

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**A. DESCRIPTION OF BUSINESS:** We underwrite selected property and casualty insurance coverages. We conduct operations principally through three insurance companies. RLI Insurance Company (RLI Ins.), our principal subsidiary, writes multiple lines insurance on an admitted basis in all 50 states, the District of Columbia and Puerto Rico. Mt. Hawley Insurance Company, a subsidiary of RLI Ins., writes surplus lines insurance in all 50 states, the District of Columbia, Puerto Rico, the Virgin Islands and Guam. RLI Indemnity Company (RIC), a subsidiary of Mt. Hawley Insurance Company, has authority to write multiple lines insurance on an admitted basis in 48 states and the District of Columbia. RIC has authority to write fidelity and surety in North Carolina.

**B. PRINCIPLES OF CONSOLIDATION AND BASIS OF PRESENTATION:** The accompanying consolidated financial statements were prepared in conformity with GAAP (generally accepted accounting principles in the United States of America), which differ in some respects from those followed in reports to insurance regulatory authorities. The consolidated financial statements include the accounts of our holding company and our subsidiaries. All significant intercompany balances and transactions have been eliminated.

#### C. ADOPTED ACCOUNTING STANDARDS

##### *FASB Accounting Standards Codification*

On July 1, 2009, the FASB Accounting Standards Codification (ASC) became the single official source of authoritative, nongovernmental GAAP, superseding existing FASB, AICPA, EITF and related literature. Prospectively, only one level of authoritative GAAP will exist, excluding the guidance issued by the Securities and Exchange Commission (SEC). All other literature will be non-authoritative. The codification does not change GAAP but instead reorganizes the U.S. GAAP pronouncements into accounting topics, and displays all topics using a consistent structure. As the codification does not change GAAP, it did not have a material impact on our financial statements. The codification was effective on a prospective basis for interim and annual reporting periods ending after September 15, 2009. Previous references to applicable literature via our disclosures have been updated with references to the new codification section.

##### *FASB ASC 323, "Investments — Debt and Equity Securities"*

In November 2008, the FASB ratified the Emerging Issues Task Force ("EITF") consensus on Issue No. 08-6,

Equity Method Investment Accounting Considerations ("EITF 08-6") which addresses certain effects of ASC 805, Business Combinations ("Topic 805"), and Topic 810 on an entity's accounting for equity-method investments. The consensus indicates, among other things, that transaction costs for an investment should be included in the cost of the equity-method investment (and not expensed) and shares subsequently issued by the equity-method investee that reduce the investor's ownership percentage should be accounted for as if the investor had sold a proportionate share of its investment, with gains or losses recorded through earnings. We adopted EITF 08-6 on January 1, 2009, and the standard did not have an impact on our consolidated financial statements. Following the effective date of the ASC, EITF 08-06 was codified within ASC 323, Investments — Debt and Equity Securities.

##### *FASB ASC 805, "Business Combinations" (previously SFAS No. 141(R), "Business Combinations")*

On January 1, 2009, we adopted new GAAP guidelines in regard to business combinations. Assets and liabilities that arose from business combinations which occurred prior to the adoption of the most recent standard are not adjusted upon the adoption. Among other things, the recent standard broadens the scope of the previous guidance to include all transactions where an acquirer obtains control of one or more other businesses. It retains the guidance to recognize intangible assets separately from goodwill and requires, with limited exceptions, that all assets acquired and liabilities assumed, including certain contractual contingencies, be measured at their acquisition date fair values. Recent guidelines require most acquisition and restructuring costs to be expensed as incurred. Step acquisitions, once control is acquired, are to be recorded at the full amounts of the fair values of the identifiable assets, liabilities and the non-controlling interest in the acquiree. The guidelines also replace the reduction of asset values and recognition of negative goodwill with a requirement to recognize a gain in earnings. The adoption had no impact on our financial position or results of operations. We will apply the provisions as applicable.

##### *FASB ASC 350, "Intangibles — Goodwill and Other" (previously FSP No. 142-3, "Determination of the Useful Life of Intangible Assets")*

New GAAP guidance regarding the useful life of intangible assets became effective January 1, 2009. It amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under previous guidance.

The intent of the new guidance is to improve the consistency between the useful life of a recognized intangible asset under FASB ASC 350 (previously SFAS 142) and the period of expected cash flows used to measure the fair value of the asset under FASB ASC 805 (previously SFAS 141(R)) and other generally accepted accounting principles. This new guidance applies to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. The implementation of this new guidance did not impact our financial position or results of operations.

*FASB ASC 320-10-65, "Debt and Equity Securities" (previously FSP No. FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments")*

In April 2009, the FASB issued new guidance on the recognition and presentation of an other-than-temporary impairment (OTTI) which amends the recognition guidance for OTTI of debt securities and expands the financial statement disclosures for OTTI on debt and equity securities. We adopted this new guidance in the second quarter of 2009.

The new guidance essentially states that an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered in circumstances where (1) an entity has the intent to sell a security, (2) it is more-likely-than-not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more-likely-than-not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the difference between the security's amortized cost and its fair value. If an entity does not intend to sell the security or it is not more-likely-than-not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income.

The guidance requires that companies record, as of the beginning of the interim period of adoption, a cumulative-effect adjustment to reclassify the noncredit component of a previously recognized OTTI loss from retained earnings to other comprehensive income if the company does not intend to sell the security and it is more-likely-than-not that the company will not be required to sell the security before recovery of its amortized cost basis. The adoption had no impact on our financial position or results of operations.

We had no cumulative-effect adjustment upon adoption at the beginning of the second quarter given our intent to sell securities with previously recognized OTTI losses, the majority of which were sold during the second quarter.

*FASB ASC 820-10-65-4, "Fair Value Measurements and Disclosures" (previously FSP No. FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly")*

In April 2009, the FASB issued new guidance on determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. Our adoption of this new guidance was effective April 1, 2009. The guidelines reaffirm that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The guidelines also reaffirm the need to use judgment in determining if a formerly active market has become inactive and in determining fair values when the market has become inactive. The adoption did not impact our financial position or results of operations.

*FASB ASC 825-10-65-1, "Financial Instruments" (previously FSP No. FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments")*

In April 2009, the FASB issued new guidance regarding interim disclosures about fair value of financial instruments. The new guidelines require disclosing qualitative and quantitative information about the fair value of all financial instruments on a quarterly basis, including methods and significant assumptions used to estimate fair value during the period. These disclosures were previously only done annually. The disclosures required by the guidelines are effective for the quarter ending June 30, 2009, and the annual disclosures are included in note 2, and in the "Liquidity and Capital Resources" section of Management's Discussion and Analysis.

*FASB ASC 855, "Subsequent Events" (previously SFAS No. 165, "Subsequent Events")*

In May 2009, the FASB issued new guidance regarding subsequent events which established general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The new standard provides guidance on the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which such recognition should take place and the disclosures that should be made. We adopted the new guidance during the second quarter of 2009, and its application had no impact on our condensed consolidated financial statements. We evaluated subsequent events through the date the accompanying financial statements were issued, which was February 24, 2010.

#### D. PROSPECTIVE ACCOUNTING STANDARDS

FASB ASC 860, "Accounting for Transfers of Financial Assets" (previously SFAS No. 166, "Accounting for Transfers of Financial Assets" (SFAS 166)) and FASB ASC 810, "Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities" (previously SFAS No. 167, "Amendments to FASB Interpretation No. 46(R)" (SFAS 167))

In June 2009, the FASB issued new guidance which updates accounting for securitizations and special-purpose entities. This guidance will require additional information regarding financial asset transfers, including securitization transactions, and the presence of continuing exposure around the risks related to transferred financial assets. It removes the concept of a qualifying special-purpose entity from FASB ASC 810, "Consolidation" (previously SFAS 140) and removes the exception from applying FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities," to variable interest entities that are qualifying special-purpose entities. The new guidance is a revision to FASB Interpretation No. 46(R) and modifies a company's determination of consolidating an entity that is insufficiently capitalized or is not controlled through voting or similar ownership rights. The new guidelines will be effective January 1, 2010, and are effective for interim periods within the first annual reporting period. Earlier application is prohibited. We do not expect the implementation of the new guidelines to have a significant impact on our financial statements.

*ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*

This ASU (Accounting Standards Update) amends certain disclosure requirements of Subtopic 820-10. This ASU provides additional disclosures for transfer of financial instruments in and out of Levels 1 and 2 and for activity in Level 3. This ASU also clarifies certain other existing disclosure requirements including level of desegregation and disclosures around inputs and valuation techniques. This will be effective for annual or interim reporting periods beginning after December 15, 2009, except for disclosure on Level 3 activity, which is effective for annual or interim reporting periods beginning after December 15, 2010. Early adoption is permitted. We do not expect the adoption of ASU 2010-06 to have a significant impact on our disclosures.

