 123R at the beginning of their next fiscal year, instead of the next reporting period that begins after June 15, 2005 as originally required. Accordingly, the Company now plans to adopt SFAS 123R effective January 1, 2006 using the modified prospective method in which compensation cost is recognized beginning with the effective date based on (a) the requirements of SFAS 123R for all share-based payments granted after the effective date and (b) the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date. In addition, the Company expects to continue to utilize the Black-Scholes option-pricing model, which is an acceptable option valuation model in accordance with SFAS 123R, to estimate the value of stock options granted to employees.

Beyond those restricted stock and stock option awards previously granted, the Company cannot predict with certainty the impact of SFAS 123R on its future consolidated financial statements as the type and amount of such awards are determined on an annual basis and encompass a potentially wide range depending upon the compensation decisions made by the Human Resources Committee of the Company s Board of Directors. SFAS 123R also requires the benefits of tax deductions in excess of compensation cost recognized in the financial statements to be reported as a financing cash flow, rather than as an operating cash flow as currently required under Statement of Financial Accounting Standards No. 95, Statement of Cash Flows ( SFAS 95 ). This requirement, to the extent it exists, will decrease net operating cash flows and increase net financing cash flows in periods subsequent to adoption. The Company cannot estimate what those amounts will be in the future because they depend on, among other things, when employees exercise stock options.

On March 29, 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ) which expresses the views of the SEC Staff regarding the interaction of SFAS 123R and certain SEC rules and regulations and provides the staff s views regarding the valuation of share-based payment arrangements. The Company believes that the views provided in SAB 107 are consistent with the approach taken in the valuation and accounting associated with share-based compensation issued in prior periods as well as those issued during 2005.

On March 30, 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations an interpretation of FASB Statement No. 143 ( FIN 47 ). FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, Accounting for Asset Retirement Obligations ( SFAS 143 ), refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional upon a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional despite uncertainty regarding the timing or method of settlement, including those that may be conditional on a future event. Accordingly, entities are required to recognize a liability for a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Uncertainty about the timing and (or) method of settlement should be factored into the measurement of the liability when sufficient information exists. FIN 47 also clarifies when sufficient information to reasonably estimate the fair value of an asset retirement obligation is considered available.

The Company is currently in the process of evaluating the requirements of FIN 47 as it applies, primarily, to active manufacturing and other facilities as well as individual components of those facilities. The Company previously recognized obligations primarily associated with certain of its inactive facilities in accordance with SFAS 143 in 2003. At this time the Company is not in a position to provide a meaningful range of estimates of any conditional asset retirement obligations that may be required to be recognized in accordance with FIN 47. To the extent any conditional asset retirement obligations are identified, the Company will recognize the cumulative effect of the initial application of FIN 47 as a change in accounting principle. The Company plans to continue its evaluation process to ensure that adoption will be completed prior to the effective date of December 31, 2005.

On June 1, 2005, the FASB issued Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 ( SFAS 154 ). SFAS 154 changes the requirements for the accounting and reporting of a change in accounting principle. SFAS 154 applies to all voluntary changes in accounting principle as well as changes required by an accounting pronouncement that do not otherwise include specific transition provisions. Previously, most changes in accounting principle were required to be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 requires retrospective application to prior periods financial statements of a change in accounting principle as if that principle had always been used. In addition, SFAS 154 requires that retrospective application of a change in accounting principle be limited to the direct effects of the change while indirect effects should be recognized in the period of the accounting change. SFAS 154 will be effective for fiscal years beginning after December 15, 2005. The impact of the adoption of SFAS 154 will depend upon the nature of accounting changes the Company may initiate in future periods, if any.

## 4. Additional Balance Sheet and Statement of Operations Detail

| | September 30, 2005 | December 31, 2004 |
|---|---|---|
| Accounts receivable, gross | $ 341.6 | $ 351.4 |
| Allowance for doubtful accounts | (5.6) | (4.7) |
| Accounts receivable, net | $ 336.0 | $ 346.7 |
| Inventories: | | |
| Finished goods | $ 100.3 | $ 95.2 |
| Raw materials and work-in-process | 63.1 | 64.9 |
| Supplies | 28.4 | 29.3 |
| Inventories | $ 191.8 | $ 189.4 |
| Property, plant and equipment: | | |
| Land | $ 17.4 | $ 19.6 |
| Buildings and equipment | 1,937.0 | 1,998.9 |
| Construction in progress | 50.9 | 70.8 |
| | 2,005.3 | 2,089.3 |
| Accumulated depreciation and amortization | (1,368.7) | (1,393.9) |
| Property, plant and equipment, net | $ 636.6 | $ 695.4 |

Cost of sales and Selling, general and administrative expenses include depreciation expense relating to continuing operations totaling $19.1 million and $18.3 million for the three months ended September 30, 2005 and 2004, respectively, and $57.7 million and $56.1 million for the nine months ended September 30, 2005 and 2004, respectively.  Charges of $0.6 million and $1.5 million related to the accelerated depreciation expense of the Barneveld research facility and related assets have been included in Other operating expense, net for the three and nine months ended September 30, 2005, respectively. In addition, accelerated depreciation expense of $0.4 million related to the Pandaan, Indonesia manufacturing facility is also included in Other operating expense, net for the three months ended September 30, 2005.

## 5. Goodwill and Other Intangible Assets

The following table shows changes in the carrying amount of goodwill by operating segment for the nine months ended September 30, 2005.

| | Performance Products | Engineered Materials and Additives | Total |
|---|---|---|---|
| Balance, December 31, 2004 | $ 465.4 | $ 84.9 | $ 550.3 |
| Foreign currency translation | (22.3) | | (22.3) |
| | | | |
| Balance, September 30, 2005 | $ 443.1 | $ 84.9 | $ 528.0 |

The following table provides information regarding the Company s other intangible assets with finite lives:

| | Customer Relationships | Trademarks and Tradenames | Other Intangibles | Total |
|---|---|---|---|---|
| Gross carrying amount | | | | |
| | | | | |
| Balance, December 31, 2004 | $ 90.0 | $ 73.9 | $ 52.5 | $ 216.4 |
| Balance, September 30, 2005 | 90.0 | 73.9 | 52.6 | 216.5 |
| | | | | |
| Accumulated amortization | | | | |
| | | | | |
| Balance, December 31, 2004 | $ 13.9 | $ 11.5 | $ 28.7 | $ 54.1 |
| Balance, September 30, 2005 | 15.8 | 13.2 | 31.1 | 60.1 |

Total amortization expense for Other intangible assets was $2.0 million for each of the three months ended September 30, 2005 and 2004, respectively, and $6.0 million for each of the nine month periods ended September 30, 2005 and 2004. Estimated amortization expense is $8.0 million for 2005, $7.8 million for both 2006 and 2007, $7.4 million for 2008, $6.1 million for 2009 and $5.9 million for 2010.

## 6. Earnings Per Share

The following tables show the amounts used in computing basic and diluted earnings (loss) per share and the weighted-average number of shares of basic and diluted common stock:

| | Three Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2005 | | 2004 | |
| | Income | Earnings Per Share | Loss | Loss Per Share |
| **Basic earnings (loss) per share:** | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net income (loss) | $ | 24.0 | $ | 0.22 | $ | (51.3) | $ | (0.47) |
| Weighted-average number of basic shares | | 108.9 | | | | 107.7 | | |
| | | | | | | | | |
| **Diluted earnings (loss) per share:** | | | | | | | | |
| Net income (loss) | $ | 24.0 | $ | 0.22 | $ | (51.3) | $ | (0.47) |
| Weighted-average number of diluted shares | | 110.7 | | | | 107.7 | | |

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| | Nine Months Ended September 30, 2005 Income | | 2005 Earnings Per Share | | 2004 Loss | | 2004 Loss Per Share |
|---|---|---|---|---|---|---|---|
| **Basic earnings (loss) per share:** | | | | | | | |
| Net income (loss) | $ | 38.1 | $ | 0.35 | $ | (20.9) | $ (0.20) |
| Weighted-average number of basic shares | | 108.7 | | | | 107.2 | |
| **Diluted earnings (loss) per share:** | | | | | | | |
| Net income (loss) | $ | 38.1 | $ | 0.34 | $ | (20.9) | $ (0.20) |
| Weighted-average number of diluted shares | | 110.5 | | | | 107.2 | . |

For each of the three and nine months ended September 30, 2005, respectively, the Company had convertible subordinated debentures, stock options and restricted stock, which were convertible into approximately 1.8 million shares of common stock. Stock options, restricted stock and convertible debentures aggregating approximately 1.4 million shares were anti-dilutive for each of the three and nine months ended September 30, 2004 and are not included in the calculation of diluted earnings per share. The related interest on the convertible subordinated debentures has an immaterial impact on the earnings per share calculations for the 2004 periods.

