SECURITIES AND EXCHANGE COMMISSION

FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

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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 March 31, 2005

or

☐ **Transition report pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934**

For the transition period from ______ to ______

Commission File Number 1-9761

ARTHUR J. GALLAGHER & CO.

(Exact name of registrant as specified in its charter)

DELAWARE	**36-2151613**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

Two Pierce Place, Itasca, Illinois 60143-3141
(Address of principal executive offices) (Zip code)

(630) 773-3800
(Registrant' s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 ☒ NO ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES ☒ NO ☐

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The number of outstanding shares of the registrant' s Common Stock, $1.00 par value, as of March 31, 2005 was 93,200,000.

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Arthur J. Gallagher & Co.

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Part I – Financial Information

Item 1. Financial Statements (Unaudited)

Arthur J. Gallagher & Co.

Consolidated Statement of Earnings
(Unaudited - in millions, except per share data)

	Three-month period ended March 31,	
	2005	2004
Commissions	$ 192.5	$ 172.9
Fees	120.4	108.2
Investment income - fiduciary funds	4.0	2.8
Investment income - all other	32.1	46.5
Investment gains (losses)	(0.1)	2.5
Total revenues	348.9	332.9
Compensation	193.2	165.3
Other operating	69.5	64.6
Investment expenses	28.7	41.5
Interest	2.6	1.9
Depreciation	8.7	8.2

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Amortization	5.3	3.0
Litigation and contingent commission related matters	166.0	–
Total expenses	474.0	284.5
Earnings (loss) from continuing operations before income taxes	(125.1)	48.4
Provision (benefit) for income taxes	(51.3)	9.6
Earnings (loss) from continuing operations	(73.8)	38.8
Discontinued operations:		
Earnings (loss) from discontinued operations before income taxes	0.5	0.2
Loss on disposal of operations	(0.8)	–
Provision (benefit) for income taxes	(0.1)	0.1
Earnings (loss) on discontinued operations	(0.2)	0.1
Net earnings (loss)	$ (74.0)	$ 38.9
Basic net earnings (loss) per share:		
Earnings (loss) from continuing operations	$ (.80)	$ .43
Earnings (loss) on discontinued operations	–	–

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Net earnings (loss)	$ (.80)	$ .43
Diluted net earnings (loss) per share:		
Earnings (loss) from continuing operations	$ (.80)	$ .41
Earnings (loss) on discontinued operations	–	–
Net earnings (loss)	$ (.80)	$ .41
Dividends declared per common share	$ .28	$ .25

See notes to consolidated financial statements.

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Arthur J. Gallagher & Co.

Consolidated Balance Sheet
(In millions)

	March 31, 2005 (Unaudited)	December 31, 2004
Cash and cash equivalents	$ 212.3	$ 224.6
Restricted cash	506.1	488.9
Unconsolidated investments - current	27.8	26.0
Premiums and fees receivable	1,305.4	1,355.5
Income taxes recoverable	5.9	–
Other current assets	159.5	132.8
Total current assets	2,217.0	2,227.8
Unconsolidated investments - noncurrent	129.4	132.4
Fixed assets related to consolidated investments - net	194.6	195.6
Other fixed assets - net	57.6	63.4
Deferred income taxes	185.9	184.8
Other noncurrent assets	70.3	59.7
Goodwill - net	209.7	219.0

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Amortizable intangible assets - net	163.2	155.2
Total assets	$ 3,227.7	$ 3,237.9
Premiums payable to insurance and reinsurance companies	$ 1,827.4	$ 1,838.9
Accrued compensation and other accrued liabilities	355.0	253.4
Unearned fees	39.3	35.0
Income taxes payable	–	24.8
Other current liabilities	17.1	18.6
Corporate related borrowings	–	–
Investment related borrowings - current	42.9	41.4
Total current liabilities	2,281.7	2,212.1
Investment related borrowings - noncurrent	138.3	140.0
Other noncurrent liabilities	125.0	124.8
Total liabilities	2,545.0	2,476.9
Stockholders' equity:		
Common stock - issued and outstanding 93.2 shares in 2005 and 92.1 shares in 2004	93.2	92.1
Capital in excess of par value	172.9	146.4

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Retained earnings	438.8	539.0
Unearned deferred compensation	(16.5)	(12.2)
Unearned restricted stock	(5.7)	(4.3)
Total stockholders' equity	682.7	761.0
Total liabilities and stockholders' equity	$ 3,227.7	$ 3,237.9

See notes to consolidated financial statements.

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Arthur J. Gallagher & Co.

Consolidated Statement of Cash Flows
(Unaudited – in millions)

	Three-month period ended March 31,	
	2005	2004
Cash flows from operating activities:		
Earnings (loss) from continuing operations	$ (73.8)	$ 38.8
Adjustments to reconcile earnings (loss) from continuing operations to net cash provided by operating activities:		
Net (gain) loss on investments and other	0.1	(2.5)
Depreciation and amortization	14.0	11.8
Amortization of deferred compensation and restricted stock	2.7	2.1
Stock-based compensation expense	2.2	1.2
Increase in restricted cash	(17.2)	(17.0)
Decrease in premiums receivable	53.0	72.8
Decrease in premiums payable	(15.7)	(55.5)
Decrease in trading securities - net	–	5.8
Decrease in other current assets	16.8	30.1
Increase (decrease) in accrued compensation and other accrued liabilities	101.3	(16.0)

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Net change in income taxes recoverable/payable	(30.8)	(4.8)
Tax benefit from issuance of common stock	4.1	5.6
Net change in deferred income taxes	(38.0)	(5.4)
Other	(5.4)	(3.6)
Net cash provided by operating activities of continuing operations	13.3	63.4
Loss from discontinued operations	(0.2)	0.1
Net loss on sales of discontinued operations	0.8	–
Net cash provided by operating activities	13.9	63.5
Cash flows from investing activities:		
Net additions to fixed assets	(4.7)	(5.4)
Cash paid for acquisitions, net of cash acquired	(13.0)	(21.3)
Proceeds from sales of discontinued operations	3.2	–
Other	2.1	2.4
Net cash used by investing activities	(12.4)	(24.3)
Cash flows from financing activities:		
Proceeds from issuance of common stock	9.4	11.0

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Repurchases of common stock	–	(18.3)
Dividends paid	(23.0)	(16.2)
Borrowings on line of credit facilities	0.5	3.4
Repayments of long-term debt	(0.7)	(1.2)
Net cash used by financing activities	(13.8)	(21.3)
Net (decrease) increase in cash and cash equivalents	(12.3)	18.0
Cash and cash equivalents at beginning of period	224.6	193.6
Cash and cash equivalents at end of period	$ 212.3	$ 211.6
Supplemental disclosures of cash flow information:		
Interest paid	$ 3.4	$ 2.3
Income taxes paid	12.7	13.9

See notes to consolidated financial statements.

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Notes to March 31, 2005 Consolidated Financial Statements (Unaudited)

1. Nature of Operations and Basis of Presentation

Arthur J. Gallagher & Co. (Gallagher) provides insurance brokerage and risk management services to a wide variety of commercial, industrial, institutional and governmental organizations. Commission revenue is principally generated through the negotiation and placement of insurance for its clients. Fee revenue is primarily generated by providing other risk management services including claims management, information management, risk control services and appraisals in either the property/casualty (P/C) market or human resource/employee benefit market. Investment income and other revenue is generated from Gallagher' s investment portfolio, which includes fiduciary funds, equity securities, and tax advantaged and other strategic investments. Gallagher is headquartered in Itasca, Illinois, has operations in eight countries and does business in more than 100 countries globally through a network of correspondent brokers and consultants.

The accompanying unaudited consolidated financial statements have been prepared by Gallagher pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements have been omitted pursuant to such rules and regulations. Gallagher believes the disclosures are adequate to make the information presented not misleading. The unaudited consolidated financial statements included herein are, in the opinion of management, prepared on a basis consistent with the audited consolidated financial statements for the year ended December 31, 2004 and include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information set forth. The quarterly results of operations are not necessarily indicative of results of operations for subsequent quarters or the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in Gallagher' s Annual Report on Form 10-K for the year ended December 31, 2004. Certain reclassifications have been made to the prior year consolidated financial information disclosed herein in order to conform to the current year' s presentation.

2. Effect of New Accounting Pronouncements

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No.123 (revised 2004) (SFAS 123(R)), "Share-Based Payment," which is a revision of Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation." SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25 (APB 25), "Accounting for Stock Issued to Employees," and amends SFAS 95, "Statement of Cash Flows." Generally, the approach to accounting for share-based payments in SFAS 123(R) is similar to the approach described in SFAS 123, which, as discussed in Note 8 to the consolidated financial statements, Gallagher adopted on a prospective basis in fourth quarter 2003. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options (for all grant years), to be recognized in the financial statements based on their fair values. Pro forma disclosure is no longer an alternative to financial statement recognition for years prior to January 1, 2003. In April 2005, the Securities and Exchange Commission amended the required adoption date of SFAS 123(R), which is effective for public companies at the beginning of the next fiscal year instead of the first interim or annual period beginning after June 15, 2005. Thus, Gallagher must adopt SFAS 123(R) no later than January 1, 2006.

SFAS 123(R) permits public companies to account for share-based payments using one of two methods: modified-prospective method or modified-retrospective method. The modified-prospective method is similar to the modified-prospective method described in SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, An Amendment of SFAS No. 123." Under this method, compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date.

Under the modified-retrospective method, which includes the requirements of the modified prospective method described above, companies are permitted to restate, based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

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Gallagher plans to adopt SFAS 123(R) no later than January 1, 2006, but has not yet determined what method it will use. Gallagher adopted the fair-value-based method of accounting for share-based payments effective January 1, 2003 using the prospective method described in SFAS 123 and 148. Currently, Gallagher uses the Black-Scholes formula to estimate the value of stock options granted to employees and expects to continue to use this acceptable option valuation model upon the required adoption of SFAS 123(R). Because SFAS 123(R) must be applied not only to new awards but to previously granted awards that are not fully vested on the effective date, and because Gallagher adopted SFAS 123 using the prospective method, which applied only to awards granted, modified or settled after the adoption date, compensation cost for some previously granted awards that were not recognized under SFAS 123, will be recognized under SFAS 123(R). Thus, Gallagher will have to apply the provisions of SFAS 123(R) to all unvested awards granted prior to the adoption of SFAS 123 (prior to January 1, 2003) for recognition of share-based payments to employees. However, had Gallagher adopted SFAS 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS 123 as described in the disclosure of pro forma net earnings and earnings per share in Note 8 to the consolidated financial statements.

SFAS 123(R) also requires the benefits of tax deductions in excess of compensation amounts recognized for book purposes, to be reported as a financing cash flow rather than as an operating cash flow as required under current rules. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. While Gallagher cannot estimate what those amounts will be in the future because they depend on, among other things, when employees exercise stock options, the amount of operating cash flows recognized in prior periods for such excess tax deductions was $4.1 million and $5.6 million for the three-month periods ended March 31, 2005 and 2004, respectively.

3. Investments

The following is a summary of Gallagher' s unconsolidated investments and the related outstanding letters of credit (LOCs), financial guarantees and funding commitments (in millions):

	March 31, 2005		December 31, 2004		March 31, 2005	
	Current	Noncurrent	Current	Noncurrent	LOCs & Financial Guarantees	Funding Commitments
Unconsolidated Investments:						
Direct and indirect investments in Asset Alliance Corporation (AAC)	$ 0.1	$ 47.3	$ 0.8	$ 46.7	$ –	$ –
Low income housing (LIH) developments:						
Bridge loans	5.3	–	5.2	–	–	–
Partnership interests	–	1.3	–	1.5	–	–
LIH Developer	–	9.1	–	9.2	–	–

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Alternative energy investments:						
Owned partnership interests	0.9	18.7	0.9	19.1	4.4	0.8
Biogas project	–	15.0	–	14.7	–	–
Partnership interest installment sales	21.4	11.3	18.6	12.9	–	–
Bermuda insurance investments	–	20.4	–	20.4	6.7	–
Real estate, venture capital and other investments	0.1	6.3	0.5	7.9	–	2.0
Total unconsolidated investments	27.8	129.4	26.0	132.4	11.1	2.8
Non-recourse borrowings - Biogas project	(0.3)	(13.7)	(0.2)	(13.8)	–	–
Net unconsolidated investments	$ 27.5	$ 115.7	$ 25.8	$ 118.6	$ 11.1	$ 2.8

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Asset Alliance Corporation - Through various debt, preferred stock and common stock investments Gallagher effectively owns 25% of AAC, a holding company that owns up to 50% of 14 private investment management firms (the Firms). The Firms manage domestic and international investment portfolios for corporations, pension funds and individuals, which totaled approximately $4.1 billion at March 31, 2005. AAC has a proportional interest in the Firms' revenues that result principally from fees and participation in investment returns from the managed investment portfolios. Gallagher accounts for its holdings in AAC' s common stock using equity method accounting.

During fourth quarter 2002, one of the Firms, Beacon Hill Asset Management LLC (Beacon Hill), withdrew from managing its portfolio due to various legal, contractual and business issues. As a result, AAC wrote down its investment and, correspondingly, Gallagher recorded a $3.0 million pretax charge to reflect its proportional loss. In first quarter 2003, investors in a Beacon Hill investment partnership filed a lawsuit to recover investment losses naming AAC as a co-defendant. In first quarter 2004, this lawsuit was dismissed by the judge without prejudice and the case was subsequently refiled in second quarter 2004. This case is still in a preliminary stage and Gallagher is unable to estimate the impact, if any, this lawsuit may have on AAC and the resulting impact on Gallagher' s investment value.

Low Income Housing (LIH) Developments - Gallagher' s investments in LIH consist of three components:

Bridge Loans represent early-stage loans on properties that are mainly being developed to qualify for LIH tax credits. The loans are collateralized by the land and buildings under development and carry interest rates ranging from 4.00% to 4.75% at March 31, 2005. The loans are generally outstanding for 12 to 36 months and accrue interest until the projects are refinanced by a purchaser or syndicator. No loan has ever defaulted since Gallagher began making these types of loans in 1996.

Partnership Interests represent Gallagher' s ownership in completed and certified LIH developments. At March 31, 2005, Gallagher owned a limited partnership interest in 26 LIH developments. These are generating tax benefits to Gallagher on an ongoing basis in the form of both tax deductions for operating losses and tax credits. These investments are generally accounted for using the effective yield method and are carried at amortized cost. Under the effective yield method, Gallagher recognizes the tax credits as they are allocated by the partnerships, which are included, net of amortization of the investment, as a component of the provision for income taxes. Gallagher has never incurred a loss on a LIH project.

Eleven of the LIH developments have been determined to be variable interest entities (VIE), as defined by FASB Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities," but are not required to be consolidated. Gallagher invested in these developments between 1990 and 2000 as a limited partner. At March 31, 2005, total assets and total debt of these developments was approximately $67.0 million and $52.0 million, respectively. Gallagher' s maximum exposure to a potential loss from these VIEs was $1.3 million at March 31, 2005, which equaled the net aggregate carrying value of its investments.

LIH Developer represents Gallagher' s 30% ownership interest in the company that is the developer and/or syndicator of most of Gallagher' s LIH development investments. It has been determined to be a VIE but is not required to be consolidated. Gallagher' s original investment was in 1996. The LIH Developer generates revenues from syndication and development fees and 84% of its equity is in cash, cash producing real estate project receivables and bridge loans. Gallagher accounts for this investment using equity method accounting. At March 31, 2005, the LIH Developer had total assets of approximately $24.0 million and no debt. Gallagher' s maximum exposure to a potential loss from this VIE was $9.1 million at March 31, 2005, which equaled the net carrying value of its investment.

Alternative Energy Investments - Gallagher has made investments in partnerships formed to develop energy that qualifies for tax credits under Internal Revenue Code (IRC) Section 29. There are two types of such investments:

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Owned Partnership Interests consist of (i) waste-to-energy (Biomass) partnerships which own the rights to gas emissions (Biogas) from landfills and the wells and infrastructure necessary to capture the Biogas and (ii) synthetic coal (Syn/Coal) partnerships which own and lease equipment that processes qualified fuel under IRC Section 29. Gallagher has an interest in seven Biomass limited partnerships and five Syn/Coal limited partnerships or limited liability companies which generate tax benefits to Gallagher on an ongoing basis in the form of both tax deductions for operating losses and tax credits. At March 31, 2005, two of the Syn/Coal limited partnerships are consolidated into Gallagher's financial statements due to ownership percentage. The remainder of these investments are carried at amortized cost. Gallagher recognizes the tax credits as they are allocated by the partnerships, which are included as a component of the provision for income taxes.

At March 31, 2005, Gallagher had an LOC and a funding commitment outstanding totaling $5.2 million related to the reclamation of a Syn/Coal property and a sulphur reduction binder venture.

Biogas Projects During first quarter 2003, Gallagher exited from the majority of its investment positions in various venture capital, developmental-stage enterprises and turn-arounds and recorded write-offs related to these investments. Since then, Gallagher has pursued recoveries where appropriate. As part of these recovery efforts, during first and second quarters 2004, one of Gallagher's partially owned Biogas projects (Biogas Project), which was being managed by a turn-around enterprise, was a party in a series of transactions to establish a publicly traded Canadian income trust, which partially funded the Biogas Project. In connection therewith, Gallagher (i) recognized a $2.0 million non-cash gain in first quarter 2004 due to the reversal of a non-cash loss contingency reserve established in first quarter 2003, (ii) received $5.0 million in cash in second quarter 2004 in full repayment of a note receivable from the turn-around enterprise, (iii) recognized a $1.0 million gain in second quarter 2004 when it received cash as payment for accrued interest income related to the note discussed in (ii) above that was written-off in first quarter 2003, and (iv) recognized $0.4 million of interest income in second quarter 2004 when it received cash for the remaining interest due on the note discussed in (ii) above. To finalize the above transactions, during second quarter 2004, Gallagher made an equity investment of $14.0 million in the Biogas Project to fund its operations and make capital improvements to increase Biogas production, which was funded by a $14.0 million non-recourse loan to Gallagher from the turn-around enterprise. Principal and interest payments are only required if, and when, cash distributions are made from the Biogas Project. There is a tri-party right to offset the distributions from the Biogas Project against the obligations under the loan between the Biogas Project, Gallagher and the turn-around enterprise, which makes the loan non-recourse to Gallagher. GAAP thereby requires the investment and related debt be presented gross in Gallagher's consolidated balance sheet. The $14.0 million investment is accounted for using equity method accounting.

During first quarter 2005, Gallagher entered into an agreement to dispose of its partnership interest in the Biogas Project discussed above. It is anticipated that the closing will be completed in May 2005. As a result of this transaction, Gallagher recorded a loss of $0.5 million in first quarter 2005 and will record a gain on the sale of approximately $1.0 million in second quarter 2005. As a result of the sale, Gallagher's investment in the Biogas Project as well as the related debt obligation to the turn-around enterprise will be eliminated from Gallagher's consolidated balance sheet in second quarter 2005.

Seven Biomass projects have been determined to be VIEs but are not required to be consolidated. Gallagher is a limited partner in each investment. The investments were entered into by Gallagher between 1991 and 1998. At March 31, 2005, total assets and total debt of these investments were approximately $62.0 million and $54.0 million, respectively. Gallagher's maximum exposure to a potential loss from these VIEs was $0.4 million at March 31, 2005, which equaled the net aggregate carrying value of its investments.

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Effective July 1, 2003, Gallagher adopted FIN 46, which required Gallagher to consolidate one 5% owned Syn/Coal entity due to Gallagher' s economic interest in the entity. The other 95% had been previously sold on the installment sale basis and had substantial residual value to Gallagher. Under FIN 46 criteria, this investment had been determined to be a VIE and required Gallagher to consolidate this facility into its consolidated financial statements. FIN 46 requires Gallagher to reevaluate each investment at any "triggering event." On August 6, 2004, Gallagher sold an additional 4% of its remaining 5% ownership to the party that previously owned 95% of the entity, resulting in Gallagher owning a 1% interest in this entity. After considering this sale transaction, it was determined that Gallagher is no longer the primary beneficiary of this VIE and therefore does not have to consolidate this partially owned entity. The net impact of this investment on Gallagher' s net earnings and stockholders' equity is the same whether it is accounted for on the consolidated basis or using equity method accounting. The following is a summary of the amounts included in the consolidated statement of earnings for the consolidation of this partially owned entity (in millions):

	Three-month period ended March 31,	
	2005	**2004**
Investment income - all other	$ –	$ 25.9
Investment expenses	–	24.7
Depreciation	–	1.2
Total expenses	–	25.9
Earnings before income taxes	$ –	$ –

Partnership Interest Installment Sales represent the remaining book value and receivables from the Biomass and Syn/Coal operations that have been either partially or completely sold to third parties. Gallagher accounts for these investments on the installment sale basis, which requires that the net gains, including the amortization of the bases of the assets sold, be recognized over time as a component of investment income.

Biomass - As part of selling its interests in Biomass partnerships, Gallagher provided indemnifications to the buyers for taxes that may arise as a result of incorrect representations. Gallagher obtained legal, tax, and other expert services and advice when making these representations. At March 31, 2005, the maximum potential amount of future payments that Gallagher could be required to make under these indemnifications totaled approximately $13.3 million, net of the applicable income tax benefit. Gallagher did not record any liability in its March 31, 2005 consolidated balance sheet for these potential indemnifications.

Syn/Coal - As part of selling its interests in Syn/Coal partnerships, Gallagher provided indemnifications to the buyers for taxes that may arise as a result of incorrect representations. Gallagher obtained legal, tax, and other expert services and advice when making these representations,

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and, subsequently obtained private letter rulings (PLRs) from the Internal Revenue Service (IRS). Gallagher has not recorded any liability in its March 31, 2005 consolidated balance sheet for these potential indemnifications.

On October 29, 2003, the IRS issued Announcement 2003-70 stating that it had completed a review of chemical change issues associated with tax credits claimed under IRC Section 29 relating to the production and sale of synthetic coal (Syn/Coal Credits). It further stated that it would resume the issuance of PLRs concerning Syn/Coal Credits consistent with the guidelines regarding chemical change previously set forth in Revenue Procedures 2001-30 and 2001-34 and certain additional requirements related to sampling, testing and recordkeeping procedures, even though the IRS does not believe the level of chemical change required under that guidance is sufficient for IRC Section 29 purposes. The IRS also stated in the announcement that it would continue to issue PLRs because it recognized that many taxpayers and their investors have relied on the IRS' s long standing PLR practice to make investments. Previously, in Announcement 2003-46 issued on June 27, 2003, the IRS had questioned the validity of certain test procedures and results that had been presented to it by taxpayers with interests in synthetic fuel operations as evidence that the required significant chemical change had occurred, and had initiated a review of these test procedures and results which was completed as noted in Announcement 2003-70.

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Separately, the Permanent Subcommittee on Investigations of the Government Affairs Committee of the U.S. Senate (Subcommittee) is conducting an ongoing investigation of potential abuses of tax credits by producers of synthetic fuel under IRC Section 29. The Subcommittee Chairman, in a memorandum updated in March 2005, has stated that the investigation is examining the utilization of Syn/Coal Credits, the nature of the technologies and the fuels created, the use of these fuels, and other aspects of IRC Section 29. The memorandum also states that the investigation will address the IRS' s administration of Syn/Coal Credits.

The effect of these two developments on the synthetic coal industry is not clear. Gallagher is aware that a number of PLRs have been issued since October 29, 2003, and management has participated in an interview with Subcommittee staff. Gallagher continues to believe it is claiming Syn/Coal Credits in accordance with IRC Section 29 and four PLRs previously obtained by Syn/Coal partnerships in which it has an interest. Gallagher understands these PLRs are consistent with those issued to other taxpayers and has received no indication from the IRS that it will seek to revoke or modify them. In that regard, one of the Syn/Coal partnerships in which Gallagher has an interest was under examination by the IRS for the tax year 2000 and in March 2004, Gallagher was notified that the examination was closed without any changes being proposed.

Notwithstanding the foregoing, the IRS is continuing to audit taxpayers claiming Syn/Coal Credits with respect to a variety of issues. The partnerships in which Gallagher has an interest may be audited in the future, and any such audit could adversely affect Gallagher' s ability to claim Syn/Coal Credits or cause it to be subject to liability under indemnification obligations related to the prior sale of interests in partnerships claiming Syn/Coal Credits. Furthermore, Syn/Coal Credits have been controversial both politically and administratively, and no assurance can be given that the IRS will not in the future discontinue issuing PLRs, issue administrative guidance adverse to Gallagher' s interests, or support the enactment of legislation to curtail or repeal IRC Section 29. In April 2005, a bill to repeal IRC Section 29 was introduced in the U.S. House of Representatives. It is not expected that this bill will be acted on during the current session of Congress, but a similar bill could be reintroduced in a future session and any such action could potentially result in the curtailment or repeal of Syn/Coal Credits prior to the end of 2007, when the Syn/Coal Credits expire under current law. Similarly, future administrative or judicial decisions could adversely affect Gallagher' s ability to claim Syn/Coal Credits or cause it to be subject to liability under indemnification obligations related to prior sales of partnership interests.

Gallagher has insurance policies in place, the scope of which Gallagher believes would provide substantial coverage in the event the Syn/Coal Credits are disallowed. While there can be no assurance that such coverage would ultimately be available, if the full amount of the policies were collected, Gallagher' s maximum after-tax exposure at March 31, 2005 relating to the disallowance of the Syn/Coal Credits is as follows (in millions):

	Maximum	Net of Insurance
Tax credits recorded by Gallagher	$ 177.2	$ 94.9
Installment sale proceeds subject to indemnification	190.3	34.2
Net carrying value of assets held at March 31, 2005	10.9	10.9
Total exposure	$ 378.4	$ 140.0

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Bermuda Insurance Investments - These investments consist primarily of a $20.0 million equity investment (less than 2% ownership) in Allied World Assurance Holdings, Ltd. (AWAH), which is a Bermuda based insurance and reinsurance company founded in 2001 by American International Group, Inc., The Chubb Corporation and affiliates of Goldman, Sachs & Co. This investment is carried at cost. On March 31, 2005, AWAH announced a distribution payable to shareholders of record as of April 1, 2005. Gallagher received $5.8 million on April 1, 2005 of which, $2.1 million was a dividend and $3.7 million was a return of capital. Gallagher' s percent ownership in AWAH did not change as a result of the return of capital. Accordingly, Gallagher' s Bermuda insurance investments will be reduced to $16.3 million in second quarter 2005. The remaining balance of $0.4 million is Gallagher' s rent-a-captive facility, formed in 1997 that Gallagher uses as a placement facility for its insurance brokerage operations. Gallagher has posted $6.7 million of LOCs to allow the rent-a-captive to meet minimum statutory surplus requirements and for additional collateral related to premium and claim funds held in a fiduciary capacity. These LOCs have never been drawn upon.

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Real Estate, Venture Capital and Other Investments - At March 31, 2005, Gallagher had investments in five real estate ventures with a net carrying value of $2.3 million in the aggregate, the largest of which was $1.4 million. Gallagher also had investments in five venture capital investments and funds that consisted of various debt and equity investments in development-stage companies and turn-arounds with an aggregate net carrying value of $4.2 million, the largest of which was $3.4 million. Four of the ten investments discussed above have been determined to be VIEs but are not required to be consolidated. These were originally invested in between 1997 and 2001. At March 31, 2005, total assets and total debt of these four investments were approximately $27.0 million and $33.0 million, respectively. Gallagher' s maximum exposure to a potential loss related to these investments was $0.9 million at March 31, 2005, which equaled the net aggregate carrying value of these investments.

Consolidated Investments - Gallagher has an ownership interest in excess of 50% in five investment enterprises, which are consolidated into Gallagher' s consolidated financial statements: two real estate partnerships, an airplane leasing limited liability company and two Syn/Coal facilities.

One real estate partnership represents a 60% investment in a limited partnership that owns the building that Gallagher leases for its home office and several of its subsidiary operations. The other real estate partnership represents an 80% investment in a limited partnership that is developing an 11,000-acre community near Orlando, Florida (Florida Community Development). Gallagher also owns 90% of an airplane leasing company that leases two cargo airplanes to the French Postal Service. On May 19, 2004, Gallagher purchased a 98% equity interest in a Syn/Coal production facility that had previously been operated by Gallagher through a facility rental agreement. The purchase price was made with an $11.1 million seller financed note payable that is non-recourse to Gallagher. Principal and interest payments are only required when the facility is operating and generating Syn/Coal Credits. The other Syn/Coal investment represents Gallagher' s 99% equity interest in a Syn/Coal facility. Both of these investments are held by Gallagher to generate Syn/Coal Credits.

On March 22, 2005, Gallagher entered into an agreement to sell its ownership interests in the limited partnership that owns the Florida Community Development investment, the closing of which occurred on April 20, 2005. Pursuant to the transaction, Gallagher received cash of approximately $25.7 million and will record a pretax gain on the sale of approximately $12.0 million in second quarter 2005. Terms of the transaction provide that Gallagher continue to post a $12.6 million letter of credit to guarantee $12.4 million of bonds issued by the Florida Community Development. Gallagher is fully indemnified by an affiliate of the purchaser and in consideration for posting the LOC will receive cash compensation sufficient to cover its costs plus 1% of certain future cash flow residuals from the Florida Community Development. Accordingly, the consolidated balances of the Florida Community Development will be eliminated from Gallagher' s consolidated balance sheet in second quarter 2005.

At December 31, 2003, Gallagher owned 5% of a Syn/Coal facility. Under the FIN 46 rules, this investment had been determined to be a VIE and required Gallagher to consolidate this facility into its consolidated financial statements. During third quarter 2004, Gallagher sold a 4% ownership interest in this investment, which eliminated the requirement to consolidate this investment under the FIN 46 rules. This investment is now accounted for using equity method accounting.

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The following is a summary of these consolidated investments and the related outstanding LOCs, financial guarantees and funding commitments (in millions):

	March 31, 2005	December 31, 2004	March 31, 2005 LOCs & Financial Guarantees	March 31, 2005 Funding Commitments
Home office land and building:				
Fixed assets	$101.4	$ 101.3	$ –	$ –
Accumulated depreciation	(16.5)	(15.8)	–	–
Non-recourse borrowings - current	(0.9)	(0.9)	–	–
Recourse borrowings - current	–	–	–	–
Non-recourse borrowings - noncurrent	(72.9)	(73.1)	–	–
Recourse borrowings - noncurrent	(3.0)	(3.0)	–	–
Net other consolidated assets and liabilities	3.0	2.8	–	–
Net investment	11.1	11.3	–	–
Florida Community Development:				
Fixed assets	62.0	60.3	–	–
Accumulated depreciation	(0.9)	(0.7)	–	–
Non-recourse borrowings - current	(19.0)	(17.9)	–	–

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Recourse borrowings - current	(17.0)	(17.0)	–	–
Non-recourse borrowings - noncurrent	(0.2)	(0.1)	–	–
Recourse borrowings - noncurrent	(12.4)	(12.4)	–	–
Net other consolidated assets and liabilities	(3.1)	(2.4)	2.7	–
Net investment	9.4	9.8	2.7	–
Airplane leasing company:				
Fixed assets	51.8	51.8	–	–
Accumulated depreciation	(15.0)	(14.1)	–	–
Non-recourse borrowings - current	(2.6)	(2.6)	–	–
Recourse borrowings - current	–	–	–	–
Non-recourse borrowings - noncurrent	(29.3)	(29.9)	–	–
Recourse borrowings - noncurrent	–	–	–	–
Net other consolidated assets and liabilities	(0.1)	–	–	–
Net investment	4.8	5.2	–	–
Syn/Coal partnerships:				
Fixed assets	15.7	15.6	–	–

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Accumulated depreciation	(3.9)	(2.8)	–	–
Non-recourse borrowings - current	(3.1)	(2.8)	–	–
Recourse borrowings - current	–	–	–	–
Non-recourse borrowings - noncurrent	(6.8)	(7.7)	–	–
Recourse borrowings - noncurrent	–	–	–	–
Net other consolidated assets and liabilities	0.4	1.6	–	–
Net investment	2.3	3.9	–	–
Total consolidated investments:				
Fixed assets	230.9	229.0	–	–
Accumulated depreciation	(36.3)	(33.4)	–	–
Non-recourse borrowings - current	(25.6)	(24.2)	–	–
Recourse borrowings - current	(17.0)	(17.0)	–	–
Non-recourse borrowings - noncurrent	(109.2)	(110.8)	–	–
Recourse borrowings - noncurrent	(15.4)	(15.4)	–	–
Net other consolidated assets and liabilities	0.2	2.0	2.7	–
Net investment	$27.6	$ 30.2	$ 2.7	$ –

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As presented in the above table, four of the five investment related enterprises have borrowings related to their assets. See Note 13 for a summary of future cash payments, excluding interest, related to the borrowings of Gallagher' s investment related enterprises.

At March 31, 2005, Gallagher' s maximum exposure to a potential loss related to these investments is as follows (in millions):

Net carrying value	$27.6
Recourse portion of debt	32.4
LOCs, financial guarantees and funding commitments	2.7
Maximum exposure	$62.7

Impairment Reviews - Gallagher has a management investment committee that meets 10 to 12 times per year to review its investments. For investments that do not have quoted market prices, Gallagher utilizes various valuation techniques to estimate fair value and proactively looks for indicators of impairment. Factors, among others, that may indicate that an impairment could exist, include defaults on interest and/or principal payments, reductions or changes to dividend payments, sustained operating losses or a trend of poor operating performance, recent refinancings or recapitalizations, unfavorable press reports, untimely filing of financial information, significant customer or revenue loss, litigation, tax audits, losses by other companies in a similar industry, overall economic conditions, management and expert advisor changes, and significant changes in strategy. In addition, in cases where the ultimate value of an investment is directly dependent on Gallagher for future financial support, Gallagher assesses its willingness and intent to provide future funding.

If an indicator of impairment exists, Gallagher compares the investment' s carrying value to an estimate of its fair value. To estimate the fair value of loans, Gallagher discounts the expected future cash flows from principal and interest payments. This requires Gallagher to exercise significant judgment when estimating both the amount and the timing of the expected cash flows. To estimate the fair value of its equity investments, Gallagher compares values established in recent recapitalizations or appraisals conducted by third parties. In some cases, no such recapitalizations or appraisals exist and Gallagher must perform its own valuations. This also requires Gallagher to exercise significant judgment. Even if impairment indicators exist, no write-down may be required if the estimated fair value is not less than the current carrying value or the decline in value is determined to be temporary and Gallagher has the ability and intent to hold the investment for a period of time sufficient for the value to recover. When Gallagher determines an impairment is other-than-temporary, and therefore that a write-down is required, it is recorded as a realized loss against current period earnings.

Both the process to review for indicators of impairment and, if such indicators exist, the method to compute the amount of impairment incorporate quantitative data and qualitative criteria including the receipt of new information that can dramatically change the decision about the valuation of an investment in a short period of time. The determination of whether a decline in fair value is other-than-temporary is necessarily a matter of subjective judgment. The timing and amount of realized losses reported in earnings could vary if management' s conclusions were different.

Due to the inherent risk of investments, Gallagher cannot give assurance that there will not be investment impairments in the future should economic and other conditions change.

