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Spring 2003

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Reconciling Environmental Disclosure with Environmental Exposure in an Evolving Regulatory Climate

By: Eileen Pleva and Peter Gilbertson, AIG Environmental®

To view the original white paper with footnotes, visit <http://home.aigonline.com/AIGEnvironmental/EnvDisclosure.pdf>

Executive Summary

Historically, publicly traded firms have employed varying approaches to reporting environmental liabilities. However, given the increasing scrutiny surrounding financial disclosure, companies' efforts to present these liabilities in their most favorable light, while balancing SEC rules and FASB interpretations, are more challenging. This manuscript discusses:

- Current regulations governing disclosure of environmental liabilities;
- The elevated vigilance necessary in today's regulatory climate;
- Enforcement trends focusing on publicly traded companies that face increased scrutiny by the SEC, shareholders, and a broad community of stakeholders; and
- Insurance solutions to environmental disclosure problems.

Protecting The Value Of A Company: Problems & Solutions

A comprehensive presentation of risk solutions is presented within this paper illustrating how, through the utilization of environmental insurance products, companies can assure all stakeholders that known and potential environmental exposures have been properly contained, managed and reported to investors, adequately protecting the shareholder's investment. Additionally, this discussion addresses:

- Insurance solutions that can remove or significantly mitigate uncertainty by specifically quantifying the liability and assuring the shareholders that the reported liability will not increase;
- Circumstances today driving the trend toward an increase in the use of environmental insurance products to manage environmental liabilities; and
- The application of environmental insurance products that may help to mitigate the adverse effects of changing a company's disclosure of environmental liability.

And finally, how boxing-up environmental liabilities through the application of environmental insurance may provide investors with confidence that environmental liabilities will not impose a drag on the value of securities. The specific insurance solutions discussed include:

- Cleanup Cost Cap Insurance,
- Pollution Legal Liability Insurance, and
- Environmental Protection Programs.

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The Mold Underwriting Market

There will be full mold exclusions on all commercial insurance policies for the foreseeable future. All property and casualty insurance underwriters have issued new mold exclusions to either eliminate or severely limit the amount the insurance company will pay for mold related damages. Anyone with an indoor air/human loss exposure combination now needs highly specialized environmental insurance covering mold.

Homeowner's Coverage

Some, but not all, homeowners and condominium owner's insurance policies will provide a sub-limit for consequential damages caused by mold if the water intrusion event is covered under the policy. Higher limits to cover mold related damages are available from some insurers for additional premium on the homeowner's policy.

Commercial Insurance Coverage

Commercial insurance buyers face a different challenge. With the new exclusions in place, building owners and their contractors will no longer have property or liability insurance coverage for new mold related damages. Environmental insurance covering mold damages is available for contractors, service providers and building owners. For building owners trying to insure their mold risk they can look to their contractors for appropriate mold insurance protection and they should insure their own risk. Where this may sound like over kill, this is the exact scenario building owners use to handle day-to-day insurance when they hire a contractor. The contractor is asked for a certificate of insurance for General Liability and Workers

Compensation. As a backstop to the contractors insurance, building owners maintain their own General Liability insurance. What is different today is the building owner and their contractors will have mold exclusions in their traditional insurance policies.

Services vendor and contractors will either need a *Contractors Pollution Liability* insurance policy if they are performing operations on the property or a *Professional Liability* policy if they are preparing reports or surveys of mold contamination. Each of these policies should specifically address mold as a covered "pollutant" in the policy form.

Property owners will need their own *Environmental Impairment Liability* (EIL) insurance policy. Although EIL is a "liability" insurance policy, it includes coverages that are normally found in property insurance policies including restoration and business interruption insurance for losses arising from mold contamination. By combining the contractors environmental coverages with their own, property owners can complete the circle of insurance protection for mold damages the same way they address all other liability loss exposures. To implement these insurance strategies property owners will need to change their procurement contracts to reflect the new insurance requirements.

For more information on environmental insurance and mold risk management see the website of the Environmental Risk Resources Association at www.erraonline.org.