*EITF 09-G, Clarification of the Definition of Deferred Acquisition Costs (DAC) of Insurance Entities*

This EITF issue intends to clarify the definition of what constitutes an acquisition cost and the types of acquisition costs capitalized by an insurance entity. In November 2009, the Task Force reached a consensus-for-exposure that would limit the costs an entity can include in DAC to those that

are "directly related to" the acquisition of new and renewal insurance contracts. They clarified that the direct costs only include those that result in the successful acquisition of a policy and exclude all costs incurred for unsuccessful efforts, along with indirect costs. The consensus-for-exposure would require that an entity include only actual costs, not costs expected to be incurred, in DAC.

If the Task Force reaches a final consensus at a subsequent meeting and it is ratified by the FASB, it would be effective for interim and annual periods ending on or after December 15, 2010, with either prospective or retrospective application permitted, as currently drafted. Early adoption would also be permitted.

This issue, if ratified, has the potential to significantly impact the way insurance companies account for DAC, and therefore, could potentially have a significant impact on results of operations. We will continue to monitor the progress of this issue.

**E. INVESTMENTS:** We classify our investments in all debt and equity securities into one of three categories: available-for-sale, held-to-maturity, or trading.

##### *Available-For-Sale Securities*

Debt and equity securities not included as held-to-maturity or trading are classified as available-for-sale and reported at fair value. Our equity securities consist of a core stock portfolio weighted toward dividend-paying stocks, as well as exchange traded funds (ETFs). Unrealized gains and losses on these securities are excluded from net earnings but are recorded as a separate component of comprehensive earnings and shareholders' equity, net of deferred income taxes. All of our equity securities and approximately 86 percent of debt securities are classified as available-for-sale.

##### *Held-to-Maturity Securities*

Debt securities that we have the positive intent and ability to hold to maturity are classified as held-to-maturity and carried at amortized cost. Except for declines that are other-than-temporary, changes in the fair value of these securities are not reflected in the financial statements. We have classified approximately 14 percent of our debt securities portfolio as held-to-maturity.

##### *Trading Securities*

Debt and equity securities purchased for short-term resale are classified as trading securities. These securities are reported at fair value with unrealized gains and losses included in earnings. We have classified less than 1 percent of our debt securities portfolio as trading.

For the years ended December 31, 2009, 2008 and 2007, no securities were transferred from held-to-maturity to available-for-sale or trading.

We regularly evaluate our fixed income and equity securities using both quantitative and qualitative criteria to determine impairment losses for other-than-temporary

declines in the fair value of the investments. The following are the key factors for determining if a security is other-than-temporarily impaired:

- The length of time and the extent to which the fair value has been less than cost,
- The probability of significant adverse changes to the cash flows on a fixed income investment,
- The occurrence of a discrete credit event resulting in the issuer defaulting on a material obligation, the issuer seeking protection from creditors under the bankruptcy laws, the issuer proposing a voluntary reorganization which creditors are asked to exchange their claims for cash or securities having a fair value substantially lower than par value of their claims,
- The probability that we will recover the entire amortized cost basis of our fixed income securities, or
- For our equity securities, our expectation of recovery to cost within a reasonable period of time.

Quantitative criteria considered during this process include, but are not limited to: the degree and duration of current fair value as compared to the cost (amortized, in certain cases) of the security, degree and duration of the security's fair value being below cost and, for fixed maturities, whether the issuer is in compliance with terms and covenants of the security. Qualitative criteria include the credit quality, current economic conditions, the anticipated speed of cost recovery, the financial health of and specific prospects for the issuer, as well as our intent and ability to hold the fixed income securities to maturity or the equity securities until forecasted recovery. In addition, we consider price declines of securities in our other-than-temporary impairment analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates. See note 2 for further discussion of OTTI.

Interest on fixed maturities and short-term investments is credited to earnings as it accrues. Premiums and discounts are amortized or accreted over the lives of the related fixed maturities. Dividends on equity securities are credited to earnings on the ex-dividend date. Realized gains and losses on disposition of investments are based on specific identification of the investments sold on the trade date.

**F. CASH:** Cash consists of cash in banks, generally in operating accounts. On a daily basis, our cash accounts are swept into short-term investments, principally money market instruments. As a result, our consolidated balance sheets do not reflect any cash balance.

**G. SHORT-TERM INVESTMENTS:** We classify money market funds and securities-lending collateral as short-term investments. Whereas our strategy is to be fully invested at all times, short-term investments in excess of demand

deposit balances are considered a component of investment activities, and thus are classified as investments in our consolidated balance sheets. Short-term investments are carried at cost, which approximates fair value. Short-term investments consist of AAA-rated prime and government money market funds. These funds generally have original maturities of less than 90 days and, therefore, bear minimal risk. We have not experienced losses on these instruments.

**H. REINSURANCE:** Ceded unearned premiums and reinsurance balances recoverable on paid and unpaid losses and settlement expenses are reported separately as assets, instead of being netted with the related liabilities, since reinsurance does not relieve us of our legal liability to our policyholders.

We continuously monitor the financial condition of our reinsurers. As part of our monitoring efforts, we review their annual financial statements and Securities and Exchange Commission filings. We also review insurance industry developments that may impact the financial condition of our reinsurers. We analyze the credit risk associated with our reinsurance balances recoverable by monitoring the A.M. Best and Standard & Poor's (S&P) ratings of our reinsurers. In addition, we subject our reinsurance recoverables to detailed recoverable tests, including one based on average default by S&P rating. Based upon our review and testing, our policy is to charge to earnings, in the form of an allowance, an estimate of unrecoverable amounts from reinsurers. This allowance is reviewed on an ongoing basis to ensure that the amount makes a reasonable provision for reinsurance balances that we may be unable to recover.

**I. POLICY ACQUISITION COSTS:** We defer commissions, premium taxes, and certain other costs that vary with and are primarily related to the acquisition of insurance contracts. This deferral includes costs associated with both successful and unsuccessful efforts in acquiring policies. Acquisition-related costs may be deemed ineligible for deferral when they are based on contingent or performance criteria beyond the basic acquisition of the insurance contract. All eligible costs are capitalized and charged to expense in proportion to premium revenue recognized. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. This would also give effect to the premiums to be earned and anticipated losses and settlement expenses, as well as certain other costs expected to be incurred as the premiums are earned. Judgments as to the ultimate recoverability of such deferred costs are highly dependent upon estimated future loss costs associated with the premiums written. This deferral methodology applies to both gross and ceded premiums and acquisition costs.

**J. PROPERTY AND EQUIPMENT:** Property and equipment are presented at cost less accumulated depreciation and are depreciated on a straight-line basis for financial statement purposes over periods ranging from three to 10 years for equipment and up to 30 years for buildings and improvements.

**K. INVESTMENT IN UNCONSOLIDATED INVESTEES:** We maintain a 40 percent interest in the earnings of Maui Jim, Inc. (Maui Jim), a manufacturer of high-quality polarized sunglasses, which is accounted for by the equity method. We also maintain a similar minority representation on their board of directors, held by our chairman, president and CFO. Maui Jim's chief executive officer owns a controlling majority of the outstanding shares of Maui Jim, Inc. Our investment in Maui Jim was \$44.3 million in 2009 and \$38.7 million in 2008. In 2009, we recorded \$5.1 million in investee earnings, compared to \$4.8 million in 2008 and \$7.3 million in 2007. Maui Jim recorded net income of \$13.6 million in 2009, \$11.9 million in 2008 and \$18.0 million in 2007. Additional summarized financial information for Maui Jim for 2009 and 2008 is outlined in the following table:

(in millions)	2009	2008
Total assets	\$141.6	\$142.6
Total liabilities	54.3	69.6
Total equity	87.3	73.0

Approximately \$31.1 million of undistributed earnings from Maui Jim are included in our retained earnings as of December 31, 2009.

We perform an impairment review of our investment in our unconsolidated investee which considers current valuation and operating results. Based upon the most recent review, this asset was not impaired.

**L. INTANGIBLE ASSETS:** In accordance with GAAP guidelines, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. Goodwill, which relates to our surety segment, is listed separately on the balance sheet and totaled \$26.2 million at December 31, 2009 and 2008. Annual impairment testing was performed during the second quarter of 2009. Based upon this review, this asset was not impaired. In addition, as of December 31, 2009, there were no triggering events that had occurred that would suggest an updated review was necessary.

Intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite-lived intangible assets that were amortized in accordance with GAAP guidelines during the periods presented relate to our purchase of customer-related and marketing-related

intangibles. These intangibles had useful lives ranging from five to 10 years. Amortization of intangible assets was \$0.1 million for 2007. There was no amortization expense in 2009 or 2008 as these assets were fully amortized in 2007.

**M. UNPAID LOSSES AND SETTLEMENT EXPENSES:** The liability for unpaid losses and settlement expenses represents estimates of amounts needed to pay reported and unreported claims and related expenses. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. Due to the inherent uncertainty in estimating reserves for losses and settlement expenses, there can be no assurance that the ultimate liability will not exceed recorded amounts. If actual liabilities do exceed recorded amounts, there will be an adverse effect. Furthermore, we may determine that recorded reserves are more than adequate to cover expected losses, as happened during 2007 through 2009, when favorable experience primarily on casualty business led us to reduce our reserves. Based on the current assumptions used in estimating reserves, we believe that our overall reserve levels at December 31, 2009, make a reasonable provision to meet our future obligations. See note 6 for a further discussion of unpaid losses and settlement expenses.

**N. INSURANCE REVENUE RECOGNITION:** Insurance premiums are recognized ratably over the term of the contracts, net of ceded reinsurance. Unearned premiums are calculated on a monthly pro rata basis.

**O. INCOME TAXES:** We file a consolidated income tax return. Income taxes are accounted for using the asset and liability method under which deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities, operating losses and tax credit carry forwards. The effect on deferred taxes for a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced by a valuation allowance if it is more-likely-than-not all or some of the deferred tax assets will not be realized.

We consider uncertainties in income taxes and recognize those in our financial statements as required. As it relates to uncertainties in income taxes, our unrecognized tax benefits, including interest and penalty accruals, are not considered material to the consolidated financial statements. Also, no tax uncertainties are expected to result in significant

increases or decreases to unrecognized tax benefits within the next 12-month period. Penalties and interest related to income tax uncertainties, should they occur, would be included in tax expense. We were notified by the IRS that they will be performing an examination of our income tax returns for tax years 2005 and 2008 and the exam began in the first quarter of 2010. In addition, tax years 2006, 2007 and 2009 remain open and could also be subject to examination.

**P. EARNINGS PER SHARE:** Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock or common stock equivalents were exercised or converted into common stock. When inclusion of common stock equivalents increases the earnings per share or reduces the loss per share, the effect on earnings is anti-dilutive. Under these circumstances, the diluted net earnings or net loss per share is computed excluding the common stock equivalents.

The following represents a reconciliation of the numerator and denominator of the basic and diluted EPS computations contained in the consolidated financial statements.

(in thousands, except per share data)	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>For the year ended December 31, 2009</b>			
Basic EPS			
Income available to common shareholders	\$ 93,845	21,562	\$4.35
Stock options	—	169	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$ 93,845	21,731	\$4.32
<b>For the year ended December 31, 2008</b>			
Basic EPS			
Income available to common shareholders	\$ 78,676	21,540	\$3.65
Stock options	—	308	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$ 78,676	21,848	\$3.60
<b>For the year ended December 31, 2007</b>			
Basic EPS			
Income available to common shareholders	\$175,867	23,574	\$7.46
Stock options	—	511	
Diluted EPS			
Income available to common shareholders and assumed conversions	\$175,867	24,085	\$7.30

**Q. COMPREHENSIVE EARNINGS:** The difference between our net earnings and our comprehensive earnings is that comprehensive earnings include unrealized gains/losses on our available-for-sale investment securities net of tax, whereas net earnings does not include such amounts, and such amounts are instead directly credited or charged against shareholders' equity. In reporting the components of comprehensive earnings on a net basis in the income statement, we have used a 35 percent tax rate. Other comprehensive income (loss), as shown in the consolidated statements of earnings and comprehensive earnings, is net of tax expense (benefit) of \$33.5 million, \$(43.3) million and \$(5.1) million, respectively, for 2009, 2008 and 2007.

**R. FAIR VALUE DISCLOSURES:** The following was considered in the estimation of fair value for each class of financial instruments for which it was practicable to estimate that value. We utilize a pricing service to estimate the fair value of our fixed income securities. The pricing service utilizes market quotations for bonds that have quoted prices in active markets. For those bonds that do not have quoted prices in active markets, the pricing service prepares estimates of fair value using a proprietary pricing application which includes relevant market information such as benchmark curves, benchmarks to similar securities, sector groupings and matrix pricing. The pricing service uses a model based on market inputs to develop prepayment and interest rate assumptions. In addition, the pricing service evaluates each asset class based on perceived market movements, sector news and relevant market and credit information. The estimates of fair value of fixed income investments are included in the amounts disclosed as Level 2. All but two of our 725 positions were priced through the pricing service at December 31, 2009. Both positions were priced by our custodian as an alternate pricing source. The total fair value of these two securities was less than \$5 million.

For the Level 2 securities, as described above, we periodically conduct a review to assess the reasonableness of the fair values provided by our pricing service. The review consists of obtaining prices from securities brokers and comparing them to the prices provided by our pricing service. Based on this assessment, we determine that the fair values provided by our pricing service are reasonable.

For common stock, we receive prices from a nationally recognized pricing service. Prices are based on observable inputs in an active market and are therefore disclosed as Level 1.

Fair value disclosures for investments are included in note 2. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, accounts payable and short-term debt, their carrying amounts are reasonable estimates of fair value. The fair value of our long-term debt is discussed further in note 4.

**S. STOCK-BASED COMPENSATION:** We account for stock-based compensation pursuant to GAAP guidance regarding stock compensation which requires companies to expense the estimated fair value of employee stock options and similar awards. Guidance requires entities to measure compensation cost for awards of equity instruments to employees based on the grant-date fair value of those awards and recognize compensation expense over the service period that the awards are expected to vest.

We calculate the tax effects of share-based compensation pursuant to GAAP guidelines and under the alternative transition method. The alternative transition method included simplified methods to determine the impact on the additional paid-in capital pool ("APIC pool") and consolidated statements of cash flows of the tax effects of employee share-based compensation awards.

See note 8 for further discussion and related disclosures regarding stock options.

**T. RISKS AND UNCERTAINTIES:** Certain risks and uncertainties are inherent to our day-to-day operations and to the process of preparing our consolidated financial statements. The more significant risks and uncertainties, as well as our attempt to mitigate, quantify and minimize such risks, are presented below and throughout the notes to the consolidated financial statements.

#### *Catastrophe Exposures*

Our insurance coverages include exposure to catastrophic events. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Our second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes we insure in Hawaii. We monitor these exposures by quantifying our exposed policy limits in each region and by using computer-assisted modeling techniques. Additionally, we further limit our risk to such catastrophes through the purchase of reinsurance. In 2009, our property underwriting was supported by \$350 million in excess of a \$25 million first-dollar retention in traditional catastrophe reinsurance protection, subject to certain retentions by us. At January 1, 2010, we renewed our \$350 million reinsured limit, subject to certain retentions by us. We actively manage our catastrophe program to keep our net retention in line with risk tolerances and to optimize the risk/return trade off.

#### *Environmental Exposures*

We are subject to environmental claims and exposures primarily through our commercial umbrella, general liability and discontinued assumed reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, we have sought to mitigate or control the extent of this exposure on the vast majority of this business through the following methods: 1) our policies include

pollution exclusions that have been continually updated to further strengthen the exclusions, 2) our policies primarily cover moderate hazard risks, and 3) we began writing this business after the insurance industry became aware of the potential pollution liability exposure and sought to limit its exposure to this hazard.

In 2009, as an extension of our excess and surplus lines general liability product, we expanded our offerings into low to moderate environmental liability exposures for small contractors and asbestos and mold remediation specialists. The business unit also provides limited coverage for individually underwritten underground storage tanks. We have attempted to mitigate the overall exposure by focusing on smaller risks with low to moderate exposures. A large portion of this business is also offered on claims-made basis with relatively low limits. In addition, we have avoided risks that have large-scale exposures including petro-chemical, chemical, mining, manufacturers and other risks that might be exposed to superfund sites. We have currently written less than \$1 million of premium from this new product extension, which is covered under casualty reinsurance treaties.

We have made loss and settlement expense payments on environmental liability claims and have loss and settlement expense reserves for others. We include this historical environmental loss experience with the remaining loss experience in the applicable line of business to project ultimate incurred losses and settlement expenses as well as related incurred but not reported (IBNR) loss and settlement expense reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, we have used this experience to record loss and settlement expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 6.