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4. Business Combinations

During the three-month period ended March 31, 2005, Gallagher acquired substantially all the net assets of the following insurance brokerage firms in exchange for its common stock and/or cash. These acquisitions have been accounted for using the purchase accounting method for recording business combinations (in millions except share data):

Name and Effective Date of Acquisitions	Common Shares Issued (000s)	Common Share Value	Cash Paid	Accrued Liability	Escrow Deposited	Recorded Purchase Price	Earnout Payables
Horton Insurance Agency, Inc. (HIA) January 1, 2005	–	$ –	$3.6	$ 0.4	$ –	$ 4.0	$ 2.8
Marine Insurance Service, LLC (MIS) January 1, 2005	–	–	1.3	0.2	–	1.5	0.8
	–	$ –	$4.9	$ 0.6	$ –	$ 5.5	$ 3.6

Common shares exchanged in connection with acquisitions are valued at closing market prices as of the effective date of the respective acquisition. Escrow deposits that are returned to Gallagher as a result of adjustments to net assets acquired are recorded as downward adjustments to goodwill when the escrows are settled. The earnout payables that are disclosed in the foregoing table represent the maximum amount of additional consideration that could be paid pursuant to the purchase agreements related to these acquisitions. These potential earnout obligations are primarily based upon future earnings of the acquired entities and were not included in the purchase price that was recorded for these acquisitions at their respective acquisition dates because they are not fixed and determinable. Future payments made under these arrangements, if any, will generally be recorded as upward adjustments to goodwill when the earnouts are settled. The aggregate amount of unrecorded earnout payables outstanding as of March 31, 2005 related to acquisitions made by Gallagher in the period from 2002 to 2005 was $79.5 million.

During the three month-period ended March 31, 2005, Gallagher issued 0.1 million shares of its common stock and paid $1.4 million in cash related to earnout obligations of four acquisitions made prior to 2005 and recorded additional goodwill of $3.4 million.

The following is a summary of the estimated fair values of the assets acquired at the date of each acquisition based on preliminary purchase price allocations (in millions):

	HIA	MIS	Total
Current assets	$2.4	$1.8	$4.2
Fixed assets	0.3	–	0.3
Goodwill	0.6	0.5	1.1

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Expiration lists	2.7	0.9	3.6
Non-compete agreements	0.5	–	0.5
Total assets acquired	6.5	3.2	9.7
Current liabilities	2.5	1.7	4.2
Total liabilities assumed	2.5	1.7	4.2
Total net assets acquired	$4.0	$1.5	$5.5

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These acquisitions allow Gallagher to expand into desirable geographic locations, further extend its presence in the retail and wholesale insurance brokerage services industry and increase the volume of general services currently provided. The excess of the purchase price over the estimated fair value of the tangible net assets acquired at the acquisition date was allocated within the Brokerage segment to goodwill, expiration lists and non-compete agreements in the amounts of $1.1 million, $3.6 million and $0.5 million, respectively. Purchase price allocations are preliminarily established at the time of the acquisition and are subsequently reviewed within the first year of operations to determine the necessity for allocation adjustments.

Expiration lists and non-compete agreements related to these acquisitions are currently being amortized on a straight-line basis over a weighted average useful life of 10 to 15 years and 5 years, respectively. Goodwill is not amortized, but is subject to periodic reviews for impairment. Gallagher reviews intangible assets for impairment periodically (at least annually) and whenever events or changes in business circumstances indicate that the carrying value of the assets may not be recoverable. In reviewing intangible assets, if the fair value were less than the carrying amount of the respective (or underlying) asset, an indicator of impairment would exist and further analysis would be required to determine whether or not a loss would need to be charged against current period earnings. No such indicators were noted in the three-month periods ended March 31, 2005 and 2004. The $3.6 million of expiration lists and $0.5 million of non-compete agreements related to the 2005 acquisitions, are expected to be deductible for income tax purposes.

Gallagher' s consolidated financial statements for the three-month period ended March 31, 2005 include the operations of these companies from the date of their respective acquisition. The following is a summary of the unaudited pro forma historical results, as if these purchased entities had been acquired at January 1, 2004 (in millions, except per share data):

	Three-month period ended March 31,	
	2005	2004
Total revenues	$ 348.9	$ 333.7
Earnings (loss) from continuing operations	(73.8)	38.8
Basic earnings (loss) from continuing operations per share	(.80)	.43
Diluted earnings (loss) from continuing operations per share	(.80)	.41

The unaudited pro forma results above have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which actually would have resulted had the acquisitions occurred at January 1, 2004, nor is it necessarily indicative of future operating results. Annualized revenues of entities acquired in 2005 totaled approximately $5.0 million.

5. Discontinued Operations

In first quarter 2005, Gallagher entered into an agreement that sold all of the stock of Gallagher Benefit Administrators, Inc. (GBA), a third party employee benefit claim payment administrator, for cash of $9.2 million and a promissory note in the amount of $4.4 million. Gallagher recognized a pretax gain of $9.6 million in first quarter 2005. The promissory note has a 10% fixed rate of interest, with interest only payments payable monthly through August 22, 2007, when the note matures. In Gallagher' s previously reported financial information, GBA' s operating results were included in the Risk Management Segment, which have been reclassified to discontinued operations in the accompanying consolidated statement of earnings for all periods presented.

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In first quarter 2005, Gallagher entered into an agreement that sold all of the stock of Northshore International Insurance Services (NiiS), a medical claims management and auditing services provider, for cash of $4.8 million. Gallagher recognized a pretax loss of $10.4 million in first quarter 2005. In Gallagher' s previously reported financial information, NiiS' s operating results were included in the Brokerage Segment, which have been reclassified to discontinued operations in the accompanying consolidated statement of earnings for all periods presented.

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Assets and liabilities included in the accompanying December 31, 2004 consolidated balance sheet, related to these two discontinued operations are as follows (in millions):

Current assets	$3.5
Fixed assets - net	3.2
Intangible assets - net	14.5
Total assets	$21.2
Current liabilities	$2.1
Noncurrent liabilities	0.6
Total liabilities	$2.7

Total revenues reclassed to discontinued operations for the three-month periods ended March 31, 2005 and 2004 were $8.0 million and $8.6 million, respectively.

6. Credit and Other Debt Agreements

Gallagher has an unsecured revolving credit agreement (Credit Agreement) with a group of ten financial institutions that provides for a revolving credit commitment of up to $250.0 million and the issuance of standby LOCs. The Credit Agreement expires on July 20, 2006. Effective March 4, 2005, Gallagher entered into an amendment of the Credit Agreement. The amendment changed the "No Material Adverse Change" and "Litigation and Other Controversies" representations in the Credit Agreement to exclude, from those representations, consideration of the judgment in the approximate amount of $175.0 million against Gallagher' s financial services subsidiary (the Utah Judgment) resulting from the jury verdict described in Note 13 to the consolidated financial statements. The amendment also included a waiver of any existing or potential default or event of default under provisions of the Credit Agreement that limit the amount of unstayed or unsatisfied judgments that could exist against Gallagher and its subsidiaries, and a waiver of a financial covenant based on EBITDA to the extent that Gallagher is required to expense any amount of the Utah Judgment from its earnings.

The amendment also increased the LOC sub-facility included in the Credit Agreement from $75.0 million to $125.0 million in the aggregate. The issuance of such LOCs reduces the amount of net funds available for future borrowing under the Credit Agreement. At March 31, 2005, $32.7 million of LOCs (of which Gallagher has $19.9 million of liabilities recorded as of March 31, 2005) were outstanding under the Credit Agreement, which primarily related to Gallagher' s investments as discussed in Notes 3 and 13 to the consolidated financial statements. There were no borrowings outstanding under the revolving credit commitment at March 31, 2005. Accordingly, as of March 31, 2005, $217.3

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million remained available for potential borrowings, of which $92.3 million may be in the form of additional LOCs. Interest rates on borrowings under the Credit Agreement are based on the prime commercial rate or LIBOR plus .575%, .800% or 1.000%, the determination of which is dependent on a financial leverage ratio maintained by Gallagher. The annual facility fee related to the Credit Agreement is either .125%, .150% or .200% of the used and unused portions, the determination of which is also dependent on a financial leverage ratio maintained by Gallagher.

The Credit Agreement contains various covenants that require Gallagher to maintain specified levels of net worth and financial leverage ratios. Gallagher was in compliance with these covenants at March 31, 2005.

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The following is a summary of Gallagher' s Credit Agreement and investment related debt (in millions):

	March 31, 2005	December 31, 2004
Corporate related borrowings:		
Gallagher' s Credit Agreement: Periodic payments of interest and principal, prime or LIBOR plus up to 1.00%, expires July 2006	$ –	$ –
Investment related borrowings:		
Mortgage loan on Gallagher' s home office: Monthly installments of principal and interest, fixed rate of 8.35%, 30 year amortization, balloon payment 2008, subject to prepayment provisions	76.8	77.0
Line of credit facility on Florida Community Development: Permits borrowings up to $17.0 million, quarterly interest-only payments, variable rate of LIBOR plus 2.00%, expires 2005	17.0	17.0
Line of credit facility on Florida Community Development: Permits borrowings up to $20.0 million, monthly interest-only payments, rate of prime plus 0.50%, expires 2005	18.2	17.7
Bonds payable on Florida Community Development: Monthly interest-only payments through 2010, variable rate based on commercial paper rate, balloon payment 2010	12.4	12.4
Equipment loans on Florida Community Development: Fixed monthly payments, fixed rates of 6.25% and 7.00%, expire 2005 and 2008	0.4	0.3
Financing fee payable on Florida Community Development: Monthly interest-only payments, fixed rate of 9.00%, balloon payment December 2005	0.6	–
Loan on airplanes leased to French Postal Service: Monthly principal and interest payments, variable rate of LIBOR plus 1.62%, balloon payment 2006	31.9	32.5

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Loan on investment in Biogas project:		
Monthly principal and interest payments, fixed rate of 15.00%, subject to prepayment provisions	14.0	14.0
Syn/Coal facility purchase note:		
Quarterly variable principal and interest payments, fixed rate of 7.00%	9.9	10.5
	$ 181.2	$ 181.4

See Note 13 for additional discussion on commitments and contingencies.

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7. Earnings Per Share

The following table sets forth the computation of basic and diluted net earnings (loss) per share (in millions, except per share data):

	Three-month period ended March 31,	
	2005	2004
Earnings (loss) from continuing operations	$ (73.8)	$ 38.8
Earnings (loss) on discontinued operations	(0.2)	0.1
Net earnings (loss)	$ (74.0)	$ 38.9
Weighted average number of common shares outstanding	92.5	90.4
Dilutive effect of stock options using the treasury stock method	2.3	3.6
Weighted average number of common and common equivalent shares outstanding	94.8	94.0
Basic net earnings (loss) per share:		
Earnings (loss) from continuing operations	$ (.80)	$ .43
Earnings (loss) on discontinued operations	–	–
Net earnings (loss)	$ (.80)	$ .43
Diluted net earnings per share		
Earnings (loss) from continuing operations	$ (.80)	$ .41

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Earnings (loss) on discontinued operations	–	–
Net earnings (loss)	$ (.80)	$ .41

The dilutive effect of stock options using the treasury stock method is not applicable for the three-month period ended March 31, 2005 due to the net loss that was reported. Options to purchase 5.9 million and 0.4 million shares of common stock were outstanding at March 31, 2005 and 2004, respectively, but were not included in the computation of the dilutive effect of stock options for the three-month periods then ended. These options were excluded from the computation because the options' exercise prices were greater than the average market price of Gallagher's common shares during the respective period and, therefore, would be antidilutive to earnings per share under the treasury stock method.

8. Stock Option-Based Compensation

In 2003, Gallagher adopted the fair value method of accounting for employee stock options pursuant to SFAS 123 and SFAS 148. Prior to January 1, 2003, Gallagher applied the intrinsic value method as permitted under SFAS 123 and defined in APB 25, which excluded employee options granted at fair market value from compensation expense. Substantially all of the stock options currently outstanding have an exercise price equal to the fair market price at the date of grant and, therefore, under APB 25, virtually no compensation expense was recorded prior to January 1, 2003. The change to the fair value method of accounting is being applied prospectively to all stock option awards granted, modified, or settled after January 1, 2003 and to all employee stock purchases made subsequent to January 1, 2003 through participation in Gallagher's employee stock purchase plan. During the three-month periods ended March 31, 2005 and 2004, Gallagher recognized $2.2 million and $1.2 million, respectively, of compensation expense related to its stock option plans and its employee stock purchase plan.

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At March 31, 2005, Gallagher has four stock option-based employee compensation plans, which are described more fully in Note 10 to the consolidated financial statements included in Gallagher' s Annual Report on Form 10-K for the year ended December 31, 2004. Gallagher primarily grants stock options for a fixed number of shares to employees, with an exercise price equal to the fair value of the underlying shares at the date of grant. For all options granted prior to January 1, 2003, Gallagher continues to account for stock option grants under the recognition and measurement principles of APB 25 and related Interpretations and, accordingly, recognizes no compensation expense for these stock options granted to employees. The following table illustrates the effect on earnings (loss) from continuing operations and earnings (loss) from continuing operations per share if Gallagher had applied the fair value recognition provisions of SFAS 123 to all of its stock-based employee compensation (in millions, except per share data):

	Three-month period ended March 31,	
	2005	2004
Earnings (loss) from continuing operations, as reported	$ (73.8)	$ 38.8
Add: Stock-based employee compensation expense included in reported net earnings, net of related tax effects	1.7	1.0
Deduct: Total stock option-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2.5)	(2.0)
Pro forma earnings (loss) from continuing operations	$ (74.6)	$ 37.8
Basic earnings (loss) from continuing operations per share - pro forma	$ (.80)	$ .42
Diluted earnings (loss) from continuing operations per share - pro forma	(.80)	.40

As presented in the table above, had Gallagher applied the fair value recognition provisions of SFAS 123 for all stock options granted prior to January 1, 2003, diluted earnings (loss) from continuing operations per share as reported for the three-month period ended March 31, 2004, would have been reduced by $.01 and there would have been no impact on the per share amount reported for the three-month period ended March 31, 2005. The pro forma disclosures above only include the effect of options granted subsequent to January 1, 1995. Accordingly, the effects of applying the SFAS 123 pro forma disclosures to future periods may not be indicative of future effects.

9. Deferred Compensation

Gallagher has a Deferred Equity Participation Plan, which is a non-qualified plan that provides for distributions to certain key executives of Gallagher upon their normal retirement. Under the provisions of the plan, Gallagher contributes shares of its common stock, in an amount approved by the Compensation Committee, to a rabbi trust on behalf of the executives participating in the plan. Distributions under the plan may not normally be made until the participant reaches age 62 and are subject to forfeiture in the event of voluntary termination of

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employment prior to age 62. All distributions from the plan, except for accumulated non-invested dividends, are made in the form of Gallagher' s common stock.

In first quarter 2005 and 2004, Gallagher contributed $4.7 million and $4.6 million, respectively, to the plan through the issuance of 157,000 and 142,000 shares, respectively, of Gallagher' s common stock. The Gallagher common stock that is issued under the plan to the rabbi trust is valued at historical cost (fair market value at the date of grant) and the unearned deferred compensation obligation is classified as a contra equity amount. The unearned deferred compensation balance is shown as a reduction of stockholders' equity in the accompanying consolidated balance sheet and is being amortized to compensation expense ratably over the vesting period of the participants. Future changes in the fair value of the Gallagher common stock that is owed to the participants does not have any impact on Gallagher' s consolidated financial statements. During the three-month periods ended March 31, 2005 and 2004, $0.4 million and $0.3 million, respectively, was charged to compensation expense related to this plan.

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10. Restricted Stock Awards

Gallagher has adopted a restricted stock plan for its directors, officers and other employees. Under the provisions of the plan, Gallagher is authorized to issue 4.0 million shares of Gallagher common stock. The Compensation Committee is responsible for the administration of the plan. Each award granted under the plan represents a right of the holder of the award to receive shares of Gallagher common stock, cash or a combination of shares and cash, subject to the holder's continued employment with Gallagher for a period of time after the date the award is granted. The Compensation Committee shall determine each recipient of an award under the plan, the number of shares of common stock subject to such award and the period of continued employment required for the vesting of such award. These terms will be included in an award agreement between Gallagher and the recipient of the award. As discussed in the paragraph below, 124,000 shares of restricted stock awards were granted under this plan during the three-month period ended March 31, 2005 (120,000 shares were issued in 2004 under the plan). Accordingly, as of March 31, 2005, 3.8 million shares are available for grant under this plan.

In first quarter 2005 and 2004, Gallagher granted 124,000 and 65,000 shares, respectively, of its common stock to employees related to incentive compensation plans, with an aggregate fair value of $3.7 million and $2.1 million, respectively, as of those dates. The majority of the 2005 and 2004 restricted stock awards vest over a two-year period (21,000 and 19,000 shares of the 2005 and 2004 grants, respectively, vest over a one-year period and 50,000 of the 2005 grants vest over a three-year period at the rate of 33 1/3% per year beginning on March 31, 2006), primarily at the rate of 50% per year beginning on March 31, 2006 and 2005, respectively. Gallagher accounts for restricted stock at historical cost which equals its fair market value at the date of grant. When restricted shares are issued, an unearned restricted stock obligation is recorded as a reduction of stockholders' equity, which will be ratably charged to compensation expense over the vesting period of the participants. Future changes in the fair value of the Gallagher common stock that is owed to the participants does not have any impact on Gallagher's consolidated financial statements. During the three-month periods ended March 31, 2005 and 2004, $2.3 million and $1.8 million, respectively, was charged to compensation expense related to restricted stock awards granted in 2002 to 2004.

11. Employee Stock Purchase Plan

Gallagher has an employee stock purchase plan (ESPP) under which the sale of 4.0 million shares of Gallagher's common stock has been authorized. Eligible employees may contribute up to 15% of their compensation towards the quarterly purchase of Gallagher's common stock. The employees' purchase price is 85% of the lesser of the fair market value of the stock on the first business day or the last business day of the quarterly offering period. Employees may annually purchase shares having a fair market value of up to $25,000 (measured as of first day of the quarterly offering period of each calendar year). Effective as of the end of first quarter 2005, Gallagher issued 0.1 million shares of common stock to employees who participated in the ESPP during the quarter at an aggregate purchase price of $3.0 million, or $24.48 per share. Effective as of the end of first quarter 2004, Gallagher issued 0.1 million shares of common stock to employees who participated in the ESPP during that quarter at an aggregate purchase price of $2.7 million, or $27.16 per share. Currently, there are 3.4 million shares reserved for future issuance. During the three-month periods ended March 31, 2005 and 2004, $0.5 million, in each period, was charged to compensation expense related to the common stock issued under the ESPP.

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12. Retirement Plans

Gallagher has a noncontributory defined benefit pension plan that covers substantially all domestic employees who have attained a specified age and one year of employment. Benefits under the plan are based on years of service and salary history. Gallagher accounts for the defined benefit pension plan in accordance with Statement of Financial Accounting Standards No. 87 (SFAS 87), "Employers' Accounting for Pensions." The difference between the present value of the pension benefit obligation at the date of adoption of SFAS 87 and the fair value of plan assets at that date is being amortized on a straight-line basis over the average remaining service period of employees expected to receive benefits.

The components of the net periodic pension benefit cost for the plan consists of the following (in millions):

	Three-month period ended March 31,	
	2005	2004
Service cost - benefits earned during the year	$ 5.3	$ 4.3
Interest cost on benefit obligation	3.0	2.5
Expected return on plan assets	(3.0)	(2.6)
Amortization of prior service cost	0.1	0.1
Amortization of net actuarial loss	0.3	0.1
Amortization of transition obligation	–	–
Net periodic benefit cost	$ 5.7	$ 4.4

Gallagher expects to contribute between $4.5 million and $18.0 million to the plan in 2005, subject to the maximum tax deductible contribution that is allowed under the IRC. During the three-month periods ended March 31, 2005 and 2004, Gallagher contributed $4.5 million and $1.0 million, respectively, to the plan.

In December 2003, the President of the U.S. signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act). The Act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. At the time the law was passed, the detailed regulations necessary to implement the Act, including guidelines to determine, and the evidence required to demonstrate, actuarial equivalency to the Secretary of Health and Human Services, had not been formulated. On January 21, 2005, the final regulations clarifying these matters were issued. The regulations provide a two-prong test to determine actuarial equivalence and require annual certification of actuarial equivalence by a credentialed actuary. To receive the subsidy for the 2006 calendar year, applications (including the certification of

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actuarial equivalence as well as a census list of all qualifying retirees under the plan) must be submitted to the Centers for Medicare and Medicaid Services (CMS) by September 30, 2005. Thereafter, an annual re-certification is required.

In May 2004, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003". FSP 106-2 provides guidance on accounting for the effects of the Act for employers that sponsor postretirement health care plans that provide drug benefits. This FSP also requires employers to provide certain disclosures regarding the effect of the federal subsidy provided by the Act. This FSP is effective for the first interim or annual period beginning after July 1, 2004 and supersedes FSP 106-1, which permitted a sponsor of a postretirement heath care plan that provides drug benefits to make a one-time election to defer accounting for the effects of the Act. In accordance with FSP 106-1, Gallagher elected to defer accounting for the effects of the Act and as such, any measures of the postretirement benefit obligation or net periodic postretirement benefit cost in the consolidated financial statements do not reflect the effects of the Act.

The transition method outlined in FSP 106-2 requires for public companies to conclude whether the enactment of the Act was a "significant event" pursuant to FASB Statement 106. If the enactment of the Act was not a significant event, its effects should be incorporated at the next measurement date pursuant to FASB Statement 106 following the first interim or annual period beginning after July 1, 2004. Gallagher has not yet determined whether the prescription drug benefit provided to plan participants is the actuarial equivalent to

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Medicare Part D, but does not believe that the effect of the Act will be material to its consolidated financial statements. Gallagher will adopt the provisions of FSP 106-2 at the Plan' s next measurement date, which will occur in 2005.

13. Commitments, Contingencies, Financial Guarantees and Off-Balance Sheet Arrangements

In connection with its investing and operating activities, Gallagher has entered into certain contractual obligations and commitments. See Notes 3 and 6 for additional discussion of these obligations and commitments. Gallagher' s future minimum cash payments, excluding interest, associated with its contractual obligations pursuant to the Credit Agreement, investment related borrowings, operating leases and purchase commitments at March 31, 2005 are as follows (in millions):

	Payments Due by Period						
Contractual Obligations	**2005**	**2006**	**2007**	**2008**	**2009**	**Thereafter**	**Total**
Credit Agreement	$–	$–	$–	$–	$–	$ –	$–
Investment related borrowings:							
Florida Community Development debt	36.0	0.1	0.1	–	–	12.4	48.6
Home office mortgage loan	0.7	0.9	1.1	74.1	–	–	76.8
Airplane leasing company debt	2.0	29.9	–	–	–	–	31.9
Biogas project loan	0.2	0.2	0.2	0.2	0.2	13.0	14.0
Syn/Coal facility purchase note	2.2	3.3	3.5	0.9	–	–	9.9
Total debt obligations	41.1	34.4	4.9	75.2	0.2	25.4	181.2
Operating lease obligations	39.0	47.8	41.5	34.8	27.5	43.0	233.6
Net Syn/Coal purchase commitments	4.3	3.4	3.0	–	–	–	10.7
Outstanding purchase obligations	2.1	–	–	–	–	–	2.1

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Total contractual obligations	$86.5	$85.6	$49.4	$110.0	$27.7	$ 68.4	$427.6

The amounts presented in the table above may not necessarily reflect the actual future cash funding requirements of Gallagher, because the actual timing of the future payments made may vary from the stated contractual obligation.

Credit Agreement - Gallagher has a $250.0 million Credit Agreement it uses to post LOCs and from time-to-time borrow to supplement operating cash flows. At March 31, 2005, $32.7 million of LOCs (of which Gallagher has $19.9 million of liabilities recorded as of March 31, 2005) were outstanding under the Credit Agreement, which primarily related to Gallagher' s investments as discussed in Note 3. There were no borrowings outstanding under the Credit Agreement at March 31, 2005. Accordingly, as of March 31, 2005, $217.3 million remained available for potential borrowings, of which $92.3 million may be in the form of additional LOCs. Gallagher is under no obligation to utilize the Credit Agreement in performing its normal business operations. See Note 6 to the consolidated financial statements for a discussion of the terms of the Credit Agreement.

Investment Related Borrowings - As more fully described in Notes 3 and 6 to the consolidated financial statements, at March 31, 2005, the accompanying balance sheet includes $181.2 million of borrowings related to Gallagher' s investment related enterprises of which $32.4 million is recourse to Gallagher. These borrowings are partially secured by the underlying assets of the investment enterprises and support their operations.

Operating Lease Obligations - Gallagher generally operates in leased premises. Certain office space leases have options permitting renewals for additional periods. In addition to minimum fixed rentals, a number of leases contain annual escalation clauses generally related to increases in an inflation index.

Net Syn/Coal Purchase Commitments - Gallagher has interests in two Syn/Coal facilities that it consolidates. See Note 3 to the consolidated financial statements for additional disclosures regarding these partnerships. The facilities have entered into raw coal purchase and Syn/Coal sales agreements. These agreements terminate immediately in the event the Syn/Coal produced ceases to qualify for credits under IRC Section 29 or upon termination of either the purchase or sales agreements. The net annual Syn/Coal purchase commitments represent the minimum raw coal purchases at estimated costs less sales of Syn/Coal at estimated prices.

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Outstanding Purchase Obligations - Gallagher is a service company and thus typically does not have a material amount of outstanding purchase obligations at any point in time. The amount disclosed in the table above represents the aggregate amount of unrecorded purchase obligations that Gallagher has outstanding as of March 31, 2005. These obligations represent agreements to purchase goods or services that were executed in the normal course of business.

Off-Balance Sheet Commitments- Gallagher' s total unrecorded commitments associated with outstanding letters of credit, financial guarantees and funding commitments as of March 31, 2005 are as follows (in millions):

Off-Balance Sheet Commitments	Amount of Commitment Expiration by Period						Total Amounts Committed
	2005	2006	2007	2008	2009	Thereafter	
Investment related:							
Letters of credit	$ –	$ –	$ –	$ –	$ –	$ 11.3	$ 11.3
Financial guarantees	–	–	–	–	–	2.5	2.5
Funding commitments	0.8	–	2.0	–	–	–	2.8
	0.8	–	2.0	–	–	13.8	16.6
Operations related:							
Letters of credit	–	–	–	–	–	1.5	1.5
Total commitments	$0.8	$–	$2.0	$–	$–	$ 15.3	$ 18.1

Since commitments may expire unused, the amounts presented in the table above do not necessarily reflect the actual future cash funding requirements of Gallagher. See Note 3 for a discussion of Gallagher' s outstanding LOCs, financial guarantees and funding commitments. All but one of the LOCs represent multiple year commitments but all have annual, automatic renewing provisions and are classified by the latest commitment date.

During the period from January 1, 2002 to March 31, 2005, Gallagher acquired 45 companies, which were accounted for as business combinations. Substantially all of the purchase agreements related to these acquisitions contain earnout obligations. The earnout obligations related to the 2005 acquisitions are disclosed in Note 4 to the consolidated financial statements. These earnout payables represent the maximum amount of additional consideration that could be paid pursuant to the purchase agreements related to these acquisitions. These potential earnout obligations are primarily based upon future earnings of the acquired entities and were not included in the purchase price that was recorded for these acquisitions at their respective acquisition dates. Future payments made under these arrangements will generally be

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recorded as upward adjustments to goodwill when the earnouts are settled. The aggregate amount of unrecorded earnout payables outstanding as of March 31, 2005 related to acquisitions made by Gallagher in the period from 2002 to 2005 was $79.5 million.

Off-Balance Sheet Debt - Gallagher' s unconsolidated investment portfolio includes investments in enterprises where Gallagher' s ownership interest is between 1% and 50%, whereby management has determined that Gallagher' s level of economic interest is not sufficient to require consolidation. As a result, these investments are accounted for using either the lower of amortized cost/cost or fair value, or the equity method, whichever is appropriate depending on the legal form of Gallagher' s ownership interest and the applicable percentage of the entity owned. As such, the balance sheets of these investees are not consolidated in Gallagher' s consolidated balance sheet at March 31, 2005 and December 31, 2004. The March 31, 2005 and December 31, 2004 balance sheets of several of these unconsolidated investments contain outstanding debt, which are also not required to be included in Gallagher' s consolidated balance sheet.

In certain cases, Gallagher guarantees a portion of the enterprises' debt. Based on the ownership structure of these investments, management believes that Gallagher' s exposure to losses related to these investments is limited to the combination of its net carrying value, funding commitments, LOCs and financial guarantees. In the event that certain of these enterprises were to default on their debt obligations and Gallagher' s net carrying value became impaired, the amount to be written-off could have a material effect on Gallagher' s consolidated operating results and/or financial position. See Note 3 to the consolidated financial statements.

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In addition to obligations and commitments related to Gallagher' s investing activities discussed above, at March 31, 2005, Gallagher has posted an LOC of $5.5 million related to Gallagher' s self-insurance deductibles, of which it has a recorded liability of $4.0 million.

Litigation - Gallagher is engaged in various legal actions incident to the nature of its business. On February 11, 2005, Gallagher announced that the jury in a case pending before the Fourth District Court for the State of Utah awarded damages in the amount of $175.0 million against its subsidiary, AJG Financial Services, Inc. (AJGFS), and in favor of Headwaters Incorporated (Headwaters) (Headwaters Incorporated v. AJG Financial Services, Inc., Case No. 000403381). Judgment on the award was entered on February 22, 2005.

AJGFS and Headwaters entered into a definitive agreement effective as of May 1, 2005 to settle this and all other litigation between the companies for $50.0 million payable to Headwaters in May 2005. Additionally, AJGFS and Headwaters have modified their existing licensing agreement allowing AJGFS to utilize Headwaters' technology on two of AJGFS' synthetic fuel facilities in exchange for (i) $70.0 million payable on or before January 15, 2006 and (ii) an annual royalty to Headwaters in 2005, 2006 and 2007, which at full production, would be approximately $20.0 million of AJGFS' estimated pre-royalty, pretax earnings of $40.0 million in total annually from these two facilities. Gallagher has recorded a pretax charge to its first quarter 2005 earnings of $131.0 million ($84.2 million after tax) related to this settlement, including litigation, bonding and other costs.

Private parties have also filed civil litigation against Gallagher under a variety of legal theories relating, among other things, to broker compensation practices. As previously reported, Gallagher is a defendant in a purported class action (Village of Orland Hills v. Arthur J. Gallagher & Co., Case No. 00 CH 13855, pending in the Circuit Court of Cook County, Illinois), which challenges the propriety of alleged "undisclosed contingent commissions" paid pursuant to certain compensation arrangements between Gallagher and various insurance carriers. This action was terminated when Gallagher' s motion for summary judgment was granted in early 2002 but was reinstated in September 2003 when such ruling was overturned by an intermediate appeals court. In addition, on October 19, 2004, Gallagher was joined as a defendant in a purported class action, originally filed in August 2004, in the U.S. District Court for the Southern District of New York by OptiCare Health Systems Inc. against the ten largest U.S. insurance brokers and four of the largest commercial insurers (OptiCare Health Systems Inc. v. Marsh & McLennan Companies, Inc., et al., Case No. 04 CV 06954 (DC)). The amended complaint alleges that the defendants used the contingent commission structure of placement service agreements in a conspiracy to deprive policyholders of "independent and unbiased brokerage services, as well as free and open competition in the market for insurance." In fourth quarter 2004 and first quarter 2005, seven other similar purported class actions were filed in the U.S. District Court for the Northern District of Illinois, the District Court of New Jersey and Seminole County, Florida, alleging claims based on allegations that are similar to those alleged by the plaintiff in the OptiCare litigation. The Seminole County case has been removed to federal court in the Middle District of Florida by a co-defendant. These cases have been or will be included in a Multi-District Litigation proceeding before the U.S. District Court for the District of New Jersey. On December 15, 2004, a shareholder derivative action was filed against Gallagher' s directors and certain officers in the U.S. District Court for the Northern District Court of Illinois (Fener v. Robert E. Gallagher, et al., Case No. 040 8093). This derivative

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action alleges that such directors and officers violated various state laws, including breaches of fiduciary duties, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment, by purportedly causing Gallagher to engage in fraudulent insurance placement practices and to violate federal securities laws by disseminating false and misleading statements concerning Gallagher' s financial results and operations. Gallagher and its counsel intend to file a motion to dismiss this case. Gallagher, and its subsidiary, Gallagher Healthcare Insurance Services, Inc., are defendants in two lawsuits filed in 2004 and 2005, pending in state court in Champaign County, Illinois. Claims for breach of fiduciary duty and professional negligence are alleged in the 2004 lawsuit and claims of breach for fiduciary duty are alleged in the 2005 lawsuit. Gallagher is also a defendant in a lawsuit filed in the fall of 2004, which is pending in Madison County, Illinois. That complaint asserts causes of action for breach of fiduciary duty and alleged violations of the Illinois Consumer Fraud Act. Gallagher believes it has meritorious defenses in all of these cases and intends to defend itself vigorously. However, neither the outcomes of these cases nor their effect upon Gallagher' s business, financial condition or results of operations cannot be predicted at this time.

Contingent Commissions and Other Industry Developments - The insurance industry in general, and Gallagher individually, continue to be the subjects of a significant level of scrutiny by various regulatory bodies, including State Attorneys General and the departments of insurance for various states, with respect to certain contingent commission arrangements (generally known as contingent commission or placement service agreements) between insurance brokers and insurance carriers. A discussion of these industry developments and the impact on Gallagher is included in Item 2 of this Report, "Management' s Discussion and Analysis of Financial Condition and Results of Operations – Contingent Commissions and Other Industry Developments." Over the last several months, three other major insurance brokers have reached settlements with one or more Attorneys General. Gallagher has recorded a pretax charge in first quarter 2005 of $35.0 million ($21.0 million after tax) representing its current best estimate of the amount to resolve the state insurance investigations, which is based on the costs of similar industry settlements thus far, plus an accrual for legal costs.

Contingent Liabilities - Gallagher purchases insurance to provide protection from errors and omissions (E&O) claims that may arise during the ordinary course of business. However, insuring 100% of potential claims is not cost effective. Effective June 1, 2004, Gallagher began to retain the first $2.5 million of each and every E&O claim. Prior to June 1, 2004, Gallagher retained the first $1.0 million of each and every E&O claim and the first $15.0 million of all E&O claims in excess of $1.0 million of each and every E&O claim. Gallagher' s E&O insurance provides aggregate coverage for E&O losses up to $165.0 million in excess of Gallagher' s retained amounts. Gallagher has historically maintained self-insurance reserves for the portion of its E&O exposure that is not insured. Gallagher periodically determines a range of possible reserve levels using actuarial techniques which rely heavily on projecting historical claim data into the future. Gallagher' s E&O reserve in the March 31, 2005 consolidated balance sheet is above the lower end of the most recently determined actuarial range by $5.0 million and below the upper end of the actuarial range by $7.0 million. There can be no assurances that the historical claim data used to project the current reserve levels will be indicative of future claim activity. Thus, the actuarial ranges and E&O reserve level could change in the future as more information becomes known, which could materially impact the amounts reported and disclosed herein.