The following table shows the number of options and warrants that have been excluded from the computation of diluted earnings per share as their exercise price exceeded their current market value:

| | Three Months Ended September 30, 2005 | Three Months Ended September 30, 2004 | Nine Months Ended September 30, 2005 | Nine Months Ended September 30, 2004 |
|---|---|---|---|---|
| Options to purchase common stock | 7.3 | 11.1 | 7.3 | 12.3 |
| Warrants to purchase common stock | 7.1 | 7.1 | 7.1 | 7.1 |

## 7. Other Operating Expense, Net

Other operating expense, net consists of the following:

| | Three Months Ended September 30, 2005 | | 2004 | | Nine Months Ended September 30, 2005 | | 2004 |
|---|---|---|---|---|---|---|---|
| Severance, restructuring and other exit costs, net | $ 9.4 | $ | 1.7 | $ | 27.7 | $ | 8.0 |
| Consulting charges related to legacy issues | | | | | 0.8 | | |
| Asset impairment charges | 0.5 | | | | 0.5 | | 6.7 |
| Nitrocellulose facility shutdown costs (recoveries) | | | (0.8) | | | | 5.5 |
| Special executive pension adjustment | | | 0.2 | | | | 1.6 |
| Other, net | 1.2 | | 0.3 | | 2.5 | | 1.2 |
| | $ 11.1 | $ | 1.4 | $ | 31.5 | $ | 23.0 |

## 8. Other Expense, Net

Other expense, net consists of the following:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Environmental charges for non-operating facilities and sites | $ 3.6 | $ 1.0 | $ 20.7 | $ 2.8 |
| Loss on repurchase of debt | 5.2 | 15.2 | 14.9 | 44.0 |
| Asbestos-related costs | 1.2 | 33.4 | 5.0 | 40.2 |
| Gain on dispositions | (10.9) | | (10.9) | |
| Other litigation settlements and accruals | 1.4 | 0.4 | 18.2 | 7.4 |
| Other, net | (0.3) | (0.2) | (0.8) | (0.8) |
| | $ 0.2 | $ 49.8 | $ 47.1 | $ 93.6 |

The gain on dispositions is attributable to the sale of properties in Langhorne, Pennsylvania and Burlington, New Jersey that were non-operating facilities associated with the previously divested water treatment and resins businesses, respectively. Approximately $4.4 million of the total gain relates to the transfer of an asset retirement obligation in connection with the sale of the Burlington property. Prior to their sales, these properties had been classified as assets held for sale and included in other current assets since the fourth quarter of 2004.

## 9. Severance, Restructuring and Other Exit Costs

During the three months ended September 30, 2005, the Company announced personnel reductions of 88 employees under its Severance Pay Plan and Dismissal Wage Plan ( Dismissal Plans ) bringing 2005 year-to-date total reductions to 251 employees. As a result, $7.8 million and $22.8 million, respectively, was recognized in Other operating expense, net for the three and nine months ended September 30, 2005. Of the year-to-date charges, $13.0 million, $4.0 million and $5.8 million related to the Performance Products segment, the Engineered Materials and Additives segment, and Corporate, respectively.

In 2004, the Company announced its intent to close a European research facility located in Barneveld, The Netherlands, which had 56 employees. The severance and termination agreements, which constitute one-time termination benefits, were approved by the local works council during the quarter ended March 31, 2005. Subsequently, the Company terminated 48 employees and offered relocation to the remaining 8 employees. Accordingly, a liability of approximately $3.7 million associated with the terminations has been recognized ratably to Other operating expense, net over a ten-month period from the communication date through the actual closure in September 2005. In addition to the termination costs which have been accrued as a liability, the Company incurred and paid approximately $1.2 million of exit costs related to the closure of the facility. During the three months ended September 30, 2005, the Company closed its Pandaan, Indonesia manufacturing facility in connection with a strategic realignment of its Pulp and Paper business in the Asia Pacific region. In connection with the closing, the Company terminated approximately 40 employees and recorded a one-time termination benefit cost of approximately $0.2 million. The termination and exit costs associated with these actions are subject to the accounting requirements of Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities ( SFAS 146 ).Year-to-date charges in accordance with SFAS 146 of approximately $3.6 million, $0.1 million, and $1.2 million were recognized by the Performance Products segment, the Engineered Materials and Additives segment, and Corporate respectively.

3. Recent Accounting Pronouncements

Cash payments for severance and restructuring during the three and nine months ended September 30, 2005 were $8.2 million and $14.6 million, respectively. Current year cash payments through September 30, 2005 include $0.6 million for severance under the Company s 2001 restructuring plan, $11.9 million for severance liabilities recognized under the Company s Dismissal Plans, and $2.1 million for SFAS 146 restructuring obligations.

A consolidated reconciliation of activity with respect to the liabilities for these plans is as follows:

| | | |
|---|---|---|
| Balance, December 31, 2004 | $ | 5.8 |
| Additional termination costs recognized | | 22.8 |
| Charges for SFAS 146 terminations and relocations | | 3.7 |
| Cash payments | | (14.6) |
| Other, including foreign currency translation | | (0.4) |
| Balance, September 30, 2005 | $ | 17.3 |

The balance at September 30, 2005 is comprised of $1.3 million pertaining to the continuing benefit payment streams under the 2001 restructuring plan, $14.1 million related to other severance benefits accounted for under the Company s Dismissal Plans and $1.9 million associated with SFAS 146 restructuring liabilities.

## 10. Debt

A summary of debt follows:

| | | September 30, 2005 | | December 31, 2004 |
|---|---|---|---|---|
| Term B Loan due 2010 | $ | 394.0 | $ | 397.0 |
| 6.60% notes due 2027 | | 100.0 | | 100.0 |
| Term notes at various rates from 2.91% to 7.16% due in varying amounts through 2020 | | 14.0 | | 27.8 |
| 11.125% senior notes due 2007 | | 140.0 | | 226.0 |
| 6.75% senior subordinated notes due 2029 | | 250.0 | | 250.0 |
| 8% convertible subordinated debentures due 2010 | | 2.6 | | 2.6 |
| 6.50% junior subordinated deferrable interest debentures due 2029 | | 229.6 | | 229.0 |
| Other | | 10.3 | | 7.7 |
| | | 1,140.5 | | 1,240.1 |
| Less: Current debt obligations | | 23.2 | | 29.8 |
| Long-term debt | $ | 1,117.3 | $ | 1,210.3 |

During the three months ended September 30, 2005, the Company acquired $33.2 million (book value) of the 11.125% senior notes for $37.8 million. The Company recognized a loss of $4.6 million on the repurchase and a $0.6 million non-cash expense for the write-off of the unamortized debt issuance costs related to the repurchased debt. For the nine months ended September 30, 2005, the Company has repurchased $86.0 million (book value) of the 11.125% senior notes for $99.2 million. The Company has recognized year-to-date losses of $13.2 million on this repurchased debt and $1.7 million of non-cash expenses for the write-off of related unamortized debt issuance costs.

As of September 30, 2005 the weighted-average interest rate on the Term B Loan, which bears interest at LIBOR + 1.75%, was 5.33%.

As of September 30, 2005, $84.5 million of the $150.0 million Revolving Facility under the Company s Senior Credit Facility was available for use. The Company had $65.5 million of outstanding letters of credit associated with the Revolving Facility at September 30, 2005. On October 3, 2005, the Company issued a further letter of credit for $25.0 million, reducing the amount available for use under the Revolving Facility to $59.5 million. In addition, the Company expects to further increase its outstanding letters of credit by an additional $15.0 million in December, 2005. During June 2005 the Senior Credit Facility was amended to reduce the interest rate on the Revolving Facility to LIBOR + 1.25%. At September 30, 2005, Hercules had available and unused foreign lines of credit totaling $33.2 million.

The Company s Senior Credit Facility requires quarterly compliance with certain financial covenants, including a debt/EBITDA ratio ( leverage ratio ) and an interest coverage ratio and established limitations on the permitted amount of capital expenditures.

## 11. Pension and Other Postretirement Benefits

The following tables set forth the consolidated net periodic pension and other postretirement benefit costs recognized for the three and nine months ended September 30, 2005 and 2004.

| | Pension Benefits | | | |
|---|---|---|---|---|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| **Net periodic benefit cost:** | | | | |
| Service cost | $ 4.5 | $ 4.7 | $ 14.4 | $ 15.1 |
| Interest cost | 25.0 | 22.2 | 75.8 | 72.7 |
| Expected return on plan assets | (28.5) | (25.5) | (87.1) | (83.5) |
| Amortization and deferrals | 0.5 | 0.9 | 1.6 | 3.0 |
| Special benefits | | 0.2 | | 1.1 |
| Actuarial losses recognized | 10.0 | 8.1 | 29.6 | 26.6 |
| | $ 11.5 | $ 10.6 | $ 34.3 | $ 35.0 |

| | Postretirement Benefits | | | |
|---|---|---|---|---|
| | Three Months Ended September 30, | | Nine months Ended September 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| **Net periodic benefit cost:** | | | | |
| Service cost | $ 0.2 | $ 0.1 | $ 0.6 | $ 0.5 |
| Interest cost | 3.1 | 1.9 | 8.3 | 8.5 |
| Amortization and deferrals | (2.5) | (1.4) | (6.7) | (6.0) |
| Actuarial losses recognized | 1.5 | 1.2 | 4.1 | 5.0 |
| | $ 2.3 | $ 1.8 | $ 6.3 | $ 8.0 |

Total contributions expected to be made to the Company s plans during 2005 are $45.0 million, including $40.0 million in voluntary contributions made to the U.S. defined benefit plan in January 2005.

During the three months ended September 30, 2005, the Company received the final evaluation report for its qualified and non-qualified pension plans as of January 1, 2005. The final valuation report indicated the additional minimum liability was $32.1 million higher than the estimated additional minimum liability recorded as of December 31, 2004 resulting in an after tax change of $20.2 million recorded in other comprehensive income.