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Environmental Underwriter Marketplace

American Safety Group's Online Environmental Underwriting System

American Safety Group's ProStar ONLINE Environmental Underwriting System is the standard for real-time online environmental insurance quoting systems. Ninety percent of all small market accounts, both new and renewal, are being processed through the system. The online system is located at www.americansafetyonline.com. Access is granted to approved producers who have developed an expertise in environmental insurance or who maintain a dedicated resource. Coverage available online includes GL, CPL and Professional or any combination. Environmental Contractors and Consultants generating up to \$3,000,000 of revenue are eligible. Mold coverage with a policy term up to 3 years, limits up to \$5M/\$5M, minimum premium of \$2,500 and minimum SIR of \$2,500 is available.

American Safety Group has hired three new individuals. Kenneth Payton will be heading the Environmental Program Business Unit. Kenneth will be taking over the management of the existing Environmental Program Business while entertaining new Environmental Program Business opportunities. Lorne Collier and Mark Cleveland, formerly RSA Environmental, have joined American Safety to head our Cherry Hill, NJ based Middle Market Environmental Underwriting Unit.

Mold Coverage Offered By The Environmental Insurance Market

Environmental Impairment Liability:

AIG - Coverage available
XL Environmental - Coverage available avoiding long-term habitational, schools, apartments.
Zurich Environmental - Coverage available with class restrictions
Evanston - Coverage available with class and territory restrictions
National Environmental Coverage Corp/Everest - Coverage available with class and territory restrictions
Liberty Mutual - Coverage available with class and territory restrictions
Gulf - Coverage available avoiding habitational, apartments, schools, hospitals, hotels.
Chubb - Coverage available

Contractors Pollution Legal Liability:

AIG - Coverage available
XL Environmental - Coverage available with class restrictions
Zurich Environmental - Coverage available on specialty contractors only
American Safety - Coverage available on specialty environmental contractors only
Evanston - Coverage available with class and territory restrictions
National Environmental Coverage Corp/Everest - Coverage available with class and territory restrictions
Liberty Mutual - Coverage available with class and territory restrictions
Gulf - Coverage available on qualified commercial contractors
Chubb - Coverage available
Seneca - Coverage available for qualified remediators or CIH

Professional

AIG - Coverage available
XL Environmental - Coverage available with class restrictions
Zurich Environmental - Coverage available on specialty contractors only
American Safety - Coverage available on specialty environmental contractors only
Evanston - Coverage available with class and territory restrictions
National Environmental Coverage Corp/Everest - Coverage available with class and territory restrictions
Liberty Mutual - Coverage available with class and territory restrictions
Gulf - Coverage available on qualified environmental professionals
Chubb - Coverage available
Seneca - Coverage available for qualified remediators or CIH

Pricing Benchmarks for Environmental Placements

Recent environmental placements:

Residential Contractor with \$45 million in receipts
\$5 million limit, \$25,000 SIR, \$60,000 premium

Commercial Contractor with \$130 million in receipts
\$5 million limit, \$100,000 SIR, \$110,000 premium

Roofing Contractor with \$15 million in receipts
\$1 million limit, \$10,000 SIR, \$22,000 premium

General Contractor with \$25 million in receipts
\$2 million limit/ \$1 million mold sublimit, \$25,000 SIR, \$20,000 premium

General Contractor with \$55 million in receipts
\$1 million limit/ \$1 million mold sublimit, \$10,000 SIR, \$40,000 premium

Steel Fabricator with multiple locations and \$200 million in revenue
\$3 million limit, \$50,000 SIR, \$60,000 premium

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- Introduce the agency to new prospects in a professional venue.
- Help establish the agency as a leader in the community on the topic of mold risk management.

For more information contact ERRA at 608-798-2904 or webmaster@erraonline.org.