#### *Reinsurance*

Reinsurance does not discharge us from our primary liability to policyholders, and to the extent that a reinsurer is unable to meet its obligations, we would be liable. We continuously monitor the financial condition of prospective and existing reinsurers. As a result, we currently purchase reinsurance from a number of financially strong reinsurers. We provide an allowance for reinsurance balances deemed uncollectible. See further discussion of reinsurance exposures in note 5.

#### *Investment Risk*

Our investment portfolio is subject to market, credit and interest rate risks. The equity portfolio will fluctuate with movements in the overall stock market. While the equity portfolio has been constructed to have lower downside risk than the market, the portfolio is sensitive to movements in the market. The bond portfolio is affected by interest rate changes and credit spreads. We attempt to mitigate

our interest rate and credit risks by constructing a well-diversified portfolio with high-quality securities with varied maturities. Our total portfolio had a positive return of 10 percent for the year. Downturns in the financial markets could have a negative effect on our portfolio. However, we attempt to manage this risk through asset allocation and security selection.

#### *Liquidity Risk*

Liquidity is essential to our business and a key component of our concept of asset-liability matching. Our liquidity may be impaired by an inability to collect premium receivable or reinsurance recoverable balances timely, an inability to sell assets or redeem our investments, an inability to access funds from our insurance subsidiaries, unforeseen outflows of cash or large claim payments, or an inability to access debt or equity capital markets. This situation may arise due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects third parties or us, or even by the perception among market participants that we, or other market participants, are experiencing greater liquidity risk.

Our credit ratings are important to our liquidity. A reduction in our credit ratings could adversely affect our liquidity and competitive position, increase our borrowing costs, or limit our access to the capital markets.

#### *Financial Statements*

The preparation of the accompanying consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions about future events. These estimates and the underlying assumptions affect the amounts of assets and liabilities reported, disclosures about contingent assets and liabilities, and reported amounts of revenues and expenses. The most significant of these amounts is the liability for unpaid losses and settlement expenses. Other estimates include investment valuation and OTTI, the collectibility of reinsurance balances, recoverability of deferred tax assets and deferred policy acquisition costs. These estimates and assumptions are based on management's best estimates and judgment. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment, which management believes to be reasonable under the circumstances. We adjust such estimates and assumptions when facts and circumstances dictate. Illiquid credit markets and volatile equity markets have combined to increase the uncertainty inherent in such estimates and

assumptions. Although recorded estimates are supported by actuarial computations and other supportive data, the estimates are ultimately based on our expectations of future events. As future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes in those estimates resulting from continuing changes in the economic environment will be reflected in the consolidated financial statements in future periods.

#### *External Factors*

Our insurance subsidiaries are highly regulated by the states in which they are incorporated and by the states in which they do business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments and regulate rates insurers may charge for various coverages. We are also subject to insolvency and guarantee fund assessments for various programs designed to ensure policyholder indemnification. We generally accrue an assessment during the period in which it becomes probable that a liability has been incurred from an insolvency and the amount of the related assessment can be reasonably estimated.

The National Association of Insurance Commissioners (NAIC) has developed Property/Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written and unearned premium) risk. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. We regularly monitor our subsidiaries' internal capital requirements and the NAIC's RBC developments. As of December 31, 2009, we have determined that our capital levels are well in excess of the minimum capital requirements for all RBC action levels and that our capital levels are sufficient to support the level of risk inherent in our operations.

In addition, ratings are a critical factor in establishing the competitive position of insurance companies. Our insurance companies are rated by A.M. Best, S&P and Moody's. Their ratings reflect their opinions of an insurance company's and an insurance holding company's financial strength, operating performance, strategic position and ability to meet its obligations to policyholders.

## 2. INVESTMENTS

A summary of net investment income is as follows:

### NET INVESTMENT INCOME

(in thousands)	2009	2008	2007
Interest on fixed income securities	\$63,104	\$68,290	\$69,481
Dividends on equity securities	7,965	13,863	12,252
Interest on short-term investments	591	1,484	2,716
Gross investment income	71,660	83,637	84,449
Less investment expenses	(4,314)	(4,651)	(5,548)
Net investment income	\$67,346	\$78,986	\$78,901

Pretax net realized investment gains (losses) and net changes in unrealized gains (losses) on investments for the years ended December 31 are summarized as follows:

### REALIZED/UNREALIZED GAINS

(in thousands)	2009	2008	2007
Net realized investment gains (losses)			
Fixed income			
Available-for-sale	\$ 11,196	\$ 3,583	\$ (966)
Available-for-sale OTTI	(4,578)	(11,933)	—
Held-to-maturity	70	270	89
Trading	67	(123)	(103)
Equity securities	21,350	25,534	29,863
Equity securities OTTI	(40,715)	(64,232)	—
Other	(145)	163	83
Total	(12,755)	(46,738)	28,966
Net changes in unrealized gains (losses) on investments			
Fixed income			
Available-for-sale	45,777	(21,032)	14,020
Held-to-maturity	(3,468)	(425)	(395)
Equity securities	49,504	(102,575)	(28,669)
Total	91,813	(124,032)	(15,044)
Net realized investment gains (losses) and changes in unrealized gains (losses) on investments	\$ 79,058	\$(170,770)	\$13,922

During 2009, we recorded \$12.8 million in net realized losses and the portfolio experienced unrealized gains of \$91.8 million. For 2009, the net realized investment losses and changes in unrealized gains (losses) on investments totaled \$79.1 million. The majority of our net realized losses were due to impairments in our equity portfolio during the first quarter. Both the equity and fixed income portfolios have seen a large change in unrealized gains as equity markets recovered and bond spreads tightened throughout the year.

The following is a summary of the disposition of fixed maturities and equities for the years ended December 31, with separate presentations for sales and calls/maturities.

In 2008, we inadvertently sold three fixed income positions (\$5.2 million) designated as held-to-maturity. From a custodial perspective, these securities were held with our available-for-sale portfolio. These transactions generated a realized gain of \$0.2 million. To mitigate the likelihood of this event reoccurring, we opened new custodial accounts to segregate our held-to-maturity investments from our available-for-sale investments.

(in thousands)	Proceeds From Sales	Gross Realized Gains	Realized Losses	Net Realized Gain (Loss)
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### SALES

2009 –	Proceeds From Sales	Gross Realized Gains	Realized Losses	Net Realized Gain (Loss)
Available-for-sale	\$230,604	\$11,224	\$ (1,598)	\$9,626
Held-to-maturity	—	—	—	—
Trading	10,264	336	(269)	67
Equities	178,098	21,350	(14,481)	6,869
2008 –				
Available-for-sale	\$143,074	\$ 4,269	\$ (3,759)	\$510
Held-to-maturity	5,230	179	—	179
Trading	10,885	241	(312)	(71)
Equities	89,032	25,959	(30,806)	(4,847)
2007 –				
Available-for-sale	\$ 99,360	\$ 452	\$ (1,435)	\$ (983)
Trading	6,619	25	(128)	(103)
Equities	77,040	32,347	(2,484)	29,863

### CALLS/MATURITIES

2009 –	Proceeds From Sales	Gross Realized Gains	Realized Losses	Net Realized Gain (Loss)
Available-for-sale	\$390,044	169	(11)	158
Held-to-maturity	60,412	70	—	70
Trading	628	—	—	—
2008 –				
Available-for-sale	\$327,462	\$137	\$ —	\$137
Held-to-maturity	28,870	92	(1)	91
Trading	1,561	1	—	1
2007 –				
Available-for-sale	\$199,427	\$ 38	\$(21)	\$ 17
Held-to-maturity	32,722	89	—	89
Trading	1,309	—	—	—

### FAIR VALUE MEASUREMENTS

*Assets and Liabilities Recorded at Fair Value on a Recurring Basis*

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

We determined the fair values of certain financial instruments based on the fair value hierarchy. GAAP guidance requires an entity to maximize the use of observable inputs and minimize the use of unobservable

inputs when measuring fair value. The guidance also describes three levels of inputs that may be used to measure fair value.

Level 1: quoted price (unadjusted) in active markets for identical assets

Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument

Level 3: inputs to the valuation methodology are unobservable for the asset or liability

To measure fair value, we obtain quoted market prices based on observable inputs for our investment securities. If a quoted market price is not available, we use quoted market prices based on observable inputs of similar securities.