**12. Asset Retirement Obligations**

The following table provides a reconciliation of the changes in the asset retirement obligations ( ARO ) during the period.

| | SFAS 143 ARO Sites | Non-SFAS 143 Sites | Total |
|---|---|---|---|
| Balance, January 1, 2005 | $ 96.3 | $ 2.8 | $ 99.1 |
| Liabilities incurred | | 16.3 | 16.3 |
| Accretion | 1.5 | | 1.5 |
| Remediation-related payments | (6.2) | (0.6) | (6.8) |
| Foreign currency translation | (0.8) | | (0.8) |
| Changes in estimated obligations | 3.4 | | 3.4 |
| Transfers of obligations | (4.4) | | (4.4) |
| Balance, September 30, 2005 | $ 89.8 | $ 18.5 | $ 108.3 |

## 13. Commitments and Contingencies

**Guarantees**

In accordance with FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others ( FIN 45 ), disclosure about each group of guarantees is provided below:

**Indemnifications**

In connection with the sale of Company assets and businesses, the Company has indemnified respective buyers against certain liabilities that may arise in connection with the sale transactions and business activities prior to the ultimate closing of the sale. The terms of these indemnifications typically pertain to environmental, tax, employee and/or product related matters. If the indemnified party were to incur a liability or have a liability increase as a result of a successful claim, pursuant to the terms of the indemnification, the Company would be required to protect, defend, and/or indemnify the buyer. These indemnifications are generally subject to threshold amounts, specified claim periods and/or other restrictions and limitations. The carrying amount recorded for indemnifications as of September 30, 2005 was $40.0 million.

In addition, in connection with these transactions, the Company has generally provided indemnifications on general corporate matters such as ownership of the relevant assets, the power and corporate authority to enter into transactions and the satisfaction of liabilities not assumed by the buyer. These indemnifications generally have indefinite terms.

As noted in greater detail in the Litigation section of this note, the Company has entered into comprehensive settlement agreements with substantially all of its insurance carriers that provided coverage for asbestos-related products liabilities. Under the terms of those agreements and in exchange for payments received and to be received from such insurance carriers, the Company has released and agreed to indemnify such insurers from claims asserted under their cancelled policies.

Although it is reasonably possible that future payments may exceed amounts accrued, due to the nature of indemnified items, it is not possible to make a reasonable estimate of the maximum potential loss or range of loss. Generally, there are no specific recourse provisions.

In addition, the Company provides certain indemnifications in the ordinary course of business such as product, patent and performance warranties in connection with the manufacture, distribution and sale of its products and services. Due to the nature of these indemnities, it is not possible to make a reasonable estimate of the maximum potential loss or range of loss.

**Debt Obligations**

The Company has directly guaranteed $53.9 million of various obligations under agreements with third parties related to subsidiaries and affiliates of which $17.2 million was outstanding at September 30, 2005. The outstanding balance reflects guarantees of $7.5 million related to the debt of FiberVisions A/S that matures at various dates through 2006, $2.8 million related to the debt of Shanghai Hercules Chemical that expires this year, $4.2 million related to a foreign-based pension plan with an indefinite term, $0.7 million related to the debt of Hercules Trading (Shanghai) and $2.0 million related to the debt obligations of previously disposed operations that expire in 2007. In addition to the aforementioned $4.2 million guarantee, the Company has provided approximately $2.6 million in collateral through a mortgage security related to the pension plan liability. Existing guarantees for subsidiaries and affiliates arose from liquidity needs in normal operations.

**Intercompany Guarantees**

The Company and its subsidiaries have authorized intercompany guarantees between and among themselves, which aggregate approximately $193.6 million of which $163.6 million was outstanding at September 30, 2005. These guarantees relate to intercompany loans used to facilitate normal business operations and have been eliminated from the Company s Consolidated Financial Statements.

**Environmental**

In the ordinary course of its business, the Company is subject to numerous environmental laws and regulations covering compliance matters or imposing liability for the costs of, and damages resulting from, cleaning up sites, past spills, disposals and other releases of hazardous substances. Changes in these laws and regulations may have a material adverse effect on the Company s financial position and results of operations. Any failure by the Company to adequately comply with such laws and regulations could subject the Company to significant future liabilities.

Hercules has been identified as a potentially responsible party ( PRP ) by U.S. federal and state authorities, or by private parties seeking contribution for the cost of environmental investigation and/or cleanup at numerous sites. Hercules becomes aware of sites in which it may be named a PRP in investigatory and/or remedial activities through correspondence from the U.S. Environmental Protection Agency ( EPA ) or other government agencies or from previously named PRPs, who either request information or notify the Company of its potential liability. The Company has established procedures for identifying environmental issues at its plant sites. In addition to environmental audit programs, the Company has environmental coordinators who are familiar with environmental laws and regulations and act as a resource for identifying environmental issues.

The range of the reasonably possible share of costs for the investigation and cleanup of current and former operating sites, and other locations where the Company may have a known liability, is between $108.3 million and $201.3 million. In accordance with generally accepted accounting principles, the Company has accrued a liability of $108.3 million at September 30, 2005, representing the low end of the range, since no amount within the range is a better estimate than any other amount (see Note 12). This accrued liability is evaluated quarterly based on currently available information, including the progress of remedial investigations at each site and the current status of negotiations with regulatory authorities regarding the method and extent of apportionment of costs among other PRPs.

The actual costs for these matters will depend upon numerous factors, including the number of parties found responsible at each environmental site and their ability to pay; the actual methods of remediation required or agreed to; outcomes of negotiations with regulatory authorities; outcomes of litigation; changes in environmental laws and regulations; technological developments; and the years of remedial activity required, which could range from 0 to 30 or more years. While it is not feasible to predict the outcome of all pending environmental matters, the ultimate resolution of one or more of these environmental matters could have a material adverse effect upon the Company s financial position, results of operations and/or cash flows for any annual, quarterly or other period.

While the Company is involved in numerous environmental matters, the following matters are described below because they are currently viewed by management as potentially material to the Company s consolidated financial position, results of operations and cash flows.

United States, et al. v. Vertac Corporation, et al., USDC No. LR-C-80-109 and LR-C-80-110 (E.D. Ark.)

This case, a cost-recovery action based upon the Comprehensive Environmental Response, Compensation and Liability Act ( CERCLA , or the Superfund statute ), as well as other statutes, has been pending since 1980, and involves liability for costs in connection with the investigation and remediation of the Vertac Chemical Company ( Vertac ) site in Jacksonville, Arkansas. Hercules owned and operated the site from December 1961 until 1971. The site was used for the manufacture of certain herbicides and, at the order of the United States, Agent Orange. In 1971, the site was leased to Vertac s predecessor. In 1976, Hercules sold the site to Vertac. The site was abandoned by Vertac in 1987, and Vertac was subsequently placed into receivership. Both prior to and following the abandonment of the site, the EPA and the Arkansas Department of Pollution Control and Ecology ( ADPC&E ) were involved in the investigation and remediation of contamination at and around the site. Pursuant to several orders issued under CERCLA, Hercules actively participated in many of these activities. The cleanup is essentially complete, except for certain on-going maintenance and monitoring activities. This litigation primarily concerns the responsibility and allocation of liability for the costs incurred in connection with the activities undertaken by the EPA and the ADPC&E.

Although the case initially involved many parties, as a result of various United States District Court rulings and decisions, as well as a trial, Hercules and Uniroyal were held jointly and severally liable for the approximately $100 million in costs allegedly incurred by the EPA and the ADPC&E, as well as costs to be incurred in the future. That decision was made final by the District Court on September 13, 1999. Both Hercules and Uniroyal timely appealed that judgment to the United States Court of Appeals for the Eighth Circuit.

On February 8, 2000, the District Court issued a final judgment on the allocation between Hercules and Uniroyal finding Uniroyal liable for 2.6% and Hercules liable for 97.4% of the costs at issue. Hercules timely appealed that judgment. Oral argument on both appeals was held before the United States Court of Appeals for the Eighth Circuit on June 12, 2000. On April 10, 2001, the Appeals Court issued an opinion in the consolidated appeals described above. In that opinion, the Appeals Court reversed the District Court s decision which had held Hercules jointly and severally liable for costs incurred and to be incurred at the Jacksonville site, and remanded the case back to the District Court for several determinations, including a determination of whether the harms at the site giving rise to the government s claims were divisible. The Appeals Court also vacated the District Court s allocation decision holding Hercules liable for 97.4% of the costs at issue, ordering that these issues be revisited following further proceedings with respect to divisibility. Finally, the Appeals Court affirmed the judgment of liability against Uniroyal.

The trial on remand commenced on October 9, 2001, continued through October 19, 2001, resumed on December 11, 2001 and concluded on December 14, 2001. At the trial, the Company presented both facts and law to the District Court in support of its belief that the Company should not be liable under CERCLA for some or all of the costs incurred by the government in connection with the site because those harms are divisible.