Coverage Enhancement Trends with the Hardening Market

By: Catherine L. Sevret, Underwriting, Investors Underwriting Managers

Waiver of subrogation, primary non-contributory, per project aggregate...do contractors realize what they are agreeing to when they sign a contract including the basket of coverage enhancements insurers won't just throw in anymore? How many insured's understand what they are agreeing to when they name a customer as an additional insured, primary and non-contributory and waive their insurance carrier's rights?

1. Primary non-contributory: The insured just made their policy primary for the additional insured, making the additional insured's policy excess.
2. Waiver: The insured just gave up their insurance companies rights to subrogate and bring the additional insured's carrier in.
3. Does the insured understand the contract they just signed can erode their policy aggregate for this one job?

As the hardening market continues agents should be educating insured's what these coverage enhancements mean so their insured's understand what they are agreeing to and weigh their options. It is always prudent to try to negotiate these requests out of their bids. The insured has paid hard earned money for their insurance program, why do they want to expose their limits as such? These enhancements can turn into losses not anticipated. For certain contracts like government work coverage enhancements are necessary. Agents can determine if coverage should be offered on a per project basis or blanket versions are more cost effective.

Reinsurance terms and conditions have tightened without sign of change. This will drive costs for higher capacity limits up, tighter terms and conditions will follow and less commission will be granted. In a hard market reinsurance is the driver of terms and conditions. Agents should be educating their clients to understand the costs of having these enhancements in their insurance program. Making clients aware that there are options like negotiating or buying enhancements on a project basis as needed. Having clients understand will not only save them money, they will also be protecting their business interest that they spent their time and energy to build.

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Background: Heightened Scrutiny and Regulatory Activity Bring Environmental Disclosure to the Forefront

Under the current Federal Securities and Exchange Commission (SEC) non-financial disclosure requirements, regulated corporate entities must disclose both real and contingent environmental liabilities within their 10-K filings. These mandatory environmental disclosure requirements have been in existence since the 1970's. However corporate entities have largely been underreporting these liabilities, or aggressively utilizing the flexibility inherent in certain rule interpretations to hide from investors the full scope of such liabilities.

Inadequate Disclosure Threatens Shareholder Perception of Value

Events over the past year, including recent corporate scandals, have had an enormous impact on the value of securities. Consequently, investor awareness has been raised to new levels, and heightened scrutiny has been brought to the adequacy of corporate disclosure of environmental liabilities. Studies relating to overly aggressive accounting practices - where corporations are limiting disclosure of environmental liabilities - indicate that such actions have a negative impact upon the price of securities. Investors realize that poor disclosure or lack of disclosure of environmental liabilities undercuts risk analysis and can threaten shareholder value.

While traditional trends have shown that the SEC has not arduously reviewed the environmental disclosure practices of regulated corporate entities, scandals such as Enron and WorldCom have led to a movement for corporate honesty and full disclosure. Included within this movement has been a hard push by the United States Environmental Protection Agency (EPA) and shareholder interest groups for meaningful environmental disclosure and stepped-up enforcement by the SEC.

Corporate management must have a strong understanding of the tools available to minimize their risk. Environmental insurance programs may be utilized by companies to insulate their balance sheets from the variability of environmental liabilities. This article will discuss the reporting requirements set forth by the SEC, the trends for greater regulation and enforcement and solutions involving the use of environmental insurance.

Current SEC Environmental Disclosure Requirements

The laws and rules that govern the securities

industry in the United States derive from the notion that all investors are entitled to information about potential investments prior to buying them. Accordingly, the SEC requires public companies to disclose material financial and non-financial information so that the public can make educated determinations about their investment decisions.

Environmental Disclosure Rules initiated in the 1970s

As environmental issues became more significant for corporate America in the 1970s, the SEC recognized that special rules were necessary to address environmental disclosure. These rules took form as part of the 10-K form for non-financial reporting under Regulation S-K, applying to any corporation that issues publicly traded equity or debt securities.

SEC Environmental Disclosure Requirements

Item 101: Material environmental disclosure.

Item 101 requires that the applicant describe the general development of the business of the registrant, its subsidiaries and any predecessors during the past five years. Under the Regulation, subsection c (xii) requires that registrants make appropriate disclosure "as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials in the environment, or otherwise relating to the protection of the environment may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries."

