

Additional issues related to, among other things, specific policy provisions, multiple insurers and allocation of liability among insurers, consequences of conduct by the insured, missing policies and proof of coverage make quantification of liabilities exceptionally difficult and subject to later adjustment based on new data.

The number of claims filed for environmental pollution coverage continues to increase. Approximately 500 claims were reported in the first quarter of 1995 and approximately 20,500 claims have been reported to date. Pending claims totaled approximately 9,800 and 9,900 at March 31, 1995 and December 31, 1994, respectively. Approximately 10,700 claims were closed through March 31, 1995, of which approximately 9,700 claims were settled without payment, except for claim expenses of \$28 million. Settlements for the remaining 1,000 claims totaled \$154 million, plus claim expenses of \$42 million (net of reinsurance recoveries of \$35 and \$4 million for claim and claim expenses, respectively). The foregoing claims statistics represent claims for accident years 1988 and prior, which coincides with CNA's adoption of the Simplified Commercial General Liability coverage form which included an absolute pollution exclusion.

The results of operations in future years may continue to be adversely affected by environmental pollution claim and claim expenses. Management will continue to monitor potential liabilities and make further adjustments as warranted.

Tobacco Litigation

A number of lawsuits have been filed against Lorillard and other manufacturers of tobacco products seeking damages for cancer and other health effects claimed to have resulted from an individual's use of cigarettes or exposure to tobacco smoke. Plaintiffs have asserted claims based on, among other things, theories of negligence, fraud, misrepresentation, strict liability, breach of warranty, enterprise liability, civil conspiracy, intentional infliction of harm, and failure to warn of the allegedly harmful and/or addictive nature of tobacco products. Plaintiffs seek unspecified amounts in compensatory and punitive damages in many cases, and in other cases damages are stated to amount to as much as \$100 million in compensatory damages and \$600 million in punitive damages. Presently, 59 such cases are pending in the United States federal and state courts against manufacturers of tobacco products generally; Lorillard is a named defendant in 20 of these cases and the Company is a defendant in three of these cases. Twenty-five of these cases have been commenced since January 1, 1994; Lorillard is a named defendant in eight of the cases filed since January 1, 1994.

In addition to cases brought by individuals, five purported class actions are pending against Lorillard and other cigarette manufacturers, and the Company is a defendant in one of these cases. Plaintiffs in four of the purported class actions seek damages for alleged nicotine addiction and health effects claimed to have resulted from the use of cigarettes, and plaintiffs in one of the purported class actions allege health effects from exposure to tobacco smoke. Theories of liability include a broad range of product liability theories, theories based upon consumer protection statutes and fraud and misrepresentation. Four of the purported class actions have been filed since January 1, 1994. These purported class actions are more fully described below.

In *Spain v. Philip Morris Companies, Inc., et al.* (Circuit Court, Dade County, Florida, filed October 31, 1991), the purported class consists of flight attendants claiming injury as a result of exposure to environmental

tobacco smoke in the cabins of aircraft. Plaintiffs seek an unspecified amount in compensatory damages and \$5 billion in punitive damages. The trial court granted plaintiffs' motion for class certification on December 12, 1994. Defendants have appealed this ruling to the Florida Court of Appeal.

In *Castano v. The American Tobacco Company, et al.* (U.S. District Court, Eastern District, Louisiana, filed March 29, 1994), the purported class consists of individuals in the United States who are allegedly nicotine dependent and the estates and heirs of individuals in the United States who were allegedly nicotine dependent. Plaintiffs in this action are represented by a well-funded and coordinated consortium of over 60 law firms from around the United States. Plaintiffs seek unspecified amounts in actual damages and punitive damages. The court issued an order on February 17, 1995 that granted in part plaintiffs' motion for class certification. Defendants have filed a motion seeking leave to file an interlocutory appeal from the order granting the motion for class certification.

In *Granier v. The American Tobacco Company, et al.* (U.S. District Court, Eastern District, Louisiana, filed September 26, 1994), plaintiffs seek certification of a class to be comprised of all residents of the United States who are addicted to nicotine, and of survivors who claim their decedents were addicted to nicotine. Plaintiffs seek unspecified dollar amounts in actual damages and punitive damages and the creation of a medical monitoring fund to monitor the health of individuals allegedly injured by their addiction to nicotine. Plaintiffs' motion to consolidate this action with *Castano*, above, has not been decided by the court.

In *Engle v. R.J. Reynolds Tobacco Co., et al.* (Circuit Court, Dade County, Florida, filed May 5, 1994), the purported class consists of citizens and residents of the United States, and the purported survivors of citizens and residents of the United States, who have had, presently have, or have died from diseases and medical conditions allegedly caused by smoking cigarettes containing nicotine. Plaintiffs in this case seek actual and punitive damages in excess of \$100 billion each, and the creation of a medical fund to compensate individuals for future health care costs. Plaintiffs' motion for class certification was granted by the court on October 31, 1994. Defendants have appealed this ruling to the Florida Court of Appeal.