By Memorandum Opinion and Order dated March 30, 2005, the District Court largely affirmed its prior findings and prior judgment against the Company and Uniroyal and the prior allocation with respect to the Company and Uniroyal, although the District Court did agree that the Company should not be liable for costs associated with a particular off-site landfill, and held that the judgment should be reduced accordingly. By Order dated June 6, 2005, the District Court entered a Final Judgment in favor of the United States and against Hercules for $119.3 million of which Uniroyal is jointly and severally liable for $110.4 million. The Final Judgment also provided that both Hercules and Uniroyal are responsible for any additional response costs incurred or to be incurred by the United States after June 1, 1998, as well as post-judgment interest running from the date of the Final Judgment. In addition, the District Court re-affirmed its prior allocation holding which allocated 2.6% of the $110.4 million in response costs for which Uniroyal is jointly and severally liable, or $2.9 million, to Uniroyal. Finally, the Final Judgment found Uniroyal liable to Hercules for 2.6% of the response costs incurred by Hercules of approximately $27.4 million, or $0.7 million. The Company believes that the District Court committed reversible error in reaching its conclusions and has appealed the District Court s judgment to the United States Court of Appeals for the Eighth Circuit. As a result of some of the findings set forth by the District Court in its opinion, however, the Company determined that it has a probable and reasonably estimable liability of $14.8 million plus interest and established an accrual in that amount in March 2005. The Company will continue to accrue interest on this amount until final disposition of the judgment.

Alleghany Ballistics Laboratory

The Alleghany Ballistics Laboratory ( ABL ) is a government-owned facility which was operated by Hercules from 1945 to 1995 under contract with the United States Department of the Navy. The Navy has notified Hercules that it would like to negotiate with Hercules with respect to certain environmental liabilities which, the Navy alleges, are attributable to Hercules past operations at ABL. During the course of discussions, the Navy has stated that, pursuant to CERCLA, it has spent a total of approximately $25.0 million and expects to spend an additional $44.0 million over the next 10 years. The Company has conducted an initial investigation of the Navy s allegations, including the basis of the Navy s claims, and believes the contracts with the government pursuant to which the Company operated ABL may provide the Company with a defense from some or all of the amounts sought. The Company has exchanged information with the Navy and discussions with the Navy are continuing. At this time, however, the Company cannot reasonably estimate its liability, if any, with respect to ABL and, accordingly, has not included this site in the range of its environmental liabilities reported above.

Kim Stan Landfill

Hercules is one of a limited number of industrial companies that have been identified by the EPA as a PRP at the Kim Stan Landfill, near Covington, Virginia. The EPA is seeking to have the PRPs undertake the remediation of the site at a currently estimated cost of $12.0 million (including EPA oversight charges). Based on the investigation conducted to date, the Company believes that parties not named by the EPA as PRPs may be responsible for the majority of the costs that have been and will be incurred at the site and intends to seek contribution from those parties to the extent it is required to pay any monies in connection with the site. The Company is continuing to evaluate the EPA s allegations and, pending further investigation, is not able to determine its exposure, if any, with respect to this site. EPA has invited the Company and two other PRPs (collectively the PRP Group ) to engage in negotiations to resolve EPA s claims.

**Litigation**

The Company is involved in litigation arising out of or incidental to the conduct of its business. Such litigation typically falls within the following broad categories: environmental (previously discussed); antitrust; commercial; intellectual property; labor and employment; personal injury; property damage; product liability; and toxic tort. These matters typically seek unspecified or large monetary damages or other relief. While it is not feasible to predict the outcome of all pending matters, the ultimate resolution of one or more of these matters could have a material adverse effect upon the Company s financial position, results of operations and/or cash flows for any annual, quarterly or other period. While the Company is involved in numerous matters, the following matters are described below because they are currently viewed by management as potentially material. From time to time, management may determine (based on further analysis or additional information that becomes available, through discovery or otherwise) that other matters are or have become potentially material to the Company. As appropriate, descriptions of such matters will be included in the periodic report following such determination. Occasionally, management may not determine that a matter is material until it has been settled or otherwise resolved. In such a situation, that matter may not have been described in the Company s periodic reports prior to such settlement or resolution, but the impact of such settlement or resolution would be reflected in the financial statements included in the periodic report following such settlement or resolution.

Asbestos

The Company is a defendant in numerous asbestos-related personal injury lawsuits and claims which typically arise from alleged exposure to asbestos fibers from resin encapsulated pipe and tank products which were sold by one of the Company s former subsidiaries to a limited industrial market ( products claims ). The Company is also a defendant in lawsuits alleging exposure to asbestos at facilities formerly or presently owned or operated by the Company ( premises claims ). Claims are received and settled or otherwise resolved on an on-going basis.

As of September 30, 2005, there were approximately 31,075 unresolved claims, of which approximately 985 were premises claims and the rest were products claims. There were also approximately 1,535 unpaid claims which have been settled or are subject to the terms of a settlement agreement. In addition, as of September 30, 2005, there were approximately 1,146 claims which have either been dismissed without payment or are in the process of being dismissed without payment, but with plaintiffs retaining the right to re-file should they be able to establish exposure to an asbestos-containing product for which the Company bears liability.

Between January 1, 2004 and December 31, 2004, the Company received approximately 8,305 new claims, approximately one third of which were included in consolidated complaints naming one hundred or more plaintiffs and a large number of defendants, but providing little information connecting any specific plaintiff s alleged injuries to any specific defendant s products or premises. It is the Company s belief that a significant majority of these consolidated claims will be dismissed for no payment. Between January 1, 2005 and September 30, 2005, the Company received approximately 3,130 new claims, none of which were in consolidated complaints.

The Company s primary and first level excess insurance policies that provided coverage for these asbestos-related matters exhausted their products limits at or before the end of July 2003. Since that time, and not taking into account the impact of the settlements described below, the Company has fully funded the costs associated with the defense and settlement of its asbestos-related liabilities. From January 1, 2005 through September 30, 2005, the Company spent approximately $31.3 million on these matters, including approximately $24.1 million in settlement payments and approximately $7.2 million for defense costs.

Both prior to and following the exhaustion of the products limits of the Company s primary and first level excess insurance policies, the Company undertook efforts to negotiate with certain of its other excess insurance carriers for reimbursement of defense costs and indemnity payments relating to these asbestos-related liabilities. Those efforts, however, did not progress at a rate satisfactory to the Company. As a result, on November 27, 2002, the Company initiated litigation against the solvent excess insurance carriers that provided insurance coverage for asbestos-related liabilities in a matter captioned Hercules Incorporated v. OneBeacon, et al., Civil Action No. 02C-11-237 (SCD), Superior Court of Delaware, New Castle County. Beginning in August 2004 and continuing through October 2004, the Company entered into settlements with all of the insurers named in that lawsuit. As a result, the lawsuit was dismissed in early November 2004.

Specifically, effective August 23, 2004, the Company entered into a comprehensive settlement agreement with respect to those insurance policies issued by certain underwriters at Lloyd s, London, and reinsured by Equitas Limited and related entities ( Equitas ) (the First Settlement Agreement ). As part of that settlement, during the third quarter of 2004, Equitas paid $30.0 million to the Company and placed $67.0 million into a trust. While many of the specific terms of that First Settlement Agreement are confidential, the First Settlement Agreement generally provides for the payment of money to the Company in exchange for the release by the Company of past, present and future claims under those policies and the cancellation of those policies; the agreement by the Company to indemnify the underwriters from any such claims asserted under those policies; and the impact on the settlement should federal asbestos reform legislation be enacted on or before January 3, 2007. The trust funds have been and are continuing to be used to reimburse the Company for a portion of costs it incurs to resolve certain asbestos claims from and after August 2004. The Company s ability to use any of the trust funds, however, is subject to specified confidential criteria, as well as limits on the amount that may be drawn from the trust in any one month. If federal asbestos reform legislation is enacted into law on or prior to January 3, 2007, the Company will be required to return any funds remaining in the trust to Equitas should certain criteria be met. If such legislation is not enacted by that date, any funds remaining in the trust will be available to the Company to pay asbestos-related liabilities or to use for other corporate purposes.

In addition, effective October 8, 2004, the Company entered into a comprehensive settlement agreement with respect to certain insurance policies issued by various insurance companies operating in the London insurance market, and by one insurance company located in the United States (the Second Settlement Agreement ). Under the terms of the Second Settlement Agreement, in 2005, the Company began to receive payments from the participating insurers which will total approximately $102.2 million over a four-year period ending in 2008. The payments will be placed by the insurance companies into a trust. The trust funds have been and are continuing to be used to reimburse the Company for costs it incurs to resolve asbestos claims from and after October 8, 2004. Any funds remaining in trust subsequent to December 31, 2008 may be used by the Company to pay both asbestos-related claims and non-asbestos related claims. As of September 30, 2005, $35.3 million of the $102.2 million has been placed into the trust. While many of the specific terms of the Second Settlement Agreement are confidential, the Second Settlement Agreement generally provides for the payment of money to the Company in exchange for the release by the Company of past, present and future claims under those policies and the cancellation of such policies; and the agreement by the Company to indemnify the released insurers from any such claims asserted under those policies.

The Company also reached settlement agreements with additional insurers whose level of participation in the Company s insurance program is substantially lower than the aggregate participation of the insurers referred to above (the Other Settlement Agreements ). Pursuant to the Other Settlement Agreements, the Company has released or partially released its rights to coverage under insurance policies issued by such insurers. The Other Settlement Agreements originally provided for cash payments to be received by the Company at various times commencing in 2004 and ending in 2011. During 2004, however, one insurer elected to pre-pay its obligations at a discounted rate. As a result of that pre-payment and other scheduled 2004 payments, combined with $6.0 million of payments received during the nine months ended September 30, 2005, the Company has received all amounts due under the Other Settlement Agreements.