A corporation's interpretation of the term "material" is essential in making a determination as to whether reporting is necessary. In *TSC Industries, Inc. v. Northway*, the Supreme Court held that the materiality standard has been held to apply only "if there is a substantial likelihood that a reasonable investor would have found the omitted information important or that the missing facts would have altered the 'total mix' of information available to the investor." In a recent SEC Staff Accounting Bulletin, the SEC asserts that an auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.

Item 103: Material pending legal proceedings.

Item 103 under Regulation S-K requires that a registrant disclose any "material pending legal proceedings" to which the corporation or any of its subsidiaries is a party. Under instruction 5 to Item 103, a public company is required to describe a proceeding if: (1) the proceeding is material to the business or financial condition of

the registrant, (2) the proceeding involves a claim in excess of 10 percent of the current consolidated assets of the registrant; or (3) the proceeding involves a governmental authority, unless the registrant reasonably believes that monetary sanctions, if imposed, will not exceed \$100,000.

Item 303: Management's discussion and analysis of financial conditions.

Item 303 under Regulation S-K, Management's Discussion and Analysis (MD&A) of financial condition and results of operation, requires the registrant to prepare a narrative report discussing liquidity, capital resources and results of operations. This item requires that the corporation provide both a historical analysis of its financial condition as well as a prospective analysis within the MDA narrative.

While environmental liability is not specifically mentioned within the context of Item 303, the Commission clearly states that environmental liabilities are applicable for reporting purposes. In its interpretive bulletin, the Commission raised a hypothetical where a registrant had been properly designated a Potentially Responsible Party (PRP) by the EPA with respect to the clean-up of hazardous waste at three sites. In the hypothetical, the registrant was to determine the nature of its potential liability and the amount of remedial costs. The ability to obtain contribution from other PRP's was unclear, as was the extent of insurance coverage.

The Commission stated that based upon the facts of the hypothetical, Item 103 reporting would not be required because PRP status alone does not constitute knowledge that a governmental agency is contemplating a proceeding. However, MD&A disclosure of the effects of the PRP status, quantified to the extent reasonably practicable, would be required. The Commission further stated that the availability of insurance coverage and potential sources of contribution from other PRPs may be factored into the determination of whether a material future effect is not reasonably likely to occur.

Contingent Liabilities

The FASB Statement of Financial Accounting Standards No. 5 (FASB-5) governs disclosure of contingent liabilities in financial statements. FASB 5 applies to environmental liabilities in the same manner as it does to other contingent liabilities. Essentially, a company may incur a liability resulting from a past activity, which may not be paid until some time in the future. The premise of accounting for loss contingencies is founded on the concept that the estimated future costs of the event should be reflected in the

financial statements covering the time of the loss.

Under FASB, estimated losses from loss contingencies must be charged to income on the balance sheet if it is probable that a liability has been incurred and it can be reasonably estimated. The rule requires that companies recognize an estimated loss by a charge to income on their balance sheets when 1) information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred as of the date of the financial statements; and when 2) the amount of loss can be reasonably estimated. While both conditions must be met to trigger disclosure, Paragraph 8 of the FASB 5 leaves it up to the executive management of the reporting company to determine whether there is a reasonable possibility that a loss or additional loss may have been incurred.

In response to initial confusion voiced by registrant companies, FASB issued an interpretive bulletin (FIN 14) indicating that if a particular loss contingency fell within a range, the company should recognize the number within the range that represents the better estimate. When no amount within the range is a better estimate than any other amount, the minimum amount should be accrued. Under the FASB interpretation, corporations may be aggressive, reporting the minimum amount accrued, while acting within the letter of the law.

Obligation and Compliance

Both the SEC regulations and FASB Rule clearly assign an obligation upon management to disclose the corporation's environmental liabilities, however, compliance with these Regulations have traditionally been characterized as inadequate. The Requirements, while clear on their face, leave room for interpretation to management. Additionally, FASB's own interpretation of its Rule suggests the opportunity to use the low-end estimated liability in what might be a very wide range of values. The FASB analysis coupled with the lack of SEC enforcement are factors that have contributed to the underreporting trend.