In the fifth purported class action, *Lacey v. Lorillard Tobacco Company, et al.* (U.S. District Court, Northern District, Alabama, filed March 15, 1994), plaintiff alleges that the defendants, Lorillard and two other cigarette manufacturers, did not disclose to the plaintiff or other cigarette smokers in the State of Alabama the nature, type, extent and identity of additives, additions, or additional substances that the defendants allegedly caused or allowed to be made a part of cigarettes or cigarette components. Plaintiff requests injunctive relief requiring defendants to list the additives, additions or additional substances that defendants have caused or allowed to be placed onto or within cigarettes or cigarette components manufactured for sale and sold in the State of Alabama. Plaintiff seeks monetary damages on behalf of his individual claim and on behalf of each member of the purported class arising out of the complaint's allegation not to exceed \$48,500 for the individual claim or for any individual member of the class.

In addition to the foregoing cases, four actions have been initiated in which states or state agencies seek recovery of funds expended by the states or state agencies to provide health care to eligible citizens with injuries or other health effects allegedly caused by use of tobacco products or exposure to cigarette smoke. These cases are based on, among other things, a number of claims including indemnity, restitution, unjust enrichment and public nuisance, and claims based on antitrust laws and state consumer protection acts. Lorillard is named as a defendant in each of these four

state of state agency actions and the Company is named as a defendant in three of them.

The case of *Moore v. The American Tobacco Company, et al.* (Chancery Court, Jackson County, Mississippi, filed May 23, 1994), was filed by the Attorney General of Mississippi. The case of *McGraw v. The American Tobacco Company, et al.* (Circuit Court, Kanawha County, West Virginia, filed on September 20, 1994), was filed by the Attorney General of West Virginia. The case of *State of Minnesota v. Philip Morris Incorporated, et al.* (District Court, Ramsey County, Minnesota, filed August 17, 1994), was filed by the Attorney General of Minnesota and Blue Cross and Blue Shield of Minnesota.

The case of *The State of Florida, et al. v. The American Tobacco Company, et al.* (Circuit Court, Palm Beach County, Florida, filed February 22, 1995), was filed by the State of Florida, the Governor of Florida, and two state agencies. Plaintiffs in this case seek reimbursement under a specific Florida statute that permits the state to sue a manufacturer to recover Medicaid costs incurred by the state that are claimed to result from the use of the manufacturer's product. In any such suit, the statute permits causation and damages to be proven by statistical analysis, abrogates all affirmative defenses, adopts a "market share" liability theory, applies joint and several liability and eliminates the statute of repose. An action for declaratory judgment has been commenced in Florida state court by companies and trade associations in several potentially affected industries challenging this statute. Lorillard also understands that elements of the Florida business community have initiated an effort to repeal or modify the statute in a future legislative session. It is impossible at this time to predict the ultimate outcome of this action or such efforts. Lorillard understands that several other states, and the Congress, have considered or are considering legislation similar to that passed in Florida.

In a fifth state, Massachusetts, the Governor on July 10, 1994 signed legislation authorizing that state's attorney general to bring an action against tobacco manufacturers to recover medical assistance payments for which such companies may be liable under existing law. No action has been brought to date by the State of Massachusetts.

The states pursuing the foregoing efforts are doing so at the urging and with the assistance of well known members of the plaintiffs bar and these lawyers have been meeting with attorneys general in other states to encourage them to file similar suits.

In addition to the foregoing cases, one pending case, *Cordova v. Liggett Group, Inc., et al.* Superior Court San Diego County, California, filed May 12, 1992), alleges that Lorillard and other named defendants, including other manufacturers of tobacco products, engaged in unfair and fraudulent business practices in connection with activities relating to the Council for Tobacco Research-USA, Inc., of which Lorillard is a sponsor, in violation of a California state consumer protection law by misrepresenting to or concealing from the public information concerning the health aspects of smoking. Plaintiff seeks an injunction ordering defendants to undertake a "corrective advertising campaign" in California to warn consumers of the health hazards associated with smoking, to provide restitution to the public for funds "unlawfully, unfairly, or fraudulently" obtained by defendants, and to "disgorge" all revenues and profits acquired as a result of defendants' "unlawful, unfair and/or fraudulent business practices." An adverse development in this case could encourage the filing of additional actions in other states with consumer protection laws similar to California's.

In addition to the foregoing cases, several cases have been filed against

Lorillard seeking damages for cancer and other health effects claimed to have resulted from exposure to asbestos fibers which were incorporated, for a limited period of time, almost forty years ago, into the filter material used in one of the brands of cigarettes manufactured by Lorillard. Presently 11 such cases are pending in federal and state courts against Lorillard. The Company is not named as a defendant in any of these cases. Six such cases have been filed since January 1, 1994. Allegations of liability against Lorillard include negligence, strict liability, fraud, misrepresentation and breach of warranty. Plaintiffs seek unspecified amounts in compensatory and punitive damages in many cases, and in other cases damages are stated to amount to as much as \$10 million in compensatory damages and \$100 million in punitive damages. Six of these cases are currently set for trial in 1995.