In addition, effective October 13, 2004, the Company reached a confidential settlement agreement with the balance of its solvent excess insurers whereby a significant portion of the costs incurred by the Company with respect to future asbestos product liability claims will be reimbursed, subject to those claims meeting certain qualifying criteria (the Future Coverage Agreement ). That agreement is not expected to result in reimbursement to the Company, however, unless and until defense costs and settlement payments for qualifying asbestos products claims paid by the Company subsequent to the effective date of the agreement aggregate to approximately $330 million to $370 million, with the foregoing approximation based on various assumptions, including that there are sufficient qualifying claims to require such payments, that for such qualifying claims the time periods of each claimant s alleged exposure to asbestos products falls within the time periods covered by the participating insurers policies, and that the participating insurers remain solvent and honor their commitments under the terms of the Future Coverage Agreement. The Company expects that such amounts, if required to be paid, would be paid by the Company using monies from the above settlements and from other sources. If and when such amounts are paid by the Company, the insurers obligations pursuant to the terms of the Future Coverage Agreement would be triggered, and the participating insurers would thereafter be required to pay their allocated share of defense costs and settlement payments for asbestos product liability claims that qualify for reimbursement subject to the limits of their insurance policies, which limits are believed to be sufficient to cover the insurers allocated shares of an amount that exceeds the high end of the reasonably possible range of financial exposure described below. The Company will be responsible for payment of the share of such costs and payments that are not paid by the participating insurers pursuant to the terms of the Future Coverage Agreement, as well as for such costs and payments for those claims that do not qualify for reimbursement under the terms of the Future Coverage Agreement. Should asbestos reform legislation be passed, some or all of the obligations under the Future Coverage Agreement will be suspended for so long as such legislation remains in effect.

As a result of the above settlements, the Company is expected to have available to it a combination of cash and trust fund monies which can be used to pay or reimburse the Company for a significant portion of the defense costs and settlement payments that may be incurred by the Company with respect to its asbestos-related liabilities. If such liabilities exceed the total amount of the cash and trust fund monies received by the Company as a result of such settlements, then the Company will be required to fund such liabilities itself until such time as the insurers obligations under the Future Coverage Agreement are triggered. If and when those obligations are triggered, the Company and the insurers who are participants in the Future Coverage Agreement will share such costs and payments at varying levels over time, with the Company typically bearing a slightly larger share than such participating insurers. Of note, as a result of the First Settlement Agreement, Second Settlement Agreement and Other Settlement Agreements, substantially all of the Company s insurance coverage applicable to asbestos products claims has been cancelled (except for obligations under the Future Coverage Agreement), and such insurance coverage will no longer be available to cover any such claims. In addition and as described above, as a result of the First Settlement Agreement, Second Settlement Agreement and Other Settlement Agreements, substantial amounts of insurance coverage that would have been available to cover insured claims other than asbestos products claims have been cancelled and will no longer be available to cover such claims.

Based on the current number of claims pending, the amounts the Company anticipates paying to resolve those claims which are not dismissed or otherwise resolved without payment, and anticipated future claims, the Company believes that the total monetary recovery under the settlements noted above will cover the majority of the Company s monetary exposure for its current and estimated future asbestos-related liabilities. The foregoing, however, assumes that all of the monies received and to be received from the settlements described above will be utilized only for asbestos liabilities. In fact, due to timing differences between the receipt of cash settlements and the payment of asbestos claims by the Company, the Company has and will likely continue to use some of the proceeds received and to be received from the settlements described above for other corporate purposes. As a result, from a cash flow perspective, in any particular period of time, the Company may be required to fund some or all of its asbestos-related liabilities using cash flows from operations or sources other than the settlements described above. Further, as monies received and to be received from the settlements described above are used by the Company, and as the balance remaining on amounts yet to be received from the settlements described above decline, it is likely that there will come a time when the Company will be responsible for payment of all or a majority of such liabilities until such time as the obligations under the Future Coverage Agreement are triggered, at which point in time the Company is expected to share such liabilities with the participating insurers, with it being anticipated that the Company will typically bear a slightly larger share than the participating insurers. In any period of time, including after obligations under the Future Coverage Agreement are triggered, the amounts paid by the Company in connection with the defense and settlement of asbestos claims versus the amounts funded and to be funded by settlement monies and amounts anticipated to be reimbursed by the Future Coverage Agreement are expected to vary significantly. Moreover, as described in greater detail below, the Company s projection of its current and estimated future asbestos-related liabilities may change. As a result of these and other factors, although the Company believes that the majority of its total monetary exposure will ultimately be covered by the total monetary recovery under the settlements described above, there can be no assurance such will be the case.

In October 2004, the Company commissioned an updated study of its asbestos-related liabilities by a professor at a major national university, who is a member of the American Academy of Actuaries with broad experience in estimating such liabilities. Taking into account the then most current data concerning, among other factors, the Company s claims and payment experience, the Company s estimated reasonably possible exposure for these matters was revised to a range of $265 million to $800 million. Such study was updated again by the aforementioned professor in January 2005 to take into account more current data, and the Company s estimated reasonably possible exposure for these matters as of December 31, 2004 was revised to a range of $260 million to $780 million. Due to inherent uncertainties in estimating the timing and amounts of future payments, the foregoing range does not include the effects of inflation and has not been discounted for the time value of money. In addition, the range of financial exposures set forth above does not include estimates for future legal costs.

It is the Company s policy to expense these legal costs as incurred. As stated above, the Company presently believes that the majority of this range of financial exposures will ultimately be funded by the settlements which it has made with the Company s insurers. Cash payments related to this exposure are expected to be made over an extended number of years and actual payments, when made, could be for amounts in excess of the range due to potential future changes in estimates as well as the effects of inflation.

The foregoing is based on the Company s assumption that the number of future claims filed per year and claim resolution payments will vary considerably from year-to-year and by plaintiff, disease, venue and other circumstances, but will, when taken as a whole, remain relatively consistent with the Company s experience to date and will decline as the population of potential future claimants expires due to non-asbestos-related causes. It is also based on the results of the updated study and the status of the Company s settlements with its insurers, as described above. However, the Company recognizes that the number of future claims filed per year and claim resolution payments could greatly exceed those reflected by its past experience and contemplated by the study referenced above, that the Company s belief of the range of its reasonably possible financial exposure could change as the study referenced above is periodically updated, and that its evaluation of the total payments to be received from its insurers may change depending upon numerous variables including potential legislation and the risk that one or more insurance carriers may refuse or be unable to meet their obligations to the Company.

Due to the dynamic nature of asbestos litigation, the Company s estimates are inherently uncertain, and these matters may present significantly greater financial exposures than presently anticipated. In addition, the Company intends to periodically update the asbestos study referenced above, and further analysis combined with new data received in the future could result in a material modification of the range of reasonably possible financial exposure set forth above. As a result of all of the foregoing, the Company s liability with respect to asbestos-related matters could vary significantly from present estimates and may require a material change in the accrued liability for these matters within the next 12 months. If the Company s liability does exceed amounts recorded in the balance sheet, the Company presently believes that the majority of the liability it may reasonably anticipate will be paid or reimbursed as a result of the settlements the Company has made with its insurers, as described above. However, there can be no assurance that such liabilities will be reimbursed.

The findings of the updated study referenced above identified a range of the Company s reasonably possible financial exposure for these asbestos-related matters. The Company adjusted its accrual for present and future potential asbestos claims before anticipated insurance recoveries at December 31, 2004 to $260.2 million, reflecting the low end of the range noted above in accordance with generally accepted accounting principles (since no amount within the range is a better estimate than any other amount). There have been no changes made regarding the underlying basis of the asbestos-related assets and liabilities during the nine months ended September 30, 2005.

The following table presents the beginning and ending balances and balance sheet activity for the Company s asbestos-related accounts for the nine months ended September 30, 2005.

| | Balance January 1, 2005 | Additional Accruals/ Interest Income | Insurance Recovered/ Liabilities Settled | Reclassifi-cations/ Accretion | Balance September 30, 2005 |
|---|---|---|---|---|---|
| Asbestos-related assets: | | | | | |
| Insurance receivable | $ 6.3 | $ (0.3) | $ (6.0) | $ | $ |
| Asbestos-related assets, current | 6.3 | (0.3) | (6.0) | | |
| | | | | | |
| Insurance receivable | 98.9 | | (35.3) | 1.2 | 64.8 |
| Restricted cash in trust (1) | 63.6 | 1.2 | (0.3) | | 64.5 |
| Asbestos-related assets, non-current | 162.5 | 1.2 | (35.6) | 1.2 | 129.3 |
| | | | | | |
| Total asbestos-related assets | $ 168.8 | $ 0.9 | $ (41.6) | $ 1.2 | $ 129.3 |
| Asbestos-related liabilities: | | | | | |
| Asbestos-related liabilities, current | $ 46.8 | $ | $ | $ | $ 46.8 |
| Asbestos-related liabilities, non-current | 213.4 | | (24.1) | | 189.3 |
| Total asbestos-related liabilities | $ 260.2 | $ | $ (24.1) | $ | $ 236.1 |

(1) Amount is reflected as a non-current asset as its availability for reimbursement to the Company is restricted to asbestos claims and related defense costs reimbursable to the Company as discussed above in connection with the First Settlement Agreement.

The Company, in conjunction with outside advisors, will continue to study its asbestos-related matters, insurance recovery expectations and reserves on an ongoing basis, and make adjustments as appropriate.