Assets measured at fair value on a recurring basis as of December 31, 2009, are summarized below:

(in thousands)	Quoted in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Trading securities	\$ —	\$ 941	—	\$ 941
Available-for-sale securities	262,693	1,273,518	—	1,536,211
Total	\$262,693	\$1,274,459	—	\$1,537,152

Assets measured at fair value on a recurring basis as of December 31, 2008, are summarized below:

(in thousands)	Quoted in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Trading securities	\$ —	\$ 10,020	—	\$ 10,020
Available-for-sale securities	286,790	1,224,215	—	1,511,005
Total	\$286,790	\$1,234,235	—	\$1,521,025

As noted in the above tables, we did not have any assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as of December 31, 2009 and 2008.

In addition, the following is a schedule of amortized costs and estimated fair values of investments in fixed income and equity securities as of December 31, 2009 and 2008:

(in thousands)	Amortized Cost	Fair Value	Gross Unrealized Gains	Losses
<b>2009</b>				
AVAILABLE-FOR-SALE				
U.S. government	\$ 5,439	\$ 5,682	\$ 243	\$ —
Non-U.S. government	945	934	—	(11)
U.S. agencies	135,554	134,832	850	(1,572)
Mtge/ABS/CMO*	283,658	291,744	8,586	(500)
Corporate	423,042	438,289	16,901	(1,654)
States, political subdivisions & revenues	391,565	402,037	11,227	(755)
Fixed maturities	1,240,203	1,273,518	37,807	(4,492)
Equity securities	177,681	262,693	85,467	(455)
Total available-for-sale	\$1,417,884	\$1,536,211	\$123,274	\$(4,947)
HELD-TO-MATURITY				
U.S. government	\$ —	\$ —	\$ —	\$ —
U.S. agencies	200,064	197,848	732	(2,948)
States, political subdivisions & revenues	10,824	11,171	347	—
Total held-to-maturity	\$ 210,888	\$ 209,019	\$ 1,079	\$(2,948)
TRADING**				
U.S. government	\$ 158	\$ 147	—	—
U.S. agencies	—	—	—	—
Mtge/ABS/CMO*	731	691	—	—
Corporate	105	103	—	—
States, political subdivisions & revenues	—	—	—	—
Total trading	\$ 994	\$ 941	\$ —	\$ —
Total	\$1,629,766	\$1,746,171	\$124,353	\$(7,895)

\*Mortgage-backed, asset-backed & collateralized mortgage obligations

\*\*Trading securities are carried at fair value with unrealized gains (losses) included in earnings.

(in thousands)	Amortized Cost	Fair Value	Gross Gains	Unrealized Losses
<b>2008</b>				
<b>AVAILABLE-FOR-SALE</b>				
U.S. government	\$ 6,596	\$ 7,065	\$ 469	\$ —
Non-U.S. government	—	—	—	—
U.S. agencies	285,937	288,177	2,664	(424)
Mtge/ABS/CMO*	233,275	231,522	4,239	(5,992)
Corporate	287,557	270,164	2,647	(20,040)
States, political subdivisions & revenues	423,311	427,287	8,841	(4,865)
Fixed maturities	1,236,676	1,224,215	18,860	(31,321)
Equity securities	251,283	286,790	63,063	(27,556)
<b>Total available-for-sale</b>	<b>\$1,487,959</b>	<b>\$1,511,005</b>	<b>\$81,923</b>	<b>\$(58,877)</b>
<b>HELD-TO-MATURITY</b>				
U.S. government	\$ 4,916	\$ 5,019	\$ 103	\$ —
U.S. agencies	8,960	9,916	956	—
States, political subdivisions & revenues	25,945	26,486	541	—
<b>Total held-to-maturity</b>	<b>\$ 39,821</b>	<b>\$ 41,421</b>	<b>\$ 1,600</b>	<b>\$ —</b>
<b>TRADING**</b>				
U.S. government	\$ 1,150	\$ 1,312	—	—
U.S. agencies	—	—	—	—
Mtge/ABS/CMO*	6,097	5,881	—	—
Corporate	2,935	2,722	—	—
States, political subdivisions & revenues	100	105	—	—
<b>Total trading</b>	<b>\$ 10,282</b>	<b>\$ 10,020</b>	<b>—</b>	<b>—</b>
<b>Total</b>	<b>\$1,538,062</b>	<b>\$1,562,446</b>	<b>\$ 83,523</b>	<b>\$(58,877)</b>

\*Mortgage-backed, asset-backed & collateralized mortgage obligations

\*\*Trading securities are carried at fair value with unrealized gains (losses) included in earnings.

#### Agency Bonds

Unrealized losses in the agency bond portfolio were caused by interest rate changes, particularly in the last month of the year. All but one bond in the portfolio is rated AAA. We believe it is probable that we will receive all contractual payments in the form of principal and interest. Additionally, we have the ability and intent to hold these investments until recovery, thus we do not consider these investments to be other-than-temporarily impaired at December 31, 2009.

#### MBS/ABS/CMO

Our mortgage-backed securities (MBS) are issued by Government Sponsored Enterprises (GSE), including FNMA and FHLMC. All carry the highest credit rating by one or more major rating agency. As of December 31, 2009, we did not own any subprime residential mortgage bonds. Our asset-backed securities (ABS) are comprised of rate reduction utility bonds and all carry the highest credit rating available by two major rating agencies. Our collateralized mortgage obligations (CMO) are all rated AAA by one or more major rating agencies. All of these securities have demonstrated the ability to make all contractual or estimated cash flows in the form of principal or interest. We have the ability and intent to hold these investments until recovery in value, and do not consider these investments to be other-than-temporarily impaired at December 31, 2009.

#### Corporate Bonds

Corporate bond rates tightened throughout 2009. Because of this, unrealized losses in the corporate bond portfolio decreased significantly relative to 2008 unrealized losses, which were caused by increased interest rate spreads due to the financial crisis and slowing economy. The corporate bond portfolio has an overall rating of A and we believe it is probable that we will receive all contractual payments in the form of principal and interest. In addition, we have the ability and intent to hold these investments until a recovery in value, which may be maturity. We do not consider these investments to be other-than-temporarily impaired at December 31, 2009.

#### Equity Securities

Our equity portfolio consists of common stocks and exchange traded funds (ETF). The unrealized loss is contained to five securities with a fair value of \$14.2 million and an unrealized loss of \$0.5 million. We eliminated our more volatile equities, including preferred stocks and a high yield municipal bond fund, during the first quarter of 2009. Given our expectation of recovery to cost within a reasonable period of time, we do not consider any of our equities to be other-than-temporarily impaired.

The amortized cost and estimated fair value of fixed income securities at December 31, 2009, by contractual maturity, are shown as follows:

(in thousands)	Amortized Cost	Fair Value
<b>AVAILABLE-FOR-SALE</b>		
Due in one year or less	\$ 23,589	\$ 23,939
Due after one year through five years	234,398	245,600
Due after five years through 10 years	429,980	442,039
Due after 10 years	268,577	270,196
Mtge/ABS/CMO*	283,659	291,744
Total available-for-sale	\$1,240,203	\$1,273,518
<b>HELD-TO-MATURITY</b>		
Due in one year or less	\$ 2,220	\$ 2,223
Due after one year through five years	24,619	25,552
Due after five years through 10 years	110,629	109,568
Due after 10 years	73,420	71,676
Total held-to-maturity	\$ 210,888	\$ 209,019
<b>TRADING</b>		
Due in one year or less	\$ —	\$ —
Due after one year through five years	54	54
Due after five years through 10 years	210	196
Due after 10 years	—	—
Mtge/ABS/CMO*	730	691
Total trading	\$ 994	\$ 941
<b>TOTAL FIXED INCOME</b>		
Due in one year or less	\$ 25,809	\$ 26,162
Due after one year through five years	259,071	271,206
Due after five years through 10 years	540,819	551,803
Due after 10 years	341,997	341,872
Mtge/ABS/CMO*	284,389	292,435
Grand total	\$1,452,085	\$1,483,478

\*Mortgage-backed, asset-backed & collateralized mortgage obligations

Expected maturities may differ from contractual maturities due to call provisions on some existing securities and prepayment features on MBS, ABS and CMOs. At December 31, 2009, the net unrealized appreciation of available-for-sale fixed maturities and equity securities totaled \$118.3 million. At December 31, 2008, the net unrealized appreciation of available-for-sale fixed maturities and equity securities totaled \$23.0 million.

The following tables are also used as part of our impairment analysis and illustrate the total value of securities that were in an unrealized loss position as of December 31, 2009, and December 31, 2008, respectively. These tables segregate the securities based on type, noting the fair value, cost (or amortized cost) and unrealized loss on each category of investment as well as in total. The tables further classify the securities based on the length of time they have been in an unrealized loss position.