Enforcement Trends: Applying Pressure to the SEC

Shareholder protection movements are applying pressure to the SEC more than ever. Joining forces with the EPA are grassroots environmental organizations, such as The Rose Foundation, which collectively represent over three billion dollars in institutional assets. The interest of the environmentalist has been coupled with the interest of the investor seeking to protect their financial future. These lobbying forces appear

likely to push the SEC to enforce regulations that are currently on the books, as well as the adoption of new ones.

In 1998, an EPA study by the Office of Enforcement and Compliance Assurance (QECA) found that 74% of publicly traded companies had failed to adequately disclose the existence of environmental legal proceedings under Regulation S-K, Item 103. In response to the EPA findings, OECA finalized an Enforcement Alert. The Notice informed publicly traded companies of their duty to disclose environmental legal proceedings pursuant to the SEC environmental disclosure regulations as well as potential fines and penalties for noncompliance. The EPA also indicated its intention to monitor the disclosures made by parties to EPA enforcement actions as well as share the information with the SEC.

Strong Correlation Between Environmental Compliance and Profitability

The National Advisory Council for Environmental Policy and Technology formed the Environmental Capital Markets Committee to examine the nature of the relationship between a firm's environmental performance and its financial performance. In a summary report to the EPA, the Committee advised the EPA to maintain a dialogue with the SEC to promote changes in corporate disclosure that would give investors more relevant information about the environmental performance of the corporation.

Utilizing market forces as a method to incent environmental compliance could be an attractive alternative to the current regulatory system. Potentially, the same level of pollution reduction can be met, while decreasing the cost of direct regulation. As an example, studies have shown a strong correlation between environmental compliance of companies and their profitability. This path of reasoning suggests that providing adequate information to investors allows them to select superior environmental performers or screen out poor ones, providing an incentive for companies to improve environmental performance.

In September, The Rose Foundation, proposed in their revised petition to the SEC the use of standardized guidelines for estimating environmental liabilities. In its Report, the Rose Foundation argues that the cost of environmental liability is now more fully estimable due to advances in engineering, science and technology. The premise of the proposals offered by the Rose Foundation Report is that "without clearly articulated methods for estimating costs and liabilities and without full and accurate disclosure,

significant underreporting and inaccurate reporting will continue. As a consequence, investors will not be able to accurately assess the value of the equities in their portfolios." Supporting literature drafted by the Rose Foundation, The Environmental Fiduciary, illustrates how accurate corporate disclosure of environmental liabilities favorably impacts environmental performance, further illuminating the positive correlation between environmental disclosure and performance, and long-term financial stability.

New SEC Rules

In addition to new regulations for Acceleration of Periodic Report Filing Dates and Management Certification of Disclosure (Sarbanes-Oxley Act), the SEC has published the proposed rule Management's Discussion and Analysis about the Application of Critical Accounting Policies, on May 10, 2002. This rule mandates extensive disclosure surrounding any accounting estimate that relies on assumptions about highly uncertain matters, or where there are a range of estimates, or where there's a likelihood that such estimates could dramatically change period-to-period. Among the additional disclosures required will be descriptions of the methodologies and assumptions used in the development of accounting estimates, and the sensitivity of financial results to changes in the assumptions used. This represents a vast departure from what has been required in the past.

Adverse Effects Of Improving Disclosure Without Environmental Insurance

With increasing pressure to improve disclosure quality, public and private companies alike need to consider potential adverse consequences of reporting a significant increase in disclosed environmental liabilities. For example, this might place a firm in violation of its debt covenants, constraining its ability to operate. Further, a substantial charge may prompt public shareholders to sell shares, causing a precipitous decline in share price. Such a chain of events can lead to legal actions by shareholders against the firm and its directors and officers.