Of note, in April, May and June 2005, respectively, Georgia, Texas and Florida passed legislation aimed at reforming the way that civil asbestos litigation is handled in the courts of those states. In general, such legislation establishes medical criteria which define whether a claimant has a physical impairment allegedly caused by exposure to asbestos, and defers the claims of those claimants who have no or minimal physical impairment, while allowing the claims of claimants who have an alleged physical impairment to proceed. While it is too early to tell what impact these legislative enactments will have or whether or to what extent these legislative enactments will survive any legal challenges to their constitutionality or applicability, the Company is optimistic that, over time, the net effect of these legislative enactments will be beneficial, although there can be no assurance that the effect of such laws will be beneficial. Of the state legislative reforms that have passed to date, the Texas legislation appears to have the most potential significance to the Company because of the number of claims historically filed and currently pending in Texas and the amount of money spent to date to defend and resolve claims filed in Texas. The Texas legislation, which became effective on September 1, 2005, largely applies to claims pending as of or filed after December 1, 2005. In addition to the medical criteria described above, the Texas legislation also prevents the bundling of groups of claims. While the Company is optimistic that, over time, the net effect of the Texas legislation will be beneficial, there can be legislation could prompt an acceleration of claims called to trial or for which settlements are demanded in the period prior to December 1, 2005.

The Company is also encouraged by the continued steps being taken in the United States Senate to develop a comprehensive national solution to the asbestos litigation problem. Should the current proposed version of the Fairness in Asbestos Injury Resolution Act of 2005 (also referred to as the FAIR Act of 2005) become law, civil litigation of asbestos bodily injury lawsuits in state and federal courts would end or abate and would be replaced by a national trust fund. The Company is closely following federal legislative developments. While the Company believes that the current version of the FAIR Act of 2005, if enacted into law, would be beneficial, there can be no assurance that the effect of such legislation would be beneficial, nor can there be any assurance that such proposed legislation will be enacted into law.

Composite Products Antitrust and Qui Tam Matters

In August 1999, the Company was sued in an action styled as Cape Composites, Inc. v. Mitsubishi Rayon Co., Ltd., Case No. 99-08260 (U.S. District Court, Central District of California), one of a series of similar purported class action lawsuits brought on behalf of purchasers (excluding government purchasers) of carbon fiber and carbon prepreg in the United States from the named defendants from January 1, 1993 through January 31, 1999. The lawsuits were brought following published reports of a Los Angeles federal grand jury investigation of the carbon fiber and carbon prepreg industries. In these lawsuits, plaintiffs allege violations of Section 1 of the Sherman Antitrust Act for alleged price fixing. In September 1999, these lawsuits were consolidated by the Court into a case captioned Thomas & Thomas Rodmakers v. Newport Adhesives and Composites, Case No. CV-99-07796-GHK (CTx) (U.S. District Court, Central District of California (the Thomas & Thomas Lawsuit ) with all related cases ordered dismissed. On May 2, 2002, the Court granted plaintiffs Motion to Certify Class. The Company is named in connection with its former Composites Products Division, which was sold to Hexcel Corporation in 1996. During the third quarter of 2004, the Company learned that four of its co-defendants had reached settlements with the plaintiffs. Those settlements were approved by the court on January 31, 2005. On February 25, 2005, the Company reached a settlement in principle with the plaintiffs for $11.3 million. On June 10, 2005, that settlement was granted preliminary approval by the Court. The settlement was approved and a stipulation of dismissal with prejudice was executed by the parties effective October 18, 2005. A final dismissal order is pending. The Company has denied and continues to deny liability to plaintiffs but entered into the settlement to avoid the risks, uncertainties and costs inherent in litigation. The settlement was agreed to by the Company without any admission of liability.

Since September 2001, the Company, along with the other defendants in the Thomas & Thomas Lawsuit referred to above, has been sued in nine California state court purported class actions brought on behalf of indirect purchasers of carbon fiber. In January 2002, these were consolidated into a case-captioned Carbon Fiber Cases I, II, and III, Judicial Council Coordination Proceeding Nos. 4212, 4216 and 4222, Superior Court of California, County of San Francisco. These actions all allege violations of the California Business and Professions Code relating to alleged price fixing of carbon fiber and unfair competition. In July 2005, the Company reached an agreement in principle to settle these consolidated actions for a portion of the amounts described in the paragraph below entitled Amounts Accrued for Non-Asbestos Litigation. That settlement was subsequently finalized and executed by the parties and is awaiting Court approval. As with the settlement of the Thomas & Thomas Lawsuit described above, the Company has denied and continues to deny liability to plaintiffs, but entered into the settlement to avoid the risks, uncertainties and costs inherent in litigation. The settlement was agreed to by the Company without any admission of liability.

In June 2002, a purported class action was filed in Massachusetts under the caption Saul M. Ostroff, et al. v. Newport Adhesives, et al., Civil Action No. 02-2385, Superior Court of Middlesex County. This matter has been brought on behalf of consumers who purchased merchandise manufactured with carbon fiber, and alleges the same types of price fixing activities alleged in the actions described in the previous two paragraphs. In July 2005, the Company reached an agreement in principle to settle this action for a portion of the amounts described in the paragraph below entitled Amounts Accrued for Non-Asbestos Litigation. As with the other settlements described herein, the Company has denied and continues to deny liability to plaintiffs, but entered into the settlement to avoid the risks, uncertainties and costs inherent in litigation. The settlement was agreed to by the Company without any admission of liability.

In October 2002, the Company was notified that Horizon Sports Technologies had opted out of the Thomas & Thomas Lawsuit referred to above and filed its own suit against the Company and the other defendants in that action (Horizon Sports Technologies, Inc. v. Newport Adhesives and Composites, Inc., et al., Case No. CV02-8126 FMC (RNEX), U.S. District Court, Central District of California, Western Division). In late June 2005, the Company reached an agreement in principle to settle this action for a portion of the amount described in the paragraph below entitled Amounts Accrued for Non-Asbestos Litigation. That settlement was subsequently finalized and this case has been dismissed with prejudice. As with the other settlements described herein, the Company has denied and continues to deny liability to plaintiffs, but entered into the settlement to avoid the risks, uncertainties and costs inherent in litigation. The settlement was agreed to by the Company without any admission of liability.

Further, in April 2002, a related Qui Tam action was unsealed by the U.S. District Court for the Southern District of California. That action is captioned Randall M. Beck, et al. v. Boeing Defense and Space Group, Inc., et al., (Civil Action No. 99 CV 1557 JM JAH), was filed under seal in 1999, and is a False Claims action brought pursuant to the False Claims Act (31 U.S.C. Section 729 et seq.). In that action, the relators, in the name of the U.S. Government, allege the same price fixing activities which are the subject of the above-described actions. The relators then allege that those alleged price fixing activities resulted in inflated prices being charged by the defendant carbon fiber manufacturers to defense contractors, who, in turn, submitted claims for payment to the U.S. Government under various government contracts. It is alleged that those claims for payment were false claims because the prices charged for the carbon fiber and carbon prepreg were fixed contrary to the laws of the United States. In late June 2005, the Company reached an agreement in principle to settle this action for a portion of the amount described in the paragraph below entitled Amounts Accrued for Non-Asbestos Litigation. The settlement was subsequently approved by the government and by the Court, and this case has been dismissed with prejudice. As with the other settlements described herein, the Company has denied and continues to deny liability to plaintiffs, but entered into the settlement to avoid the risks, uncertainties and costs inherent in litigation. The settlement was agreed to by the Company without any admission of liability.

In December 2004, the Company filed a lawsuit against Hexcel Corporation (Hercules Incorporated v. Hexcel Corporation, Supreme Court of the State of New York, County of New York, Index No. 04/604098) seeking indemnification for the composite products and Qui Tam lawsuits described above. The lawsuit is based on the terms of the purchase and sale agreement by which the Company sold to Hexcel Corporation its Composite Products Division in 1996. In response, Hexcel Corporation has denied liability and has filed a counter-claim also seeking indemnification. That lawsuit is proceeding through discovery.

In connection with the grand jury investigation noted above in the paragraph describing the Cape Composites Lawsuit, in January 2000, the United States Department of Justice ( DOJ ), Antitrust Division, served a grand jury subpoena duces tecum upon the Company. The Company was advised that it was one of several manufacturers of carbon fiber and carbon prepreg that were served with such a subpoena. In December 2003, the Company was advised that the grand jury investigation had been closed.

Agent Orange Litigation

Agent Orange is a defoliant that was manufactured by several companies, including Hercules, at the direction of the U.S. Government, and used by the U.S. Government in military operations in both Korea and Vietnam from 1965 to 1970. In 1984, as part of a class action settlement, the Company and other defendants settled the claims of persons who were in the U.S., New Zealand and Australian Armed Forces who alleged injury due to exposure to Agent Orange. In Re Agent Orange Prod. Liab. Litig., 597 F. Supp. 740 (E.D.N.Y. 1984). Following that settlement, all claims for alleged injuries due to exposure to Agent Orange by persons who had served in the Armed Forces of those countries were treated as covered by that class action settlement.

On June 9, 2003, the United States Supreme Court affirmed the decision of the United States Court of Appeals for the Second Circuit in a case captioned Dow Chemical Company, et al. v. Daniel Raymond Stephenson, et al., 123 S. Ct. 2161 (2003), where plaintiffs Stephenson and

Isaacson (in a separate but consolidated case) alleged that they were injured from exposure to Agent Orange and that such injury did not manifest until after exhaustion of the settlement fund created through the 1984 class action settlement. As a result of that decision, the claims of persons who allege injuries due to exposure to Agent Orange and whose injuries first manifest themselves after exhaustion of the settlement fund created through the 1984 class action settlement may no longer be barred by the 1984 class action settlement and such persons may now be able to pursue claims against the Company and the other former manufacturers of Agent Orange.