<b>DECEMBER 31, 2009</b> (in thousands)	<12 Mos.	12 Mos. & Greater	Total
<b>U.S. Government</b>			
Fair value	\$ —	\$ —	\$ —
Cost or amortized cost	—	—	—
Unrealized loss	—	—	—
<b>Non-U.S. Government</b>			
Fair value	\$ 934	\$ —	\$ 934
Cost or amortized cost	945	—	945
Unrealized loss	(11)	—	(11)
<b>U.S. Agency</b>			
Fair value	\$248,507	\$ —	\$248,507
Cost or amortized cost	253,027	—	253,027
Unrealized loss	(4,520)	—	(4,520)
<b>Mortgage Backed</b>			
Fair value	\$ 24,931	\$ —	\$ 24,931
Cost or amortized cost	25,302	—	25,302
Unrealized loss	(371)	—	(371)
<b>ABS/CMO*</b>			
Fair value	\$ 4,587	\$ 3,255	\$ 7,842
Cost or amortized cost	4,640	3,331	7,971
Unrealized loss	(53)	(76)	(129)
<b>Corporate</b>			
Fair value	\$ 68,436	\$ 8,420	\$ 76,856
Cost or amortized cost	69,541	8,969	78,510
Unrealized loss	(1,105)	(549)	(1,654)
<b>States, political subdivisions and revenues</b>			
Fair value	\$ 72,922	\$ 7,028	\$ 79,950
Cost or amortized cost	73,531	7,174	80,705
Unrealized loss	(609)	(146)	(755)
<b>Subtotal, debt securities</b>			
Fair value	\$420,317	\$18,703	\$439,020
Cost or amortized cost	426,986	19,474	446,460
Unrealized loss	(6,669)	(771)	(7,440)
<b>Common stock</b>			
Fair value	\$ 11,720	\$ 2,468	\$ 14,188
Cost or amortized cost	12,019	2,624	14,643
Unrealized loss	(299)	(156)	(455)
<b>Preferred stock</b>			
Fair value	\$ —	\$ —	\$ —
Cost or amortized cost	—	—	—
Unrealized loss	—	—	—
<b>Total</b>			
Fair value	\$432,037	\$21,171	\$453,208
Cost or amortized cost	439,005	22,098	461,103
Unrealized loss	(6,968)	(927)	(7,895)

\*Asset-backed & collateralized mortgage obligations

DECEMBER 31, 2008 (in thousands)	<12 Mos.	12 Mos. & Greater	Total
<b>U.S. Government</b>			
Fair value	\$ —	\$ —	\$ —
Cost or amortized cost	—	—	—
Unrealized loss	—	—	—
<b>Non-U.S. Government</b>			
Fair value	\$ —	\$ —	\$ —
Cost or amortized cost	—	—	—
Unrealized loss	—	—	—
<b>U.S. Agency</b>			
Fair value	\$ 34,955	\$ —	\$ 34,955
Cost or amortized cost	35,379	—	35,379
Unrealized loss	(424)	—	(424)
<b>Mortgage Backed</b>			
Fair value	\$ 61	\$ —	\$ 61
Cost or amortized cost	61	—	61
Unrealized loss	—	—	—
<b>ABS/CMO*</b>			
Fair value	\$ 23,191	\$32,020	\$ 55,211
Cost or amortized cost	24,570	36,633	61,203
Unrealized loss	(1,379)	(4,613)	(5,992)
<b>Corporate</b>			
Fair value	\$135,865	\$32,737	\$168,602
Cost or amortized cost	149,935	38,707	188,642
Unrealized loss	(14,070)	(5,970)	(20,040)
<b>States, political subdivisions and revenues</b>			
Fair value	\$123,464	\$23,301	\$146,765
Cost or amortized cost	127,049	24,581	151,630
Unrealized loss	(3,585)	(1,280)	(4,865)
<b>Subtotal, debt securities</b>			
Fair value	\$317,536	\$88,058	\$405,594
Cost or amortized cost	336,994	99,921	436,915
Unrealized loss	(19,458)	(11,863)	(31,321)
<b>Common stock</b>			
Fair value	\$ 81,192	\$14,126	\$ 95,318
Cost or amortized cost	103,465	19,151	122,616
Unrealized loss	(22,273)	(5,025)	(27,298)
<b>Preferred stock</b>			
Fair value	\$ 2,613	\$ —	\$ 2,613
Cost or amortized cost	2,871	—	2,871
Unrealized loss	(258)	—	(258)
<b>Total</b>			
Fair value	\$401,341	\$102,184	\$503,525
Cost or amortized cost	443,330	119,072	562,402
Unrealized loss	(41,989)	(16,888)	(58,877)

\*Asset-backed & collateralized mortgage obligations

As of December 31, 2009, we held five common stocks that were in unrealized loss positions. The total unrealized loss on these securities was \$0.5 million. In considering both the significance and duration of the unrealized loss positions, we have no equity securities in an unrealized loss position of greater than 20 percent for more than six consecutive months. The fixed income portfolio contained 135 securities at a loss as of December 31, 2009. Of these 135 securities, 12 have been in an unrealized loss position for 12 consecutive months or longer and these collectively represent \$0.8 million in unrealized losses. The fixed income unrealized losses can be primarily attributed to spreads widening in the corporate, municipal and mortgage-backed security markets at the end of 2009. We have the ability and intent to hold these securities to maturity. In addition, we continually monitor the credit quality of our fixed income investments to assess if it is probable that we will receive our contractual or estimated cash flows in the form of principal and interest. We consider price declines of securities in our OTTI analysis where such price declines provide evidence of declining credit quality, and we distinguish between price changes caused by credit deterioration, as opposed to rising interest rates.

Key factors that we consider in the evaluation of credit quality include:

- Changes in technology that may impair the earnings potential of the investment,
- The discontinuance of a segment of the business that may affect the future earnings potential,
- Reduction or elimination of dividends,
- Specific concerns related to the issuer's industry or geographic area of operation,
- Significant or recurring operating losses, poor cash flows, and/or deteriorating liquidity ratios, and
- Downgrade in credit quality by a major rating agency.

Based on our analysis, we've concluded that the securities in an unrealized loss position are not other-than-temporarily impaired.

During 2009, we recognized impairment losses of \$45.3 million. This total includes declines of \$40.7 million in equities and \$4.6 million in fixed income securities. Of the total charge, \$38.6 million came during the first quarter as the overall market continued its downward trend. Less than \$0.1 million was impaired during the second half of 2009. During 2008, we recognized impairment losses of \$76.2 million. There were no losses associated with the OTTI of securities in 2007.

We completely exited our securities lending program as of June 30, 2009. At December 31, 2008, fixed maturities with a fair value of \$15.4 million were loaned.

As required by law, certain fixed maturities and short-term investments amounting to \$17.8 million at December 31, 2009, were on deposit with either regulatory authorities or banks. Additionally, we have certain fixed maturities held

in trust amounting to \$0.9 million at December 31, 2009. These funds cover net premiums, losses and expenses related to a property and casualty insurance program.

### 3. POLICY ACQUISITION COSTS

Policy acquisition costs deferred and amortized to income for the years ended December 31 are summarized as follows:

(in thousands)	2009	2008	2007
Deferred policy acquisition costs, beginning of year	\$ 78,520	\$ 78,882	\$ 73,817
Deferred:			
Direct commissions	100,727	110,985	119,344
Premium taxes	6,596	7,663	6,902
Other direct underwriting expenses	69,496	65,270	60,695
Ceding commissions	(26,156)	(27,438)	(31,454)
Net deferred	150,663	156,480	155,487
Amortized	153,303	156,842	150,422
Deferred policy acquisition costs, end of year	\$ 75,880	\$ 78,520	\$ 78,882
Policy acquisition costs:			
Amortized to expense	153,303	156,842	150,422
Period costs:			
Ceding commission - contingent	(1,998)	(2,683)	(3,334)
Other	10,715	9,161	8,522
Total policy acquisition costs	\$162,020	\$163,320	\$155,610

### 4. DEBT

As of December 31, 2009, outstanding debt balances totaled \$100.0 million, all of which was our long-term senior notes. The senior notes are rated Baa2 by Moody's and BBB+ by S&P.

On December 12, 2003, we completed a public debt offering, issuing \$100.0 million in senior notes maturing January 15, 2014, and paying interest semi-annually at the rate of 5.95 percent. The notes were issued at a discount resulting in proceeds, net of discount and commission, of \$98.9 million. The amount of the discount is being charged to income over the life of the debt on an effective-yield basis. Of the proceeds, capital contributions totaling \$65.0 million were made to our insurance subsidiaries to increase their statutory surplus. The balance of the proceeds was used by the holding company to fund investment and operating activities. The estimated fair value for the senior note is \$101.0 million. The fair value of our long-term debt is estimated based on the limited observable prices that reflect thinly traded securities.