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14. Segment Information

Gallagher has identified three operating segments: Brokerage, Risk Management and Financial Services. The Brokerage segment comprises three operating divisions: Brokerage Services - Retail Division, Specialty Marketing and International and Gallagher Benefit Services. The Brokerage segment, for commission or fee compensation, places commercial property/casualty (P/C) and employee benefit-related insurance on behalf of its customers. The Risk Management segment provides P/C claim third-party administration, loss control and risk management consulting and insurance property appraisals. Third-party administration is principally the management and processing of claims for self-insurance programs of Gallagher' s clients or clients of other brokers. The Financial Services segment is responsible for managing Gallagher' s investment portfolio. Allocations of investment income and certain expenses are based on reasonable assumptions and estimates. Reported operating results by segment would change if different methods were applied. Financial information relating to Gallagher' s segments for 2005 and 2004 is as follows (in millions):

	Three-month period ended March 31,	
	2005	2004
Brokerage		
Total revenues	$ 225.3	$ 202.5
Earnings (loss) from continuing operations before income taxes	$ (8.5)	$ 33.5
Identifiable assets at March 31, 2005 and 2004	$ 2,291.6	$ 2,051.2
Risk Management		
Total revenues	$ 91.6	$ 81.4
Earnings from continuing operations before income taxes	$ 17.2	$ 12.4
Identifiable assets at March 31, 2005 and 2004	$ 243.2	$ 228.8
Financial Services		

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Total revenues	$32.0	$49.0
Earnings (loss) from continuing operations before income taxes	$(133.8)	$2.5
Identifiable assets at March 31, 2005 and 2004	$692.9	$593.0

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Review by Independent Registered Public Accounting Firm

The interim consolidated financial statements at March 31, 2005 and for the three-month periods ended March 31, 2005 and 2004 have been reviewed by Ernst & Young LLP, Gallagher’ s independent registered public accounting firm, and their report is included herein.

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Arthur J. Gallagher & Co.

We have reviewed the consolidated balance sheet of Arthur J. Gallagher & Co. as of March 31, 2005 and the related consolidated statement of earnings for the three-month periods ended March 31, 2005 and 2004, and the consolidated statement of cash flows for the three-month periods ended March 31, 2005 and 2004. These financial statements are the responsibility of Gallagher’ s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the interim consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) the consolidated balance sheet of Arthur J. Gallagher & Co. as of December 31, 2004, and the related consolidated statements of earnings, stockholders’ equity, and cash flows for the year then ended, not presented herein, and in our report dated January 27, 2005, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2004, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP

Ernst & Young LLP

Chicago, Illinois
April 26, 2005

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Item 2. Management' s Discussion and Analysis of Financial Condition and Results of Operations

Introduction

The following discussion and analysis should be read in conjunction with Gallagher' s consolidated financial statements and the related notes thereto that are included elsewhere in this quarterly report.

Gallagher provides insurance brokerage and risk management services to a wide variety of commercial, industrial, institutional, governmental and personal accounts throughout the U.S. and abroad. Commission revenue is primarily generated through the negotiation and placement of insurance for its clients. Fee revenue is primarily generated by providing other risk management services including claims management, information management, risk control services and appraisals in the property/casualty (P/C) market. Investment income and other revenue is generated from Gallagher' s investment portfolio, which includes fiduciary funds, tax advantaged and other investments. Gallagher is headquartered in Itasca, Illinois, has operations in eight countries and does business in more than 100 countries globally through a network of correspondent brokers and consultants.

Insurance Market Overview

During the period from 1986 to 2000, heavy competition for market share among P/C insurance carriers (Carriers) resulted in low premium rates. This "soft market" (i.e., low premium rates) generally resulted in flat or reduced renewal commissions. During this soft market, natural catastrophes and other losses resulted in billions of dollars in underwriting losses to the insurance market. Substantial mergers, both domestically and internationally, resulted in fewer Carriers. Increased property replacement costs and increasingly large litigation awards caused some clients to seek higher levels of insurance coverage. These factors would generally have the effect of generating higher premiums to clients and higher commissions to Gallagher. However, there were opposing factors including favorable equity markets, increased underwriting capital causing heavy competition for market share and improved economies of scale following consolidations, all of which tended to lower premium rates. The net result was that P/C premium rates remained low through 1999. Years of underwriting losses, coupled with the downward turn in equity markets and the decline in interest rates during the three-year period that preceded 2003, significantly reduced many Carriers' capital. In order to restore their capital to adequate levels, many Carriers began to increase premium rates in 2000 and continued to do so well into 2003, particularly after the events described below.

The insurance industry was jolted by the tragic terrorist attacks that occurred on September 11, 2001. The devastation caused by those events resulted in the largest insurance loss ever. Along with this historic loss, larger than anticipated loss experience across most risks, the stock market' s steep decline, lower interest rates and diminished risk capacity led to an acceleration of premium rate increases. A higher premium rate environment is referred to as a "hard market" and generally results in increased commission revenues. Fluctuations in premiums charged by Carriers have a direct and potentially material impact on the insurance brokerage industry. Commission revenues are generally based on a percentage of the premiums paid by insureds and normally follow premium levels. Thus, a hard market will generally contribute positively to Gallagher' s operating results. Following September 11th, the increased premium rates charged by Carriers had a positive impact on Gallagher' s 2002 and 2003 operating results. The magnitude of rate increases began to moderate in 2003 and softening market conditions continued into 2004. A market survey conducted by the Council of Insurance Agents & Brokers indicated that the average premium for commercial accounts declined 9.4% in first quarter 2005 compared to fourth quarter 2004, with medium and large accounts experiencing somewhat higher reductions. Some of Gallagher' s clients are beginning to take advantage of lower premium pricing and are purchasing additional insurance coverage, which partially offsets the impact of rate decreases. Gallagher is unable to predict with a high degree of certainty, future rate and volume movement. However, with the industry apparently operating in a soft market, the effect of this trend may have a negative impact on Gallagher' s brokerage revenues.

In a period of rising insurance costs, there is resistance among certain insureds, who are the buyers of insurance (Gallagher' s clients), to pay increased premiums and the higher commissions generated by these premiums. Such resistance often causes some buyers to raise their deductibles and/or reduce the overall amount of insurance coverage they purchase. As the market softens, or costs decrease, these trends have

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historically reversed. During the most recent hard market period, some buyers switched to negotiated fee in lieu of commission arrangements with Gallagher for placing their risks. Other buyers moved toward the alternative insurance market, which

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includes self-insurance, captives, rent-a-captives and risk retention groups. According to industry estimates, these mechanisms now account for nearly 50% of the total commercial P/C market in the U.S. Gallagher' s brokerage units are very active in these markets as well. This could also have a favorable effect on Gallagher' s Risk Management Services segment. While the gradual movement towards these alternative markets has reduced commission revenue to Gallagher, Gallagher anticipates that new sales and renewal increases in the areas of risk management, claims management, captive insurance and self-insurance services may continue to be major factors in Gallagher' s fee revenue growth in 2005. Though inflation tends to increase the levels of insured values and risk exposures, premium rates charged by Carriers have had a greater impact on Gallagher' s revenues than inflation.

Historically, Gallagher has utilized acquisitions to grow its Brokerage Segment' s commission and fee revenues. Acquisitions allow Gallagher to expand into desirable geographic locations and further extend its presence in the retail and wholesale insurance brokerage services industry. Acquisitions also increase the volume of general services currently provided while not substantially changing the nature of the services performed by Gallagher. Gallagher expects that its commission and fee revenues will continue to grow partially from acquisitions. Gallagher is considering and intends to continue to consider from time-to-time, additional acquisitions on terms that it deems advantageous. At this time, Gallagher is engaged in preliminary discussions with several candidates for possible future acquisitions. However, no assurances can be given that any additional acquisitions will be consummated, or, if consummated, will be advantageous to Gallagher.

Contingent Commissions and Other Industry Developments

The insurance industry has recently come under a significant level of scrutiny by various regulatory bodies, including State Attorneys General and the departments of insurance for various states, with respect to contingent compensation arrangements and other matters. The Attorney General of the State of New York (the New York AG) issued subpoenas to various insurance brokerages and Carriers beginning in April 2004. The investigation by the New York AG, among other things, led to its filing a complaint on October 14, 2004 against Marsh & McLennan Companies, Inc. and its subsidiary, Marsh Inc. (collectively, Marsh), stating claims for, among other things, fraud and violations of New York State antitrust and securities laws. In light of these allegations, Marsh announced on October 15, 2004 that it was suspending its use of contingent commission agreements. On October 26, 2004, Marsh announced that it would permanently eliminate the practice of receiving any form of contingent compensation from Carriers. Within the week following Marsh' s initial announcement, two other large insurance brokerage companies, Willis Group and Aon Corporation (Aon), each announced that it would discontinue contingent commission agreements and unwind such arrangements by the end of 2004. On October 26, 2004, Gallagher announced that it would not enter into any new volume-based or profit-based contingent commission agreements as a retail broker effective January 1, 2005. Accordingly, it is expected that Gallagher' s future contingent commission revenues will be substantially reduced.

Although the New York AG' s October 14, 2004 complaint against Marsh focused primarily upon arrangements with P/C Carriers, subpoenas have been served on a number of group life and disability and traditional health Carriers, as well as the insurance brokerage companies who assist in the placement of such types of insurance. At the press conference announcing its complaint against Marsh, the New York AG indicated that its investigation would look across various lines of insurance.

On January 30, 2005, Marsh entered into a settlement agreement with the New York AG and the New York State Insurance Department (NYSID) settling the allegations raised in the October 14, 2004 complaint and certain related matters. The settlement required Marsh to establish a fund of $850.0 million, payable over a four year period, for the benefit of Marsh policyholder clients. On March 4, 2005, Aon entered into a settlement agreement with the New York AG, the Superintendent of Insurance of the State of New York, the Connecticut Attorney General, the Illinois Attorney General and the Director of Insurance of the Illinois Division of Insurance, Illinois Department of Financial and Professional Regulation (Illinois DOI), settling all issues related to investigations by those various agencies. The Aon settlement agreement required Aon to pay $190.0 million, payable in several installments over a two and a half year period, into a fund to be distributed to certain of its eligible policyholders. Both the Marsh and Aon settlement agreements also contained covenants pursuant to which Marsh and Aon were to undertake certain business reforms. Certain of the business reforms which were agreed to by both Marsh and Aon were: (i) to accept only a specific fee paid by the client, a specific percentage commission on premium to be paid by an insurer set at the time of purchase, renewal, placement or servicing of an insurance policy, or a

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combination of both; (ii) to fully disclose to clients information about compensation and quotes received in connection with the client' s policy, and to obtain the client' s written consent to all compensation arrangements; (iii) not to request or accept from any insurer any form of contingent compensation; (iv) not to place, renew or service a client' s business through a wholesale broker unless agreed to by the client; and (v) to implement company-wide written standards of conduct regarding compensation from insurers consistent with the terms of the settlement and institute appropriate training of employees, including business ethics, professional obligations, conflicts of interest, antitrust and trade practices compliance and record keeping.

On April 8, 2005, Willis Group Holdings Limited, Willis North America Inc. and Willis of New York, Inc. (collectively, "Willis"), entered into an Assurance of Discontinuance (the "AOD") with the New York AG and the Superintendent of Insurance of the State of New York (collectively, the "NY State Agencies") to resolve all of the issues related to the investigations of contingent commissions conducted by the NY State Agencies. Pursuant to the AOD, Willis agreed to pay $50.0 million into a fund to be distributed to certain of its eligible policyholders and to continue a number of practices that Willis had adopted previously. These practices include the continued ban on contingent commissions and the implementation, to the extent not already undertaken, of certain business reforms. The business reforms set forth in the AOD are similar to the business reforms agreed to by Aon and Marsh in each of their settlement agreements. Willis entered into the AOD without the New York AG filing a lawsuit against Willis. In addition, Willis entered into an Assurance of Discontinuance (the "Minnesota AOD") with the Minnesota Attorney General on April 8, 2005. The Minnesota AOD requires Willis to pay $1.0 million into a fund to be distributed to eligible policyholders and to implement business reforms including additional disclosures to clients and greater transparency in insurance transactions.

The investigations of the New York AG and other state agencies are continuing with respect to other industry participants. In connection with its investigation of the insurance industry, the New York AG has brought criminal charges against company executives and employees at various brokers and Carriers, some of which have resulted in guilty pleas being entered.

In first quarter 2004, the NYSID commenced an investigation and issued requests to various brokers and Carriers for information, including one of Gallagher' s New York brokerage subsidiaries, concerning such arrangements. Twenty other State Attorneys General and other state departments of insurance, including the Attorney General of the State of Illinois and the Illinois DOI, have also issued subpoenas to Gallagher or initiated investigations relating to Gallagher concerning contingent commissions and other business practices. On December 2, 2004, Gallagher Bassett Services, Inc., a third party administrator and a wholly-owned subsidiary of Gallagher, received a subpoena from the New York AG requesting information in connection with an investigation it is conducting. The subpoena did not seek information concerning Gallagher' s insurance brokerage operations. Gallagher is fully cooperating with each of these investigations. Subject to further questions or requests from the state or regulatory agencies, Gallagher has submitted responses to twelve agencies and is in the process of responding to the remaining investigations. In addition, the departments of insurance for various states have proposed new regulations, and other state insurance departments have indicated that they will propose new regulations, that address contingent commission arrangements, including prohibitions involving the payment of money by Carriers in return for business and enhanced disclosure of contingent commission arrangements to insureds. On December 29, 2004, the National Association of Insurance Commissioners announced that it has proposed model legislation to implement new disclosure requirements related to broker compensation arrangements.

In response to these industry developments, Gallagher retained independent counsel to perform an internal review of certain of its business practices. Such independent counsel completed its internal review and found no evidence that Gallagher had engaged in any price fixing or bid rigging of the type alleged in the New York AG' s October 14, 2004 complaint against Marsh, nor had it engaged in any improper tying arrangements.

Gallagher is also a defendant in thirteen lawsuits brought by private litigants which relate to these practices. Seven of these lawsuits have been or will be included in a Multi-District Litigation proceeding before the U.S. District Court for the District of New Jersey. Gallagher cannot predict the outcome of these investigations, regulatory proceedings, and lawsuits, nor their effect upon Gallagher' s business, financial condition or results of operations. However, in first quarter 2005, Gallagher recorded a pretax charge of $35.0 million ($21.0 million after tax), which represents its current best estimate of the amount to resolve the state insurance investigations and is based on the costs of similar industry settlements thus far, plus an accrual for legal costs.

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Gallagher' s contingent commissions were $20.7 million in first quarter 2005 and $20.0 million in first quarter 2004. The contingent commissions recognized in 2005 by Gallagher relate to contingent commission agreements in force during 2004, but received in 2005. The following table summarizes Gallagher' s contingent commissions for the three-month period ended March 31, 2005. Expenses directly associated with these agreements are not specifically identified, but are minimal.

	Three-month period ended March 31, 2005		
		Approximate Number of	
Contingent Commission Revenue From	**Revenues** (in millions)	**Agreements**	**Carriers**
Local contingent commission - U.S.-based retail contracts and programs	$ 16.4	322	100
Local contingent commission - managing general agent, managing general underwriter, wholesaler, program administration and international contracts	4.0	27	21
National contingent commission contracts	0.3	4	4
Total contingent commission revenue	$ 20.7	353	125

The amount of contingent commission revenue for the three-month periods ended March 31, 2005 and 2004 in which Gallagher participated as a retail broker and which involved volume-based or profit-based contingent commission agreements, aggregated to $16.7 million and $15.9 million, respectively. The reduction in contingent commissions, as discussed above, could have a substantial negative impact on Gallagher' s pretax earnings beginning in 2006.

Critical Accounting Policies

Gallagher' s consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP), which require management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Gallagher believes the following significant accounting policies may involve a higher degree of judgment and complexity. See Note 1 to the consolidated financial statements included in Gallagher' s Annual Report on Form 10-K for the year ended December 31, 2004 for other significant accounting policies.

Revenue Recognition

Commission revenues are recognized at the latter of the billing or the effective date of the related insurance policies, net of an allowance for estimated policy cancellations. Commission revenues related to installment premiums are recognized periodically as billed. Contingent commissions and commissions on premiums directly billed by insurance carriers, are recognized as revenue when the data necessary to reasonably determine such amounts has been obtained by Gallagher. Typically, these types of commission revenues cannot be reasonably determined until the cash or the related policy detail is received by Gallagher from the insurance carrier. A contingent commission is a commission paid by an insurance carrier that is based on the overall profit and/or volume of the business placed with that insurance carrier. Commissions on premiums billed directly by insurance carriers relate to a large number of small premium transactions, whereby the billing and policy issuance process is controlled entirely by the insurance carrier. The income effects of subsequent premium adjustments are recorded when the adjustments become known.

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Fee revenues generated from the Brokerage segment primarily relate to fees negotiated in lieu of commissions, which are recognized in the same manner as commission revenues. Fee revenues generated from the Risk Management segment relate to third party claims administration, loss control and other risk management consulting services, which are provided over a period of time, typically one year. These fee revenues are recognized ratably as the services are rendered. The income effects of subsequent fee adjustments are recorded when the adjustments become known.

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Premiums and fees receivable in the consolidated balance sheet are net of allowances for estimated policy cancellations and doubtful accounts. The allowance for estimated policy cancellations is established through a charge to revenues, while the allowance for doubtful accounts is established through a charge to other operating expenses. Both of these allowances are based on estimates and assumptions using historical data to project future experience. Gallagher periodically reviews the adequacy of these allowances and makes adjustments as necessary. The use of different estimates or assumptions could produce different results.

Fair Value of Investments

For investments that do not have quoted market prices, Gallagher utilizes various valuation techniques to estimate fair value and proactively looks for indicators of impairment. Factors, among others, that may indicate that an impairment could exist, include defaults on interest and/or principal payments, reductions or changes to dividend payments, sustained operating losses or a trend of poor operating performance, recent refinancings or recapitalizations, unfavorable press reports, untimely filing of financial information, significant customer or revenue loss, litigation, tax audits, losses by other companies in a similar industry, overall economic conditions, management and expert advisor changes, and significant changes in strategy. In addition, in cases where the ultimate value of an investment is directly dependent on Gallagher for future financial support, Gallagher assesses its willingness and intent to provide future funding.

If an indicator of impairment exists, Gallagher compares the investment' s carrying value to an estimate of its fair value. To estimate the fair value of loans, Gallagher discounts the expected future cash flows from principal and interest payments. This requires Gallagher to exercise significant judgment when estimating both the amount and the timing of the expected cash flows. To estimate the fair value of its equity investments, Gallagher compares values established in recent recapitalizations or appraisals conducted by third parties. In some cases, no such recapitalizations or appraisals exist and Gallagher must perform its own valuations. This also requires Gallagher to exercise significant judgment. Even if impairment indicators exist, no write-down may be required if the estimated fair value is not less than the current carrying value or the decline in value is determined to be temporary and Gallagher has the ability and intent to hold the investment for a period of time sufficient for the value to recover. When Gallagher determines an impairment is other-than-temporary, and therefore that a write-down is required, it is recorded as a realized loss against current period earnings.

Both the process to review for indicators of impairment and, if such indicators exist, the method to compute the amount of impairment incorporate quantitative data and qualitative criteria including the receipt of new information that can dramatically change the decision about the valuation of an investment in a short period of time. The determination of whether a decline in fair value is other-than-temporary is necessarily a matter of subjective judgment. The timing and amount of realized losses reported in earnings could vary if management' s conclusions were different.

Due to the inherent risk of investments, Gallagher cannot give assurance that there will not be impairments in the future should economic and other conditions change.

Intangible Assets

Intangible assets represent the excess of cost over the value of net tangible assets of acquired businesses. Gallagher classifies its intangible assets as either goodwill, expiration lists or non-compete agreements. Expiration lists and non-compete agreements are amortized using the straight-line method over their estimated useful lives (5 to 15 years for expiration lists and 5 to 6 years for non-compete agreements), while goodwill is not subject to amortization. Allocation of intangible assets between goodwill, expiration lists and non-compete agreements and the determination of estimated useful lives are based on valuations Gallagher receives from qualified independent appraisers. The calculations of these amounts are based on estimates and assumptions using historical and pro forma data and recognized valuation methods. The use of different estimates or assumptions could produce different results. Intangible assets are carried at cost, less accumulated amortization in the accompanying consolidated balance sheet.

While goodwill is not amortized, it is subject to periodic reviews for impairment. Gallagher reviews intangible assets for impairment periodically (at least annually) and whenever events or changes in business circumstances indicate that the carrying value of the assets may

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not be recoverable. Such impairment reviews are performed at the division level with respect to goodwill and at the business unit level for amortizable intangible assets. In reviewing intangible assets, if the fair value were less than the carrying amount of the respective (or underlying) asset, an indicator of impairment would exist and further analysis would be required to determine whether or not a loss would need to be charged against current period earnings. No such indicators were noted in the three-month

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periods ended March 31, 2005 and 2004. The determinations of impairment indicators and fair value are based on estimates and assumptions related to the amount and timing of future cash flows and future interest rates. The use of different estimates or assumptions could produce different results.

Business Combinations and Dispositions

See Notes 4 and 5 to the consolidated financial statements for a discussion on the 2005 business combinations and dispositions, respectively. In addition, see Note 3 to the consolidated financial statements for a discussion on the disposition of its consolidated investments.

Results of Operations

In the discussion that follows regarding Gallagher' s results of operations, Gallagher provides organic growth percentages with respect to its commission and fee revenues. This information may be considered a "non-GAAP financial measure" because it is derived from Gallagher' s consolidated financial information but is not required to be presented in financial statements that are prepared in conformity with GAAP. Rules and regulations of the Securities and Exchange Commission (SEC) require supplemental explanations and reconciliations of all "non-GAAP financial measures." When Gallagher refers to organic growth percentages with respect to its commission and fee revenues in its discussion of results of operations, Gallagher excludes the first twelve months of net commission and fee revenues generated from the acquisitions in each year presented. These acquisition-related commissions and fees are excluded from organic revenues in order to determine the revenue growth that is associated with the operations that were part of Gallagher in the prior year. In addition, organic growth excludes contingent commission revenues. Management has historically utilized organic revenue growth as an important indicator when assessing and evaluating the performance of its Brokerage and Risk Management segments. Management also believes that the use of this measure allows financial statement users to measure, analyze and compare the growth from its Brokerage and Risk Management segments in a meaningful and consistent manner. A reconciliation of organic revenue growth percentages to the reported revenue growth percentages for the Brokerage and Risk Management segments is presented in the paragraphs immediately following each table in which such percentages are presented.

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Brokerage

The Brokerage segment comprises three operating divisions: the Brokerage Services-Retail Division (BSD), Specialty Marketing and International (SMI) and Gallagher Benefit Services (GBS). The Brokerage segment, for commission or fee compensation, places commercial P/C and employee benefit-related insurance on behalf of its customers. Financial information relating to Gallagher' s Brokerage segment is as follows (in millions):

	Three-month period ended March 31,		Percent
	2005	2004	Change
Commissions	$192.5	$172.9	11 %
Fees	29.4	27.1	8 %
Investment income - fiduciary	3.4	2.5	36 %
Total revenues	225.3	202.5	11 %
Compensation	141.8	120.9	17 %
Operating	48.4	42.1	15 %
Depreciation	3.4	3.1	10 %
Amortization	5.2	2.9	79 %
Litigation and contingent commission related matters	35.0	–	NMF
Total expenses	233.8	169.0	38 %
Earnings (loss) from continuing operations before income taxes	(8.5)	33.5	NMF

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Provision (benefit) for income taxes	(7.9)	6.8	NMF
Earnings (loss) from continuing operations	$(0.6)	$26.7	NMF
Growth - revenues	11 %	9 %	
Organic growth in commissions and fees	1 %	1 %	
Growth - pretax earnings	NMF	25 %	
Compensation expense ratio	63 %	60 %	
Operating expense ratio	21 %	21 %	
Pretax profit margin before litigation related matters	12 %	17 %	
Effective tax rate	NMF	20 %	
Identifiable assets at March 31, 2005 and 2004	$2,291.6	$2,051.2	

The increase in commissions for the three-month period ended March 31, 2005 was principally due to revenues associated with acquisitions that were made in the last 12 months ($19.1 million). Also contributing to the increase in commissions and fees in 2005 was new business production, which aggregated to $29.0 million and was offset by renewal rate decreases and lost business of $26.0 million. The increase in fees for the three-month period ended March 31, 2005 was principally due to new business production and renewal rate increases, which aggregated to $5.0 million, which was offset by lost business of $4.0 million. Also contributing to the increase in commissions and fees in 2005 were revenues associated with acquisitions that were made in the last 12 months. The organic growth in commission and fee revenues for the three-month periods ended March 31, 2005 and 2004 was 1%. The following net commission and fee revenues were excluded in deriving the organic growth percentages: $39.8 million in 2005 and $28.5 million in 2004.

Investment income - fiduciary, which represents interest income earned on cash and restricted funds, increased in 2005 compared to 2004 as short-term interest rates have increased and the amount of invested cash has continued to grow. However, short-term interest rates are still at historically low levels.

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The increase in compensation expense in 2005 compared to 2004 was primarily due to an increase in the average number of employees, salary increases, increases in incentive compensation linked to Gallagher' s overall operating results ($11.5 million in the aggregate), compensation related to new hires in the retail operations ($2.1 million), new hires and one-time charges related to staffing changes made in Gallagher' s London and reinsurance operations ($4.3 million), an increase in employee benefit expenses ($2.0 million), the adverse impact of foreign currency translation ($0.5 million) and an increase in expense related to stock-based compensation ($0.5 million). The increase in employee headcount in 2005 primarily relates to the addition of employees associated with the acquisitions that were made in the last 12 months.

The increase in operating expenses in 2005 over 2004 was due primarily to increases in professional services fees ($1.8 million), an increase in rent and utility costs associated with leased office space and office expansion ($1.0 million) and the adverse impact of foreign currency translation ($1.0 million). The increase in professional fees is primarily related to legal fees and consulting fees for sourcing and other cost containment initiatives. Also contributing to the increase in operating expenses in 2005 were expenses associated with the acquisitions completed in the last 12 months.

Depreciation expense was relatively unchanged in 2005 compared to 2004. Changes in depreciation expense from quarter-to-quarter are due primarily to the timing of purchases of furniture, equipment and leasehold improvements related to office expansions and moves.

The increase in amortization in 2005 was due primarily to amortization expense associated with acquisitions completed in the last 12 months. Expiration lists and non-compete agreements are amortized using the straight-line method over their estimated useful lives (5 to 15 years for expiration lists and 5 to 6 years for non-compete agreements).

Litigation and contingent commission related matters in 2005 represent a charge of $35.0 million ($21.0 million after tax) recorded by Gallagher in first quarter 2005 in connection with currently outstanding investigations and inquiries from governmental authorities related to contingent commissions and various other historical business practices, as described more fully in Note 13 to the consolidated financial statements and "Management' s Discussion and Analysis - Contingent Commissions and Other Industry Developments". This amount represents Gallagher' s best estimate of the costs that it has incurred or will incur in the future to resolve the state insurance investigations, which is based on the costs of similar industry settlements thus far, plus an accrual for legal costs associated with the subpoenas received from State Attorneys General and investigations by governmental authorities and the internal review that was conducted by Gallagher' s independent counsel. Gallagher continues to be the subject of a substantial number of regulatory and legal actions by State Attorneys General and private litigants investigating various historical business practices.

See the Results of Operations for the Financial Services segment for a discussion on changes in the overall effective income tax rate in 2005 compared to 2004.

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Risk Management

The Risk Management segment provides P/C claim third-party administration, loss control and risk management consulting and insurance property appraisals. Third-party administration is principally the management and processing of claims for self-insurance programs of Gallagher's clients or clients of other brokers. Financial information relating to Gallagher's Risk Management segment is as follows (in millions):

	Three-month period ended March 31,		Percent
	2005	2004	Change
Fees	$91.0	$81.1	12 %
Investment income - fiduciary	0.6	0.3	100 %
Total revenues	91.6	81.4	13 %
Compensation	51.4	44.4	16 %
Operating	21.1	22.5	(6)%
Depreciation	1.8	2.0	(10)%
Amortization	0.1	0.1	–
Total expenses	74.4	69.0	8 %
Earnings from continuing operations before income taxes	17.2	12.4	39 %
Provision for income taxes	4.0	2.3	74 %
Earnings from continuing operations	$13.2	$10.1	31 %

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	2005	2004
Growth - revenues	13 %	18 %
Organic growth in fees	12 %	18 %
Growth - pretax earnings	39 %	19 %
Compensation expense ratio	56 %	55 %
Operating expense ratio	23 %	28 %
Pretax profit margin	19 %	15 %
Effective tax rate	23 %	19 %
Identifiable assets at March 31, 2005 and 2004	$243.2	$228.8

The increase in fees for the three-month period ended March 31, 2005 was due primarily to new business production, renewal rate increases and favorable retention rates on existing business, which aggregated to $12.0 million and was offset by lost business of $2.0 million. The organic growth in fee revenues in 2005 was 12% compared to 18% in 2004. Historically, the Risk Management segment has made few acquisitions, which have not been material to this segment' s operations. Thus, there is no material difference between GAAP revenues and organic revenues for this segment.

Investment income - fiduciary, which represents interest income earned on cash and cash equivalents, increased in 2005 compared to 2004 as short-term interest rates have increased and the amount of invested cash has continued to grow. However, short-term interest rates are still at historically low levels.

The increase in compensation expense in 2005 compared to 2004 was due to an increase in the average number of employees and increases in incentive compensation linked to Gallagher' s overall operating results ($5.0 million in the aggregate) and an increase in employee benefit expenses ($2.0 million). The increase in employee headcount relates to the hiring of additional staff to support claims activity related to new business generated.

The decrease in operating expenses in 2005 from 2004 was due primarily to the overall impact of sourcing and other cost containment initiatives implemented in the latter part of 2004 and to a decrease in professional services fees ($1.0 million) in 2005.

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Depreciation expense was relatively unchanged in 2005 compared to 2004. Changes in depreciation expense from quarter-to-quarter are due primarily to the timing of purchases of furniture, equipment and leasehold improvements related to office expansions and moves.

Amortization expense was unchanged in 2005 compared to 2004. Historically, the Risk Management segment has made few acquisitions, which have not been material to this segment' s operations. Expiration lists and non-compete agreements are amortized using the straight-line method over their estimated useful lives (5 to 15 years for expiration lists and 5 to 6 years for non-compete agreements).

See the Results of Operations for the Financial Services segment for a discussion on changes in the overall effective income tax rate in 2005 compared to 2004.

Financial Services

The Financial Services segment is responsible for managing Gallagher' s diversified investment portfolio. See Note 3 to the consolidated financial statements for a summary of Gallagher' s investments as of March 31, 2005 and December 31, 2004 and a discussion on the nature of the investments held. Financial information relating to Gallagher' s Financial Services segment is as follows (in millions):

	Three-month period ended March 31,		Percent
	2005	2004	Change
Investment income:			
Trading securities	$–	$0.2	NMF
Asset Alliance Corporation (AAC) related investments	0.9	2.4	(63)%
Low income housing investments	–	1.0	(100)%
Alternative energy investments	13.5	11.5	17 %
Real estate, venture capital and other investments	0.4	0.1	300 %
Consolidated investments	17.3	5.4	220 %
Impact of FIN 46 on consolidated investments	–	25.9	(100)%
Total investment income	32.1	46.5	(31)%

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Investment gains (losses)	(0.1)	2.5	(104)%
Total revenues	32.0	49.0	(35)%
Investment expenses	28.7	16.8	71 %
Impact of FIN 46 on investment expenses	–	24.7	NMF
Interest	2.6	1.9	37 %
Depreciation	3.5	1.9	84 %
Impact of FIN 46 on depreciation	–	1.2	NMF
Litigation related matters	131.0	–	NMF
Total expenses	165.8	46.5	257 %
Earnings (loss) from continuing operations before income taxes	(133.8)	2.5	NMF
Provision (benefit) for income taxes	(47.4)	0.5	NMF
Earnings (loss) from continuing operations before income taxes	$(86.4)	$2.0	NMF
Identifiable assets at March 31, 2005 and 2004	$692.9	$593.0	

Investment income from trading securities decreased in 2005 compared to 2004 due to Gallagher liquidating its trading securities portfolio for cash during the latter part of 2003 and first quarter 2004.

Investment income from AAC related investments primarily represents income associated with Gallagher' s debt, preferred and common stock investments in AAC. Gallagher accounts for the common stock portion of its investment using equity method accounting and accounts for the interest and dividend income on its debt and preferred stock investments as it is earned. The decrease in AAC related income in 2005 compared to 2004 was due to a decline in AAC' s operational results in 2005.

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Investment income from low income housing (LIH) developments primarily represents income associated with Gallagher' s equity investment in a LIH Developer that is accounted for using equity method accounting and interest income from bridge loans made by Gallagher related to LIH developments. The decrease in LIH income in 2005 compared to 2004 was due to the timing of project sale transactions of the LIH developer that generated equity income to Gallagher in 2004 and to a decrease in bridge loans and the related interest income in 2005.

Investment income from alternative energy investments primarily relates to installment gains from the sales of Gallagher' s interests in limited partnerships that operate Syn/Coal facilities. The increase in income from these investments in 2005 was due to higher Syn/Coal production at the facilities and to installment gains from 2004 limited partnership sales.

Income from real estate, venture capital and other investments principally relates to Gallagher' s portion of the earnings of these entities accounted for using equity method accounting. The increase in income from these investments in 2005 compared to 2004 is primarily due to a $0.3 million increase in earnings from one of the remaining investment funds.

Investment income from consolidated investments includes income related to the Florida Community Development, Gallagher' s home office building, the airplane leasing company and two Syn/Coal facilities. Investment income related to the Florida Community Development in 2005 and 2004 was $2.1 million and $1.5 million, respectively, and primarily relates to sales of lots at the development. Total expenses, including interest and depreciation expense, relating to this income were $2.5 million and $2.4 million in 2005 and 2004, respectively. Rental income of the home office building was $1.4 million in 2005 and 2004. Total expenses associated with the home office building rental income, including interest and depreciation expense, were $1.7 million and $1.6 million in 2005 and 2004, respectively. In 2005 and 2004, rental income of the airplane leasing company was $1.0 million and $0.8 million, respectively, and total expenses associated with this income, including interest and depreciation expense, was $1.3 million and $1.2 million, respectively. In 2005 and 2004, income from the Syn/Coal facilities was $12.8 million and $1.7 million, respectively. Total expenses, including interest and depreciation expense, relating to this income were $24.0 million and $7.2 million in 2005 and 2004, respectively. Gallagher acquired its interest in one of these two facilities in second quarter 2004, which resulted in increased production in 2005 compared to 2004 and the increases in Syn/Coal related income and expenses.

On March 22, 2005, Gallagher entered into an agreement to sell its ownership interests in the limited partnership that owns the Florida Community Development investment, the closing of which occurred on April 20, 2005. See Note 3 to the consolidated financial statements for a discussion of this sale transaction.

Investment income from consolidated investments for 2004 was also impacted by the adoption of FIN 46. In 2003, Gallagher adopted FIN 46, which required Gallagher to consolidate a Syn/Coal partnership in which it had a 5% ownership interest at the time of consolidation. Prior to 2003, this partnership was not consolidated because it was not controlled by Gallagher through a majority voting interest. Gallagher recognized both investment income and expenses of $25.9 million in 2004, related to the consolidation of the Syn/Coal partnership. During third quarter 2004, Gallagher sold a 4% ownership interest in this investment, which eliminated the requirement to consolidate the investment under the FIN 46 rules. This investment is now accounted for using equity method accounting.

Investment gains (losses) primarily include realized gains and losses that occurred in the respective years related to write-downs, dispositions and recoveries of venture capital investments, which included loans and equity holdings in start-up companies. During first quarter 2005, Gallagher realized a $0.6 million gain on the sale of a shopping center investment, recognized a $0.5 million loss from an investment related to the Biogas Project and realized a loss of $0.2 million as a result of the research and development costs of an investment in a sulphur reduction binder venture. During first quarter 2004, Gallagher recognized $2.5 million of net gains, the primary component of which was a $2.0 million gain on the reversal of a contingency loss reserve associated with the Biogas Project.