Since 1998, the Company has been sued in approximately twenty-five lawsuits (including two purported class actions) where plaintiffs allege that exposure to Agent Orange caused them to sustain various personal injuries. On February 9, 2004, the U.S. District Court for the Eastern District of New York issued a series of rulings granting several motions filed by defendants in the two cases that had been remanded to the U.S. District Court by the U.S. Court of Appeals for the Second Circuit on remand from the U.S. Supreme Court (In re: Agent Orange Product Liability Litigation: Joe Isaacson, et al v. Dow Chemical Company, et al. and Daniel Raymond Stephenson, et al. v. Dow Chemical Company, et al. (MDL 381, CV 98-6383 (JBW), CV 99-3056 (JBW))). In relevant part, those rulings held that plaintiffs claims against the defendant manufacturers of Agent Orange are properly removable to federal court under the federal officer removal statute and that such claims are subject to dismissal by application of the government contractor defense. The Court then dismissed plaintiffs claims, but stayed its decision to allow plaintiffs to obtain additional discovery and to move for reconsideration of the Court s decision. A hearing on the motion for reconsideration was held on February 28, 2005. By Orders dated March 2, 2005, the Court denied reconsideration, lifted the stay of the earlier decision, and dismissed plaintiffs claims in all of the lawsuits that were before the Court at that time. Plaintiffs have appealed those dismissals to the United States Court of Appeals for the Second Circuit.

In addition, in January 2004, the Company was sued in a purported class action filed in the United States District Court for the Eastern District of New York by The Vietnam Association for Victims of Agent Orange/Dioxin and several individuals who claim to represent between two and four million Vietnamese who allege that Agent Orange used by the United States during the Vietnam War caused them or their families to sustain personal injuries. (The Vietnam Association for Victims of Agent Orange/Dioxin, et al. v. The Dow Chemical Company, et al., Civil Action No. 04 CV 0400 (JBW)). That complaint alleges violations of international law and war crimes, as well as violations of the common law for products liability, negligence and international torts. The defendants moved to dismiss this case on several grounds, including failure to state a claim under the Alien Tort Claims Statute, lack of jurisdiction and justiciability, the bar of the statute of limitations, failure to state claims for violations of international law, and the government contractor defense. A hearing on these motions was held on February 28, 2005. By order dated March 10, 2005, the Court dismissed this lawsuit. Plaintiffs have appealed that dismissal to the United States Court of Appeals for the Second Circuit.

The Company believes that it has substantial meritorious defenses to all of the Agent Orange-related claims described above and those that may yet be brought. To that end, the Company denies any liability to plaintiffs, and will vigorously defend all actions now pending or that may be brought in the future.

Other Litigation

In November 2002, an action for declaratory judgment was filed in the U.S. District Court for the District of Delaware under the caption of Atofina Chemicals, Inc. and Atofina v. Hercules Incorporated (Civil Action No. 02-1613). In this action, Atofina seeks a declaratory judgment that Hercules cannot recover antitrust damages for purchases of monochloroacetic acid ( MCAA ) that Hercules made outside of the United States or for purchases from producers of MCAA not alleged to have participated in any conspiracy to fix prices and allocate the market for MCAA. In response, Hercules has filed a counter-claim, seeking damages from and injunctive relief against Akzo Nobel Chemicals, Atofina Chemicals, Hoechst AG, Hoechst Celanese, Clariant and others related to the fixing of prices of MCAA and sodium monochloracetate from approximately 1995 through 2000. The lawsuit is in the discovery phase. Hercules has settled with some of the parties. The terms of those settlements are confidential.

By Order dated May 6, 2003, the U.S. District Court for the Middle District of Louisiana remanded to the 18th Judicial District Court for the Parish of Iberville, Louisiana, a total of nine consolidated lawsuits, including two lawsuits in which the Company is a defendant. These two lawsuits, Jerry Oldham, et al. v. The State of Louisiana, et al., Civil Action No. 55,160, 18th Judicial District Court, Parish of Iberville, Louisiana, and John Capone, et al. v. The State of Louisiana, et al., Civil Action No. 56,048C, 18th Judicial District Court, Parish of Iberville, Louisiana, were served on the Company in September 2002 and October 2002, respectively. The Oldham case is a purported class action comprised of approximately 2,000 plaintiffs who are or were direct employees of Georgia Gulf, and the Capone case is a consolidated action by approximately 44 plaintiffs who are or were contract employees at Georgia Gulf. Both actions assert claims against the State of Louisiana, the Company, American PetroFina, Inc., Hercofina, Ashland Oil, International Minerals and Chemicals, Allemania Chemical, Ashland Chemical and the Parish of Iberville. The purported class members and plaintiffs, who claim to have worked or lived at or around the Georgia Gulf plant in Iberville Parish, allege injury and fear of future illness from the consumption of contaminated water and, specifically, elevated levels of arsenic in that water. As to the Company, plaintiffs allege that the Company itself and as part of a joint venture operated a nearby plant and, as part of those operations, used a groundwater injection well to dispose of various wastes, and that those wastes contaminated the potable water supply at Georgia Gulf. On October 17, 2002, the Company removed these matters to federal court. In January 2003, the U.S. District Court for the Middle District of Louisiana consolidated the Oldham and Capone matters with other lawsuits (including the Batton matter, discussed below) in which the Company is not or was not a party. Plaintiffs sought remand, which, as noted above, was granted by Order dated May 6, 2003. In March 2004, Atofina, successor to American PetroFina, Inc. was dismissed without prejudice. In January 2005, plaintiffs filed a motion to add Hercules and other defendants to a case captioned Georgenner Batton, et al. v. The State of Louisiana, et al., Civil Action No. 55,285, 18th Judicial District Court, Parish of Iberville, Louisiana; that motion was granted by the Court in February 2005. The Batton lawsuit is a purported class action comprised of plaintiffs who are or were contract employees of Georgia Gulf since 1995 and who are asserting nearly identical allegations as the plaintiffs in the Oldham lawsuit. In August 2005, the Company entered into an agreement in principle to settle these matters for a portion of the amount described in the paragraph below entitled Amounts Accrued for Non-Asbestos Litigation. That settlement, which will be structured as a class action settlement and which was agreed to by the Company without any admission of liability, is subject to Court approval.

On October 6, 2003, the Company received a Notice of Deficiency with respect to the Company s 1996 through 1997 federal income tax returns wherein, among other issues, the Internal Revenue Service ( IRS ) disallowed a capital loss that the Company carried back to 1996 and 1997. On December 23, 2003, the Company filed a Petition asking the U.S. Tax Court for a re-determination of the deficiency set forth in the October 6, 2003 Notice of Deficiency. As previously reported, on December 16, 2004, the Company and the IRS settled the capital loss issue. The Company expects to settle the remaining issues through standard IRS administrative appeals procedures outside of Tax Court. The Company believes that it is remote that the ultimate disposition of these other issues will have a material adverse impact on the Company s financial position in light of existing tax reserves and amounts already on deposit with the IRS.

On May 7, 2004, Ciba Specialty Chemicals Corporation ( Ciba ) filed a Complaint against Hercules Incorporated and Cytec Industries, Inc. ( Cytec ) in the United States District Court for the District of Delaware alleging infringement of two patents owned by Ciba. The two patents in question are U.S. Patent 5,167,766 (issued on December 1, 1992) entitled Charged Organic Polymer Microbeads in Paper Making Process and U.S. Patent 5,171,808 (issued on December 15, 1992) entitled Cross-linked Anionic and Amphoteric Polymeric Microparticles. The alleged conduct relates to the manufacture, use, sale and offer to sell of certain products of the Company s Pulp and Paper business. Ciba seeks to enjoin alleged continued infringement, obtain a judgment that the defendants have infringed the patents, and obtain an award of damages and reasonable attorney s fees. In June 2005, Ciba filed a motion for leave to file a First Amended Complaint alleging, in relevant part, breach of contract as to Cytec and tortious interference with contractual relations as to Hercules. In October 2005, the Court denied that motion. Also in June, Hercules filed a motion for leave to file an Amended Answer and Counterclaims alleging, in relevant part, that Ciba s patents are invalid and unenforceable, and seeking a declaratory judgment as to invalidity. In October 2005, that motion was granted by the Court. The Company believes that there are substantial meritorious defenses to this action, and has denied liability to Ciba and will vigorously defend against this action. The Company has agreed to indemnify Cytec with respect to the patent infringement charges. Discovery is proceeding, and trial has been scheduled to begin on August 14, 2006.

On or about June 1, 2004, a Complaint captioned <u>Charles Stepnowski v. Hercules Inc.; The Pension Plan of Hercules Inc.; The Hercules Inc. Finance Committee; and Edward V. Carrington, Hercules Vice President Human Resource</u>s, Civil Action No. 04-cv-2296, was filed in the United States District Court, Eastern District of Pennsylvania. An Amended Complaint was filed on June 16, 2004. Styled as a class action, the Amended Complaint seeks benefits under the Pension Plan of Hercules Incorporated (the Plan ), and alleges violations of the Employee Retirement Income Security Act, 29 U.S.C. §1001 et seq. ( ERISA ). Under the Plan, eligible retirees of the Company may opt to receive a single cash payment of 51% of the present value of their accrued benefit (with the remaining 49% payable as a monthly annuity). The Amended Complaint alleges that the Company s adoption of a new interest rate assumption used to determine the 51% cash payment constitutes a breach of fiduciary duty and a violation of the anti-cutback requirements of ERISA and the Internal Revenue Code. The Amended Complaint seeks the payment of additional benefits under ERISA (as well as costs and attorneys fees) and seeks to compel the Company to use an interest rate assumption that is more favorable to eligible retirees. The Amended Complaint seeks to establish a class comprised of all Plan participants who retired (or who will retire) on or after December 1, 2001. By Memorandum and Order dated May 26, 2005, the Court denied without prejudice plaintiff s motion for class certification and dismissed plaintiff s anti-cutback claim, but allowed plaintiff s claim for benefits and breach of fiduciary duty to proceed. The Company denies all liability, and intends to vigorously defend this action.