One of the defenses raised by Lorillard in certain cases is preemption by the Federal Cigarette Labeling and Advertising Act (the "Labeling Act"). In the case of *Cipollone v. Liggett Group, Inc., et al.*, the United States Supreme Court, in a plurality opinion issued on June 24, 1992, held that the Labeling Act as enacted in 1965 does not preempt common law damage claims but that the Labeling Act, as amended in 1969, does preempt claims against tobacco companies arising after July 1, 1969, which assert that the tobacco companies failed to adequately warn of the alleged health risks of cigarettes, sought to undermine or neutralize the Labeling Act's mandatory health warnings, or concealed material facts concerning the health effects of smoking in their advertising and promotion of cigarettes. The Supreme Court held that claims against tobacco companies based on fraudulent misrepresentation, breach of express warranty, or conspiracy to misrepresent material facts concerning the alleged health effects of smoking are not preempted by the Labeling Act. The Supreme Court in so holding did not consider whether such common law damage actions were valid under state law. The effect of the Supreme Court's decision on pending and future cases against Lorillard and other tobacco companies will likely be the subject of further legal proceedings. Additional litigation involving claims such as those held to be preempted by the Supreme Court in *Cipollone* could be encouraged if legislative proposals to eliminate the federal preemption defense, pending in Congress since 1991, are enacted. It is not possible to predict whether any such legislation will be enacted.

In addition to the defenses based on preemption under the Supreme Court decision referred to above, Lorillard believes that it has a number of other valid defenses to pending cases. These defenses, where applicable, include, among others, statutes of limitations or repose, assumption of the risk, comparative fault, the lack of proximate causation, and the lack of any defect in the product alleged by a plaintiff. Lorillard believes, and has been so advised by counsel, that some or all of these defenses may, in any of the pending or anticipated cases, be found by a jury or court to bar recovery by a plaintiff. Application of valid defenses, including those of preemption, are likely to be the subject of further legal proceedings in the class action cases and in the actions brought by states or state agencies.

Smoking and health related litigation has been brought by plaintiffs against Lorillard and other manufacturers of tobacco products for many years. While Lorillard intends to defend vigorously all such actions which may be brought against it, it is not possible to predict the outcome of any of this litigation. Litigation is subject to many uncertainties, and it is possible that some of these actions could be decided unfavorably. An unfavorable outcome of a pending smoking and health case could encourage the commencement of additional similar litigation.

Management is unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome of pending litigation. It is possible that the Company's results of operations or cash flows in a

Also pending in the United States District Court for the Eastern District of Texas is litigation over the Trilateral Agreement. Trial on the issues raised by this agreement occurred on February 13, 1995, with evidence submitted to the Court in opposition to final court approval of the Trilateral Agreement. A final hearing occurred on May 9, 1995 and the Court ordered briefs to be submitted on May 23, 1995; the Court's rulings on the Trilateral Agreement are also expected in the summer of 1995.

CNA and the other parties to the Global Settlement agreement and the Trilateral Agreement completed a comprehensive court approved notice program to provide potential claimants information about their rights and possible benefits under the Global Settlement agreement and Trilateral Agreement.

CNA and the insurance industry are exposed to an unknown amount of liability for environmental pollution, primarily related to toxic waste site clean-up. See Note 5 of the Notes to Consolidated Condensed Financial Statements for a further discussion of environmental pollution exposures.

The liquidity requirements of CNA, excluding the acquisition of CIC, have been met primarily by funds generated from operations. The principal operating cash flow sources of CNA's property and casualty and life insurance subsidiaries are premiums and investment income. The primary operating cash flow uses are payments for claims, policy benefits and operating expenses.

For the first three months of 1995, CNA's operating activities generated net cash flows of \$561 million, compared to \$164 million for the same period in 1994. The increase in cash flows is due primarily to an increase in investment income of \$226 million and improved insurance subsidiaries underwriting cash flow of \$107 million for the first three months of 1995, as compared to the same period in 1994. Net cash flows are invested in marketable securities. Investment strategies employed by CNA's insurance subsidiaries consider the cash flow requirements of the insurance products sold and the tax attributes of the various types of marketable investments.

Cigarettes

Lorillard, Inc. and subsidiaries ("Lorillard")--

Lorillard continues to be negatively impacted by the August 1993 industry wide price reduction of approximately 25%. While the price reduction has slowed the rapid growth of discount cigarettes, unit sales volume gains have not compensated for the reduced selling prices. Virtually all of Lorillard's sales are in the premium priced segment. In May 1995, Lorillard increased its wholesale prices by \$1.50 per thousand cigarettes.

A number of lawsuits have been filed against Lorillard and other manufacturers of tobacco products seeking damages for cancer and other health effects claimed to have resulted from the use of cigarettes or exposure to tobacco smoke. In several of these cases the Company is named as a defendant. Pending litigation includes actions commenced by individuals and purported class actions brought by state governments, most of which claim very substantial damages. These actions are described in Note 5 of the Notes to Consolidated Condensed Financial Statements.

Corporate

On May 19, 1995 the three months ended March 31, 1995 the Company purchased 48,500 shares of its outstanding Common Stock at an aggregate cost of approximately \$1 million. The funds required for such purchases were provided from working