Investment expenses include operating expenses of the alternative energy investments, expenses of the real estate partnerships and airplane leasing company and expenses related to compensation, professional fees and overhead expenses such as rent and utilities. The increase in investment expenses for 2005 compared to 2004 was primarily due to increases in direct operating expenses of the alternative energy investments.

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The increase in interest expense in 2005 compared to 2004 was due to the new debt in second quarter 2004 related to the Biogas Project and one Syn/Coal facility.

Depreciation expense was relatively unchanged in 2005 compared to 2004.

Litigation related matters in 2005 represents a charge of $131.0 million recorded by Gallagher in first quarter 2005. As previously reported on February 11, 2005, a jury in the Fourth District Court for the State of Utah awarded damages against Gallagher' s subsidiary, AJGFS, and in favor of Headwaters in the amount of $175.0 million. See Note 13 to the consolidated financial statements for a discussion of this litigation. AJGFS and Headwaters entered into a definitive agreement effective as of May 1, 2005 to settle this and all other litigation between the companies for $50.0 million payable to Headwaters in May 2005. Additionally, AJGFS and Headwaters have modified their existing licensing agreement allowing AJGFS to utilize Headwaters' technology on two of AJGFS' synthetic fuel facilities in exchange for (i) $70.0 million payable on or before January 15, 2006 and (ii) an annual royalty to Headwaters in 2005, 2006 and 2007, which at full production, would be approximately $20.0 million of AJGFS' estimated pre-royalty, pretax earnings of $40.0 million in total annually from these two facilities. Gallagher has recorded a pretax charge to its first quarter 2005 earnings of $131.0 million ($84.2 million after tax) related to this settlement, including litigation, bonding and other costs.

The overall effective income tax rate reflects the tax credits generated by investments in limited partnerships that operate alternative energy projects (IRC Section 29) and low income housing, which are partially offset by state and foreign taxes. The effective income tax rate reported in 2005 has been impacted by the marginal income tax (benefit) effect on the two previously discussed litigation related charges that Gallagher recorded in first quarter 2005. Due to the size and nature of the litigation charges, Gallagher has recorded an income tax benefit using an effective marginal income tax rate of 40.0% for the Brokerage related litigation charge and 35.7% for the Financial Services related litigation charge.

IRC Section 29 tax credits expire on December 31, 2007 and, if the law is not extended, Gallagher' s effective tax rate in 2008 will likely adjust upward to approximately 35.0% to 40.0%. In addition, through December 31, 2007, IRC Section 29 has a phase-out provision that is triggered when the "Market Wellhead Price" of domestic crude oil reaches certain "Phase-out Prices" as determined by the IRS. The "Market Wellhead Prices" of domestic crude and the "Phase-out Prices" as determined by the IRS for the last five years are as follows:

Calendar Year	Market Wellhead Price (1)	Phase-out Price (2) Starts At	Phase-out Price (2) Fully Phased Out At
2000	$26.73	$48.07	$ 60.34
2001	21.86	49.15	61.70
2002	22.51	49.75	62.45
2003	27.56	50.14	62.94
2004	36.75 (3)	51.35	64.47

(1) Market Wellhead Price is the IRS' estimate of the calendar year average wellhead price per barrel for all domestic crude oil, the price of which is not subject to regulation by the U.S.. The IRS historically estimates this price based on the monthly average wellhead price of

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domestic crude oil as published by the Department of Energy as Domestic First Purchase Prices. This Market Wellhead Price has historically been approximately $3.50 to $4.00 below the commonly reported crude oil price of futures contracts traded on the New York Mercantile Exchange. For January 2005, Market Wellhead Price was $6.60 below the commonly reported crude oil price of futures contracts traded on the New York Mercantile Exchange.

(2) Phase-out Prices for 2000 to 2004 as established by the IRS. These Phase-out Prices are based on an inflation adjustment factor. This factor represents the change since calendar year 1979 of the first revision of the implicit price deflator for the gross national product of the U.S. as computed and published by the U.S. Department of Commerce. The IRS will not publish the Phase-out Prices for calendar year 2005 until April 2006.

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(3) This amount represents the 2004 published average of Market Wellhead Prices. The table below shows the published prices for 2004, which are as follows:

January	$ 30.35	April	$ 33.23	July	$ 36.54	October	$ 46.28
February	31.21	May	36.07	August	40.10	November	42.81
March	32.86	June	34.53	September	40.62	December	38.22

As indicated in the above table, oil prices fluctuated dramatically in 2004. Because oil prices were substantially below the 2004 estimated Phase-out Price, there was no phase-out for 2004. To trigger the start of a phase-out in 2005, management estimates that the Market Wellhead Price would need to average over $52 for the entire calendar year and over $65 to fully phase-out for 2005. As of April 18, 2005, the commonly reported price of crude oil (which has historically been about $3.50 to $4.00 above the Wellhead Price and was $6.60 above for January 2005) was $50.37. There can be no assurance that future oil prices will average under future phase-out levels. Should Gallagher or its partners anticipate that oil prices may reach the range of Phase-out Prices in 2005, some or all of Gallagher' s IRC Section 29 operations could be curtailed.

The following table illustrates the impact on net earnings and net earnings per share as if Gallagher had curtailed all IRC Section 29-related operations as of January 1, 2004 for the three-month periods ended March 31, 2005 and 2004. This illustration is prepared for comparative purposes only and does not purport to be indicative of past or future operating results.

	Three-month period ended March 31,	
	2005	**2004**
Pretax earnings (loss) from continuing operations, as reported	$ (125.1)	$ 48.4
Pro forma pretax adjustment for IRC Section 29 operations	(0.3)	(2.2)
Pro forma pretax earnings (loss) from continuing operations	(125.4)	46.2
Pro forma income tax provision assuming a 40.0% effective rate	(50.2)	18.5
Pro forma earnings (loss) from continuing operations	$ (75.2)	$ 27.7
Diluted earnings (loss) from continuing operations per share - pro forma	$ (0.81)	$ 0.30

Financial Condition and Liquidity

Cash Provided by Operations - Liquidity describes the ability of a company to generate sufficient cash flows to meet the cash requirements of its business operations. The insurance brokerage industry is not capital intensive. Historically, Gallagher' s capital requirements have primarily included dividend payments on its common stock, repurchases of its common stock, funding of its investments, acquisitions of

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brokerage and risk management operations and capital expenditures. The capital used to fund Gallagher' s investment portfolio was primarily generated from the excess cash provided by its operations and tax savings generated from tax advantaged investments. During 2003, Gallagher decided to withdraw virtually all continued support for its venture capital investments and to liquidate its trading securities portfolio. As a result, the capital requirements for funding Gallagher' s investments have decreased dramatically and the net cash flow directly related to investment activities in 2004 and 2005 has been cash flow positive and should continue to be cash flow positive in the future.

The litigation and contingent commission related matters could have a substantial negative impact on Gallagher' s net cash provided by operating activities. As previously announced, AJGFS has been in the process of reducing its ownership interests in its non-tax-advantaged investments. Because of the Headwaters judgment, that process has been accelerated in 2005 in anticipation of possible payments that will need to be made as a result of the Headwaters litigation matter. It is anticipated that the liquidation of AJGFS' investments along with positive net cash flows from AJGFS' operating activities will provide enough liquidity to fund any payments related to Headwaters litigation matters. If the timing of AJGFS' liquidation efforts do not provide the necessary cash flow to cover the Headwaters related payments, then Gallagher can use borrowings under its Credit Agreement to meet its short-term cash flow needs. Gallagher anticipates that any agreements entered into related to the contingent commission matters will be funded by net cash flows from operating activities.

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Gallagher' s ability to meet its future cash requirements related to the payments of dividends on its common stock and the repurchases of its common stock substantially depends upon its ability to generate positive cash flows from its operating activities. Cash provided by operating activities was $13.9 million and $63.5 million for the three-month periods ended March 31, 2005 and 2004, respectively. The decrease in cash provided by operating activities in 2005 compared to 2004 is primarily due to the decrease in earnings from continuing operations. Gallagher' s cash flows from operating activities are primarily derived from its earnings from continuing operations, as adjusted for realized gains and losses and its noncash expenses, which include depreciation, amortization, deferred compensation, restricted stock and stock-based compensation expenses. When assessing the overall liquidity of Gallagher, the focus should be on earnings from continuing operations, adjusted for noncash items, in the statement of earnings and cash provided by operating activities in the statement of cash flows as indicators of trends in liquidity. From a balance sheet perspective, the focus should not be on premium and fees receivable, premiums payable or restricted cash for trends in liquidity. Because of the variability related to the timing of premiums and fees receivable and premiums payable, net cash flows provided by operations will vary substantially from quarter-to-quarter and year-to-year related to these items. In addition, funds restricted as to Gallagher' s use, premiums and clients' claim funds held as fiduciary funds, are presented in Gallagher' s consolidated balance sheet as "Restricted cash" and have not been included in determining Gallagher' s overall liquidity. In order to consider these items in assessing trends in liquidity for Gallagher, they should be looked at in a combined manner, because changes in these balances are interrelated and are based on the timing of premium movement. In assessing the overall liquidity of Gallagher from a balance sheet perspective, it should be noted that at March 31, 2005, Gallagher had no Corporate related borrowings outstanding, a cash and cash equivalent balance of $212.3 million and tangible net worth of $309.8 million. Gallagher has a $250.0 million unsecured revolving credit agreement (Credit Agreement) it uses from time-to-time to borrow funds to supplement operating cash flows. Due to outstanding letters of credit, $217.3 million remained available for potential borrowings at March 31, 2005. The Credit Agreement contains various covenants that require Gallagher to maintain specified levels of net worth and financial leverage ratios. As discussed in Note 6 to the consolidated financial statements, the Credit Agreement was amended effective March 8, 2005 to, among other things, amend various covenants. Gallagher was in compliance with these covenants at March 31, 2005.

Gallagher' s earnings from continuing operations have increased every year since 1991. Except for the adverse impact on earnings from continuing operations relating to the charges recorded in first quarter 2005 for the litigation and contingent commission related matters, Gallagher expects this favorable trend in earnings from continuing operations to continue in the foreseeable future because it intends to continue to expand its business through organic growth from existing operations and growth through acquisitions. Acquisitions allow Gallagher to expand into desirable businesses and geographic locations, further extend its presence in the retail and wholesale insurance brokerage services industry and increase the volume of general services currently provided. However, management has no plans to substantially change the nature of the services performed by Gallagher. Gallagher believes that it has the ability to adequately fund future acquisitions through the use of cash and/or its common stock.

Another source of liquidity to Gallagher is the issuance of its common stock related to its stock option and employee stock purchase plans. Gallagher has four stock option plans for directors, officers and key employees of Gallagher and its subsidiaries. The options are primarily granted at the fair value of the underlying shares at the date of grant and generally become exercisable at the rate of 10% per year beginning the calendar year after the date of grant. In addition, Gallagher has an employee stock purchase plan which allows Gallagher' s employees to purchase its common stock at 85% of its fair market value. Proceeds from the issuance of its common stock related to these plans have contributed favorably to net cash provided by financing activities and Gallagher believes this favorable trend will continue in the foreseeable future.

Currently, Gallagher believes it has sufficient capital to meet its cash flow needs. However, in the event that Gallagher needs capital to fund its operations and investing requirements, it would use borrowings under its Credit Agreement to meet its short-term needs and would consider other alternatives for its long-term needs. Such alternatives would include raising capital through public markets or restructuring its operations in the event that cash flows from operations are reduced dramatically due to lost business. However, Gallagher has historically been profitable and cash flows from operations and short-term borrowings under its line-of-credit agreement have been sufficient to fund Gallagher' s operating, investment and capital expenditure needs. Gallagher expects this favorable cash flow trend to continue in the foreseeable future.

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Dividends - In the three-month period ended March 31, 2005, Gallagher declared $26.1 million in cash dividends on its common stock, or $.28 per common share. Gallagher' s dividend policy is determined by the Board of Directors. Quarterly dividends are declared after considering Gallagher' s available cash from earnings and its anticipated cash needs. On April 15, 2005, Gallagher paid a first quarter dividend of $.28 per common share to shareholders of record at March 31, 2005, a 12% increase over the first quarter dividend per share in 2004. If each quarterly dividend in 2005 is $.28 per common share, this increase in the dividend will result in an annualized increase in the net cash used by financing activities in 2005 of approximately $12.0 million.

Capital Expenditures - Net capital expenditures were $4.7 million and $5.4 million for the three-month periods ended March 31, 2005 and 2004, respectively. These amounts include net capital expenditures of the two previously discussed real estate partnerships of $1.8 million in 2005 and $1.7 million in 2004, the majority of which are related to the Florida Community Development project. In 2005, exclusive of the net capital expenditures related to those two real estate partnerships, Gallagher expects total expenditures for capital improvements to be approximately $30.0 million, primarily related to office moves and expansions and updating computer systems and equipment.

Common Stock Repurchases - Gallagher has a common stock repurchase plan that has been approved by the Board of Directors. Under the plan, Gallagher repurchased 0.6 million shares at a cost of $18.3 million during the three-month period ended March 31, 2004. Gallagher did not repurchase any shares during the three-month period ended March 31, 2005. Repurchased shares are held for reissuance in connection with its equity compensation and stock option plans. Under the provisions of the repurchase plan, as of March 31, 2005, Gallagher was authorized to repurchase approximately 3.8 million additional shares. Gallagher is under no commitment or obligation to repurchase any particular amount of common stock and at its discretion may suspend the repurchase plan at any time.

Acquisitions - Cash paid for acquisitions, net of cash acquired was $13.0 million and $21.3 million in the three-month periods ended March 31, 2005 and 2004, respectively. Prior to July 2001, substantially all acquisitions completed by Gallagher were paid for with stock consideration and were accounted for using pooling of interests accounting. Beginning in July 2001, Gallagher began accounting for acquisitions using purchase accounting, which provides the flexibility to use cash consideration in acquisitions. While stock is Gallagher' s preferred "currency" for acquisitions, cash in lieu of stock was used in order to complete the acquisitions in 2005. The increased use of cash for acquisitions correlates with the reduction in common stock repurchases in 2005. Gallagher completed two acquisitions and seven acquisitions in the three-month periods ended March 31, 2005 and 2004, respectively.

Dispositions - In first quarter 2005, Gallagher entered into an agreement that sold all of the stock of GBA for cash of $9.2 million and a promissory note in the amount of $4.4 million. Gallagher recognized a pretax gain of $9.6 million in first quarter 2005. Also in first quarter 2005, Gallagher entered into an agreement that sold all of the stock of NiiS for cash of $4.8 million. Gallagher recognized a pretax loss of $10.4 million in first quarter 2005. See Note 5 to the consolidated financial statements for an additional discussion on the 2005 business dispositions.

Contractual Obligations and Commitments

In connection with its investing and operating activities, Gallagher has entered into certain contractual obligations as well as funding commitments and financial guarantees. See Notes 3 and 13 to the March 31, 2005 consolidated financial statements for a discussion of Gallagher' s outstanding financial guarantees and funding commitments. In addition, see Notes 3, 7 and 16 to the consolidated financial statements included in Gallagher' s Annual Report on Form 10-K for the year ended December 31, 2004 for additional discussion of these obligations and commitments.

Off-Balance Sheet Arrangements

See Notes 3 and 13 to the March 31, 2005 consolidated financial statements for a discussion of Gallagher' s off-balance sheet arrangements. In addition, see Notes 3, 7 and 16 to the consolidated financial statements included in Gallagher' s Annual Report on Form 10-K for the year ended December 31, 2004 for additional discussion of these off-balance sheet arrangements.

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Information Concerning Forward-Looking Statements

This quarterly report contains forward-looking statements within the meaning of that term in the Private Securities Litigation Reform Act of 1995 (the Act) found at Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). Additional written or oral forward-looking statements may be made by Gallagher from time to time in information provided to the Securities and Exchange Commission (SEC), press releases, its website, or otherwise. Statements contained in this report that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Act.

Forward-looking statements may include, but are not limited to, discussions concerning revenues, expenses, earnings, cash flow, capital structure, financial losses, as well as market and industry conditions, premium rates, financial markets, interest rates, foreign exchange rates, contingencies and matters relating to Gallagher' s operations and income taxes. In addition, when used in this report, the words "anticipates," "believes," "should," "estimates," "expects," "intends," "plans" and variations thereof and similar expressions are intended to identify forward-looking statements. Such forward-looking statements are based on available current market and industry material, experts' reports and opinions and long-term trends, as well as management' s expectations concerning future events impacting Gallagher.

Forward-looking statements made by or on behalf of Gallagher are subject to risks and uncertainties, including but not limited to the following: Gallagher' s commission revenues are highly dependent on premiums charged by insurers, which are subject to fluctuation; lower interest rates reduce Gallagher' s income earned on invested funds; the alternative insurance market continues to grow which could unfavorably impact commission and favorably impact fee revenue, though not necessarily to the same extent; Gallagher' s revenues vary significantly from period to period as a result of the timing of policy inception dates and the net effect of new and lost business production; the insurance brokerage industry is subject to a great deal of uncertainty due to investigations into its business practices by various governmental authorities and related private litigation; the general level of economic activity can have a substantial impact on Gallagher' s renewal business; Gallagher' s operating results, returns on investments and financial position may be adversely impacted by exposure to various market risks such as interest rate, equity pricing, foreign exchange rates and the competitive environment or the outcome of litigation concerning Gallagher' s Syn/Coal production, Gallagher' s revenues and net earnings may be subject to reduction due to the elimination of contingent commission arrangements in 2005 and related developments in the insurance industry; and Gallagher' s effective income tax rate may be subject to increase as a result of changes in income tax laws, unfavorable interpretations of such laws or developments resulting in the loss or unavailability of Syn/Coal Credits. Gallagher' s ability to grow has been enhanced through acquisitions, which may or may not be available on acceptable terms in the future and which, if consummated, may or may not be advantageous to Gallagher. Accordingly, actual results may differ materially from those set forth in the forward-looking statements.

Readers are cautioned not to place undue reliance on any forward-looking statements contained in this report, which speak only as of the date set forth on the signature page hereto. Gallagher undertakes no obligation to publicly release the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after such date or to reflect the occurrence of anticipated or unanticipated events.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Gallagher is exposed to various market risks in its day to day operations. Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest and foreign currency exchange rates and equity prices. The following analyses present the hypothetical loss in fair value of the financial instruments held by Gallagher at March 31, 2005 that are sensitive to changes in interest rates and equity prices. The range of changes in interest rates used in the analyses reflects Gallagher' s view of changes that are reasonably possible over a one-year period. This discussion of market risks related to Gallagher' s consolidated balance sheet includes estimates of future economic environments caused by changes in market risks. The effect of actual changes in these risk factors may differ materially from Gallagher' s estimates. In the ordinary course of business, Gallagher also faces risks that are either nonfinancial or unquantifiable, including credit risk and legal risk. These risks are not included in the following analyses.

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Gallagher' s invested assets are primarily held as cash and cash equivalents, which are subject to various market risk exposures such as interest rate risk. The fair value of Gallagher' s cash and cash equivalents investment portfolio at March 31, 2005 approximated its carrying value due to its short-term duration. Market risk was estimated as the potential decrease in fair value resulting from a hypothetical one percentage point increase in interest rates for the instruments contained in the cash and cash equivalents investment portfolio. The resulting fair values were not materially different from the carrying values at March 31, 2005.

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Gallagher has other investments that have valuations that are indirectly influenced by equity market and general economic conditions that can change rapidly. In addition, some investments require direct and active financial and operational support from Gallagher. A future material adverse effect may result from changes in market conditions or if Gallagher elects to withdraw financial or operational support.

At March 31, 2005, Gallagher had no borrowings outstanding under its Credit Agreement. However, in the event that Gallagher does have borrowings outstanding, the fair value of these borrowings would likely approximate their carrying value due to their short-term duration and variable interest rates. The market risk would be estimated as the potential increase in the fair value resulting from a hypothetical one-percentage point decrease in Gallagher' s weighted average short-term borrowing rate at March 31, 2005 and the resulting fair values would not be materially different from its carrying value.

Gallagher is subject to foreign currency exchange rate risk primarily from its United Kingdom based subsidiaries that incur expenses denominated primarily in British pounds while receiving a substantial portion of their revenues in U.S. dollars. Foreign currency gains (losses) related to this market risk are recorded in earnings before income taxes as they are incurred. Assuming a hypothetical adverse change of 10% in the average foreign currency exchange rate for 2005 (a weakening of the U.S. dollar), earnings before income taxes would decrease by approximately $2.1 million. Gallagher is also subject to foreign currency exchange rate risk associated with the translation of its foreign subsidiaries into U.S. dollars. However, it is management' s opinion that this foreign currency exchange risk is not material to Gallagher' s consolidated operating results or financial position. Gallagher manages the balance sheet of its foreign subsidiaries such that foreign liabilities are matched with equal foreign assets thereby maintaining a "balanced book" which minimizes the effects of currency fluctuations. Historically, Gallagher has not entered into derivatives or other similar financial instruments for hedging, trading or speculative purposes. However, with respect to managing foreign currency exchange rate risk, Gallagher engaged a consultant in the latter part of 2004 to explore foreign currency hedging strategies. Based on the recommendations of the consultant, Gallagher did implement a foreign currency hedging strategy in 2005, the impact of which was not material to Gallagher' s first quarter consolidated financial statements.

Item 4. Controls and Procedures

As of March 31, 2005, Gallagher' s management, including Gallagher' s Chief Executive Officer (CEO) and Chief Financial Officer (CFO), have conducted an evaluation of the effectiveness of its disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) pursuant to Rule 13a-15(b) of the Exchange Act. Based on that evaluation, the CEO and CFO concluded that Gallagher' s disclosure controls and procedures are effective as of March 31, 2005.

There has been no change in Gallagher' s internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the three months ended March 31, 2005 that has materially affected, or is reasonably likely to materially affect, Gallagher' s internal control over financial reporting.

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Part II– Other Information

Item 1. Legal Proceedings

See Note 13 (Commitments, Contingencies, Financial Guarantees and Off-Balance Sheet Arrangements) to the consolidated financial statements.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities
(in thousands, except per share data)

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs
January 1 to January 31, 2005	–	$ –	–	3,772.0
February 1 to February 28, 2005	–	–	–	3,772.0
March 1 to March 31, 2005	–	–	–	3,772.0
Total	–	$ –	–	

(1) As set forth in its public filings, Gallagher has a common stock repurchase plan that has been approved by the Board of Directors. Under the provisions of the repurchase plan, as of March 31, 2005, Gallagher was authorized to repurchase approximately 3.8 million additional shares. There is no expiration date for the plan and Gallagher is under no commitment or obligation to repurchase any particular amount of common stock under the plan. At its discretion Gallagher may suspend the repurchase plan at any time.

Item 6. Exhibits

10.8.2 Second Amendment to Credit Agreement Dated as of March 4, 2005 Among Arthur J. Gallagher & Co., The Guarantors Party Thereto, The Banks Party Thereto, Citibank, N.A, as Syndication Agent, and Harris Trust and Savings Bank, as Agent and Lead Arranger.

10.36 Purchase and Sale Agreement Dated as of March 22, 2005, entered into by and among AJG Financial Services, Inc., a wholly-owned subsidiary of Arthur J. Gallagher & Co., Three E Corporation and SOF-HARMONY, L.L.C.

10.37 Settlement Agreement and Mutual Release Dated as of May 1, 2005 by and between Headwaters Incorporated (formerly known as Covol Technologies, Inc.), Square D Company, Arthur J. Gallagher & Co. and AJG Financial Services, Inc.

15.1 Letter of acknowledgement from Ernst & Young LLP concerning unaudited interim financial information.

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31.1 Rule 13a-14(a) Certification of Chief Executive Officer.

31.2 Rule 13a-14(a) Certification of Chief Financial Officer.

32.1 Section 1350 Certification of Chief Executive Officer.

32.2 Section 1350 Certification of Chief Financial Officer.

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Signature

Pursuant to the requirements of the Exchange Act, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Arthur J. Gallagher & Co.

Date: May 2, 2005

/s/ Douglas K. Howell

Douglas K. Howell
Vice President and Chief Financial Officer
(principal financial officer and duly
authorized officer)

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Arthur J. Gallagher & Co.

Quarterly Report on Form 10-Q

For The Quarterly Period Ended March 31, 2005

Exhibit Index

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31.1 Rule 13a-14(a) Certification of Chief Executive Officer.

31.2 Rule 13a-14(a) Certification of Chief Financial Officer.

32.1 Section 1350 Certification of Chief Executive Officer.

32.2 Section 1350 Certification of Chief Financial Officer.

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Exhibit 10.8.2

ARTHUR J. GALLAGHER & CO.
SECOND AMENDMENT AND WAIVER TO CREDIT AGREEMENT

Harris Trust and Savings Bank
Chicago, Illinois

Citibank, N.A.
New York, New York

Bank of America, N.A.
Chicago, Illinois

LaSalle Bank National Association
Chicago, Illinois

Barclays Bank Plc
Chicago, Illinois

Union Bank of California, N.A.
Los Angeles, California

U.S. Bank National Association
Milwaukee, Wisconsin

Fifth Third Bank (Chicago)
Rolling Meadows, Illinois

Comerica Bank
Detroit, Michigan

PNC Bank
Pittsburgh, Pennsylvania

Ladies and Gentlemen:

This Second Amendment and Waiver to Credit Agreement dated as of March 4, 2005 (herein, the *"Amendment"*) is entered into by and between the undersigned, Arthur J. Gallagher & Co., a Delaware corporation (the *"Borrower"*), the Banks and the Agent. Reference is hereby made to that certain Credit Agreement dated as of July 21, 2003 (said Credit Agreement, as amended prior to the date hereof, being referred to herein as the *"Credit Agreement"*) between the Borrower, Citibank, N.A., Bank of America, N.A., LaSalle Bank National Association, Barclays Bank Plc, Union Bank of California, N.A., U.S. Bank National Association, Fifth Third Bank (Chicago), Comerica Bank, PNC Bank and Harris Trust and Savings Bank, individually and as Agent. All capitalized terms used herein without definition shall have the same meanings herein as such terms have in the Credit Agreement.

The Borrower has requested that the Banks amend certain representations contained in the Credit Agreement and waive certain potential Defaults or Events of Default arising by reason of the Utah Verdict and the Related Accounting Treatment (each as hereinafter defined), and the Banks are willing to do so under the terms and conditions set forth in this Amendment.

SECTION 1. AMENDMENTS.

Subject to the satisfaction of the conditions precedent set forth in Section 3 below, the Credit Agreement shall be and hereby is amended as follows:

1.1. The definition of the term "L/C Commitment" appearing in Section 6.1 of the Credit Agreement shall be amended and restated in its entirety to read as follows:

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"*"L/C Commitment"* means $125,000,000, as such amount may be reduced pursuant to the terms hereof."

1.2. Section 7.6 of the Credit Agreement shall be amended and restated in its entirety to read as follows:

"*Section 7.6. No Material Adverse Change.* Since December 31, 2004, except as previously disclosed in the Borrower' s Form 8-K filed with the SEC on February 14, 2005, there has been no change in the condition (financial or otherwise) or business prospects of the Borrower and its Subsidiaries taken as a whole which could reasonably be expected to have a Material Adverse Effect."

1.3. Section 7.9 of the Credit Agreement shall be amended and restated in its entirety to read as follows:

"*Section 7.9. Litigation and Other Controversies* Except as otherwise disclosed in (i) the Borrower' s financial statements heretofore delivered to the Agent and (ii) the Borrower' s Form 8-K filed with the SEC on February 14, 2005, there is no litigation or governmental proceeding or labor controversy pending, nor to the knowledge of the Borrower threatened, against the Borrower or any of its Subsidiaries which could reasonably be expected to have a Material Adverse Effect."

SECTION 2. WAIVERS.

On February 11, 2005, a jury in the Fourth District Court for the State of Utah rendered a verdict against AJG Financial Services, Inc. (*"AJGFS"*), a Material Wholly-Owned Subsidiary of the Borrower, in favor of Headwaters Incorporated in the approximate amount of $175,000,000 (the *"Utah Verdict"*) and, in connection with the Utah Verdict, it is possible that AJGFS will take a deduction from its pre-tax net income in the first quarter of the 2005 fiscal year of a like amount (the *"Related Accounting Treatment"*).

In connection with the Utah Verdict and the Related Accounting Treatment, the Borrower has requested that the Banks waive any existing or potential Defaults or Events of Default under the second sentence of Section 9.17 of the Credit Agreement, Section 10.1(c) of the Credit Agreement and Section 10.1(h) of the Credit Agreement, in each case, arising by reason of the Utah Verdict, the judgment entered on the Utah Verdict or the Related Accounting Treatment (collectively, the *"Utah Defaults"*).

Accordingly, upon the satisfaction of the conditions precedent set forth in Section 3 below, the Banks hereby waive the Utah Defaults. This waiver shall be limited specifically to the matters stated herein and it shall not constitute a waiver of the application of any other term, provision, or condition of the Credit Agreement.

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SECTION 3. CONDITIONS PRECEDENT.

The effectiveness of this Amendment is subject to the satisfaction of all of the following conditions precedent:

3.1. The Borrower and the Banks shall have executed and delivered this Amendment.

3.2. The Borrower shall have paid to the Agent, for the account of the Banks, an amendment fee in the amount of $187,500.

SECTION 4. REPRESENTATIONS.

In order to induce the Agent and the Banks to execute and deliver this Amendment, the Borrower hereby represents to the Agent and the Banks that as of the date hereof the representations and warranties set forth in Section 7 of the Credit Agreement (as amended hereby) are and shall be and remain true and correct (except that the representations contained in Section 7.5 shall be deemed to refer to the most recent financial statements of the Borrower delivered to the Agent and the Banks) and the Borrower is in compliance with the terms and conditions of the Credit Agreement and no Default or Event of Default (other than the Utah Defaults, if any) has occurred and is continuing under the Credit Agreement or shall result after giving effect to this Amendment.

SECTION 5. MISCELLANEOUS.

5.1. Except as specifically amended herein, the Credit Agreement shall continue in full force and effect in accordance with its original terms. Reference to this specific Amendment need not be made in the Credit Agreement, the Notes, or any other instrument or document executed in connection therewith, or in any certificate, letter or communication issued or made pursuant to or with respect to the Credit Agreement, any reference in any of such items to the Credit Agreement being sufficient to refer to the Credit Agreement as amended hereby.

5.2. The Borrower agrees to pay on demand all costs and expenses of or incurred by the Agent in connection with the negotiation, preparation, execution and delivery of this Amendment, including the fees and expenses of counsel for the Agent.

5.3. This Amendment may be executed in any number of counterparts, and by the different parties on different counterpart signature pages, all of which taken together shall constitute one and the same agreement. Any of the parties hereto may execute this Amendment by signing any such counterpart and each of such counterparts shall for all purposes be deemed to be an original. This Amendment shall be governed by the internal laws of the State of Illinois.

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This Amendment is entered into as of the date and year first above written.

ARTHUR J. GALLAGHER & CO.

By /s/ Jack H. Lazzaro
Name: Jack H. Lazzaro
Title: Vice President Treasurer

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Accepted and agreed to.

HARRIS TRUST AND SAVINGS BANK,
individually and as Agent

By /s/ Peter F. Stack
Name: Peter F. Stack
Title: Director

CITIBANK, N.A.

By /s/ Christopher J. Soltis
Name: Christopher J. Soltis
Title: Director

LASALLE BANK NATIONAL ASSOCIATION

By /s/ Siamak Saidi
Name: Siamak Saidi
Title: Commercial Banking Officer

BANK OF AMERICA, N.A.

By /s/ Debra Basler
Name: Debra Basier
Title: Senior Vice President

BARCLAYS BANK PLC

By /s/ Rory M. Merchant
Name: Rory M. Merchant
Title: Relationship Director

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UNION BANK OF CALIFORNIA, N.A.

By /s/ Christine Davis
Name: Christine Davis
Title: Vice President

U.S. BANK NATIONAL ASSOCIATION

By /s/ James DeVries
Name: James DeVries
Title: Senior Vice President

FIFTH THIRD BANK (CHICAGO), a Michigan Banking Corporation

By /s/ Kim Puszczewicz
Name: Kim Puszczewicz
Title: Assistant Vice President

COMERICA BANK

By /s/ Felicia M. Maxwell
Name: Felicia M. Maxwell
Title: Vice President

PNC BANK

By /s/ Edward J. Chidiac
Name: Edward J. Chidiac
Title: Managing Director

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Exhibit 10.36

PURCHASE AND SALE AGREEMENT

(Partnership Interests in Birchwood Acres Limited Partnership, LLLP)

by and among

Three E Corporation and AJG Financial Services, Inc., Sellers

and

SOF-Harmony Funding, L.L.C., Purchaser

Dated as of March 22, 2005

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Exhibits

Exhibit A Description of Property (including Alligator Inn)

Exhibit B List of Personal Property

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Exhibit C	Excluded Property
Exhibit D	Deferred Payment Agreement
Exhibit E	January Balance Sheet
Exhibit F	None
Exhibit G	Property Rent Roll
Exhibit H	None
Exhibit I	None
Exhibit J	Lentz Employment Agreement

Schedules

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Schedule 6(d)	Federal, State or Local Consents or Waivers needed
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Schedule 26(h)	Employee "For Cause" Criteria
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PURCHASE AND SALE AGREEMENT

THIS PURCHASE AND SALE AGREEMENT (this "Agreement") dated as of March 22, 2005, by and among Three E Corporation ("Three E"), a Florida corporation having offices at 3500 Harmony Square Drive West, Harmony, Florida 34773, AJG Financial Services, Inc. ("AJG") a Delaware corporation having offices at The Gallagher Centre, Two Pierce Place, Itasca, Illinois 60143-3141 (Three E and AJG being herein collectively referred to as the "Seller" and being severally, and not jointly and severally liable for all obligations and liabilities of Seller hereunder) and SOF-HARMONY FUNDING, L.L.C., a Delaware limited liability company having offices c/o Starwood Capital Group Global, L.L.C., 591 W. Putnam Avenue, Greenwich, CT 06830 ("Purchaser"); at Closing, Purchaser shall cause an entity which is acceptable to Seller in its reasonable discretion and which is affiliated with SOF - VI U.S. Holdings II, L.L.C., a Delaware limited liability company, having offices at 591 W. Putnam Avenue, Greenwich, CT 06830 or, pursuant to **Section 3A(e)** hereof, shall cause another entity which is acceptable to Seller in its reasonable discretion ("Guarantor") solely for the purposes specified in **Sections 3A(e), 6** and **35** below, to execute this Agreement and the "Deferred Payment Agreements" referred to in such sections, in lieu of Purchaser' s providing the "Purchaser' s Letter of Credit" or other security at "Closing" (as such terms are hereinafter defined) in accordance with the terms hereof. The term "Purchaser" as used herein shall also refer to and include all "Purchaser Designees" (hereinafter defined).

Each "Company Subsidiary" and the "Three E Parent" (hereinafter defined) executes this Agreement to acknowledge its agreement to abide by those terms hereof and perform and cause the performance of those obligations of Seller set forth herein which relate to such person or entity and its assets and activities. The "Company" (hereinafter defined) executes this Agreement to acknowledge its agreement to abide by and perform its obligations set forth herein prior to Closing. Each of Seller, Purchaser and Guarantor are sometimes herein referred to as a "Party" and they are sometimes herein referred to collectively as the "Parties".