In February 2005, the Company was among the Defendants who filed a Petition for Writ of Mandamus in the Texas Supreme Court seeking to set aside an order of the trial court consolidating five plaintiffs for a single trial. The underlying case, <u>Acevedo, et al. v. Union Pacific Railroad Company, et al.</u>, Case No. C-4885-99-F. 332$^{nd}$ Judicial District Court, Hidalgo County, Texas, was originally filed in 2001, has been consolidated with another related action, and is a toxic tort lawsuit alleging pesticide exposure relating to operations at a former pesticide formulation facility in Mission, Texas. There are currently approximately 1,900 plaintiffs and approximately 30 defendants, including the Company. Plaintiffs include former workers at the pesticide formulation facility, and persons who currently reside, or in the past resided, near the facility. All plaintiffs allege personal injuries and some plaintiffs also allege property damage. The vast majority of the plaintiffs allege residential exposure to a variety of pesticide and chemical products as a result of leaks, spills, flooding, and airborne emissions from the pesticide formulation facility. It is alleged that certain of the Company s products were sold to or used by the pesticide formulation facility prior to its ceasing operations in 1967. In November 2004, Defendants filed a Petition for a Writ of Mandamus in the Texas Supreme Court.

While no decision has yet been rendered with respect to that petition, the Texas Supreme Court did issue a partial stay of the underlying litigation. Oral argument with respect to Defendants Petition for Writ of Mandamus is scheduled for November 16, 2005. The Company denies any liability to plaintiffs and intends to vigorously defend these matters.

The Company and others have been sued by approximately 250 former employees and employees of third-party contractors who allege hearing loss as a result of their having worked at plants located in or about Lake Charles, Louisiana. The Company formerly owned and operated a plant in Lake Charles. In July 2005, the Company and other defendants reached a settlement in principle with plaintiffs lawyers which provides for the resolution of these claims over a period of approximately two years. The Company has accrued its probable and reasonably estimable liability as a portion of the amount described in the paragraph below entitled Amounts Accrued for Non-Asbestos Litigation. The lawsuits at issue are all pending in the 14$^{th}$ Judicial District Court of Calcasieu Parish, Louisiana, and are captioned as follows: James Allee, et al. v. Canadianoxy Offshore Production Co., et al., Case No. 2001-4085, James Hollingsworth, et al. v. Hercules Inc., Civil Action No. 2001-4064, Joseph Kelley, et al. v. Canadianoxy Offshore Production Co., et al., Civil Action No. 98-2802, and Robert Corbin, et al. v. Canadianoxy Offshore Production Co., et al., Civil Action No. 98-1097.

Amounts Accrued for Non-Asbestos Litigation

During the period January 1, 2005 through September 30, 2005, the Company paid $27.4 million in settlement payments with respect to the settlement of non-asbestos and non-environmental litigation, including for the matters as described above. The September 30, 2005 Consolidated Balance Sheet reflects a current cumulative liability of $3.9 million for non-asbestos and non-environmental related litigation matters, representing management s best estimate of the probable and reasonably estimable losses for such matters. While it is not feasible to predict the outcome of all pending legal proceedings, it is reasonably possible that an exposure to loss exists in excess of the amounts accrued for these and other matters, and the ultimate resolution of one or more of these matters could have a material adverse effect upon the Company s financial position, results of operations and/or cash flows for any annual, quarterly or other period.

## 14. Consolidation of Variable Interest Entities

In accordance with the provisions of FASB Interpretation No. 46 Consolidation of Variable Interest Entities (revised December 2003) ( FIN 46R ), the financial statements of the Company reflect the consolidation of two joint venture Variable Interest Entities ( VIE s ), ES FiberVision Holdings A/S and ES FiberVisions L.P. These entities serve as global marketers of the Company s bicomponent fibers. As of September 30, 2005, the fair value of the assets in these joint ventures was approximately $6.9 million and the fair value of the associated liabilities and non-controlling interests was approximately $4.6 million. There are no assets of the Company that serve as collateral for the VIEs and the creditors of the VIEs have no recourse to the general credit of the Company.

## 15. Segment Information

The table below reflects Net sales and Profit from operations for the three and nine months ended September 30, 2005 and 2004.

| | Three Months Ended September 30, 2005 | Three Months Ended September 30, 2004 | Nine Months Ended September 30, 2005 | Nine Months Ended September 30, 2004 |
|---|---|---|---|---|
| Net Sales: | | | | |
| Performance Products | $ 429.4 | $ 406.0 | $ 1,275.9 | $ 1,203.5 |
| Engineered Materials and Additives | 93.5 | 94.5 | 290.7 | 282.4 |
| Consolidated | $ 522.9 | $ 500.5 | $ 1,566.6 | $ 1,485.9 |
| | | | | |
| Profit from operations: | | | | |
| Performance Products | $ 59.7 | $ 69.3 | $ 173.6 | $ 189.0 |
| Engineered Materials and Additives | (6.2) | (4.7) | (10.7) | (8.2) |
| Corporate items (a) | (4.1) | 0.4 | (11.1) | (4.6) |
| | | | | |
| Consolidated | $ 49.4 | $ 65.0 | $ 151.8 | $ 176.2 |

(a) For the three months ended September 30, 2005, Corporate items primarily represent severance costs. For the comparative period in 2004, Corporate items include charges related to previously divested businesses and executive pension adjustments. Corporate items for the nine months ended September 30, 2005 include severance charges, accelerated vesting of stock-based compensation for retirement eligible employees and consulting costs associated with legacy issues. For the nine months ended September 30, 2004, Corporate items include charges related to previously divested businesses, executive pension adjustments, and a gain on the revaluation of insurance-related costs.

## 16. Income Taxes

For the three months ended September 30, 2005, the Company recognized pretax income of $26.7 million and tax expense of $2.6 million. For the nine months ended September 30, 2005, the company recognized pretax income of $37.2 million and a tax benefit of $1.3 million. The tax benefit for the nine months ended September 30, 2005 includes the following discrete items: (a) a $1.6 million decrease to the valuation allowance due to the Company s ability to use a portion of its capital loss previously included in the valuation allowance; (b) interest income of $2.9 million from the IRS resulting from the return of cash tax deposits; (c) a $7.1 million increase to state tax expense relating to the filing of amended tax returns to reflect IRS audit adjustments; (d) a $10.0 million reversal of federal income tax reserves due to the favorable resolution of prior year tax issues; (e) additional reserves for state income taxes of $1.2 million; and (f) a tax benefit of $1.3 million to reflect the favorable resolution of a prior year tax issue. The full year effective tax rate for 2005 is estimated to be approximately 1%. The prior year effective tax rate was 6.8% reflecting the nominal net taxes on the gain from the Company s sale of its interest in CP Kelco ApS.

## 17. Financial Information of Guarantor Subsidiaries

The following condensed consolidating financial information for the Company presents the financial information of Hercules, the guarantor subsidiaries and the non-guarantor subsidiaries based on the Company s understanding of the Securities and Exchange Commission s interpretation and application of Rule 3-10 under the Securities and Exchange Commission s Regulation S-X. The financial information may not necessarily be indicative of results of operations or financial position had the guarantor subsidiaries or non-guarantor subsidiaries operated as independent entities.

In this presentation, Hercules consists of the parent company s operations. Guarantor subsidiaries and non-guarantor subsidiaries of Hercules are reported on an equity basis. Additionally, prior year information has been restated to conform to the current period presentation.

**Condensed Consolidating Statement of Operations**

**Three Months Ended September 30, 2005**

| | Unconsolidated | | | | |
|---|---|---|---|---|---|
| | Parent | Guarantor Subsidiaries | Non-Guarantor Subsidiaries | Eliminations and Adjustments | Consolidated |
| Net sales | $ 140.8 | $ 120.8 | $ 299.1 | $ (37.8) | $ 522.9 |
| Cost of sales | 101.1 | 99.5 | 210.5 | (53.6) | 357.5 |
| Selling, general and administrative expenses | 24.1 | 31.6 | 37.1 | | 92.8 |
| Research and development | 4.9 | 4.8 | 0.4 | | 10.1 |
| Intangible asset amortization | 1.5 | 0.4 | 0.1 | | 2.0 |
| Other operating expense, net | 3.4 | 2.5 | 5.2 | | 11.1 |
| Profit (loss) from operations | 5.8 | (18.0) | 45.8 | 15.8 | 49.4 |
| Interest and debt expense (income), net | 48.4 | (22.4) | (3.5) | | 22.5 |
| Other expense (income), net | 0.2 | 0.9 | (0.9) | | 0.2 |
| Income (loss) before income taxes and equity (loss) income | (42.8) | 3.5 | 50.2 | 15.8 | 26.7 |