As of December 31, 2009, we had no short-term debt outstanding, consistent with short-term debt balances as of December 31, 2008. We maintain a revolving line of credit with JP Morgan which permits us to borrow up to an aggregate principal amount of \$25.0 million. Under certain conditions, the line may be increased up to an aggregate principal amount of \$50.0 million. This facility has a three-year term that expires on May 31, 2011. As of December 31, 2009, no amounts were outstanding on this facility.

We incurred interest expense on debt at the following average interest rates for 2009, 2008 and 2007:

	2009	2008	2007
Line of credit	—	—	—
Reverse repurchase agreements	—	3.42%	5.15%
Total short-term debt	—	3.42%	5.15%
Senior notes	6.02%	6.02%	6.02%
Total debt	6.02%	5.60%	5.88%

Interest paid on outstanding debt for 2009, 2008 and 2007, amounted to \$6.0 million, \$6.7 million and \$7.0 million, respectively.

### 5. REINSURANCE

In the ordinary course of business, the insurance subsidiaries assume and cede premiums with other insurance companies. A large portion of the reinsurance is put into effect under contracts known as treaties and, in some instances, by negotiation on each individual risk (known as facultative reinsurance). In addition, there are several types of treaties including: quota share, excess of loss and catastrophe reinsurance contracts that protect against losses over stipulated amounts arising from any one occurrence or event. The arrangements allow us to pursue greater diversification of business and serve to limit the maximum net loss to a single event, such as catastrophes. Through the quantification of exposed policy limits in each region and the extensive use of computer-assisted modeling techniques, we monitor the concentration of risks exposed to catastrophic events.

Through the purchase of reinsurance, we also generally limit our net loss on any individual risk to a maximum of \$2.0 million, although retentions can range from \$0.5 million to \$7.5 million.

Premiums written and earned along with losses and settlement expenses incurred for the years ended December 31 are summarized as follows:

(in thousands)	2009	2008	2007
<b>WRITTEN</b>			
Direct	\$614,887	\$673,226	\$734,287
Reinsurance assumed	16,313	7,943	5,047
Reinsurance ceded	(161,284)	(167,713)	(200,571)
Net	\$469,916	\$513,456	\$538,763
<b>EARNED</b>			
Direct	\$640,034	\$695,824	\$765,894
Reinsurance assumed	14,289	5,218	5,729
Reinsurance ceded	(162,362)	(172,278)	(227,145)
Net	\$491,961	\$528,764	\$544,478
<b>LOSSES AND SETTLEMENT EXPENSES INCURRED</b>			
Direct	\$245,671	\$234,121	\$180,140
Reinsurance assumed	9,696	7,399	7,746
Reinsurance ceded	(51,979)	5,654	2,982
Net	\$203,388	\$247,174	\$190,868

The direct incurred losses shown in the table above have increased the last two years. However, significant adjustments to our loss reserve methodologies two years ago caused the 2007 number to be much smaller than comparable amounts for previous years. 2009 and 2008 represent a return to more normal levels. The assumed number is higher in 2009 because of growth in our property reinsurance business. The ceded number for 2009 reflects a return to the more normal situation in which ceded reinsurance provides a benefit to net incurred losses. In 2008 and 2007, the effects of favorable emergence were unusually significant for ceded reserves causing the positive numbers in the table. The net amounts decreased for 2009 due to a combination of lower earned premiums and a lower loss ratio.

At December 31, 2009, we had prepaid reinsurance premiums on paid and unpaid losses and settlement expenses totaling \$370.6 million. More than 91 percent of our reinsurance recoverables are due from companies rated "A" or better by A.M. Best and S&P rating services.

The following table displays net reinsurance balances recoverable, after consideration of collateral, from our top 10 reinsurers, as of December 31, 2009. All other reinsurance balances recoverable, when considered by individual reinsurer, are less than 2 percent of shareholders' equity.

REINSURER (in thousands)	Amounts Recoverable	A.M Best Rating	S&P Rating
Munich Re America / HSB	\$60,053	A+, Superior	AA-, Very Strong
Endurance Re	47,488	A, Excellent	A, Strong
Swiss Re/Westport Ins. Corp.	35,033	A, Excellent	A+, Strong
Axis Re	34,586	A, Excellent	A+, Strong
Berkley Insurance Co.	25,001	A+, Superior	A+, Strong
General Cologne Re	22,871	A++, Superior	AAA, Extremely Strong
Transatlantic Re	18,980	A, Excellent	A+, Strong
Toa-Re	17,885	A, Excellent	A+, Strong
Aspen UK Ltd.	16,227	A, Excellent	A, Strong
Lloyds of London	14,537	A, Excellent	A+, Strong

## 6. HISTORICAL LOSS AND LAE DEVELOPMENT

The table which follows is a reconciliation of our unpaid losses and settlement expenses (LAE) for the years 2009, 2008 and 2007.

(in thousands)	2009	2008	2007
Unpaid losses and LAE at beginning of year:			
Gross	\$1,159,311	\$1,192,178	\$1,318,777
Ceded	(350,284)	(417,250)	(525,671)
Net	\$ 809,027	\$ 774,928	\$ 793,106
Increase (decrease) in incurred losses and LAE:			
Current accident year	\$ 269,965	\$ 309,512	\$ 296,047
Prior accident years	(66,577)	(62,338)	(105,179)
Total incurred	\$ 203,388	\$ 247,174	\$ 190,868
Loss and LAE payments for claims incurred:			
Current accident year	\$ (41,890)	\$ (51,599)	\$ (46,598)
Prior accident year	(160,457)	(161,476)	(162,448)
Total paid	\$ (202,347)	\$ (213,075)	\$ (209,046)
Net unpaid losses and LAE at end of year	\$ 810,068	\$ 809,027	\$ 774,928
Unpaid losses and LAE at end of year:			
Gross	1,146,460	1,159,311	1,192,178
Ceded	(336,392)	(350,284)	(417,250)
Net	\$ 810,068	\$ 809,027	\$ 774,928

The deviations from our initial reserve estimates appeared as changes in our ultimate loss estimates as we updated those estimates through our reserve analysis process. The recognition of the changes in initial reserve estimates occurred over time as claims were reported, initial case reserves were established, initial reserves were reviewed in light of additional information, and ultimate payments were made on the collective set of claims incurred as of that evaluation date. The new information on the ultimate settlement value of claims is therefore continually updated and revised as this process takes place until all claims in a defined set of claims are settled. As a relatively small insurer, our experience will ordinarily exhibit fluctuations from period to period. While we attempt to identify and react to systematic changes in the loss environment, we also must consider the volume of experience directly available to us, and interpret any particular period's indications with a realistic technical understanding of the reliability of those observations.

The table below summarizes our prior accident years' loss reserve development by segment for 2009, 2008 and 2007:

<b>(FAVORABLE)/UNFAVORABLE RESERVE DEVELOPMENT BY SEGMENT</b>			
(in thousands)	<b>2009</b>	2008	2007
Casualty	<b>\$(65,523)</b>	\$(50,562)	\$(87,397)
Property	<b>3,434</b>	(6,646)	(6,690)
Surety	<b>(4,488)</b>	(5,130)	(11,092)
<b>Total</b>	<b>\$(66,577)</b>	\$(62,338)	\$(105,179)

A discussion of significant components of reserve development for the three most recent calendar years follows:

**2009.** During 2009, we experienced favorable loss emergence from prior years' reserve estimates across our casualty and surety segments, which were partially offset by unfavorable loss emergence in our property segment. For our casualty segment, we experienced \$65.5 million of favorable development, predominantly from the accident years 2003 through 2008. In retrospect, the expected loss ratios initially used to set booked reserves for these accident years proved to be conservative, which resulted in loss emergence significantly lower than expected. This was predominantly caused by favorable frequency and severity trends that were considerably less than we would expect over the long term. This was particularly true for our general liability, personal umbrella and transportation products, which experienced favorable loss development of \$38.2 million, \$11.2 million and \$10.1 million, respectively. The construction class was the largest contributor to the favorable emergence in the general liability product. We also saw favorable loss emergence across almost all of our casualty products

including our commercial umbrella products and executive products group (D&O/E&O). Offsetting this favorable trend, our program business experienced \$4.5 million of unfavorable prior years' loss development during the year, almost all in the 2008 accident year. We have re-underwritten and downsized this product offering during 2009. We also realized \$5.2 million of unfavorable development from some runoff casualty business from accident year 1987 related to environmental and asbestos exposures and resulting changes in collectibility estimates.