W I T N E S S E T H:

WHEREAS, Sellers collectively own all of the partnership interests (the "Partnership Interests") in Birchwood Acres Limited Partnership, LLLP, a Florida limited liability limited partnership (the "Company" having offices at 3500 Harmony Square Drive West, Harmony, Florida 34773, and

WHEREAS, AJG is the sole limited partner of the Company, and Three E is the sole general partner of the Company, and

WHEREAS, James Lentz, ("Lentz") an individual is a majority and controlling shareholder of Three E, and Harmony Institute ("Harmony Institute"), an eleemosynary organization is a minority and non-controlling shareholder of Three E (Lentz is herein sometimes referred to as the "Three E Parent"); and

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WHEREAS, the Company owns and holds in its own name, record title to a tract which originally consisted of approximately 11,030 acres (excluding certain parcels which were sold and conveyed to parties unrelated to Seller on or prior to the Closing Date, which is more particularly described on **Exhibit A** hereto; and

WHEREAS, the Company owns all of the interests in, and controls each of, Harmony Development Co, LLC, a Florida limited liability company, Harmony Golf Facilities, LLC, a Florida limited liability company, Harmony Restaurant Facilities, LLC, a Florida limited liability company Harmony Ground Maintenance Co. LLC, a Florida limited liability company and Harmony Real Estate Co., LLC, a Florida limited liability company (each, a "Company Subsidiary" or "Subsidiary" and collectively, the "Company Subsidiaries" or "Subsidiaries"), each of which provides certain services and conducts certain operations at the Property and holds certain related permits, licenses, contract rights and other property; and

WHEREAS, the term "Property", as used herein, includes, in addition to all other property and rights to be owned by the Company on the Closing Date as hereinafter set forth, the land described on **Exhibit A** together with all appurtenances and rights benefiting and running with same (the "Land"), together with the buildings and other improvements thereon (each a "Building" or "Improvement", and collectively, the "Buildings and Improvements"), all personal property, equipment and other tangible property owned by the Company and the Company Subsidiaries on the date hereof, of which Seller shall provide a list designated as excluded property to Purchaser within five (5) Business Days after the date hereof, which list shall then be attached hereto as, and which is herein referred to as, **Exhibit B** hereto and such property is collectively herein referred to as the "Personal Property") and all Leases but excluding any property of which Seller shall provide a list designated as excluded property to Purchaser within five (5) Business Days after the date hereof, which shall then be attached hereto as, and which list is herein referred to as, **Exhibit C** and which property is collectively herein referred to as "Excluded Property", and

WHEREAS, each of Three E and AJG desires to sell that portion of the Partnership Interests owned by such party, and the Purchaser desires to purchase the Partnership Interests pursuant to the terms hereof.

NOW, THEREFORE, in consideration of the recitals, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto hereby agree to the foregoing and the following:

1. Definitions. Those capitalized terms which are used in this Agreement but which are not defined in the body of this Agreement (including the recitals set forth above), shall have the meanings specified in **Schedule 1** attached hereto.

2. Purchase and Sale. Each of Three E and AJG agrees to sell, assign and transfer that portion of the Partnership Interests owned by such party to Purchaser, and Purchaser agrees to purchase the same from each of Three E and AJG, respectively, for the price and subject to the terms of this Agreement.

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3. A. Purchase Price; Cash Portion; Deferred Portion; Downpayment; L/C; Guaranty.

(a) The aggregate purchase price to be paid by Purchaser to Seller for the Partnership Interests (the "Purchase Price"), shall consist of the aggregate of the sums specified in **Section 3(b)** below which shall be payable in cash at Closing (the "Cash Portion") and the sums specified in **Section 3(c)** below which shall be deferred and payable after Closing (the "Deferred Portion"). The Cash Portion payable to each of Three E and AJG (as set forth in **Section 3(c)** below) shall be paid to each of Three E and AJG, respectively, by bank wire transfer on the Closing Date (as hereinafter defined) in immediately available federal funds to the account of the respective receiving party specified by such party prior to the Closing Date. Simultaneously with the making of such payment, the Escrow Agent shall be directed by the Parties to return the "Downpayment" (hereinafter defined) to Purchaser. The portion of the Purchase Price which is tentatively allocated to each particular tract within the Property shall be specified in an amendment to **Exhibit A** which Seller and Purchaser shall reasonably agree to between the date hereof and the Closing Date. Subject to the following sentence, each of Seller and Purchaser shall utilize and apply such allocation for all purposes and shall not take a position to the contrary, including without limitation, in any documents or filings. Pursuant to § 1060 of the Code, within 30 days after the Closing Date, the Seller and Purchaser shall adjust such allocations if necessary to reflect any change between the date of such initial allocation and the Closing Date.

(b) The Cash Portion shall consist of the following sums:

(i) Three Million Seven Hundred Fifty Thousand Dollars ($3,750,000) which Purchaser shall pay to Three E or as directed by Three E; and

(ii) The sum, which Purchaser shall pay to AJG or as directed by AJG, of Seventy Five Million Dollars ($75,000,000), reduced by the aggregate unpaid principal amount of the following bank or institutional funded indebtedness of the Company outstanding immediately prior to the Closing on the Closing Date: (A) the $12,410,000 Birchwood Acres Limited Partnership Taxable Variable Rate Bonds (Birchwood Triple E Ranch Project), Series 2000, the entire indebtedness evidenced by such bonds being hereinafter referred to as the "Bond Indebtedness"; (B) the First National equipment credit line; (C) the Franklin Bank debt; and (D) the MuniMae debt; it is understood and agreed that the indebtedness of the Company to each of AJG and Harris Bank shall be paid in full by (Seller' s utilizing funds from the Purchase Price) at Closing immediately prior to Purchaser' s acquisition of the Partnership Interests and that Purchaser shall take subject to the other obligations of the Company which are set forth on the January Balance Sheet (as hereinafter defined), without a credit against the Purchase Price in respect of such other obligations which are set forth on the January Balance Sheet (and Purchaser shall bear without a credit against the Purchase Price therefore, any additional obligations of the Company which are shown on the Closing Date Balance Sheet (as hereinafter defined) which are not "Material Variances", as hereinafter defined in **Section 3B(a)**); the foregoing obligations

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which Purchaser shall take subject to are herein referred to as the "Assumed Indebtedness"; for the avoidance of doubt, the Purchaser shall not receive a credit against or a reduction of the Purchase Price in respect of the payment which the Company is obligated to make after May 1, 2005 pursuant to the special assessments required by Harmony CDD for payment of semi-annual principal and interest due on the $17,700,000 Harmony Community Development District Bonds (Series 2001); and

(iii) The aggregate amount of Six Hundred and Fifty Thousand Dollars ($650,000) for the acquisition of the Alligator Lakeside Inn assets, property or equity interests. The closing costs of such acquisition shall be borne by the Partnership. Any payment due under this **Section 3A(b)(iii)** shall be made solely to AJG to the extent that such acquisition shall have increased the Partnership' s indebtedness for which Purchaser shall receive a credit pursuant to clause (ii) above.

(c) The Deferred Portion shall consist of those sums, if any, payable by Purchaser to Three E or as directed by Three E pursuant to a "Deferred Payment Agreement" which Purchaser and Three E (and such other party or parties as may be set forth as signatories in such form) shall execute and deliver to each other at Closing, in the form attached hereto as **Exhibit D** (the "Deferred Payment Agreement").

(d) (i) On the date hereof, Purchaser has delivered to First American Title Insurance Company, as escrow agent (the "Escrow Agent") the cash in the amount of Two Million Dollars ($2,000,000) (which together with any interest earned thereon after the date hereof is defined as the "Downpayment"). The Escrow Agent shall invest the Downpayment in a money market fund or a demand deposit interest bearing bank account in the name of Escrow Agent at a financial institution. The Downpayment shall be held in escrow by the Escrow Agent and dealt with in accordance with the provisions hereof.

(ii) Anything to the contrary herein notwithstanding and subject to offset for any payment required to be made by Purchaser pursuant to **Sections 20(a)(iv)** and **20(d)** below, (x) if Purchaser shall timely give a termination notice pursuant to the provisions of **Section 20(c)**, the Escrow Agent shall promptly remit $250,000 of the Downpayment to Seller and shall promptly remit the remainder of the Downpayment to Purchaser (subject to the other express provisions hereof); provided, however, that if Seller shall have breached its obligations hereunder during the Due Diligence Period, and Purchaser shall have given Seller written notice thereof (setting forth a detailed description of the alleged breach) at least three (3) Business Days prior to expiration of the Due Diligence Period and such breach shall not be cured by Seller or waived in writing by Purchaser within ten (10) Business Days after receipt of such notice, but not later than two (2) Business Days prior to the end of the Due Diligence Period, then the Escrow Agent shall promptly remit the entire Downpayment to Purchaser; and (y) if Purchaser shall not have timely given a termination notice pursuant to the provisions of **Section 20(c)** and if Closing shall not thereafter occur for any reason other than Seller' s breach hereunder, then Seller shall be entitled to receive the entire Downpayment and same shall not be refundable to Purchaser.

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(e) Purchaser shall at Closing cause Guarantor to do each of the items (i) through (iv) below or else shall provide the alternative guaranty or other security described in the sentence following this sentence: (i) to execute and deliver to Three E and Lentz the Deferred Payment Agreement; and (ii) to execute and deliver to AJG an agreement pursuant to which Purchaser shall pay to AJG one percent (1%) of the net cash flow of the Company on terms substantially identical to those contained in the Deferred Payment Agreement (except that such agreement shall not contain provisions similar to **Sections 3.3** or **3.4** or **Articles IV** and **V** of the Deferred Payment Agreement); the agreements referred to in these clauses (i) and (ii) are herein collectively referred to as the "Deferred Payment Agreements"; and (iii) to execute and deliver a copy of this Agreement to AJG to evidence its obligation to AJG pursuant to **Section 35** below; and (iv) to execute and deliver a copy of this Agreement to AJG and Three E to evidence its obligation to indemnify, defend and hold harmless each of the Seller Indemnified Parties (as hereinafter defined) from and against any and all Damages (as hereinafter defined) relating to, arising from or in connection with any breach of representation, warranty, covenant or agreement by Guarantor hereunder. In lieu of causing items (i) through (iv) above to occur, Purchaser may elect to provide at Closing: (x) an irrevocable and evergreen, clean standby letter of credit in the face amount of $12,600,000 (the "Purchaser' s Letter of Credit") in form and substance reasonably acceptable to AJG and issued by an issuer which is reasonably acceptable to AJG, which Purchaser' s Letter of Credit shall be accepted by AJG as security in lieu of the obligations of Guarantor under **Section 35(c)**, **(d)** and **(e)**; and (y) a guaranty or other security reasonably satisfactory to Three E and AJG, in lieu of the obligations of Guarantor pursuant to clauses (i), (ii) and (iv) of this subsection (e). If security in a form other than a guaranty is provided for all of the obligations referred to in items (i) through (iv) of the preceding sentence, then references to "Guarantor" in this Agreement shall be deemed deleted and of no force or effect and references to "Starwood" in the form of Deferred Payment Agreement attached hereto as Exhibit D shall be deemed deleted and of no force or effect except that in Article V thereof (entitled "Future Opportunities"), the term "Starwood" shall be deemed to mean "Purchaser". In the event that Purchaser shall at Closing, initially provide the Purchaser' s Letter of Credit and any other form of security than the guaranty referred to in clauses (i) through (iv) above, it may nevertheless, at any time thereafter replace such security by the guaranty referred to in clauses (i) through (iv) above, whereupon the changes effected by the preceding sentence shall be deemed reversed.

B. Closing Adjustment. (f) The Purchase Price shall not be adjusted in any manner unless the Closing Date Balance Sheet reflects material and adverse variances in liabilities from the balance sheet of the Company as at January 31, 2005 (the "January Balance Sheet") which variances are caused by transactions by the Company outside of the customary and usual course of business consistent with past practices (the "Material Variances"). Seller shall prepare a balance sheet of the Company as at the Closing Date (the "Closing Date Balance Sheet") in the same format and utilizing the same methods, procedures and assumptions that were used in the preparation of the January Balance Sheet and shall deliver a copy of the Closing Date Balance Sheet to Purchaser within thirty (30) days after the Closing Date. A copy of the January Balance Sheet is attached hereto as **Exhibit E**.

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(g) In the event the Closing Date Balance Sheet shall reflect Material Variances then, within ten (10) Business Days after the last of AJG and Three E to receive notice thereof from Purchaser, Purchaser, AJG and Three E shall confer for purposes of determining the effect, if any, such Material Variances shall have upon the Purchase Price. In the event the Parties shall be unable to resolve any dispute regarding Material Variances within thirty (30) days after the first conference of the Parties with respect thereto, then such dispute shall be submitted by any party to any of the following firms selected by Purchaser (provided that Purchaser may not select any firm which has provided services to, or otherwise had a relationship with, Purchaser or any of its Affiliates within the prior twelve (12) month period): BDO Seidman, Price Waterhouse Coopers, KPMG or Moore Stephens Lovelace, P.A., certified public accountants which are located at 1201 S. Orlando Avenue, Suite 400, Winter Park, FL 32789-7192 (the "Arbitrator"), as soon as possible and the decision of the Arbitrator shall be final and binding upon the parties without further recourse. If Purchaser shall fail to select an arbitrator in a writing delivered to Seller within ten (10) Business Days after the expiration of the aforesaid thirty (30) day period, then the arbitrator shall be Moore Stephens Lovelace, PA. In the event the Arbitrator shall determine that the Purchase Price shall be reduced as a result of Material Variances at the Closing Date, such reduction shall not exceed the aggregate increase in the book value of the assets of the Company and the Company Subsidiaries between January 31, 2005 and the Closing Date. The fees and costs of the Arbitrator will be borne equally by Purchaser and Seller (one half each).

4. Closing Date. The consummation of the transactions contemplated by this Agreement (the "Closing") shall take place at the offices of Baker & Hostetler, 200 South Orange Avenue, Orlando, Florida, or at such other location as may be agreed upon by the Parties, at 10:00AM E.S.T. on April 20, 2005, or on such earlier or later date pursuant to **Section 17(a)** below, or otherwise as Seller and Purchaser may hereafter mutually agree upon (the actual date on which the Closing occurs is herein sometimes referred to as the "Closing Date").

5. Seller' s Representations and Warranties. Seller represents and warrants to Purchaser that the statements set forth in the recitals of this Agreement and the following are true, correct and accurate in all material respects:

(i) Except as set forth on **Schedule 5(i)**, there is no litigation, dispute or proceeding before any federal, state or municipal department, board, bureau, agency or instrumentality pending, or to Seller' s Knowledge, threatened, against or relating to (X) Seller, the Company, the Company Subsidiaries or the Property; or (Y) the Seller Parents, if in the case of this clause (Y), it is likely to have a material adverse effect on Seller' s ability to perform its obligations hereunder or upon the Company after the Closing.

(ii) Except as is set forth on **Schedule 5(ii)** or as is reflected in any report identified on **Schedule 5(ii)** Seller has no Knowledge that there are Hazardous Materials

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at the Property, or that Hazardous Materials from the Property have been placed on, or have migrated to adjoining property or, that except as set forth on **Schedule 5(ii)**, Seller has received any citations, summonses, directives or orders relating to Hazardous Materials in or about the Property which are pending or unresolved at the date hereof or which were resolved within the past three years.

(iii) The execution, delivery and performance of this Agreement by Three E (as to itself) and AJG (as to itself) has been duly authorized by all requisite action of such party and this Agreement is the valid and binding obligation of Three E (as to itself) and AJG (as to itself) enforceable against such party in accordance with its terms except to the extent that enforcement may be affected by laws relating to bankruptcy, reorganization, insolvency and creditors rights and by the availability of injunctive relief, specific performance and other equitable remedies.

(iv) Each of the Company and Three E (as to itself) and AJG (as to itself) is a valid and existing entity of the type specified elsewhere herein, organized under the laws of the jurisdiction specified elsewhere herein and has the requisite power and authority to enter into and to perform the terms of this Agreement; Three E (as to itself) and AJG (as to itself) is the lawful owner, both beneficially and of record, of all of the partnership interests in the Company reflected on the books and records of the Company as owned by such party (each of Three E and AJG represents that such partnership interests together constitute all of the partnership interests in the Company, the "Partnership Interests") free and clear of liens and encumbrances, the delivery to Purchaser of the Assignment of Partnership Interests by Three E (as to itself) and AJG (as to itself) pursuant to this Agreement will transfer to Purchaser good, valid and marketable title to the portion of the Partnership Interests owned by Three E and AJG respectively, free and clear of all liens, encumbrances and claims of others. The Company owns no equity interest or other ownership interest in any entity other than the Company Subsidiaries.

(v) No consents, approvals, orders or authorizations of any federal, state or local governmental commission, board, agency, authority or other regulatory body are required for Three E' s (as to itself) or AJG' s (as to itself) execution, delivery and performance of this Agreement except as set forth on **Schedule 5(v)**.

(vi) Except as set forth on **Schedule 5(vi),** no consent of any mortgagee, Underlying Obligee or any other third party is required for or in connection with the execution, delivery or performance by the Seller and the Company of this Agreement or for or in connection with its consummation of the transactions contemplated hereby.

(vii) There are no employees (including without limitation, employees of Seller, the Company or the Company Subsidiaries) except for those set forth on **Schedule 5(vii)** who have written employment agreements with the Company or any Company Subsidiary providing for employment beyond the Closing Date.

(viii) **Schedule 5(viii)** (referred to in this **Section 5(viii)** as the "Schedule") lists all existing material (A) leases and amendments, renewals and guaranties thereof which

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are in effect for the lease of space in or at the Buildings and Improvements or otherwise at the Property (whether or not the terms thereof have commenced) under which the Company is the landlord (collectively, together with any "New Leases", hereinafter defined, the "Leases"); tenants under Leases are herein referred to as "Tenants" and (B) contracts (and all deposits thereunder and guarantees thereof) ("Pending Unit/Site Contracts") under which title closing has not as of the date hereof, occurred, for the sale of homes and/or home sites by Seller to purchasers (the "Pending Unit/Site Purchasers). The Pending Unit/Site Contracts are together with any "New Contracts", hereinafter defined, referred to as the "Sale Contracts". Except as set forth on the Schedule, there are no Sale Contracts (or other contracts for sale of lots at or about the Property) at or for the Property to which Company Affiliates or Seller Affiliates (as distinct from the Company itself are a party). No person or entity has or to Seller' s Knowledge claims any right pursuant to any written agreement with the Company (or to which the Company is bound) to purchase, occupy or otherwise utilize the Property or any part thereof (other than access rights for ingress, egress and utilities which are set forth of record in plats filed in the appropriate land records office or in recorded deeds except as shown on the Schedule, and the Company has made available to Purchaser true and complete copies of all of the existing Leases and Sale Contracts. Seller has also set forth on the Schedule all of the subleases under any of the Leases and all assignments of the Sale Contracts by contract vendees, to which the Company has consented or of which Seller has Knowledge. Other than the Leases and Sale Contracts listed on the Schedule (and the rights referred to in the parenthetical clause in the preceding sentence), there are no agreements in force or effect for the use, lease or occupancy of space at the Property or the purchase of homes, home sites or other property to which the Company is a party or by which the Company is bound as landlord or of which Seller or the Company has Knowledge.

(ix) Except to the extent set forth in **Schedule 5(ix)** (or in other schedules referred to in particular sub-subsections below in this **Section 5(ix)):**

(1) each of the Leases and Pending Unit/Site Contracts is in full force and effect; the Company is not in material default of any of its obligations under any Lease or any Sale Contract; no Tenant or Pending Unit/Site Purchaser is in arrears or in default (after any applicable notice and/or grace period) in the payment of fixed rent or "Additional Rents" (defined below) or the contract deposit or purchase price, as applicable or to the Knowledge of Seller is in material default of its non-monetary obligations after any applicable notice or grace period under its Lease or Sale Contract.

(2) except as may be set forth in the Leases or Pending Unit/Site Contracts, in this Agreement or in any exhibit or schedule hereto or as is otherwise granted by the Company in the ordinary course of business, no Tenant or Pending Unit/Site Purchaser is entitled to and to the Knowledge of Seller none has asserted any right to any rent concession or purchase price concession, rebate, abatement, improvement allowance, work or other benefits;

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(3) except as set forth on **Schedule 5(ix)(3),** neither Seller nor the Company has received written notice from a Tenant or a Pending Unit/Site Purchaser claiming or asserting any defenses, counterclaims, set-offs or offsets against the rents specified in its Lease or against its obligations under its Sale Contract;

(4) except as provided in the Leases or Pending Unit/Site Contracts, no renewal, extension, expansion or purchase rights or options have been granted and remain outstanding in favor of any Tenant or any Pending Unit/Site Purchaser;

(5) except as set forth in **Schedule 5(ix)(5),** no action or proceeding is pending, or to Seller' s or the Company' s knowledge, threatened, against Seller or the Company by any Tenant or any Pending Unit/Site Purchaser;

(6) except as set forth in **Schedule 5(ix)(6),** there are no security deposits under the Leases or Sale Contracts; and

(7) no Tenant has prepaid any fixed rent or Additional Rents for more than one month in advance.

(x) Except as set forth on **Schedule 5(x),** neither the Company nor Seller has received written notice of any pending real property tax reduction proceedings with respect to the Property.

(xi) **Schedule 5(xi)** (which shall be prepared by Seller and delivered to Purchaser within five (5) Business Days after the date hereof and shall then be attached hereto) is a true and complete list of all material (other than brokerage agreements, which are addressed in **Section 5(xiv)** below) service, maintenance, utilities, supply and other contracts relating to the Property, or by which the Company is bound, or affecting the Property or the use thereof, together, in each case, with all amendments and modifications thereof to which the Company is a party (collectively, the "Service Contracts"); a true and complete copy of each Service Contract has been made available to Purchaser.

(xii) Neither the Company nor Seller is a "foreign person" within the meaning of Section 1445 of the Internal Revenue Code 1986, as amended, or any regulations promulgated thereunder (collectively, the "Code").

(xiii) Except for Permitted Exceptions, there are no court (or other governmental entity) judgments, orders, or decrees of any kind against the Company or Seller which are unpaid or unsatisfied of record, nor any actions, suits or other legal or governmental administrative proceedings pending or, to the best of the Company' s or Seller' s knowledge, threatened against the Company or Seller, which is likely to have any material adverse effect on the Company or the ability of the Company or Seller to consummate the transactions contemplated by this Agreement.

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(xiv) Except as set forth on **Schedule 5(xiv)** (brokerage commissions set forth thereon, if any, are referred to herein as the "Payable Commissions") there are no brokerage commissions (or unpaid installments thereof) with respect to any Leases or Sale Contracts which are now due and payable or which will become due and payable hereafter (including after the Closing), other than with respect to transactions consummated on or subsequent to December 31, 2004 for which proceeds have either remained with the Company, reduced indebtedness of the Company or otherwise have been utilized in connection with the conduct of the Company's business in the ordinary course of business. **Schedule 5(xiv)** lists all of the leasing and/or sales brokerage agreements (the "Leasing/ Sales Brokerage Agreements") which are presently in effect relating to the Property and binding on the Company, any Company Subsidiary, Seller or any Affiliate of Seller; true and complete copies thereof have been made available to Purchaser.

(xv) Except as set forth on **Schedule 5(xv)** and except for any improvement work or allowance or reimbursement in respect thereof to which a Tenant or a Pending Unit/Site Purchaser may be entitled in accordance with the terms of any presently unexercised renewal, extension, expansion or other options expressly set forth in any Leases or Pending Unit/Site Contracts and except for developer liability imposed by Florida law (Seller hereby represents that it has received no written notices of any such claims) and warranty obligations incurred in the ordinary course of the Company's business, there is no improvement work required to be performed by the Company under any Lease or Sale Contract or for which the Company is required under any Lease or Sale Contract to reimburse any Tenant or Pending Unit/Site Purchaser or grant any allowance in favor of any Tenant or Pending Unit/Site Purchaser, in excess of Two Hundred Thousand Dollars ($200,000) in the aggregate as to all such required work which has not already been completed and/or the costs of which (the "Inducement Costs") have not already been paid or allowed as a credit to the Tenant or the Pending Unit/Site Purchaser.

(xvi) Neither Seller, the Company, any Company Subsidiary nor, to Seller's Knowledge, any Tenant or Pending Unit/Site Purchaser is presently the subject of any of the following: a petition under any federal or state bankruptcy or insolvency laws, the appointment of a receiver to take possession of all or substantially all of its assets, the attachment or other judicial seizure of all or substantially all of its assets, an admission in writing of its inability to pay its debts as they come due, or an offer of settlement, extension or composition made to its creditors generally.

(xvii) Attached hereto as **Schedule 5(xvii)** is a list of all property casualty insurance coverages, including fire and extended coverage, maintained by the Company with respect to the Property ("Company's Casualty Insurance"). The Company's Casualty Insurance is in full force and effect.

(xviii) Seller has made available to Purchaser a true, correct and complete copy of each of the agreements and documents which constitute the Underlying Obligations, all of which Underlying Obligations are generally described on **Schedule 5(xviii)**. The Underlying Obligations have not been amended. All payments due and payable by the

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Company under the Underlying Obligations to and including the date of this Agreement have been made. The Company has not given or received written notice of any default under any of the Underlying Obligations which is outstanding and not remedied.

(xix) **Schedule 5(xix)** contains a complete list of each Benefit Plan. The Company has made available to Purchaser true and complete copies of each Benefit Plan and with respect to any Benefit Plan that is sponsored or maintained by the Company or any Company Subsidiary (a "Company Sponsored Benefit Plan") all contracts relating thereto, or to the funding thereof, including, without limitation, all trust agreements, insurance contracts, administration contracts, investment management agreements, subscription and participation agreements and recordkeeping agreements. In the case of any Company Sponsored Benefit Plan that is not in written form, the Purchaser has been supplied with an accurate written description of such Company Sponsored Benefit plan. A true and correct copy of the most recent annual report, actuarial report, accountant' s opinion of the plan' s financial statements, summary plan description and Internal Revenue Service determination letter with respect to each Company Sponsored Benefit Plan, to the extent applicable, has been made available to the Purchaser, and there have been no materially adverse changes in the financial condition in the respective plans from that stated in the annual reports and actuarial reports supplied.

Except as disclosed on **Schedule 5(xix)(1):**

(a) All Benefit Plans have been maintained and administered in form and in operation in all material respects in accordance with their terms and with all applicable requirements of law (including, in the case of any Benefit Plan which is an employee pension benefit plan, the requirements of sections 401(a) and 501(a) of the Code), except for any instances of failure to so maintain or administer that would not, individually or in the aggregate, result in a material liability of the Company or any Company Subsidiary and no notice issued by any governmental authority questioning or challenging such compliance has been received by the Company or any Company Subsidiary.

(b) None of the assets of any Benefit Plan are invested in employer securities or employer real property.

(c) There have been no "prohibited transactions" (as described in section 406 of ERISA or section 4975 of the Code) with respect to any Benefit Plan and neither the Company nor any Company Subsidiary has engaged in any prohibited transaction.

(d) There are no audits, examinations, investigations, actions, suits or claims (other than routine claims for benefits) pending with respect to which Seller or the Company has been served with process or received written notice of the pendency thereof or, to Sellers' Knowledge, threatened involving any Benefit Plan or the assets thereof.

(e) Neither the Company nor any Company Subsidiary has any liability or contingent liability for providing, under any Benefit Plan or otherwise, any post-retirement medical or life insurance benefits, other than statutory liability for providing group health plan continuation coverage under Part 6 of Title I of ERISA and section 4980B of the Code or applicable state law.

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(f) There has been no act or omission that would impair the ability of the Company (or any successor thereto) or any Company Subsidiary (or any successor thereto) to unilaterally amend or terminate any Benefit Plan.

(g) Neither the Company nor any Company Subsidiary, nor any employer (whether or not incorporated) that would be treated together with the Company, any Company Subsidiary and/or the Seller, as a single employer within the meaning of Section 414 of the Code, sponsors, maintains or contributes to, has sponsored, maintained or contributed to, or has any liability, contingent or otherwise, with respect to a plan covered by Title IV or Section 302 of ERISA or Section 412 of the Code or a "multiemployer plan", as such term is defined in Section 3(37) of ERISA.

(h) The execution of this Agreement and the consummation of the transactions contemplated hereby do not constitute a triggering event under any Benefit Plan, policy, arrangement, statement, commitment or agreement, which (either alone or upon the occurrence of any additional or subsequent event) will or may result in any payment, "parachute payment" (as such term is defined in Section 280G of the Code), severance, bonus, retirement or job security or similar-type benefit, or increase any benefits or accelerate the payment or vesting of any benefits to any employee or former employee or director of the Company or any Company Subsidiary.

(xx) neither Three E (as to itself and its Affiliates), AJG (as to itself and its Affiliates), the Company, any Company Subsidiary nor any of their respective Affiliates, nor any of their respective members, and none of their respective officers or directors is, nor prior to Closing or the earlier termination of this Agreement, will they become, a person or entity with whom U.S. persons or entities are restricted from doing business under regulations of the Office of Foreign Asset Control ("OFAC") of the Department of the Treasury (including those named on OFAC' s Specially Designated Blocked Persons List) or under any U.S. statute, executive order (including the September 24, 2001, Executive Order Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit or Support Terrorism) or other governmental action and, with respect to the Company, any Company Subsidiary or any of their Affiliates, is not and prior to Closing for the earlier termination of this Agreement will not engage in any dealings or transactions with or be otherwise associated with such persons or entities.

(xxi) for purposes of this Agreement, "Environmental Law" shall mean any law, order or other requirement of law, including any principle of common law, relating to the protection of human health or the environment, or to the manufacture, use, transport, treatment, storage, disposal, release or threatened release of Hazardous Materials. Except as set forth on **Schedule 5(xxi)** or in any of the reports identified on Schedule 5(xxi) Seller has no Knowledge that (i) the Company or any of the Company Subsidiaries (x) is not in material compliance with all applicable Environmental Laws, or (y) has failed to obtain, or is not in material compliance with, any Permits required of them under

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applicable Environmental Laws; (ii) there are any claims, proceedings, investigations or actions by any Governmental or Regulatory Authority or other Person or entity pending or threatened against the Company or any of the Company Subsidiaries under any Environmental Law; (iii) Hazardous Materials are, or have been, located on (except in small amounts used in the ordinary course for the operation or maintenance of the Property by the Company or its predecessor in accordance with all applicable Environmental Laws), in or under the Property or have been released into the environment, or discharged, placed or disposed of at, on or under the Property; (iv) underground storage tanks are, or have been, located at the Property; or (v) the Property has been used to store, treat or dispose of Hazardous Materials.

(xxii) Each of the Company and the Company Subsidiaries (each is referred to as a "Tax Entity" in **Sections 5(xxii), (xxiii)** and **(xxiv)**) has timely filed or caused to be timely filed with the appropriate taxing authorities all material tax returns, statements, forms and reports (including, elections, declarations, disclosures, schedules, estimates and informational tax returns) for Taxes ("Returns") that are required to be filed by, or with respect to, such Tax Entity on or prior to the Closing Date. The Returns have accurately reflected and will accurately reflect all material liability for Taxes of, or with respect to, such Tax Entity for the periods covered thereby.

All material Taxes and Tax liabilities of each Tax Entity for all taxable years or period that end on or before the Closing Date ("Pre-Closing Periods") have been or will be timely paid in full within the period (or any extension thereof) prescribed under applicable laws and regulations other than Taxes and Tax liabilities that are being contested in good faith.

(xxiii)

A. Except as set forth on **Schedule 5(xxiii)A**, no Tax Entity has been the subject of an audit or other examination of Taxes by the tax authorities of any nation, state or locality (and no such audit is pending or, to the Knowledge of Seller, contemplated) nor has any Tax Entity received any notices from any taxing authority relating to any issue which could reasonably be expected to materially and adversely affect the Tax liability of the Company or any of its Subsidiaries.

B. Except as set forth on **Schedule 5(xxiii)B**, neither the Company nor any of the Company Subsidiaries has, as of the Closing Date, (A) entered into an agreement or waiver or requested to enter into an agreement or waiver extending any statute of limitations relating to the payment or collection of Taxes of such Tax Entity or (B) is presently contesting the Tax liability of such Tax Entity before any court, tribunal or agency.

C. Except as set forth on **Schedule 5(xxiii)C**, no Tax Entity has been included in any "consolidated," "unitary" or "combined" Return provided for under the law of the United States, any non-U.S. jurisdiction or any state, province, prefect or locality with respect to Taxes for any taxable period for which the statute of limitations has not expired.

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D. All Taxes which the Company or any of the Subsidiaries is (or was) required by law to withhold or collect in connection with amounts paid or owing to any employee, independent contractor, creditor, stockholder or other third party have been duly withheld or collected, and have been timely paid over to the proper authorities to the extent due and payable.

E. Except as set forth on **Schedule 5(xiii)E**, no written claim has ever been received by a Tax Entity from any taxing authority in a jurisdiction where the Company or any of the Company Subsidiaries does not file Returns that the Company or any of its Company Subsidiaries is or may by subject to taxation by that jurisdiction.

F. There are no tax sharing, allocation, indemnification or similar agreements in effect as between the Company or any predecessor or Affiliate thereof and any other party (including Seller and any predecessors or Affiliates thereof) under which Purchaser or the Company could be liable for any Taxes or other claims of any party.

G. Neither the Company nor any of the Company Subsidiaries has applied for, been granted, or agreed to any accounting method change for which it will be required to take into account any adjustment under Section 481 of the Code or any similar provision of the Code or the corresponding tax laws of any nation, state, province, prefect or locality.

H. Neither the Company nor any of the Subsidiaries is a party to any agreement that would require it to make any payment that would constitute an "excess parachute payment" for purposes of Sections 280G and 4999 of the Code.

For purposes of this Agreement, "Taxes" shall mean all taxes, assessments, charges, duties, fees, levies or other governmental charges, including all U.S. and non-U.S. federal, state, local and other income, franchise, profits, capital gains, capital stock, transfer, sales, use, occupation, property, excise, severance, windfall profits, stamp, license, payroll, withholding and other taxes, assessments, charges, duties, fees, levies or other governmental charges of any kind whatsoever (whether payable directly or by withholding and whether or not requiring the filing of a Return (as defined below)), all estimated taxes, deficiency assessments, additions to tax, penalties and interest and shall include any liability for such amounts as a result either of being a member of a combined, consolidated, unitary or affiliated group or of a contractual obligation to indemnify any Person or other entity.

(xxiv) The Company has no liabilities of any nature, matured or unmatured, fixed or contingent, known or unknown, (x) which are required to be disclosed on the 2004 Balance Sheet, in accordance with GAAP, which have not been so disclosed, and (y) other than liabilities incurred or arising in the normal course of business, consistent with past practices, since December 31, 2004.

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(xxv) Except for personal property listed in **Schedule 5(xxv)** (which shall be prepared by Seller and delivered to Purchaser within five (5) Business Days after the date hereof and shall be attached hereto) leased by the Company or any of the Company Subsidiaries the Company and the Company Subsidiaries own all rights and personal property which are necessary for the continued use of the Property after the Closing Date in a manner which is consistent with the use of the Property immediately prior to the date hereof.