Directors and Officers Exposure

Most Directors and Officers are personally protected by insurance, which covers them for actions brought by shareholders alleging malfeasance. These Director's and Officer's policies contain exclusions, which may be triggered in the event that a securities claim is the result of environmental liabilities. The first of those exclusions is the Pollution Exclusion - this exclusion eliminates coverage for any claim

against a Director or Officer, which has as its underlying cause the release or threatened release of pollutants.

The second of the exclusions is the failure to maintain insurance - this exclusion eliminates coverage for any claim arising out of the failure of the company to purchase or maintain coverage that would have protected it from a significant loss. The availability of environmental insurance, as discussed below, could cause this exclusion to be triggered if the complaint alleges that insurance was available and its advantages were not investigated by the company.

The Solution

Neither the letter of the law nor the shareholder public will continue to permit companies to be aggressive in a fashion that potentially distorts value. The ability to cap costs on clean-up projects through environmental insurance can play a significant role in companies' attempts to assure their shareholders that environmental risks are properly disclosed and contained. Concern regarding disclosure has fueled awareness of environmental insurance as an effective approach to addressing these business problems.

The benefits of using environmental insurance to manage environmental liabilities are numerous, but most prominently include the ability to assure shareholders that reported environmental liabilities are fixed and will not increase. Insurance solutions can remove or significantly mitigate, uncertainty by specifically quantifying the liability. This can be particularly valuable in light of the new proposed SEC requirements concerning the estimation of highly uncertain matters, such as environmental liabilities, in which making accounting assumptions is necessary.

Applicable Insurance Products

Cleanup Cost Cap Insurance

The Cleanup Cost Cap insurance policy provides coverage to cap environmental clean-up costs, mitigating the uncertainty inherent in forecasting pollution remediation costs. The policy covers insureds for cost overruns associated with the clean-up of known contamination, as well as optional coverage to cover costs associated with clean-up of new found contamination at the site.

Pollution Legal Liability Insurance

Pollution Legal Liability (PLL) helps provide protection against environmental risk, presenting flexible solutions to regulatory obligations, contract requirements, lender or landlord requirements, and board-of-director objectives. PLL can provide environmental insurance coverage for losses due to on- or off-site pollution

conditions from an owned or operated property, when such conditions are pre-existing and unknown. Coverage for losses arising from future conditions created during the operation of the facility can also be purchased. Losses arising out of pollution conditions can be triggered by government orders, third-party claims, or first-party discovery, any of which can be unpredictable, and difficult to quantify. The PLL suite of products transfers environmental liabilities to the insurer, helping organizations achieve greater financial stability.

Environmental Protection Programs

Environmental Protection Programs are unique and flexible insurance programs that companies can use to manage their environmental liabilities. These policies combine traditional environmental insurance coverages, such as the Cleanup Cost Cap coverage or Pollution Legal Liability insurance, with discounted funding techniques for existing liabilities. The Environmental Protection Program is designed to meet the specific financial and risk management objectives of the client, and often involves "finite" policies with multi-year terms that incorporate elements of both self-funding and significant risk transfer.

Conclusion

With the evolution of environmental regulation comes an increased possibility of assessments of fines, penalties, sanctions and clean-up costs due to inadequate environmental compliance and/or risk management mechanisms within corporate structures. These costs may add up to millions of dollars, offsetting corporate income and reducing shareholder perception of firm value.

Environmental insurance can help take the uncertainty off the table, increasingly, companies are using environmental insurance products to manage their environmental liabilities. The development of these products has expanded significantly over the last several years and with the increase in SEC scrutiny, they are becoming an essential component of a corporation's financial management strategy. By utilizing environmental insurance products, companies can assure all stakeholders that known, unknown and future environmental exposures have been properly contained, managed and reported, adequately protecting the value of the company and the shareholder's investment.

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The ERRA Newsletter is published quarterly. Anne Simmons, Editor

Comments, suggestions and articles are welcomed. Potential guest columnists are encouraged to submit a brief topic outline and biographical summary to Anne Simmons at anne@erraonline.org.

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