6. Representations and Warranties of Purchaser and Guarantor. Each of Purchaser and Guarantor, as to itself, represents and warrants to Three E and AJG as follows:

(a) The execution, delivery and performance of this Agreement and all other agreements, instruments, certificates and documents, if any, to be executed and delivered to Three E, James Lentz or AJG, as the case may be, pursuant to the terms hereof (the "Additional Documents") by Purchaser or Guarantor, as the case may be, have been duly authorized by all requisite action of Purchaser or Guarantor, as the case may be, and this Agreement and the Additional Documents are valid and binding obligations of Purchaser or Guarantor, as the case may be, enforceable against Purchaser or Guarantor, as the case may be, in accordance with their respective terms except to the extent that enforcement may be affected by laws relating to bankruptcy, reorganization, insolvency and creditors rights and by the availability of injunctive relief, specific performance and other equitable remedies.

(b) There is no litigation, dispute or proceeding pending, or to Purchaser's or Guarantor's knowledge, threatened, against or relating to Purchaser or Guarantor and which would have a material adverse effect on Purchaser's or Guarantor's ability to perform its obligations hereunder (including without limitation in each such case, any proceeding before any federal, state or municipal department, board, bureau, agency or instrumentality).

(c) Each of Purchaser and Guarantor is a valid and existing entity of the type specified elsewhere herein, organized under the laws of the jurisdiction specified elsewhere herein and has the requisite power and authority to enter into and to perform the terms of this Agreement and each of the Additional Documents.

(d) Except for any consent or waiver listed in **Schedule 6(d),** no consents, approvals, orders or authorizations of any federal, state or local governmental commission, board, agency, authority or other regulatory body, or any nongovernmental third party, are required for Purchaser's or Guarantor's execution, delivery and performance of this Agreement or any of the Additional Documents.

(e) There are no court (or other governmental entity) judgments, orders, or decrees of any kind against Purchaser or Guarantor which are unpaid or unsatisfied of record, nor any actions, suits or other legal or governmental administrative proceedings pending or, to the best of Purchaser's or Guarantor's knowledge, threatened against Purchaser or Guarantor, as the case may be, which is likely to have a material adverse effect on Purchaser or Guarantor or the ability of Purchaser or Guarantor to consummate the transactions contemplated by this Agreement and each of the Additional Documents.

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(f) The Partnership Interests to be acquired by Purchaser pursuant to this Agreement are and shall be acquired for Purchaser' s own account, for investment purposes only and not with a present view to or intention of, distribution or resale thereof in violation of any federal or state securities laws and that, irrespective of any other provisions of this Agreement, the Partnership Interests shall be transferred only in compliance with all applicable federal and state securities laws.

(g) If the Due Diligence Period expires without a termination of this Agreement by Purchaser pursuant to **Section 20(c)** below, then each of Purchaser and Guarantor represents and warrants that it (i) has had the opportunity to ask questions and receive answers concerning the terms and conditions of the sale of the Partnership Interests hereunder; and (ii) has had full access to such information and materials concerning the Company, the Company Subsidiaries and the Property as Purchaser or Guarantor, as the case may be, has requested. Each of the Company, Three E, Lentz and AJG, respectively, has answered all inquiries that Purchaser or Guarantor, as the case may be, has made to the Company, Three E, Lentz and AJG, respectively relating to the Company, the Company Subsidiaries, the Property and the sale of the Partnership Interests hereunder.

(h) The execution, delivery and performance of this Agreement or any of the Additional Documents by Purchaser or Guarantor, as the case may be, does not and shall not conflict with, violate or cause a breach of its organizational documents or bylaws or any agreement, contract or instrument to which Purchaser or Guarantor, as the case may be, is a party or by which it is bound, or any judgment, order of decree to which Purchaser or Guarantor, as the case may be, is subject.

Filings Under the Hart Scott Rodino Act. Within ten (10) Business Days after the execution of this Agreement, Purchaser shall file with the Federal Trade Commission ("FTC") and the United States Department of Justice, Antitrust Division ("Justice"), all required filings by Purchaser under the Hart Scott Rodino Antitrust Improvement Act of 1976, as amended, with respect to the transactions contemplated by this Agreement and shall pay the applicable filing fee for such filing. The Company and Seller shall take whatever steps shall be reasonably required to make any filing required of the Company or Seller under the HSR Act within the aforesaid ten (10) Business Day period. Each of the Company, Seller and Purchaser, each at its respective expense, shall diligently take and pursue such steps and provide such additional information or responses as shall be required to satisfy any request for additional information received from the FTC or Justice.

Indemnification, Limitations and Survival.

(a) (i) Subject to the limitations set forth in this Agreement, Three E, AJG and Lentz shall jointly and severally indemnify, defend and hold harmless Purchaser, its Affiliates, and each of their respective partners, officers, directors,

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shareholders, members, employees and agents, and each of their successors, heirs, and assigns, jointly and severally, from and against any and all loss, cost, liability and claims whatsoever, including reasonable attorneys' fees actually incurred by Purchaser herein with respect to "Claims" resulting from any misrepresentation or breach of any warranty or non-fulfillment of any covenant or agreement made by Seller in this Agreement, (including without limitation a representation or warranty becoming inaccurate, untrue or incorrect as a result of Seller's breach of any of its obligations under this Agreement) and which is not waived or otherwise accepted by Purchaser. Purchaser acknowledges and agrees that (i) Three E and Lentz (and not AJG) shall be jointly and severally liable for any misrepresentation or breach of warranty which is made by Three E solely as to itself and set forth in **Sections 5(i), (iii), (iv), (v)** and **(xx)** hereof; and (ii) AJG (and not Lentz or Three E) shall be solely liable for any misrepresentation or breach of warranty which is made by AJG solely as to itself and set forth in **Sections 5(i), (iii), (iv), (v)** and **(xx)** hereof; and (iii) in the event of any claim for indemnification relating to, arising from or in connection with title to the Property, Purchaser shall first seek recovery from the title insurance company or companies which has or have issued a title insurance policy to the Company with respect to the Property and shall not make a claim against Three E, Lentz or AJG with respect thereto to the extent same is a matter which is insurable against by a title insurance company

(ii) The aggregate liability of each of Three E and Lentz under all indemnification provisions of this Agreement shall, if Closing occurs hereunder, be limited to the sum of (i) One Million Dollars ($1,000,000) under the second sentence following this sentence, or Two Million Dollars ($2,000,000) in the aggregate under the second and third sentences following this sentence, or such lesser sum as shall be payable pursuant to the Deferred Payment Agreement (subject to the provisions of **Section 8(g)** below, Purchaser and the Company shall only be entitled to offset against sums payable to Three E by the Company or the Purchaser, pursuant to the Deferred Payment Agreement, the amounts of all obligations and liabilities of Three E and Lentz hereunder) and (ii) Claims resulting from Exclusion Items (as that term is defined below). Neither Three E, Lentz nor AJG shall have any liability for breach of representation or warranty under this Agreement unless the aggregate Damages for all such breaches shall exceed Five Hundred Thousand Dollars ($500,000) (the "Threshold") in which event they each, subject to the liability limitations and other provisions set forth below, shall be liable for Damages from the first dollar of Damages; provided, however, that any representation or warranty of Seller which, to the Knowledge of Lentz or the Knowledge of Three E or AJG, was untrue when made, and claims resulting from Exclusion Items (as that term is defined below) shall not be subject to the Threshold. Purchaser agrees that the first One Million Dollars ($1,000,000) of indemnification liability of Seller hereunder shall be payable solely by Three E and Lentz (solely from any sums otherwise payable to Three E pursuant to the Deferred Payment Agreement) and, anything in this Agreement to the contrary notwithstanding, AJG shall have no responsibility therefor. Thereafter any

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indemnification liability of Seller hereunder shall, to the extent not exceeding an additional Five Million dollars ($5,000,000), be payable pro rata 80% by AJG currently and 20% by Three E and Lentz from any sums otherwise payable to Three E pursuant to the Deferred Payment Agreement and AJG shall bear 100% of aggregate indemnification obligations of Seller in excess of Six Million Dollars ($6,000,000), subject to the provisions for maximum indemnification liability set forth in this Agreement. "Exclusion Items," as such term is used herein, shall mean any and all of the following: (i) claims of and liabilities to taxing authorities for taxes, interest and penalties; (ii) gross negligence; (iii) willful or wanton misconduct; (iv) knowing and material misrepresentations or breach of warranties or covenants; (v) violations of law; (vi) actions which subject the Company to liability to a third party under any "bad boy" covenants from nonrecourse provisions of loan documents or other agreements; (vii) liability relating to employee matters; and (viii) liability relating to environmental matters with respect to which the representations and warranties of **Sections 5(ii)** or **(xxi)** have been breached. Anything to the contrary herein notwithstanding, but subject to the provisions of **Section 8(b)** below, Claims resulting from Exclusion Items shall not be subject to any limitation on the extent of liability for indemnification under this Agreement.

(b) Anything in this Agreement to the contrary notwithstanding, the aggregate liability of AJG under all indemnification provisions of this Agreement shall, if Closing occurs hereunder, be limited to the sum of Eight Million Dollars ($8,000,000) plus Damages relating to the Exclusion Items described in (i), (ii), (iii) and (iv) of the definition of Exclusion Items above, but solely as it relates to the conduct of AJG and no other person.

(c) The representations, warranties, covenants and indemnities of Three E, Lentz and AJG, respectively, herein shall survive the Closing for a period of eighteen (18) months except that the survival period for subparagraph (i) of the Exclusion Items shall be the expiration of the statute of limitations respecting the particular tax liability at issue, and the survival period for the remaining Exclusion Items shall be three (3) years from the Closing Date (as applicable, the "Survival Period"). Any claim thereunder must be made by notice to Seller given prior to the expiration of the Survival Period. Except with respect to breaches that are known to Purchaser at the time of Closing (which breaches shall be deemed waived for all purposes upon consummation of the Closing if Purchaser fails to notify Seller in writing prior to the Closing that Purchaser intends to assert a claim therefor), Purchaser shall not be deemed to have waived any claim based upon Seller' s breach of any of the representations, warranties, covenants or indemnities herein.

(d) The provisions set forth in this Agreement respecting the obligations and liabilities of Three E, Lentz and AJG, respectively, including, without limitation, the provisions of this **Section 8**, shall be the exclusive remedy Purchaser shall have with respect to any claim arising from, in connection with or related to this Agreement or any transaction contemplated hereby.

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(e) Any indemnity obligations of Three E, Lentz and AJG, respectively, shall be reduced by (i) the amount of any insurance proceeds paid to Purchaser, or any Affiliate of Purchaser, the Company or any Company Subsidiary with respect to the matter which is the subject of the indemnification claim; and (ii) the amount of any net savings received from any tax benefits to Purchaser, the Company or any Company Subsidiary resulting from any such matter; and (iii) any amount paid to Purchaser, any Affiliate of Purchaser, the Company or any Company Subsidiary with respect to such matter pursuant to any surety, guarantee, contribution agreement, indemnification agreement or other agreement or arrangement with a third party (other than Three E, Lentz or AJG). In the event Purchaser shall be indemnified hereunder prior to the receipt by Purchaser or any Affiliate of Purchaser or the Company or any Company Subsidiary of any payment or benefit to which it is entitled and which would reduce the indemnification obligation of Three E, Lentz or AJG, respectively pursuant to this **Section 8(e)** then, contemporaneously with any indemnification payment and as a condition precedent thereto, Purchaser shall execute and deliver to the indemnifying party or parties, an assignment of all rights of recovery of any such insurance claim or otherwise pursue payment and the right to retain the proceeds thereof (to the extent of the indemnification payment made to Purchaser, any excess thereof to be promptly remitted to Purchaser), provided however that Purchaser shall retain the right to adjust same with the insurance company or otherwise pursue such claim and hereby agrees to act reasonably and diligently in doing so and to keep Seller reasonably informed as to the status and progress thereof..

(f) Any indemnity obligation of Three E, Lentz and AJG, respectively, shall only be to the extent of actual direct damages, and any claim for special, punitive, exemplary or any other type of damages shall be deemed waived by Purchaser and shall not be recoverable in connection with any asserted claim for indemnity by Purchaser or any Affiliate of Purchaser; provided, however, if any claim for indemnification results from any suit, action or proceeding against the Company or any Company Subsidiary by an independent third party for which Lentz, Three E or AJG has liability hereunder, then the indemnification obligation shall be based upon the damages, if any and of whatever type, that are awarded to such third party by a court of competent jurisdiction.

(g) Any indemnification obligation of Three E, Lentz or AJG, as the case may be, shall solely be based upon a final adjudication by a court of competent jurisdiction from which all rights of appeal have expired or as a result of a duly executed settlement agreement entered into between Purchaser and the party against which indemnification is sought. Purchaser shall have no direct right of setoff against any amounts owing to Lentz, Three E or AJG unless and until such final adjudication has been made. To the extent a claim is asserted by Purchaser against Lentz or Three E, Purchaser shall make payment of so much of the sums to which they are otherwise entitled pursuant to the Deferred Payment Agreement up to the amount of alleged Damages into escrow with the

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Escrow Agent in an interest bearing account pending final resolution of any claim. Interest or earnings will be prorated based upon the amount distributed to each party from the escrow.

(h) In furtherance of the provisions of **Section 28(l)** hereof, in the event Purchaser or Seller shall assert a claim under this Agreement against another Party, and shall not be the prevailing party as determined by order of a court of competent jurisdiction from which all rights to appeal have expired, then upon demand such claimant shall reimburse such other Party(ies), for all fees, costs and expenses, including reasonable attorneys fees, suffered, sustained or incurred by such other Party in defending against such claim.

(i) Purchaser shall, and shall cause each of the Company and each Company Subsidiary to, provide to Three E, AJG and their respective representatives, full and complete unrestricted access to the Books and Records of Purchaser, the Company or any such Company Subsidiary during normal business hours, with the full right to make copies, extracts, compilations or other paper or electronic evidence thereof, in connection with the defense of any claim asserted against Three E, Lentz or AJG hereunder, or in connection with any federal or state tax matters regarding or affecting Three E, Lentz or AJG, as the case may be.

9. Violations. At Closing the Property (other than with respect to environmental matters which are separately provided for elsewhere herein and subject to the other provisions herein including, without limitation, **Section 8(c)**), shall be free from any and all violations of law or governmental ordinances, orders or requirements which are now or hereafter existing and/or noted, filed or recorded in or issued by any federal, state, county or municipal department, agency, authority or bureau as to conditions affecting the Property which materially and adversely affect the value or intended use of the Property (the "Violations"), and with respect to which the Company or Seller has received written notice, it being understood and agreed that none of Three E, Lentz, AJG, the Company or any of the Company Subsidiaries shall have any duty whatsoever to make any independent investigation or inquiry as to conditions affecting the Property. It is further understood and agreed that Seller and the Company shall have the right to contest any alleged violation in good faith, and to terminate this Agreement and the purchase rights of Purchaser hereunder, by giving written notice of termination to Purchaser, if the reasonably anticipated aggregate cost to cure all such violations exceeds One Million Dollars ($1,000,000). Seller, in its discretion, may adjourn the Closing for up to thirty (30) days in order to resolve any claimed Violations. If Seller is unable to eliminate all Violations in accordance with the terms of this Agreement on or before such adjourned date for the Closing, Purchaser may, in addition to any additional rights and remedies which it may have hereunder, or at law or in equity, elect by written notice given to Seller within five (5) days after such adjourned date for the Closing, either to (1) terminate this Agreement and receive the return of the Downpayment as Purchaser's sole and exclusive remedy, or (2) close hereunder subject to such Violations and proceed to make a claim against Seller (subject to any limitations provided herein). In the event Purchaser shall fail to timely give the aforesaid written notice to Seller, then Purchaser shall be deemed, without further notice or action of any kind by Seller, to have elected to close hereunder pursuant to clause (2) of the immediately preceding sentence.

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10. Certain Books and Records. In augmentation of and without limitation upon Seller' s obligation herein to provide or cause the Company to provide access to all Books and Records to Purchaser, Seller shall make available and shall cause the Company to make available for Purchaser' s examination until the earlier to occur of the Closing or the termination of this Agreement, at Seller' s office or such other location reasonably convenient to Purchaser as Seller may designate, all documents, records, statements and accounts in the possession or control of Seller, the Company or the Company' s property manager relating to (i) Sale Contracts and the deposits and payments thereunder and conveyances thereunder; (ii) rents under the Leases and the collection or payment thereof; and (iii) the Underlying Obligations and expenditures thereunder; and (iv) the operation of the Property and expenditures made in connection therewith. On the Closing Date, Seller shall furnish or cause to be furnished to Purchaser a statement which shall be accurate as of the Closing Date, of all purchase prices and deposits under the Sale Contracts and all then prepaid and all then uncollected and delinquent rents and under the Leases.

11. Intentionally omitted.

12. Operation of the Business of the Company and the Company Subsidiaries. The Company and each of the Company Subsidiaries shall have the unrestricted right to operate and conduct its respective business between the date hereof and the Closing Date in the ordinary course and consistent with past practices.

13. Deliveries by Seller at Closing. At the Closing, Seller shall deliver the following to Purchaser:

(i) (i) Assignments of Partnership Interests in a commercially reasonable form agreed to by Purchaser and Seller prior to the Closing Date, executed by each of the Sellers (as to the portion of the Partnership Interests owned by such Seller), assigning and transferring to Purchaser, good and marketable title to that portion of the Partnership Interests owned by such Seller, free of all liens, encumbrances and claims of others, such that, through the Company, Purchaser shall have good, marketable and insurable title in and to the feehold of the Land, Buildings and Improvement, together with all appurtenances and rights running with the Land, subject only to the "Permitted Exceptions" (defined below), and (ii) its certified check(s), to the order of the appropriate tax collecting agency or official, in the amount of any and all transfer taxes, documentary transfer stamps, and any local "recording" tax and other taxes, fees and charges, which shall be payable by reason of the transfer and assignment of the Partnership Interests from Seller to Purchaser. In lieu of delivering such certified checks, Seller may, by notice given to Purchaser not later than fifteen days prior to the Closing Date, elect to have Purchaser pay any of such taxes and charges and give Purchaser a credit on the Closing Date against the Purchase Price in the amount thereof.

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(j) A schedule of all cash security deposits paid by the tenants under the Leases and the accrued interest on each of such cash security deposits. With respect to any lease securities which are in a form other than cash, Seller shall deliver to the Company at the Closing any documents or instruments constituting or evidencing such lease securities together with any appropriate instruments of assignment or transfer executed by the named beneficiary thereunder, if it is not the Company.

(k) Notices to the tenants under the Leases in a commercially reasonable form agreed to by Purchaser and Seller prior to Closing, executed by Seller, directing that rents and other payments thereafter be sent to the Company at such address as Purchaser may direct, and including such other matters as may be reasonably required by Purchaser.

(l) All keys to all entrance doors to, and equipment and utility rooms located in, the Property, which keys shall be properly tagged for identification, and all of the following: computer passwords, access cards and security codes to all portions of the Property.

(m) All (A) original permits and licenses issued for or with respect to the Property by governmental and quasi governmental authorities having jurisdiction that are in Seller' s possession and (B) warranties and guarantees (collectively, the "Warranties"), in Seller' s possession, which Seller has received in connection with any work or services performed or equipment installed at the Property.

(n) A current Rent Roll listing each tenant of the Property in the form annexed hereto as **Exhibit G** and a current list of all Underlying Obligations.

(o) An assignment to the Company, in a commercially reasonable form agreed to by Purchaser and Seller prior to Closing, of all right, title and interest of the nominal holder thereof, in and to those Service Contracts if any, which are held in a name other than that of the Company or any Company Subsidiary.

(p) Resolutions and consents evidencing Seller' s (such term includes all Seller Affiliates) authority to execute and deliver the documents and instruments described herein.

(q) A "FIRPTA" certificate duly executed and acknowledge by Seller and any other directed transferee of any portion of the Purchase Price, in accordance with Section 1445 of the Code.

(r) A certificate of Seller, dated as of the Closing, certifying the fulfillment of the conditions set forth in **Section 16** hereof.

(s) From each holder of Assumed Indebtedness and each other Underlying Obligee, to the extent required by the express terms of the Assumed Indebtedness or Underlying Obligation (i) an original Underlying Obligee' s consent to the transaction contemplated hereby (provided, however that Seller' s failure to obtain any of such consents, if and to the extent that the lack of such consents not so obtained would not, in

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the aggregate result in a material adverse effect upon the Company or Purchaser, shall not be deemed a default by Seller under this subsection (k)) and (ii) estoppel certificates to the extent received by the Company, acknowledging that the Company is not in breach under the Underlying Obligations (it being understood that if a particular Underlying Obligee is not under any obligation to deliver such estoppel certificate, that Seller is only required to use commercially reasonable efforts to obtain same, which shall not be deemed to include the payment of any funds therefor other than reasonable ministerial processing fees), each such consent and estoppel certificate to be dated not more than forty-five (45) days prior to the Closing Date in form reasonably acceptable to Purchaser and Seller.

(t) The Deferred Payment Agreements, duly executed by Three E and Lentz and by AJG, respectively.

(u) The Harmony License duly executed by Three E and Harmony Institute.

(v) The Lentz Employment Agreement executed by Lentz.

(w) The Veterinary Restriction Agreement duly executed by Harmony Institute.

(x) Written resignations of all officers and other representatives of the Company and Company Subsidiaries (as such officers and representatives, having control of the Company and Company Subsidiaries, as distinct from resignation from employment, it being intended that such employment shall continue in accordance with **Section 25(h)**) requested in writing by Purchaser to Seller not less than three (3) Business Days before the Closing Date signed by each such officer or representative.

(y) A fully-paid (by Sellers, rather than the Company) directors and officers liability insurance policy in form and content reasonably acceptable to Three E and Lentz, pursuant to which Lentz and Three E will be provided coverage for their activities on behalf of the Partnership for the period prior to the Closing Date.

(z) Any and all other documents Seller is required to deliver pursuant to the provisions of this Agreement.

14. Intentionally Omitted.

15. Deliveries by Purchaser at Closing. At the Closing, Purchaser shall deliver the following to Seller:

(a) The Cash Portion of the Purchase Price.

(b) Documentation establishing to Seller’ s reasonable satisfaction the due authorization of Purchaser’ s acquisition of the Partnership Interests and the delivery of the documents required to be delivered by Purchaser pursuant to this Agreement.

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(c) Documentation establishing to Seller' s reasonable satisfaction the due authorization of Guarantor' s execution and performance of all of Guarantor' s obligations under this Agreement and the Deferred Payment Agreements.

(d) The Deferred Payment Agreements, duly executed by Purchaser.

(e) The Harmony License duly executed by the Company.

(f) The Lentz Employment Agreement and other employment agreements, duly executed by the Company and Purchaser.

(g) The Veterinary Restriction Agreement, duly executed by the Company

(h) Any and all other documents Purchaser or Guarantor is required to deliver pursuant to the provisions of this Agreement.

Conditions to Closing Obligations.

(a) Notwithstanding anything to the contrary contained herein, the obligation of Seller to consummate the sale, transfer and assignment of the Partnership Interests and the other transactions contemplated by this Agreement is expressly conditioned upon the fulfillment by and as of the time of the Closing of each of the conditions listed below, provided that Seller, at its election, evidenced by written notice duly executed by each of Three E and AJG and delivered to Purchaser at or prior to the Closing, may waive any of such conditions:

(i) Each of Guarantor and Purchaser shall have executed and delivered to Three E, AJG and Lentz, respectively, all documents specified in **Section 15**, which are deliverable to each such respective party, Purchaser shall have paid the Purchase Price and each of Purchaser or Guarantor, as the case may be, shall have taken or caused to be taken all of the other material action required of such party in this Agreement.

(ii) All representations and warranties made by Purchaser in this Agreement shall be true and correct in all material respects as of the date of the Closing.

(iii) No suit, proceeding, investigation or other action shall be instituted and pending on the Closing Date against the Company or either Seller which seeks to enjoin or otherwise impair the consummation of the transactions contemplated by this Agreement.

(iv) The waiting period under the HSR Act shall have expired.

(v) Guarantor shall have provided to Three E, Lentz and AJG such financial information and other supporting documentation reasonably required by any of Three E, Lentz or AJG to confirm the financial ability of Guarantor to fully satisfy any obligations it has or may have pursuant to this Agreement and the Deferred Payment Agreements.

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(b) Notwithstanding anything to the contrary contained herein, the obligation of AJG to consummate the sale, transfer and assignment of the Partnership Interests and the other transactions contemplated by this Agreement is expressly conditioned upon the receipt by AJG of written documentation establishing to AJG' s reasonable satisfaction that, effective with the Closing on the Closing Date, (i) AJG shall be fully and completely released from any guarantee of any indebtedness of the Company or any Company Subsidiary or indebtedness to which the Property will remain subject, following the Closing, other than with respect to the Bond Indebtedness, and (ii) AJG shall be entitled to the prompt return of all collateral or other security provided by AJG or any of its Affiliates with respect to, or in connection with any such indebtedness other than with respect to the Bond Indebtedness. The parties agree that the transactions contemplated by this Agreement shall not be consummated unless the condition precedent in this **Section 16(b)** shall be satisfied or waived by AJG in writing.

(c) Notwithstanding anything to the contrary contained herein and subject to the provisions set forth below, the obligation of Purchaser to consummate the sale, transfer and assignment of the Partnership Interests and the other transactions contemplated by this Agreement is expressly conditioned upon the fulfillment by and as of the time of the Closing of each of the conditions listed below, provided that Purchaser, at its election, evidenced by written notice delivered to Seller at or prior to the Closing, may waive all or any of such conditions:

(i) Seller shall have executed and delivered to Purchaser all of the documents, and shall have taken or caused to be taken all of the other material action required of Seller under this Agreement.

(ii) All representations and warranties made by Seller in this Agreement shall be true and correct in all material respects when made and, subject to the following, as of the Closing Date. Subsequent to the date hereof, to and including the Closing Date, Seller shall have the right to amend the Schedules hereto to reflect the operations of the Company and each Company Subsidiary in the normal course of business between the date hereof and the Closing Date. No such amendment shall have the effect of correcting or remedying any breach of representation or warranty made by Seller on the date of this Agreement. Purchaser shall otherwise be obligated to close. Purchaser shall be entitled to make a claim based on such failure, subject to and in accordance with the applicable indemnification provisions of this Agreement.

(iii) No suit, proceeding, investigation or other action shall be instituted and pending on the Closing Date against Purchaser which seeks to enjoin or otherwise impair the consummation of the transactions contemplated by this Agreement.

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(iv) The waiting period under the HSR Act shall have expired.

(v) The Title Company shall be willing to insure title to the Property pursuant to an ALTA 1992 Owner' s policy of Title Insurance in the amount of the Purchase Price at regular rates and without additional premium, subject only to the Permitted Exceptions and other standard exceptions including survey exceptions and as otherwise provided for in this Agreement (the "Title Policy").

Anything in this Agreement to the contrary notwithstanding, Purchaser shall be obligated to close unless on the Closing Date, the aggregate of the failures of Seller to take any required action hereunder, and the effect of all breaches of representation and warranty by Seller hereunder, and any failure to occur of any condition to Closing specified in **Section 16(c)** above, taken together, are material and adverse to the Property or the business of the Company and the Company Subsidiaries, taken as a whole. If Purchaser shall fail or refuse to close, as aforesaid, then Seller, subject to the following sentence, shall be entitled to the payment (as provided in **Section 24** hereof) of the Downpayment by the Escrow Agent as liquidated damages and as Seller' s sole and exclusive remedy, it being understood and agreed that Seller shall not have a right of specific performance against Purchaser. If there shall be a dispute between Purchaser and Seller as to whether Purchaser is or is not obligated to close the purchase of Partnership Interests pursuant to the test set forth above in this paragraph, then such dispute shall be submitted by any Party to the Arbitrator for decision, which decision shall be final and binding upon the Parties without further recourse. If the Arbitrator shall decide in favor of Purchaser then it shall be entitled to the return of the Downpayment as liquidated damages and as its sole and exclusive remedy.

Title.

(a) Upon Closing, the Company shall hold good marketable and insurable feehold title to the Property subject only to the "Permitted Exceptions" (as defined below). Seller shall eliminate defects, objections or exceptions disclosed in any title commitment or continuation thereof obtained by Purchaser from the Title Company other than Permitted Exceptions, including without limitation: (i) mortgages or other liens other than mortgages securing Assumed Indebtedness which Purchaser shall have elected to have remain on the Property after Closing and for which Purchaser shall have received a credit against the Purchase Price as provided in **Section 3**, (ii) judgments against the Company or other defects or objections to title caused by Seller or the Company which are not Permitted Exceptions or (iii) liens and encumbrances created by the act or omission of Seller or the Company after the date hereof; other than immaterial ones created in the ordinary course of the Company' s business. Seller, in its discretion, may adjourn the Closing for up to thirty (30) days in order to eliminate unacceptable defects, objections or exceptions. If Seller is unable to eliminate all unacceptable defects, objections or exceptions in accordance with the terms of this Agreement on or before such adjourned date for the Closing, Purchaser may, in addition to any additional rights and remedies which it may have hereunder, or at law or in equity, elect by written notice

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given to Seller within five (5) days after such adjourned date for the Closing, either to (1) terminate this Agreement if the aggregate cost to cure or eliminate all such defects, objections or exceptions shall exceed One Million Dollars ($1,000,000), in which event the provisions of **Section 17(d)** shall apply, or (2) close hereunder notwithstanding that the Company' s title is subject to such defects, objections or exceptions and proceed to make a claim against Seller; provided, however, that anything in this Agreement to the contrary notwithstanding, in the event the aggregate cost to cure or eliminate all such defects, objections or exceptions (other than Permitted Exceptions and defects, objections or exceptions of the types specified in clauses (i), (ii) and (iii) above, all of which Seller shall be obligated to eliminate) shall exceed One Million Dollars ($1,000,000) then Seller (or either of them) shall have the unrestricted right to terminate this Agreement by sending written notice of termination to the Purchaser, unless Purchaser shall accept title subject to such defect, objection or exception in which case it shall receive at Closing a credit against the Purchase Price in the amount of One Million Dollars ($1,000,000), failing which Purchaser' s sole and exclusive remedy hereunder shall be the return of the Downpayment. In the event Purchaser shall fail to timely give the aforesaid written notice to Seller, then Purchaser shall be deemed, without further notice or action of any kind by Seller, to have elected to close hereunder pursuant to clause (2) of the immediately preceding sentence.

(b) If a search of the title discloses judgments, bankruptcies or other returns against other persons having names the same as or similar to that of the Company, Seller, upon request by Purchaser or the Title Company, shall deliver to Purchaser or the Title Company affidavits showing that such judgments, bankruptcies or other returns are not against the Company.

(c) If any instruments, affidavits, documentary evidence or deposits are required by the Title Company in order to eliminate an exception for a defect in or objection to title (including, without limitation, standard printed exceptions), the following shall apply:

(i) all such instruments and affidavits shall be in such form and shall contain such terms and conditions as may be reasonably required by the Title Company to cause it to eliminate an exception from its title policy for such defect in or objection or exception to title;

(ii) any such documentary evidence shall be delivered to, and any such deposits shall be made with, the Title Company;

(iii) Seller agrees to execute, acknowledge and deliver any such instrument and affidavit, to deliver any such documentary evidence, and to make any such deposit, in and to the extent necessary to release or discharge items of the types set forth in clauses (i) through (iii) of **Section 17(a);** and

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(iv) Purchaser agrees to promptly execute, acknowledge and deliver any instrument, document or affidavit reasonably requested by the Title Company.

(d) If Seller fails or is unable to perform its obligations in accordance with the terms of this **Section 17** and Purchaser elects to terminate this Agreement as a result thereof, the Escrow Agent shall promptly cause the Downpayment to be returned to Purchaser in accordance with **Section 24** below as Purchaser' s sole and exclusive remedy. Upon the making of such refund and payment, this Agreement shall terminate and no party to this Agreement shall have any further rights or obligations hereunder except under **Sections 21, 22** and **28**, which shall survive such termination.

Seller' s Remedies. Subject to the provisions below, if Purchaser shall fail to close pursuant to and in accordance with the terms of this Agreement (Seller having performed its obligations hereunder in all material respects), then Seller' s sole remedy shall be to direct the Escrow Agent to deliver the Downpayment to Seller in accordance with **Section 24** below as liquidated damages for all loss, damage and expense suffered by Seller, and thereupon this Agreement shall terminate and the Parties shall have no further rights or obligations hereunder except under **Sections 20(a)(iv), 20(d)**, **20(e**), **21**, **22** and **27**, which shall survive such termination; provided, however that all indemnification obligations of Purchaser which arise pursuant to the terms hereof (those being solely pursuant to **Section 20** hereof) shall survive any termination of this Agreement and shall not be limited in any manner pursuant to this Section or any other provision hereof.

Purchaser' s Remedies. If Seller shall fail to close pursuant to and in accordance with this Agreement, (each of Purchaser and Guarantor having performed its respective obligations hereunder in all material respects), then Purchaser shall have the right (in addition to any other or additional right herein provided) to either (i) terminate this Agreement and receive the prompt return of the Downpayment, whereupon neither party shall have any rights or obligations under the Agreement except under **Sections 8**, **21**, **22** and **28**, which shall survive such termination, or (ii) bring an equitable action for specific performance against Seller to compel assignment and transfer of the Partnership Interests in accordance with the provisions of this Agreement.

Purchaser' s Inspection; Due Diligence Period.

(a) The Company hereby grants to Purchaser and to Purchaser' s representatives a license to enter upon all parts of the Property and to perform such inspections (including, without limitation, environmental inspections), studies and surveys of the Property and the Company' s operations there, as Purchaser deems necessary or appropriate in Purchaser' s sole, absolute and subjective discretion during the Due Diligence Period. In connection therewith, Purchaser and Seller shall comply with the following terms and conditions:

(i) Purchaser shall give Seller and the Company reasonable advance notice of any such inspection; all such inspections shall take place during normal business hours of Seller and the Company; each of Seller and the Company shall

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instruct and cause its personnel to cooperate with Purchaser and its representatives with respect to providing access to books, records, facilities and the Property, but no Company employee or any employee of Three or AJG shall in any manner be required to actively participate in any inspection or other due diligence activities of Purchaser;

(ii) Prior to Purchaser or Purchaser' s representatives performing any inspections or tests of the Property, Purchaser shall name, or cause the relevant Purchaser' s representative to name each of the Company, Three E and AJG as an insured party on a commercial general liability insurance policy with coverage not less than a combined, single limit of One Million Dollars (U.S. $1,000,000) per occurrence and shall provide the Company with a certificate of insurance evidencing such coverage;

(iii) Purchaser shall exercise reasonable efforts to minimize interference with the activity of the Company and each of the Company Subsidiaries, its employees, agents, contractors, developers of individual sites and others at the Property;

(iv) Purchaser, at its sole cost and expense, promptly shall repair, replace or restore to its preinspection condition any physical damage to the Property or any other assets of the Company or any Company Subsidiary caused by its or its representatives' entry thereon or contact therewith or handling thereof to perform such inspection and Purchaser' s obligations under this **Section 20** shall not in any manner be limited to the Downpayment in the event this Agreement shall be terminated;

(v) Any such inspections shall be at Purchaser' s sole cost and expense;

(vi) Seller or its representative may be present at all such inspections or reviews and at any discussion with a party identified by Purchaser as set forth below in this **Section 20(a)(vi);** Purchaser and Purchaser' s representatives may have discussions with any Tenants, Pending Unit/Site Purchasers, Underlying Obligees, or representatives of any of them; each of the Company and Seller shall make itself available, and shall request its vendors, developers, contractors and others to be available as Purchaser shall reasonably request, to meet with Purchaser and shall cooperate with Purchaser in all respects in connection with arranging such discussions, anything in **Section 34** below to the contrary notwithstanding; and

(vii) Purchaser shall, in conducting such review, exercise reasonable efforts to minimize interference with the operation of the Property or with the activity of each of the Company, each Company Subsidiary and Seller or any employees or agents of any of them .

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(b) Seller shall, promptly after the date hereof, make the Books and Records available to Purchaser and shall thereafter make available to Purchaser any additional Books or Records subsequently generated, all at Purchaser' s cost and expense. During the Due Diligence Period and thereafter until Closing, Purchaser and Purchaser' s representatives shall have the right to review the Books and Records at the Company' s offices or at another location mutually agreed upon by Seller and Purchaser. Without limiting the foregoing, Seller hereby represents that it has made available to Purchaser, true and complete copies of all of the items listed on **Schedule 20** (which shall be prepared by Seller and delivered to Purchaser within five (5) Business Days after the date hereof and shall be attached hereto) which are in existence on the date hereof, all Leases, all Building Contracts Service Agreements, Warranties, all Underlying Obligations, and all Permitted Encumbrances and Seller hereby agrees to promptly make available to Purchaser any updated operating statements and Rent Rolls, to the extent changed after the date hereof, as applicable from the Rent Roll attached hereto, and any other material documents relating to the business of Company or any Company Subsidiary, or the Property first discovered by Seller after the date of this Agreement.

(c) Purchaser has had access to the Property and all portions thereof as well as the Books and Records. Purchaser shall promptly complete due diligence review process as it shall desire in connection with the Property, the Books and Records and the activities of the Company, the Company Subsidiaries, Seller and its Affiliates. The period from the date hereof until March 28, 2005 is herein referred to as the "Due Diligence Period". During the Due Diligence Period, Purchaser shall have the absolute right, in its sole discretion, for any reason or no reason at all, to cancel and terminate this Agreement in its entirety. If Purchaser elects to so cancel and terminate this Agreement, Purchaser shall on or before 12:00 Midnight (EST) of the last day of the Due Diligence Period deliver to Seller written notice of Purchaser' s election to terminate this Agreement which termination shall be effective upon the giving of such notice. Subject to the provisions of **Section 3(d)** hereof, within five (5) Business Days after Seller' s receipt of Purchaser' s termination notice Three E shall cause the Escrow Agent to refund the Downpayment to Purchaser minus the amount, if any, for which Purchaser is liable under **Section 20(a)(iv)** above, it being understood and agreed by Purchaser that such liability is not limited to the Downpayment. If Purchaser does not deliver to Seller a timely termination notice, as aforesaid, then Purchaser shall be deemed to have approved the results of its due diligence examination, this Agreement shall not terminate, the Downpayment shall be retained by the Escrow Agent subject to the terms of this Agreement, and Purchaser shall have no further rights of termination other than as a result of a failure of Purchaser' s conditions precedent to Closing which permit Purchaser to terminate this Agreement.

(d) Except to the extent arising out of the gross negligence or willful misconduct of any of the Company, Company Subsidiaries, or Seller or any of their respective officers, directors, shareholders and employees, Purchaser shall indemnify, defend, and hold each of Three E, Lentz, AJG, the Company and each Company Subsidiary, and their respective managers, officers, directors, employees, agents, shareholders, partners, members, and Affiliates of any of them, and their respective heirs,

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executors, administrators, personal representatives, legatees, successors and assigns (the "Seller Indemnified Parties") harmless from and against all liabilities, damages, losses, fines, penalties, fees, costs and expenses whatsoever including without limitation, reasonable attorneys' fees, paralegal fees, accounting fees, expert witness fees, proof of claim expenses, court costs (including any of the foregoing which arise from the enforcement of this indemnity) (collectively the "Damages"), as a result of, relating to, or arising in connection with (i) claims for personal injury, wrongful death or property damage against any of the Seller, Indemnified Parties, or the Property, (ii) claims of violation of any law, regulation, order, rule, permit, requirement or policy of any governmental body or agency; or (iii) creation of any lien or encumbrance upon any portion of the Property, in each instance to the extent caused by Purchaser or Purchaser' s representatives' inspection or due diligence examination of the Property (as distinct from being caused by the pre-existing condition of the Property). Anything to the contrary in the preceding portion of this subsection (d) notwithstanding, any claim under this subsection (d) shall survive Closing only for a period of eighteen (18) months from the Closing Date. Any such claim not made (with reasonably specificity) by Seller within such period shall be deemed waived and extinguished.

Indemnification Procedure.

(e) Notice of Claims. If any of the Seller Indemnified Parties or any of the Purchaser Indemnified Parties (an "Indemnified Party") believes that it is entitled to indemnification under this Agreement, such Indemnified Party shall so notify the Party from whom indemnification is being claimed (the "Indemnifying Party") as promptly as practicable, with reasonable particularity in light of the circumstances then existing, but in any event within sixty (60) days of the date the Indemnified Party obtained actual knowledge. If any claim is instituted by or against a third party with respect to which any Indemnified Party intends to claim indemnification under this Agreement, such Indemnified Party shall as promptly as practicable, but in any event within sixty (60) days of the date the Indemnified Party obtained actual knowledge, notify the Indemnifying Party of such claim. The notice provided by the Indemnified Party to the Indemnifying Party shall describe the claim (the "Asserted Liability") in reasonable detail and shall indicate the amount (or an estimate) of the losses or damages that have been or may be suffered by the Indemnified Party. The failure of an Indemnified Party to give any notice required by this **Section 21(a)** shall not affect any of the Indemnified Party' s rights under this Agreement or otherwise except and to the extent that such failure is prejudicial to the rights or obligations of the Indemnifying Party.

(f) If any action is brought by a third party against any Indemnified Party, the Indemnifying Party shall be entitled, at its own expense: (a) to participate in such action and (b) upon notice to the Indemnified Party made at any time during the course of any such claim, suit, action or proceeding, to assume the defense thereof; provided, that (i) the Indemnifying Party' s counsel is reasonably satisfactory to the Indemnified Party, (ii) the Indemnifying Party shall keep the Indemnified Party informed, on a regular basis, of the status of such claim, suit, action or proceeding and (iii) the Indemnifying Party shall consult with the Indemnified Party upon the Indemnified Party' s reasonable request

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for such consultation from time to time with respect to such claim, suit, action or proceeding. The Indemnified Party shall cooperate with respect to any such participation, defense, settlement or compromise. The Indemnified Party shall have the right to employ its own counsel in any such case, but the fees and expenses of the Indemnified Party' s counsel shall be at the sole expense of the Indemnified Party unless: (i) the Indemnifying Party shall have authorized in writing employment of such counsel at the expense of the Indemnifying Party; (ii) the Indemnifying Party shall not have employed counsel reasonably satisfactory to the Indemnified Party to defend such action within thirty (30) days after the Indemnifying Party received notice of the Asserted Liability; (iii) the Indemnified Party shall have reasonably determined that the Indemnifying Party is not diligently pursuing such action or is not keeping the Indemnified Party reasonably informed of the status of such action; or (iv) the Indemnified Party shall have reasonably concluded that a conflict of interest exists between the Indemnified Party and the Indemnifying Party, in any of which events the fees and expenses of one additional counsel shall be borne by the Indemnifying Party. The Indemnifying Party shall not settle or compromise any action or consent to the entry of a judgment without the written consent of the Indemnified Party (which shall not be unreasonably withheld) that: (a) does not provide for the claimant to give an unconditional release to the Indemnified Party in respect of the Asserted Liability; (b) involves relief other than monetary damages; or (c) places restrictions or conditions on the operation of the business of the Indemnified Party or any of its Affiliates. The Indemnifying Party shall not be liable for any settlement of any claim or action effected without its written consent. After payment of any Asserted Liability by the Indemnifying Party, the Indemnified Party, if requested by the Indemnifying Party, shall assign to the Indemnifying Party all rights the Indemnified Party may have against any applicable responsible Person in respect of the Asserted Liability. If the Indemnifying Party chooses to defend any Asserted Liability, the Indemnified Party shall make available to the Indemnifying Party any books, records or other documents within its control that are necessary or appropriate for such defense.

Broker. Each party represents and warrants to the other that it has not had any communications, contacts or dealings regarding the subject matter of the transaction provided for in this Agreement, through any real estate broker or other person who, on the basis thereof, could be entitled to a finder' s fee or commission in connection with this transaction. Seller and Purchaser hereby indemnify and agree to defend each other against any and all claims, demands, costs, expenses (including, without limitation, attorneys' fees and disbursements) or causes of action arising out of a breach of their respective representations, warranties and agreements contained in this Section. The representations, warranties and obligations contained in this Section shall survive the Closing, or if the Closing does not occur, the termination of this Agreement.

Casualty; Condemnation.

(g) Purchaser shall purchase the Partnership Interests for the full Purchase Price as required by the terms hereof, without regard to the occurrence or effect of any casualty, damage to or destruction of the Property or any Improvements thereon or condemnation of any portion of the Property, provided that (i) the cost to repair any such damage or destruction, or the diminution in the value of the remaining Property as a

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result of a partial condemnation, as reasonably determined by Seller, does not exceed One Million Dollars ($1,000,000), and (ii) upon the Closing either the Company shall, at Closing, retain on hand the insurance proceeds or condemnation award collected by the Company plus an amount equal to any insurance deductible and uninsured loss or else there shall be a credit against the Purchase Price equal to the amount of any insurance proceeds or condemnation awards collected by Seller as a result thereof, plus the amount of any insurance deductible and uninsured loss. At Closing, Seller shall assign to Purchaser the right to any such proceeds or awards which shall not have been collected as of the Closing.

(h) If, prior to the Closing Date, the Property (or any portion thereof) is damaged or destroyed or taken by eminent domain or condemnation, and the amount of the damage or destruction or condemnation as referred to in **Section 23(a)** above, as reasonably determined by Seller, exceeds One Million Dollars ($1,000,000), then Purchaser may, at its option, to be exercised by written notice to Seller within ten (10) days after Seller' s notice to Purchaser of the occurrence thereof, elect to either terminate this Agreement or consummate the purchase for the full Purchase Price specified herein. If Purchaser so elects to terminate this Agreement, then this Agreement shall terminate and the Downpayment shall be returned to Purchaser and neither party shall have any further rights or obligations hereunder. If Purchaser does not so elect to terminate, then upon the Closing, either the Company shall, at Closing, retain on hand the insurance proceeds or condemnation due and collected by the Company plus an amount equal to any insurance deductible and uninsured loss or else Purchaser shall receive a credit against the Purchase Price equal to the amount of any insurance proceeds or condemnation awards collected by Seller as a result thereof, plus the amount of any insurance deductible and uninsured loss. Following Closing, the Company shall retain the right to any such proceeds or awards which shall not have been collected as of the Closing.

(i) The provisions of this **Section 23** supersede the provisions of any applicable statutory or decisional law with respect to the subject matter of this **Section 23**.

Escrow. The Downpayment and any interest earned thereon, shall be held by the Escrow Agent, in escrow, and disposed of only in accordance with the following provisions:

(j) If the Closing under this Agreement occurs, the Escrow Agent shall, at Closing, deliver the Downpayment to Purchaser.

(k) If for any reason the Closing does not occur and either party makes a demand upon the Escrow Agent for delivery of the Downpayment and any interest earned thereon, the Escrow Agent shall give notice of such demand to the other party. If the Escrow Agent does not receive an objection from the other party to the action so demanded within five (5) Business Days after the giving of such notice, the Escrow Agent is hereby authorized to take such action. If the Escrow Agent does receive such objection within such period or if for any other reason the Escrow Agent in good faith

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shall elect not to make such payment, or take such action, the Escrow Agent shall continue to hold the Downpayment and any interest earned thereon, until otherwise directed by instructions signed by both Sellers and Purchaser or a final judgment of a court. However, the Escrow Agent shall have the right in the event of a dispute to deposit the Downpayment and all interest thereon with a court of competent jurisdiction. The Escrow Agent shall give notice of any such deposit to Seller and Purchaser. Upon such deposit, the Escrow Agent shall be relieved and discharged of all further obligations and responsibilities hereunder.

(l) The parties acknowledge that the Escrow Agent is acting solely as a stakeholder at their request and for their convenience that the Escrow Agent shall not be deemed to be acting on behalf of any particular party, and that the Escrow Agent shall not be liable to any of the parties for any act or omission on its part unless taken or suffered in bad faith, in willful disregard of this Agreement or constituting its gross negligence. Seller and Purchaser shall jointly and severally indemnify and hold the Escrow Agent harmless from and against all costs, claims and expenses, including attorneys' fees, incurred in connection with the performance of the Escrow Agent's duties hereunder, except to the extent same results from actions or omissions taken or suffered by the Escrow Agent in bad faith, in willful disregard of this Agreement or constituting gross negligence of the Escrow Agent. Any fees of the Escrow Agent shall be borne one-half (1/2) by Purchaser and one-half (1/2) by Seller.

Additional Covenants.

(m) During the period beginning on the date hereof and ending on the Closing Date or the date of termination of this Agreement without Closing occurring, Three E shall cause the Company to conduct its activities, operations and affairs as specified in **Section 12** hereof. Three E shall not and shall cause the Company to not do otherwise, without approval of Purchaser. Seller shall, prior to the Company's or a Company Subsidiary's taking any action which is not permitted without Purchaser's consent under this **Section 25**, give written notice thereof to Purchaser, describing in detail the action which it proposes to take, and consult with Purchaser with regard thereto and not take such proposed action unless Purchaser shall have approved; provided, however, that if Purchaser shall not have disapproved of such action in writing within three (3) Business Days after notice thereof, such action shall be deemed approved and authorized. Promptly after entering into documents or agreements, Seller shall deliver to Purchaser true, correct and complete copies of all documents or agreements entered into by the Company or a Company Subsidiary in connection with such action.

(n) Between the date hereof and the Closing, Three E shall cause the Company to maintain in effect the Company's Casualty Insurance. If Purchaser shall desire to have the Company's Casualty Insurance continue beyond the Closing Date, Purchaser shall give written notice thereof to Three E not less than five (5) Business Days before the Closing Date and Three E, without any cost to Seller, shall cooperate to request such continuation of coverage.

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(o) During the Due Diligence Period, Purchaser and its representatives shall be entitled to arrange for and meet with any Tenant, Underlying Obligee and other person having dealings or a relationship with Seller, the Company or the Company Subsidiaries, provided that Seller and the Company shall be given reasonable prior notice of any proposed such meeting and any rescheduled or adjournment date thereof, and shall be entitled to accompany and, upon request by Purchaser, shall accompany Purchaser or its representative during any such meeting.

(p) Between the date of this Agreement and the Closing, Three E shall cause the Company to (i) maintain the Property in the same condition and state of repair as exists on the date hereof, reasonable wear and tear and normal maintenance, repair and replacement excepted, (ii) observe and perform all material obligations to be observed and performed by the Company under the terms of any Sale Contracts, Underlying Obligations, Leases, service contracts, mortgages and loan documents and (iii) otherwise operate the Property in materially the same manner as before the making of this Agreement. Seller shall not and shall not permit the Company, the Company Subsidiaries or the Seller' s Parents to remove or transfer to any third party any real or personal, tangible or intangible property included in the term "Property" after the date hereof other than in the normal course of business and consistent with past practices.

(q) In the event that the Company, any Company Subsidiary, Purchaser or any Affiliate of Purchaser, subsequent to the Closing Date, shall receive any rebate, refund or payment of any claim including without limitation, any refund of real estate taxes or other assessments or impositions which were paid under protest or were otherwise challenged or contested by the Company or any Company Subsidiary and which relates to any period prior to the Closing Date, then Seller shall not be entitled to any portion thereof.

(r) Seller shall prepare and timely file, or cause to be prepared and timely filed, all income Tax returns and related filings in respect of the Company and Company Subsidiaries for any taxable period ending on or before the Closing Date. Each of Three E as to itself and AJG as to itself shall timely pay (except to the extent such Tax liability is timely contested to the relevant taxing authority in good faith) its own share of all income Taxes to the relevant taxing authority all Taxes due in connection with any such tax returns.

(s) Purchaser shall prepare and or cause to be prepared, all income Tax returns in respect of the Company and the Company Subsidiaries for any Tax period ending after the Closing Date which begins before the Closing Date (a "Straddle Period"). In order to permit the accurate and timely filing of such returns, Seller shall deliver to Purchaser, all books and records necessary for the preparation of any Straddle Period returns. Purchaser shall provide Seller with the completed Straddle Period tax returns (and such additional information regarding such Straddle Period tax returns as may reasonably be requested by Seller). Seller shall notify Purchaser of any proposed amendments to any such return within ten (10) days of its receipt of the return. Purchaser shall sign and file such returns in a timely fashion. Purchaser shall be responsible to

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make any payment required with the filing of any Straddle Period return (except to the extent such Tax liability is timely contested to the relevant Tax authority in good faith). Each of Three E, as to itself, and AJG as to itself shall, within ten (10) days after demand, reimburse Purchaser for its portion of any Tax for that portion of the Straddle Period which ends on or before the Closing Date.

(t) Purchaser shall, or shall cause the Company and each of the Company Subsidiaries to, employ all of the persons who were employees of the Company immediately prior to Closing of the Company and each Subsidiary for a period of twelve (12) months immediately succeeding the Closing Date on terms of employment, including title, duties, base compensation, incentive compensation, if any, and benefits, which are, in the case of each employee, no less favorable than the terms of employment which are, in effect for such employee immediately prior to the Closing, subject to the right of the Company to dismiss any such employee for cause the standards for which are set forth on **Schedule 26(h)** which is attached hereto, provided however, that anything herein to the contrary notwithstanding, the standard for any dismissal for cause of Lentz shall be such standard as is set forth in Lentz' s Employment Agreement with the Company;

(u) Until such time as 2500 lots shall be sold and closed at the Property, Purchaser shall continue to consult with the Board of the Arthur J. Gallagher Neighborhood School in Harmony, Florida (the "School") respecting the funding needs of the school, and Purchaser shall continue to provide such funding needs (up to an aggregate sum of Two Hundred and Fifty Thousand Dollars ($250,000)) consistent with the manner in which funding was provided prior to closing.

Termination and Exclusivity. In addition to the termination rights of the Parties set forth above, this Agreement may be terminated as follows:

(v) By either Purchaser, Three E or AJG if the Closing has not been consummated on or before April 20, 2005 provided that such failure has not been caused by any act or omission of the party seeking termination, and further provided that such failure is not caused by the failure of the waiting period under the HSR Act to expire.

(w) From the date hereof until the earlier to occur of the termination of this Agreement or the Closing Date, neither Three E, Lentz, AJG nor the Company shall engage in discussions with any third party respecting the possible purchase and sale of Partnership Interests or, except as contemplated in this Agreement, any of the Property of the Company, and they shall not, except in connection with such possible sales contemplated hereby, make available to said third party the same level of due diligence investigation and review as is provided for to Purchaser herein.

Notices. All notices, elections, consents, demands, objections, requests or other communications (including any notice of change of address) which Seller, Purchaser or Escrow Agent may be required or desire to give pursuant to, under or by virtue of this Agreement must be in writing and sent by first class U.S. certified or registered mail, return receipt requested, with postage

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prepaid, or by Federal Express or other nationally recognized overnight courier service with receipt signed by or on behalf of the recipient, or by hand delivery by messenger, addressed as follows:

If to Seller:

Three E Corporation
3500 Harmony Square Drive West
Harmony, Florida 34773
Attn: Mr. James Lentz, President

with a copy to Three E' s counsel:

Baker & Hostetler, LLP
200 South Orange Avenue
Sun Trust Center, Suite 2300
Orlando, Florida 32802
Attn: Kenneth C. Wright, Esq.

and

AJG Financial Services, Inc.
The Gallagher Centre
Two Pierce Place
Itasca, Illinois 60143-3141
Attn: Kerry Abbott, Esq.

with a copy to AJG' s counsel:

DLA Piper Rudnick Gray Cary US LLP
203 N. LaSalle Street
Suite 1900
Chicago, IL 60601-1293
Attn: Stephen A. Landsman, Esq.

If to the Company prior to Closing (all notices given to the Company shall be deemed given to the Company Subsidiaries)

Birchwood Acres Limited Partnership LLLP
3500 Harmony Square Drive West
Harmony, Florida 34773
Attn: Mr. James Lentz

With a copy to Company' s Counsel:

Baker & Hostetler, LLP

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200 South Orange Avenue
Sun Trust Center, Suite 2300
Orlando, Florida 32802
Attn: Kenneth C. Wright, Esq.

and

AJG Financial Services, Inc.
The Gallagher Centre
Two Pierce Place
Itasca, Illinois 60143-3141
Attn: Kerry Abbott, Esq.

with a copy to AJG' s counsel:

DLA Piper Rudnick Gray Cary US LLP
203 N. LaSalle Street
Suite 1900
Chicago, IL 60601-1293
Attn: Stephen A. Landsman, Esq.

If to the Company after Closing:

Birchwood Acres LLP
c/o Starwood Capital Group Global, L.L.C.
320 Interstate North Parkway, Suite 220
Atlanta, Georgia 30339
Attn: Robert Geimer

If to Purchaser or Guarantor:

SOF-HARMONY, L.L.C.
c/o Starwood Capital Group Global, L.L.C.
320 Interstate North Parkway, Suite 220
Atlanta, Georgia 30339
Attn: Robert Geimer

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with a copy to:

Starwood Capital Group, L.L.C.
591 West Putnam Avenue
Greenwich, Connecticut 06830
Attention: Merrick Kleeman

with a copy to Purchaser' s consultant:

Lochmere Development Group, Inc.
920 Harbor Bay Drive
Tampa, Florida 33602
Attn: Robert D. Evans, President

with a copy to Purchaser' s counsel:

Rinaldi Finkelstein & Franklin LLC
591 West Putnam Avenue
Greenwich, Connecticut 06830
Attn: Eric Franklin, Esq.

If to Escrow Agent:

First American Title Insurance Company
633 Third Avenue
New York, NY 10017
Attn: Philip Salomon, Esq.

Each of Seller, Purchaser and the Company may change the person to whose attention notices and other communications to it shall be addressed or change its address for notices and other communications hereunder by a notice given to the others in the manner provided in this Section. A notice or other communication sent in compliance with the provisions of this Section shall be effective on the day delivered or if earlier, the first day of failure or refusal to accept delivery of same as shown on the return receipt if sent by U.S. mail, or on the day delivered, if sent by Federal Express or other nationally recognized overnight courier service; or on the date delivered if hand delivered by messenger. Any notice required or permitted to be given by Seller or Purchaser under this Agreement may be given by such party' s counsel named above.

Miscellaneous.

(x) Except as is otherwise provided for herein, this Agreement embodies and constitutes the entire understanding between the parties with respect to the transactions contemplated herein, and all prior agreements, understandings, representations and statements, oral or written, are merged into this Agreement. Neither this Agreement nor any provision hereof may be waived, modified, amended, discharged or terminated except by an instrument signed by the party against whom the enforcement of such waiver, modification, amendment, discharge or termination is sought, and then only to the extent set forth in such instrument.

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(y) This Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, successors or legal representatives and permitted assigns. Purchaser shall have the right, exercisable by notice to Seller, to assign all of its right, title and interest in and to this Agreement and the Downpayment to an Affiliate or Affiliates of Purchaser, or designate one or more Affiliates of Purchaser to whom one or more portions of the Partnership Interests shall be assigned by Seller; provided, however, that no such assignment shall release or relieve Purchaser or Guarantor from any obligations hereunder.

(z) As used in this Agreement, the masculine shall include the feminine and neuter, the singular shall include the plural and the plural shall include the singular, as the context may require.

(aa) No waiver by either party of any failure or refusal by the other party to comply with its obligations shall be deemed a waiver of any other or subsequent failure or refusal so to comply.

(bb) If any term or provision of this Agreement or the application thereof to any person or circumstance shall, to any extent, be invalid or unenforceable, the remainder of this Agreement, or the application of such term or provision to persons or circumstances other than those as to which it is held invalid or unenforceable, shall not be affected thereby, and each term and provision of this Agreement shall be valid and be enforced to the fullest extent permitted by law.

(cc) This Agreement shall be governed by, and enforced in accordance with, the laws of the State of Florida. Seller and Purchaser waive the right to trial by jury in any action, proceeding or counterclaim in any matter relating to this Agreement. Seller and Purchaser each hereby irrevocably and unconditionally submits to the jurisdiction of any Florida State Court in Osceola County, Florida or Federal Court of the United States of America sitting in Orlando, Florida, and any appellate court from any such court, in any suit, action or proceeding arising out of or relating to this Agreement, or for recognition or enforcement of any judgment thereon, and each hereby irrevocably and unconditionally agrees that all claims in respect of any such suit, action or proceeding shall be heard and determined in such courts. Seller and Purchaser each agrees that a final judgment in any such suit, action or proceeding shall be conclusive and may be enforced in other jurisdictions by suit on the judgment or in any other manner provided by law. Seller and Purchaser each hereby irrevocably and unconditionally waives, to the fullest extent it may legally and effectively do so, any objection which it may now or hereafter have to the laying of venue of any suit, action or proceeding arising out of or relating to this Agreement in any such court.

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(dd) Nothing in this Agreement shall benefit or be enforceable by any person or entity which is not a party hereto. There are no third party beneficiaries of this Agreement.

(ee) The captions in this Agreement are inserted for convenience of reference only and do not define, describe or limit the scope or the intent of this Agreement or of any of the provisions hereof, and shall not be considered in interpreting or construing this Agreement.

(ff) This Agreement shall not be binding or effective until executed and delivered by Seller and Purchaser.

(gg) This Agreement may be executed in counterparts, each of which shall be an original and all of which counterparts taken together shall constitute one and the same agreement.

(hh) Seller and Purchaser each will from time to time subsequent to the Closing Date, at the other' s request and sole expense but otherwise without further consideration, execute and deliver such other instruments of conveyance, assignment and transfer and take such other actions as may be reasonably requested in order to more effectively assign and transfer to and vest in Purchaser the Partnership Interests and otherwise to confirm and effectuate all of the transactions contemplated by this Agreement, provided the same does not increase the liability of the delivering party.

(ii) In connection with any litigation between the parties hereto arising out of this Agreement, the prevailing party shall be entitled to recover from the other party all costs incurred by the prevailing party (including, without limitation, reasonable attorneys' fees and disbursements, which shall be deemed to include fees on retrial, rehearing and/or appeal).

(jj) Any Party may waive in writing compliance by any other Party with respect to any of such other Party' s representations, warranties and agreements set forth in this Agreement and/or may waive in writing any of the conditions of this Agreement in its favor, provided, however, that no such waiver shall be binding upon Seller unless it is duly executed by AJG and Three E.

(kk) All press releases and other publicity and communications relating to the transactions contemplated by this Agreement (exclusive of matters relating to Purchaser' s continuing ownership of the Company after the Closing Date, and the timing and method of release thereof, shall require prior written approval of each of Purchaser, Lentz and AJG.

Conveyance of Parcels to Harmony Institute.

(ll) Seller shall, no later than the Closing Date, cause the Company to convey to Harmony Institute by special warranty deed with covenant against grantor' s acts portions of the Property consisting of two parcels of land (one on each side of US

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Highway 192/441) as depicted on the sketches attached hereto as **Schedule 29(a)** hereto aggregating approximately one hundred acres of land (herein individually referred to as a "Harmony Parcel" and collectively referred to as the "Harmony Parcels"**).** As of the date hereof, Purchaser has not yet completed its site planning in respect of portions of the Property lying between US Highway 192/441 and the respective Harmony Parcels. Purchaser shall, no later than the third (3rd) anniversary of the Closing Date, cause the Company to execute and deliver to Harmony Institute an access easement in form reasonably acceptable to Purchaser and Harmony Institute for ingress and egress between the Harmony Parcels and U.S. Highway Number 192/441, it being understood and agreed that temporary easements for such ingress and egress shall be granted to the Harmony Institute and its invitees over the areas indicated in the sketches attached as **Schedule 29(a)** hereto. Purchaser shall be entitled to select such commercially reasonable routes and areas of the Property over which such easement will run as it shall reasonably determine, which will describe by courses and distances, the easement areas of Harmony Institute and containing certain other restrictions and covenants (including a provision limiting to a period of four (4) years following Closing, Harmony Institute' s use of temporary stables on the Harmony Parcels. As soon as is reasonably practicable after the Closing Date, if not already done, Seller shall cause the Company to have the Harmony Parcels designated as separate tax lots and to not be part of any tax lot which contains any of the Property. From and after the Closing Date until such tax division shall be effectuated, the taxes allocable to the Harmony Parcels shall be allocated on a pro rata basis according to the acreage of the parcels involved. Seller and Harmony Institute shall, at their sole cost and expense and at no cost or expense to Purchaser or the Company, cause the Company to apply for and diligently pursue the receipt of all necessary governmental subdivision, permits and approvals, subdividing the Harmony Parcels from the remainder of the Property.

(mm) At Closing, Purchaser shall cause the Company to enter into an agreement with the Harmony Institute in a form reasonably acceptable to both of them (the "Veterinary Restriction Agreement"), pursuant to which the Company shall agree that for a period of ten (10) years commencing on the Closing Date, it will not establish or permit a facility to be established on the Property for the provision of veterinary services to homeowners at the Property (including without limitation, Closed Unit/Site Purchasers). However, the Company is permitted to establish an equestrian facility as an amenity to the Property. Harmony Institute shall be granted an exclusive right to establish a veterinary service facility within the Property, for a period of ten (10) years commencing on the Closing Date, provided the Harmony Institute begins such services as soon as certificates of occupancy for 1500 residential units at the Property have been issued. This exclusive right shall not prohibit the residents, developers or anyone else within the Property from utilizing veterinary services from providers other than Harmony Institute or its assigns.

(nn) After Closing, Purchaser shall cause the Company to cooperate with the Harmony Institute in conducting an annual golf tournament for the benefit of the Harmony Institute. The Company shall donate $7,500 in goods and services annually, subject to an annual inflation rate, as long as the Company owns the golf facilities within the Property.

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Lentz Agreement. On the Closing Date, the Company and James Lentz shall enter into an Employment Agreement in the form of **Exhibit J** hereto (the "Lentz Employment Agreement")

Harmony Name and Mark. Three E represents to Purchaser that it owns all rights to the name "Harmony" and the mark identified on Schedule 31. On the Closing Date Three E and the Company shall execute and deliver a License Agreement in reasonable form (the "Harmony License") at no cost to the Company.

Contingency. Prior to the date hereof, the Company conducted negotiations with certain parties (each, a "Prospective Purchaser") for the sale of certain undeveloped land at the Property (the "Offered Undeveloped Land"). If, after the expiration of the Due Diligence Period and prior to the Closing Date (provided Purchaser has not terminated this Agreement): (i) the Company from time to time receives from a Prospective Purchaser, a contract for sale and purchase for the Offered Undeveloped Land (a "Sale Contract") on commercially reasonable terms and negotiated at arm' s length executed by the Prospective Purchaser, together with such downpayment or deposit as may be required thereby; and (ii) the Company wishes to enter into the Sale Contract, then the following procedure shall be followed. Seller shall deliver a copy of the Sale Contract to Purchaser, together with such information regarding the Prospective Purchaser as shall be reasonably necessary for Purchaser to evaluate the Prospective Purchaser. Seller shall, within two (2) Business Days after request by Purchaser, deliver to Purchaser such additional information concerning the Prospective Purchaser as Purchaser shall reasonably require (collectively, the "Information"). Within five (5) business days after Purchaser shall have received the information, Purchaser shall advise Seller in writing whether the Sale Contract and the terms thereof are acceptable to Purchaser. If Purchaser shall fail to give timely notice to Seller, as aforesaid, then the Sale Contract and the terms thereof shall be deemed acceptable to Purchaser. If Purchaser shall advise that they are not, then Purchaser may also, at its option, advise as to what changes would be necessary in order for it to become acceptable to it. The Company may elect to enter into a Sale Contract even if it is not acceptable to Purchaser, in which case, Purchaser may elect to either (i) terminate this Agreement whereupon the Downpayment with any interest earned thereon shall be promptly paid over to Purchaser and Seller shall reimburse Purchaser for its out-of-pocket costs in connection with this Agreement and its due diligence, but not to exceed $50,000; or (ii) to acquire the Partnership Interests notwithstanding the Company' s obligations under the Sale Contract (if closing of title under a Sale Contract occurs prior to the Closing hereunder, the net proceeds thereof shall, without increase of the Purchase Price hereunder, remain with the Company **[but subject to utilization by the Company for operating expenses in the ordinary course of business]** through and following Closing hereunder such that Purchaser, rather than Seller, shall receive the benefit thereof).

Lentz Lot Purchase Agreement. Purchaser acknowledges that Lentz currently has an existing purchase/option agreement for a single-family lot, 7B in the Drake Neighborhood within the Property for One Hundred Twenty Thousand Dollars ($120,000) plus normal closing fees

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and prorations which is expected to close on or before July 1, 2005 (the "Lentz Purchase Agreement"). Purchaser shall recognize and take subject to all rights of Lentz under the Lentz Purchase Agreement.

Confidentiality.

(oo) Each of Seller and, until the day immediately following the Closing Date following the consummation of the Closing by Purchaser, Purchaser shall maintain all information received from the other and the other' s attorneys, accountants, representatives, agents and contractors in strict confidence, and shall take precautions reasonably necessary to prevent disclosure, access to, or transmission of such information to any other third party, except as provided in (b) below or as may otherwise be required by law.

(pp) Except to the extent Purchaser and Seller shall otherwise agree in writing, Purchaser, Seller and Lentz shall maintain confidentiality as to the terms and conditions of this Agreement, as well as to the terms of the sale of the Partnership Interests contemplated hereby, except such disclosures to each party' s attorneys, accountants, consultants, lenders and others (including third parties and applicable government agencies but only to the extent required by applicable law or regulation) as such party deems to be reasonably required in order to consummate the transactions contemplated in this Agreement, or otherwise required by a court with appropriate jurisdiction or other governmental authority. Purchaser and Seller shall each instruct all others engaged by it in connection with the transactions contemplated in this Agreement to abide by such confidentiality provisions, and each shall be responsible for violations by such third parties to whom it discloses such information.

Purchaser' s and Guarantor' s Obligations to AJG Respecting the Bond Indebtedness.

(qq) In consideration of AJG' s agreement (which AJG hereby makes) to leave in place the approximately Twelve Million Six Hundred Thousand Dollar ($12,600,000) letter of credit posted by AJG to secure the repayment of the Bond Indebtedness (the "Letter of Credit") on the maturity date of November 1, 2010 (the "Maturity Date"), Purchaser shall pay to AJG an annual fee of Ninety Thousand Dollars ($90,000) each year from the Closing Date through the Maturity Date, which fee shall be payable in equal quarterly installments on the last day of each calendar quarter after the Closing Date, except for the first and last such payment which shall be properly prorated based on the number of days of the relevant quarter.

(rr) Purchaser shall not, and shall not permit the Company to, extend the Maturity Date without a full and complete release and return of the Letter of Credit to AJG.

(ss) From and after the Closing Date through the Maturity Date, Guarantor shall maintain and/or have in cash or through one of the following facilities, access to sums aggregating not less than the face amount of the Letter of Credit: (i) cash on hand

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(or in a money market account) or (ii) the unrestricted right to call for cash pursuant to Guarantor' s subscription documents, which Guarantor hereby agrees to call upon, if and when necessary for the purposes of **Section 35(e)**; or (iii) unrestricted availability under Guarantor' s credit agreements which Guarantor hereby agrees to draw upon, if and when necessary for the purposes of **Section 35(e)**.

(tt) Within thirty (30) days after the end of each calendar year after the Closing Date a senior executive of Guarantor or its Chief Financial Officer shall execute and deliver to AJG a duly dated certificate attesting to the satisfaction of the financial requirements described in **Section 35(c)** above and detailing the manner in which such requirement was satisfied.

(uu) In the event of (i) any breach of the obligation set forth in **Section 35(a**) above which is not cured within ten (10) Business Days after written notice thereof given to Guarantor; or (ii) a breach of **Section 35(b)** above or **Sections 35(c)** or **(d)** where the breach of **Section 35(c)** or **Section 35(d)** is not cured within ten (10) Business Days after written notice thereof given to Guarantor; or (iii) any event under the Bond Indebtedness which results in a draw upon the Letter of Credit then, within five (5) Business Days after written demand therefor by AJG, Guarantor shall remit payment to AJG by wire transfer of immediately available funds in an amount which is, in the case of clauses (i) and (ii), equal to the amount of the Letter of Credit and which is, in the case of clause (iii), equal to the amount of the funds so drawn thereunder.

[SIGNATURE PAGE IMMEDIATELY FOLLOWS]

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IN WITNESS WHEREOF, this Agreement has been duly executed by the parties hereto as of the day and year first above written.

Company Subsidiaries:

HARMONY DEVELOPMENT CO., LLC

By: /s/ James L. Lentz
Name: James L. Lentz
Title: President

HARMONY GOLF FACILITIES, LLC

By: /s/ James L. Lentz
Name: James L. Lentz
Title: President

HARMONY RESTAURANT FACILITIES, LLC

By: /s/ James L. Lentz
Name: James L. Lentz
Title: President

HARMONY GROUND MAINTENANCE CO., LLC

By: /s/ James L. Lentz
Name: James L. Lentz
Title: President

HARMONY REAL ESTATE CO., LLC.

By: /s/ James L. Lentz
Name: James L. Lentz
Title: President

Seller:

THREE E CORPORATION

By: /s/ James L. Lentz
Name: James L. Lentz
Title: President

AJG FINANCIAL SERVICES, INC.

By: /s/ Mark P. Strauch
Name: Mark P. Strauch
Title: Executive Vice President

Company:

BIRCHWOOD ACRES LIMITED PARTNERSHIP, LLLP

By: /s/ James L. Lentz
Name: James L. Lentz
Title: as President of Three Corp., it' s General Partner

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Three E Parent:

/s/ James L. Letz

James Lentz

Purchaser:

SOF-HARMONY FUNDING, L.L.C.

By: /s/ Robert Geimer
Name: Robert Geimer
Title: Sr. Vice President

The undersigned Guarantors have executed this Agreement on April 20, 2005, to acknowledge and agree that they are jointly and severally obligated for all obligations of Purchaser hereunder; provided, however, no recourse for any such obligations shall extend to any officer, director, employee, agent, representative, partner or member of either such Guarantor and all liability of each such Guarantor hereunder shall be limited to the assets of such Guarantor.

Guarantors

STARWOOD U.S. OPPORTUNITY
FUND VII D-2, L.P.

By: SOF VII MANAGEMENT, L.L.C.,
its general partner

By: Starwood Capital Group Global, L.L.C.,
its General Manager

By: /s/ Robert Geimer
Name: Robert Geimer
Title: Senior Vice President

SOF-VII U.S. HOLDINGS I, L.L.C.

By: /s/ Robert Geimer
Name: Robert Geimer
Title: Senior Vice President

The Escrow Agent hereby acknowledges receipt of the Downpayment and shall hold the same, including interest, if any, in escrow pursuant to the provisions of this Agreement.

Escrow Agent:
FIRST AMERICAN TITLE INSURANCE COMPANY

By: /s/ Phillip Saloman

Name: Phillip Saloman

Title: Senior Vice President

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Certain Definitions

"Affiliates" means a Person or Persons, directly or indirectly, through one or more intermediaries, controlling, controlled by or under common control with the Person(s) in question. The term "control", as used in the immediately preceding sentence, means, with respect to a Person that is a corporation, the right to exercise, directly or indirectly, more than fifty percent (50%) of the voting rights attributable to the shares of the controlled corporation and, with respect to a Person that is not a corporation, the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of the controlled Person.

"Benefit Plan" means any employee benefit or compensation plan, program, policy, contract (whether or not written) or arrangement, including any pension or retirement plan, deferred compensation plan, vacation pay plan, stock option plan, bonus or incentive plan, change in control agreement or plan, stock purchase plan, hospitalization, disability or other insurance plan, employment agreement or severance, retention or termination pay plan or policy, maintained, sponsored, or contributed to by the Company or any Company Subsidiary (including, for purposes of this definition, all employers (whether or not incorporated) that would be treated together with the Company, any Company Subsidiary and/or the Seller as a single employer within the meaning of Section 414 of the Code) or with respect to which the Company or any Company Subsidiary has any liability whether contingent or otherwise.

"Books and Records" means, collectively, all of the books and records of the Company and the Company Subsidiaries.

"Business Day" means any day other than a Saturday, Sunday or a day on which banks in Orlando, Florida are authorized or obligated by applicable law to close.

"Claim" or "Claims" means any and all claims, actions, proceedings, suits, litigation, demands, obligations, liabilities, indebtedness, breaches of contract, breaches of duty or any relationship, acts, omissions, misfeasance, malfeasance, cause or causes of action, debt, sums of money, accounts, compensation, contracts, controversies, promises, damages, costs, losses, expenses or governmental or other investigations including but not limited to, attorneys' and experts' fees and expenses, and investigation and remediation costs whether direct or indirect, known or unknown, foreseen or unforeseen.

"Code" means the Internal Revenue Code of 1986, as amended as it may be further amended from time to time, any successor statute thereto, and applicable U.S. Department of Treasury regulations issued pursuant thereto in temporary or final form.

"Days" or "days" shall mean calendar days (as distinct from being limited to those days which are Business Days).

"Environmental Laws" means all federal, and applicable state and local laws, statutes, guidelines, codes, ordinances, regulations, now or hereafter in effect, in each case as amended or supplemented from time to time, including, without limitation, all applicable judicial or administrative orders, applicable consent decrees and binding judgments relating to the regulation and protection of human health, safety, the environment and natural resources.

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"Existing Company" shall mean and refer to the Company prior to the transfer of the Partnership Interests to Purchaser at the Closing.

"Hazardous Materials" shall mean (a) those substances included within the definitions of any one or more of the terms "hazardous materials", "hazardous wastes", "hazardous substances", "industrial wastes", and "toxic pollutants", as such terms are defined under the Environmental Laws, or any of them, (b) petroleum and petroleum products, including, without limitation, crude oil and any fractions thereof, (c) natural gas, synthetic gas and any mixtures thereof, (d) asbestos and or any material which contains any hydrated mineral silicate, including, without limitation, chrysotile, amosite, crocidolite, tremolite, anthophylite and/or actinolite, whether friable or non-friable, (e) polychlorinated biphenyl ("PCB") or PCB-containing materials or fluids, (f) radon, (g) any pathogen, toxin or other biological agent or condition including, without limitation, any fungus, mold, mycotoxin or microbial matter naturally occurring or otherwise, (h) any other hazardous or radioactive substance, material, pollutant, contaminant or waste, and (i) any other substance with respect to which any Environmental Law or governmental authority requires environmental investigation, monitoring or remediation.

"Knowledge of AJG" shall mean the actual conscious knowledge of any of Mark Strauch, David long, Sally Wasikowski, Kerry Abbott, Douglas K. Howell or Jack Lazzaro, without any duty of independent inquiry or investigation.

"Knowledge of Three E" shall mean the actual conscious knowledge of James Lentz, without any duty of independent inquiry or investigation.

"Knowledge of Seller" shall mean the Knowledge of AJG or the Knowledge of Three E.

"Permitted Encumbrances" means as relates to the Property: (a) any lien imposed by law for Taxes, assessments or governmental charges that are not delinquent and remain payable without penalty or that are being contested in good faith by appropriate proceedings; (b) any carrier' s, warehousemen' s, mechanic' s, materialmen' s, repairmen' s or other like lien imposed by law, arising in the ordinary course of business and securing obligations that are not yet due and payable or are being contested in good faith by appropriate proceedings; (c) any pledge or deposit made in the ordinary course of business in compliance with workers' compensation, unemployment insurance or other social security laws or other statutory obligations of any Seller or the Company; (d) any lien created by Purchaser; and (e) any cash deposit or right of set-off to secure the performance of bids, tenders, trade contracts, leases, statutory obligations, surety and appeal bonds, performance bonds, government contracts and other obligations of a like nature, in each case imposed in the ordinary course of business.

"Permitted Exceptions" shall be:

(i) (X) Zoning and building restrictions, regulations, ordinances and requirements heretofore or hereafter adopted by any governmental, public or municipal authority

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having jurisdiction thereof, and amendments and additions thereto now in force and effect, which relate to the Property and which do not prohibit or materially interfere with the Company' s present use and Purchaser' s contemplated use of the Property by the Company.

(Y) Such state of facts which an accurate survey would show, provided such facts do not render title uninsurable.

(ii) Rights of tenants in possession (as tenants only) pursuant to the Leases which are listed on **Schedule 5(viii)**, any New Leases entered into in accordance with the terms hereof and substances and other occupancies thereunder.

(iii) Minor variations between tax lot lines and lines of record title.

(iv) Rights, if any, of utility companies to lay, maintain, construct and/or repair pipes, lines, conduits, cable boxes and other installments on, under and across the Property for purposes of providing utility services to the Land and the Building provided same do not impose any monetary obligations on the owner of the property and are similar relative to those over other properties in the vicinity.

(v) Any agreements, financing statements, chattel mortgages, liens or encumbrances entered into by, or arising from the acts of any Tenant of the Property, which encumber only the Tenant' s leasehold estate or the Tenant' s personal property in the Property.

(vi) Minor encroachments of stoop areas, roof cornices, sidewalk elevators, window trims, cellar doors, steps, columns and column bases, signs, piers, lintels, window sills, fire escapes, ledges, fencing, coping, retaining walls and yard wall, if any, upon any street or highway or adjoining property, as well as encroachments of improvements located upon or belonging to this Property on adjoining properties, provided the Title Company will affirmatively insure, at regular rates, without additional premium, that the Building may remain undisturbed.

(vii) The Violations, if and to the extent permitted by the express terms of the Agreement.

(viii) The Underlying Obligations, if and to the extent they are recorded in the government land records against the Property but in the case of any of them which are mortgage liens, only to the extent that they secure Assumed Indebtedness.

(ix) Anything which does not materially and adversely affect the Company' s ability to utilize and operate the Property as it is being utilized and operated by the Company on the date hereof.

(x) The items excepted on the Company' s title insurance Policy Number OPM1520291 issued August 13, 1998 by Attorneys Title Insurance Fund, Inc. and the mortgagee' s title insurance policy issued to Franklin Bank SSB by First American Title Insurance Company dated October 28, 2003 as policy number FA-36-517969 as amended

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by Endorsement Numbers 1, 2 and 3, respectively, dated December 8, 2003, October 18, 2004 and December 29, 2004) and any other items placed of record by the Company subsequent to the date of issuance of such title insurance policies, in the ordinary course of the Company' s business, in its interests, and consistent with its past practice (but in the case of all of the above, including mortgage liens only to the extent they secure Assumed Indebtedness) and, to the extent not placed of record by the Company, only to the extent the same shall not otherwise be prohibited by or result in a breach of the provisions of this Agreement, and further, the Master Trust Indenture and other instruments and agreements currently of record relating to the 2004 Harmony Community Development District Capital Improvement Bonds.

"Purchaser Designee" shall mean any entity which is an Affiliate of Purchaser and which Purchaser shall, by notice given to Seller prior to the Closing, designate to acquire title to any or all of the Partnership Interests.

"Underlying Obligations" shall mean, collectively, all of those obligations which are generally described on **Schedule 5(xviii)**.

"Underlying Obligee" shall mean a party or entity to which the Company has obligations under an Underlying Obligation.

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Exhibit 10.37

SETTLEMENT AGREEMENT AND MUTUAL RELEASE

This Settlement Agreement and Mutual Release ("2nd Settlement Agreement") is entered into as of May 1, 2005 (the "Effective Date") by and between Headwaters Incorporated (formerly known as Covol Technologies, Inc.) ("Headwaters"), on the one hand, and Square D Company ("Square D"), Arthur J. Gallagher & Co. ("Gallagher") and AJG Financial Services, Inc. ("AJG") on the other hand. The foregoing parties will hereinafter collectively be called the "Parties."

Recitals

The Parties acknowledge and agree:

A. On December 27, 1996 AJG and Headwaters entered into a contract entitled Agreement Concerning Additional Facilities (the "License Agreement").

B. On October 22, 1997 AJG and Headwaters entered into a letter agreement (the "Letter Agreement") which, among other things, modified the License Agreement and established royalties in connection with the Algoma Facility, as defined below.

C. On June 26, 2000 AJG, Headwaters, and Square D entered into a Settlement Agreement and Release (the "1st Settlement Agreement") related to the Utah 1 Facility, as defined below.

D. On October 17, 2001, Headwaters commenced litigation against AJG in the Fourth Judicial Court for Utah County, State of Utah, Case No. 000403381 (the "1st Litigation"). During the course of the 1st Litigation, Headwaters and AJG asserted claims against each other relating to the operation of and royalties payable under the License Agreement and the Letter Agreement from the following synthetic fuel manufacturing facilities:

(i) two double-line synthetic fuel production facilities (hereinafter the "AJG Lines" or as termed in the License Agreement, the "Facilities") owned initially by AJG and placed in service at Pawnee, Illinois, and later relocated to Wateree and Winyah, South Carolina;

(ii) one production line (hereinafter the "Algoma Facility") initially owned by Headwaters and located at Algoma, West Virginia, and later relocated to Kentucky.

E. On June 7, 2002 Headwaters commenced litigation against AJG and Square D in the Fourth Judicial Court for Utah County, State of Utah, Case No. 010402901 (the "2nd Litigation"). During the course of the 2nd Litigation, the Parties asserted claims and defenses related to payments under the 1st Settlement Agreement related to the following synthetic fuel manufacturing facility:

one production line (hereinafter the "Utah 1 Facility") owned initially by Headwaters and placed in service at Price, Utah, and later relocated to Canadys, South Carolina.

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F. On February 12, 2005, the jury in the 1st Litigation rendered a verdict in favor of Headwaters on some of the claims in the amount of $175,294,532 and a verdict in favor of AJG on some of the counterclaims in the amount of $270,734. The claims addressed in the jury' s verdict included claims by Headwaters against AJG for unpaid royalties due and owing on the AJG Lines through December 31, 2004 and various counterclaims by AJG against Headwaters. The Court entered a net judgment on the verdict in the amount of $175,023,798 in favor of Headwaters on February 22, 2005 (the "Judgment").

G. The remaining unresolved claim in the 1st Litigation, which consists of Headwaters' claim against AJG for declaratory relief relating to royalty obligations in calendar year 2005 and thereafter on production from the AJG Lines, is pending before the Court.

H. There has been no trial in the 2nd Litigation.

I. Gallagher is the parent corporation of AJG.

J. Headwaters and AJG deem it to be in their mutual best interests to modify and extend the license provided for under the License Agreement.

K. Headwaters, on the one hand, and Square D and Gallagher and AJG on the other hand, desire finally and fully to resolve all claims that have been or could have been asserted by each party against each other in the 1st Litigation and the 2nd Litigation, as the case may be, and all other claims between them, subject to the limitations set forth in this 2nd Settlement Agreement, without further expenditure of time or expense of litigation and without admitting liability.

Agreement

In consideration of the covenants, promises, mutual releases and payments set forth herein, and intending to be legally bound, the Parties agree to the following terms, conditions and releases:

1. Gallagher or AJG will make the following payments to Headwaters:

(a) Gallagher and AJG jointly and severally will pay Headwaters the sum of $50 million in currently available funds within five days of the Effective Date. The Parties agree that $6,509,000 of this amount will constitute reimbursement of Headwaters' legal fees and expenses in conducting the Lawsuit, and that the balance of said $50 million payment shall be in complete settlement and satisfaction of the Judgment. This payment will be made by wire transfer in accordance with the following instructions:

Bank Name:	Bank One, N. A.
ABA #:	124001545
Account #:	6020641403407
Account Name:	Headwaters, Inc.
SWIFT Code:	BONEUS44

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(b) In consideration of Headwaters' agreement to modify the License Agreement and for the right to use the technology and other rights granted therein during the period commencing January 1, 2005 and ending December 31, 2014, in accordance with paragraph 2 below, Gallagher and AJG, jointly and severally, shall pay Headwaters the additional sum of $70 million, together with simple interest at the rate of 4% per annum from the Effective Date hereof. Such payment shall be made on or before January 15, 2006, in accordance with the wire transfer instructions set forth in subparagraph 1(a), above, regardless of whether license rights or technology are claimed to be used.

2. AJG and Headwaters hereby modify the License Agreement as of January 1, 2005, as follows:

(a) Section 3 of the License Agreement as amended is further modified by deleting the text thereof in its entirety and replacing it with the following:

"AJG and Arthur J. Gallagher & Co. ("Gallagher") will jointly and severally pay Headwaters additional amounts for each of calendar years 2005, 2006 and 2007 ("Modification Payments") in the amount of $0.135 per dollar of tax credit earned on all production from the Facilities for calendar years 2005, 2006 or 2007, whichever is applicable, but in no event more than $20 million for such calendar year. For example, if tax credits for calendar year 2005 for all applicable production for such year from the Facilities was $160 million before any phase out of tax credits under Section 29 of the Internal Revenue Code and then a 30% phase out was applied, the required payment would be $15,120,000 ($160 million x 70% x $0.135).

On or before each February 15, May 15, August 15 and November 15, commencing May 15, 2005 and ending February 15, 2008, AJG shall cause a written report to be prepared and delivered to Headwaters which sets forth the aggregate production of synthetic fuel ("Synfuel") from the Facilities during the immediately preceding calendar quarter which report shall be accompanied by a check payable to the order of Headwaters in the amount referred to in the immediately preceding paragraph above as it relates to the reported production from the Facilities; provided, however, that the payments under this section for any calendar year shall terminate when the aggregate payments made with respect to such year' s production pursuant to this section shall equal $20 million. Any such payment which is not made when it is due shall bear interest from the due date thereof until it shall be paid in full at the simple rate of four percent (4%) per annum, with respect to any payment due for production in calendar year

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2005, and at the simple rate of eight (8%) per annum, with respect to any payment due for production in calendar years 2006 or 2007.

Within forty five (45) days after the Internal Revenue Service publishes its annual inflation adjustment factor pursuant to Section 29(d)(2), AJG and Headwaters shall mutually determine whether there has been any underpayment or overpayment, as the case may be, of amounts for which AJG is obligated to pay Headwaters pursuant to this section above. AJG shall pay to Headwaters the amount of any underpayment, or Headwaters shall pay to AJG the amount of any overpayment, as the case may be, within said forty five (45) day period. Any amount which is not paid prior to the expiration of said forty five (45) day period shall bear interest from the expiration date of said forty five (45) day period until payment is received in full at the applicable rate of interest specified in the immediately preceding paragraph.

Payments hereunder shall be based on 100% of the production from the Facilities, regardless of whether AJG or its partners actually use the tax credits, regardless of where the Facilities are located at the time of production, regardless of any change in ownership of the Facilities and regardless of what technology or process AJG and its partners claim to use in producing the synfuel that qualifies for tax credits."

(b) The License Agreement, section 5, Records; Inspection; Confidentiality, is modified by adding the following to the end thereof:

"Disputes concerning payment obligations under section 3 hereof shall be attempted to be resolved by the parties first by discussion between the respective Chief Financial Officers of Headwaters and Gallagher. If such discussions are unsuccessful, the parties shall submit the dispute to nonbinding mediation within 30 days of the date the dispute first arises. If the parties are unable to agree upon a mutually acceptable mediator, one shall be appointed by the Utah director of the American Arbitration Association. If mediation is unsuccessful, the parties shall have the right to file suit in any Utah state court."

(c) The License Agreement, section 8, Term, is modified by deleting the text thereof in its entirety and replacing it with the following:

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"This Agreement and the license granted hereunder shall be for the period from the Closing Date to and including December 31, 2014 and AJG and any entity in which AJG has or had any ownership interest (or any transferee thereof or any purchaser of the assets of any such entity) shall have the unrestricted right, power, privilege and authority to use any technology and other rights granted in, or contemplated by, this Agreement through and including December 31, 2014; provided however, that the obligations to pay the Modification Payments shall continue only for the periods described in section 3 hereof, it being understood and agreed that no further amounts shall be payable at any time beyond the amounts provided for in section 3 respecting the subject matter of this Agreement."

3. **Utah 1 Facility Payments.** Square D and AJG shall continue to make Net Benefit payments to Headwaters relating to the Utah 1 Facility under the 1st Settlement Agreement as such payments have historically been calculated by AJG in the manner reflected on Exhibit A attached hereto. Payments shall be made by Square D and AJG to Headwaters on each February 15, May 15, August 15 and November 15, and each such payment shall be accompanied by a written report in the manner reflected on Exhibit A. Any payment not made when due shall bear interest from the due date thereof until payment in full at the simple rate of four percent (4%) per annum with respect to Net Benefits received with respect to calendar year 2005, and at the simple rate of eight percent (8%) per annum with respect to Net Benefits received with respect to succeeding calendar years. Headwaters, at its sole cost and expense, either directly or through its authorized representative, shall have the right, upon reasonable advance notice and during normal business hours, to inspect the books and records of Square D, AJG, and Coaltech No. 1, LP with respect to the Net Benefits received by Square D and AJG with respect to the Utah 1 Facility. Any dispute shall be resolved in the manner described in section 2(b) above.

4. **Algoma Payments.** Headwaters will continue to make payments to AJG relating to the Algoma Facility under the eighth bullet paragraph (as originally counted) of the Letter Agreement at the current rate of 5.9% of net royalties received by Headwaters. Payments shall be made by Headwaters to AJG on each February 15, May 15, August 15 and November 15, commencing May 15, 2005, and each such payment shall be accompanied by a written report prepared by Headwaters which sets forth a detailed calculation of the amount of net royalties received by Headwaters during the immediately preceding quarter. Any payment not made when due shall bear interest from the due date thereof until payment in full at the simple rate of four percent (4%) per annum with respect to net royalties received with respect to calendar year 2005, and at the simple rate of eight percent (8%) per annum with respect to net royalties received with respect to succeeding calendar years. AJG, at its sole cost and expense, either directly or through its authorized representative, shall have the right, upon reasonable advance notice and during normal business hours, to inspect the books and records of Headwaters with respect to the net royalties received by Headwaters with respect to the Algoma Facility. Any dispute shall be resolved in the manner described in section 2(b) above.

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5. **Joint and Several Obligations.** The payment obligations of AJG and Gallagher under sections 1(a), 1(b), 2(a) and 3 (not including Square D' s portion of the Net Benefits) of this 2nd Settlement Agreement are joint and several and Gallagher shall not be deemed to have any further payment obligations hereunder.

6. **Mutual Release.** Headwaters, on behalf of itself, its parents, subsidiaries, affiliates, officers, directors, shareholders, agents, employees, legal representatives, predecessors, successors, assigns, and their respective parents, subsidiaries, affiliates, officers, directors, shareholders, agents, employees, legal representatives, successors and assigns, and all others claiming by or through Headwaters hereby releases, remises and forever discharges each of AJG, Gallagher, Square D and owners of the AJG Lines and their respective parents, subsidiaries, affiliates, officers, directors, shareholders, partners, agents, employees, legal representatives, successors and assigns and all other acting in concert with them of and from any and all actions, causes of actions, claims, demands, costs, suits, debts, damages, liabilities, obligations, sums of monies, accounts, contracts, promises and/or executions (collectively, "Claims") of any and every kind or nature, at law or in equity, whether known or unknown, which Headwaters and any of such parties have, had or may have in the future, or claim to have for, upon or by reason of, any matter, cause or thing whatsoever, from the beginning of time through the date of this 2nd Settlement Agreement, including but not limited to any and all claims for breach of contract, negligence, intentional tort or statutory violation, with the sole exceptions of any future Claims arising by reason of a breach of (i) this 2nd Settlement Agreement, (ii) the 1st Settlement Agreement, (iii) the License Agreement, as modified herein; and (iv) the eighth bullet paragraph of the Letter Agreement.

Each of AJG, Gallagher and Square D, on behalf of itself, its parents, subsidiaries, affiliates, officers, directors, shareholders, agents, employees, legal representatives, predecessors, successors, assigns, and their respective parents, subsidiaries, affiliates, officers, directors, agents, employees, legal representatives, successors and assigns, and all others claiming by or through any of the foregoing ("AJG Releasing Parties") hereby releases, remises and forever discharges Headwaters and its respective parents, subsidiaries, affiliates, officers, directors, shareholders, agents, employees, legal representatives, predecessors, successors and assigns and all other acting in concert with them of and from any and all Claims of any and every kind or nature whatsoever, at law or in equity, whether known or unknown, which AJG Releasing Parties or any of such parties has, had or may have in the future, or claim to have for, upon or by reason of, any matter, cause or thing whatsoever, from the beginning of time through the date of this 2nd Settlement Agreement, including but not limited to any and all claims for breach of contract, negligence, intentional tort or statutory violation, with the sole exceptions of any future Claims arising by reason of a breach of (i) this 2nd Settlement Agreement, (ii) the 1st Settlement Agreement, (iii) the License Agreement, as modified herein; and (iv) the eighth bullet paragraph of the Letter Agreement.

7. **Covenant Not to Sue.** This 2nd Settlement Agreement may be pled as a full and complete defense to any claims that may be instituted, prosecuted, or attempted in breach of this 2nd Settlement Agreement. Except for any Claims for breach of this Agreement and the other Claims expressly not released under section 6 above, Headwaters on the one hand, and AJG, Gallagher and Square D on the other hand, hereby covenant never to institute or aid in the institution or prosecution of any claim, action, complaint, charge or suit, whether at law or in

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equity, against the other party or any of their respective parents, subsidiaries, affiliates, officers, directors, shareholders, employees, agents, legal representatives, successors or assigns in any court or administrative agency, or before any other public or private tribunal, which in any way arises from or relates to any event, dispute, or occurrence which arose on or prior to the date of this 2nd Settlement Agreement.

8. **Dismissal.** Within five days of the Effective Date, the Parties agree to jointly file motions for the dismissal of the 1st Litigation, including all post-trial motions, and the 2nd Litigation, both with prejudice, and a notice of satisfaction of the Judgment, each party to bear its own costs and attorneys' fees except as paid pursuant to Section 1(a) of this 2nd Settlement Agreement.

9. **Confidentiality.** The terms of this 2nd Settlement Agreement and all negotiations and communications relating to this 2nd Settlement Agreement shall not be disclosed to any person or entity except (a) to the extent necessary for accounting, tax, insurance or legal reporting purposes, including disclosure requirements imposed by the securities laws, (b) as may be necessary to fulfill existing third-party contract obligations of the parties; (c) as may be required by law; or (d) to the extent necessary to enforce the terms of this 2nd Settlement Agreement.

10. **Denial of Liability.** This 2nd Settlement Agreement is the result of a compromise of disputed claims and shall not be considered or construed as an admission of liability or responsibility by either party. Each party acknowledges the contentions and claims of the other but, by entering into this 2nd Settlement Agreement, does not acknowledge the propriety of such contentions and claims.

11. **Integration Clause.** This 2nd Settlement Agreement, plus the 1st Settlement Agreement, the License Agreement, as modified herein, and the eighth bullet paragraph of the Letter Agreement (the "Outstanding Agreements") contain the entire agreement between the Parties relating to the subject matter contained herein and supersedes any and all other prior agreements and negotiations between the Parties leading up to the execution of this 2nd Settlement Agreement, whether oral or in writing. The Parties each acknowledge that no other agreements, covenants, representations or warranties, inducements, promises or statements, express or implied, oral or otherwise have been made by any of the Parties that are not embodied or incorporated by reference herein, and further agree that no other agreement, covenant, representation or warranty, inducement, promise or statement not set forth in writing in the Outstanding Agreements shall be valid or binding.

12. **Representation by Counsel.** The Parties hereby acknowledge that each party has been represented by counsel with respect to this 2nd Settlement Agreement and has been fully advised by said counsel with respect to its rights and obligations with respect to this 2nd Settlement Agreement.

13. **Modification or Amendment.** This 2nd Settlement Agreement may not be modified or amended except in a writing signed by all Parties.

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14. **Construction and Interpretation.** This 2nd Settlement Agreement shall be construed in accordance with the laws of the State of Delaware without regard to the principles of conflicts of laws. Counsel for each of the Parties has participated in the drafting and negotiation of this 2nd Settlement Agreement and any rule of construction to the effect that any ambiguity shall be construed against the drafting party shall not be applied to this 2nd Settlement Agreement.

15. **Mistake.** In entering and making this 2nd Settlement Agreement, the Parties assume the risk of any mistake of fact or law. If the Parties, or any of them, should later discover that any fact they relied upon in entering this 2nd Settlement Agreement is not true, or that their understanding of the facts or law was incorrect, the Parties shall not be entitled to set aside this 2nd Settlement Agreement by reason thereof. This 2nd Settlement Agreement is intended to be final and binding upon the Parties regardless of any mistake of fact or law.

16. **Execution, Counterparts and Facsimile Signatures**. This 2nd Settlement Agreement may be executed in counterparts, each of which shall be deemed an original. All counterparts taken together shall constitute one and the same original 2nd Settlement Agreement, with the same force and effect as if all signatures had been entered on one document. Facsimile signatures shall constitute original signatures.

17. **Authority.** Each party represents and warrants that the individual signing this 2nd Settlement Agreement on behalf of the party is authorized to do so and binds the party on whose behalf he or she is signing. The parties further represent and warrant that each is the sole holder of the claims being released in this 2nd Settlement Agreement, that the party has not assigned those claims to any other person or entity, and that no one else has any claim, title or interest in or to the claims being released herein.

IN WITNESS WHEREOF, the duly authorized individuals below have executed this Settlement Agreement and Mutual Release on behalf of their respective parties as indicated below.

Headwaters Incorporated

By: /s/ Steven G. Stewart

Its: Chief Financial Officer

Arthur J. Gallagher & Co.

By: /s/ John C. Rosengren

Its: Vice President, General Counsel & Secretary

AJG Financial Services, Inc.

By: /s/ John C. Rosengren

Its: Vice President, General Counsel & Secretary

Square D Company

By: /s/ Vincent A. Inendino

Its: Vice President

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Exhibit 15.1

Board of Directors and Stockholders
Arthur J. Gallagher & Co.

We are aware of the incorporation by reference in the Registration Statements (Form S-8, No. 33-604 and Form S-8, No. 33-14625) pertaining to the Arthur J. Gallagher & Co. Incentive and United Kingdom Incentive Plans, in the Registration Statements (Form S-8, No. 33-24251, Form S-8, No. 33-38031 and Form S-8, No. 333-57155) pertaining to the Arthur J. Gallagher & Co. 1988 Incentive and 1988 Nonqualified Stock Option Plans, in the Registration Statement (Form S-8, No. 33-30816) pertaining to the Arthur J. Gallagher & Co. Non-Employee Directors' Stock Option Plan, in the Registration Statements (Form S-8, No. 33-64614 and Form S-8, No. 33-80648) pertaining to the Arthur J. Gallagher & Co. 1988 Incentive, 1988 Nonqualified, and Non-Employee Directors' Stock Option Plans, in the Registration Statements (Form S-8, No. 333-06359, Form S-8, No. 333-40000, Form S-8, No. 333-87320 and Form S-8, No. 333-106535) pertaining to the Arthur J. Gallagher & Co. 1988 Nonqualified and Non-Employee Directors' Stock Option Plans, in the Registration Statement (Form S-8, No. 333-62930) pertaining to the Arthur J. Gallagher & Co. 1988 Nonqualified and Non-Employee Directors' Stock Option Plans and the Gallagher Healthcare Insurance Services, Inc. 2001 Nonqualified Stock Option Plan, in the Registration Statement (Form S-8, No. 333-106534) pertaining to the Arthur J. Gallagher & Co. Employee Stock Purchase Plan, in the Registration Statement (Form S-8, No. 333-106539) pertaining to the Arthur J. Gallagher & Co. Restricted Stock Plan, in the Registration Statements (Form S-4, No. 333-75197, Form S-3, No. 333-84139 and Form S-4, No. 333-55254), and in the related Prospectuses, of our review report dated April 26, 2005 relating to the unaudited consolidated interim financial statements of Arthur J. Gallagher & Co. that are included in its Quarterly Report on Form 10-Q for the quarter ended March 31, 2005.

/s/ Ernst & Young LLP

Ernst & Young LLP

Chicago, Illinois
April 26, 2005

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Exhibit 31.1

Rule 13a-14(a) Certification of Chief Executive Officer

Certification

I, J. Patrick Gallagher, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arthur J. Gallagher & Co.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant' s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a.) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b.) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c.) Evaluated the effectiveness of the registrant' s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d.) Disclosed in this report any change in the registrant' s internal control over financial reporting that occurred during the registrant' s most recent fiscal quarter (the registrant' s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant' s internal control over financial reporting; and

5. The registrant' s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant' s auditors and the audit committee of the registrant' s board of directors (or persons performing the equivalent functions):

   (a.) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant' s ability to record, process, summarize and report financial information; and

   (b.) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant' s internal control over financial reporting.

Date: May 2, 2005

/s/ J. Patrick Gallagher, Jr.

J. Patrick Gallagher, Jr.
President and Chief Executive Officer
(principal executive officer)

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Exhibit 31.2

Rule 13a-14(a) Certification of Chief Financial Officer

Certification

I, Douglas K. Howell, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Arthur J. Gallagher & Co.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant' s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a.) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b.) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c.) Evaluated the effectiveness of the registrant' s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d.) Disclosed in this report any change in the registrant' s internal control over financial reporting that occurred during the registrant' s most recent fiscal quarter (the registrant' s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant' s internal control over financial reporting; and

5. The registrant' s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant' s auditors and the audit committee of the registrant' s board of directors (or persons performing the equivalent functions):

   (a.) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant' s ability to record, process, summarize and report financial information; and

   (b.) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant' s internal control over financial reporting.

Date: May 2, 2005

/s/ Douglas K. Howell

Douglas K. Howell
Vice President
Chief Financial Officer
(principal financial officer)

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Exhibit 32.1

Section 1350 Certification of Chief Executive Officer

I, J. Patrick Gallagher, Jr., the chief executive officer of Arthur J. Gallagher & Co., certify that (i) the Quarterly Report on Form 10-Q of Arthur J. Gallagher & Co. for the quarterly period ended March 31, 2005 (the "Form 10-Q") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Arthur J. Gallagher & Co. and its subsidiaries.

Date: May 2, 2005

/s/ J. Patrick Gallagher, Jr.
J. Patrick Gallagher, Jr.
President and Chief Executive Officer
(principal executive officer)

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Exhibit 32.2

Section 1350 Certification of Chief Financial Officer

I, Douglas K. Howell, the chief financial officer of Arthur J. Gallagher & Co., certify that (i) the Quarterly Report on Form 10-Q of Arthur J. Gallagher & Co. for the quarterly period ended March 31, 2005 (the "Form 10-Q") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Arthur J. Gallagher & Co. and its subsidiaries.

Date: May 2, 2005

/s/ Douglas K. Howell

Douglas K. Howell
Vice President Chief Financial Officer
(principal financial officer)

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