Our property segment realized \$3.4 million of unfavorable loss development in 2009. Most of this emergence was in accident years 2007 and 2008 and the direct result of the longer-tailed coverage within our marine business. We entered the marine business in 2005 and it had grown steadily until the first half of 2009. We had relied extensively on external loss development patterns to that point. Our losses have developed much more slowly than would be expected particularly in the hull, protection & indemnity and marine liability lines. As a result, we booked \$11.4 million of adverse development on prior years' reserves. We took underwriting action in 2009, exiting certain heavy commercial segments of the book and reorganizing the business. Offsetting the marine development was favorable development on catastrophes including \$4.2 million from the 2008 hurricanes and Midwest flood. We also observed favorable loss emergence in our fire and runoff construction businesses.

Our surety segment experienced \$4.5 million of favorable emergence in 2009. Almost all of the favorable emergence was from the 2008 accident year. Very little observed loss severity in the commercial surety product resulted in \$1.5 million of favorable emergence. Continued improvement in our contract surety loss ratio resulting from past re-underwriting of the business led to \$3.4 million of favorable loss reserve development. We continue to watch these products closely as they can be significantly impacted by economic downturns; however, there has been no impact to loss frequency or severity to this point.

**2008.** During 2008, we experienced favorable loss emergence from prior years' reserve estimates across all of our segments. For our casualty segment, we experienced \$50.6 million of favorable development, predominantly from the accident years 2002 through 2006. In retrospect, the expected loss ratios initially used to set booked reserves for these accident years proved to be conservative, which resulted in loss emergence significantly lower than expected. This was particularly true for our general liability, personal umbrella and commercial umbrella products, which experienced favorable loss development of \$33.1 million, \$12.7 million and \$11.8 million, respectively. The construction class was the largest contributor to the favorable emergence in the general liability product. In

addition, our program business experienced \$9.3 million of unfavorable prior years' loss development during the year, mostly isolated in accident years 2004 through 2007. Our experience in the liquor liability class has been particularly adverse. In the past, we relied on external loss development patterns that have not proven predictive of actual emergence. As a result, this class was re-underwritten and we implemented a more stringent reserving approach in 2008.

Our property segment realized \$6.6 million of favorable loss development in 2008. Most of this emergence was in accident years 2005 through 2007. The construction and fire products were the drivers of the favorable emergence, recording \$4.4 million and \$4.2 million, respectively. The construction business was in run-off for three years and recent experience was much better than expected, with a reduction in both frequency and severity of claims. Only a handful of contracts remain open and we observed little new activity from this product line. Our fire product saw favorable emergence from the 2007 accident year, as our year-end 2007 reserves developed more favorably than originally estimated.

Our surety segment experienced \$5.1 million of favorable emergence. Almost all of the favorable emergence was from the 2007 accident year. Very little observed loss severity in the commercial surety product resulted in \$1.7 million of favorable emergence. Continued improvement in our contract surety loss ratio resulting from past re-underwriting of the business led to \$2.5 million of favorable loss reserve development.

2007. We periodically review our loss reserve estimates and underlying actuarial reserving methodologies in order to assess their accuracy and suitability, and to benchmark our reserving practices against industry best practices. A detailed assessment of recent trends and reserve risk factors was undertaken in 2007. As part of our reviews, we performed a more detailed, ground-up analysis of the actuarial estimation risks associated with each of our products and segments, including an assessment of industry information.

Our analyses also revealed that our quarterly actuarial reserve estimates over recent historical periods had shown a downward trend as a result of a moderating loss trend environment, improvements in policy terms and conditions and a favorable underlying exposure mix that occurred during the hard market period from 2001 through 2004.

Based on this review, we made certain refinements to our reserving methodologies to include a more detailed consideration of the impact of risk factors on total recorded reserves through increased internal dialogue among the claim, underwriting, risk management and actuarial departments, greater transparency of the actuarial process and results, and improved reserving diagnostics. Overall,

these enhancements and improved information provide better and faster feedback to management regarding loss development resulting in greater overall confidence in the actuarial estimates. This and the increased stability in our business in the last few years diminished the needed level of carried reserves above the actuarial point estimate. We believe that these reserve methodology enhancements improved the overall accuracy of our best estimate of loss and LAE reserves. Over half of the favorable prior years' loss development was the result of this detailed assessment and resulting changes in our booked reserves.

Our casualty segment was most impacted by prior years' loss development realizing a total of \$87.4 million of favorable emergence. All casualty products were impacted by the enhanced risk assessment previously mentioned. Our general liability, transportation, personal umbrella and professional liability products realized favorable development of \$42.5 million, \$19.6 million, \$10.5 million and \$8.1 million, respectively. This favorable emergence was concentrated in accident years 2004 through 2006. As a result of significant favorable loss development observed over the past several years for our general liability product, we reassessed the expected loss ratios used in our actuarial analysis and subsequently lowered them for the construction classes. For our transportation and personal umbrella products, we reassessed and subsequently lowered the loss development factors in our analysis, reflecting our observation that the emergence patterns were more favorable than previously anticipated. Finally, our professional liability products realized actual loss emergence much more favorably than expected.

The property segment realized \$6.7 million of favorable prior years' development. The favorable emergence was realized across almost all of our property products, predominantly in accident years 2005 and 2006. We also executed a favorable reinsurance commutation impacting accident years prior to 2000.

The surety segment realized \$11.1 million of favorable prior years' development. Almost all of the development was the result of the risk reassessment and reflection of significantly lower reserve risk after achieving settlement with the larger banks involved in the CMC litigation (see note 10 of the 2007 annual report for more details).

## **ENVIRONMENTAL, ASBESTOS AND MASS TORT EXPOSURES**

We are subject to environmental site cleanup, asbestos removal and mass tort claims and exposures through our commercial umbrella, general liability and discontinued assumed casualty reinsurance lines of business. The majority of the exposure is in the excess layers of our commercial umbrella and assumed reinsurance books of business.

The following table represents inception-to-date paid and unpaid environmental, asbestos and mass tort claims data (including incurred but not reported losses) as of December 31, 2009, 2008 and 2007:

(in thousands)	2009	2008	2007
<b>LOSS AND LAE PAYMENTS</b>			
Gross	\$75,544	\$70,210	\$56,060
Ceded	(41,639)	(39,143)	(30,607)
Net	\$33,905	\$31,067	\$25,453
<b>UNPAID LOSSES AND LAE AT END OF YEAR</b>			
Gross	\$68,198	\$65,583	\$67,891
Ceded	(20,142)	(20,407)	(29,198)
Net	\$48,056	\$45,176	\$38,693

Our environmental, asbestos and mass tort exposure is limited, relative to other insurers, as a result of entering the affected liability lines after the insurance industry had already recognized environmental and asbestos exposure as a problem and adopted appropriate coverage exclusions.

During 2009, the increase in inception-to-date gross loss payments was significantly less than we experienced in 2008, but still greater than in 2007. Of particular note was a mass tort claim from accident year 2005 against an insured hotel involving carbon monoxide discharge. This resulted in payments of \$1.6 million direct and \$0.8 million net; approximately the same amounts as the case reserves established in 2008. Also, a marine liability claim from accident year 2007 involving a fuel spill resulted in payments of \$0.3 million direct and net.

The increase in reserves over last year is driven primarily by claim activity from the 1980s associated with Underwriter's Indemnity Company which we purchased in 1999. In recent years, we have had unexpected claim activity from this book of business, which caused us to add \$4.7 million of both direct and net IBNR in 2009. Claim activity was lower in 2009 than in 2008 and 2007, but we are still receiving new claim notifications.

During 2008, payment activity was more than we experienced in 2007, which was not surprising, given the increased amount of case reserve activity during 2007. However, we did not observe a corresponding decrease in case reserves, as gross case reserves decreased by only \$4.8 million while net case reserves increased by \$0.5 million. Much of the reported adverse development can be tied to a small number of claims. Two related asbestos claims from our assumed reinsurance book accounted for \$2.7 million in gross emergence and \$2.1 million in net emergence with large payments being made. In light of these two asbestos claims and the aforementioned mass tort claim, we decided to strengthen our IBNR position.

While our environmental exposure is limited, the ultimate liability for this exposure is difficult to assess because of the extensive and complicated litigation involved in the settlement of claims and evolving legislation on such issues as joint and several liability, retroactive liability and standards of cleanup. Additionally, we participate primarily in the excess layers of coverage, where accurate estimates of ultimate loss are more difficult to derive than for primary coverage.

## 7. INCOME TAXES

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are summarized as follows:

(in thousands)	2009	2008
Deferred tax assets:		
Tax discounting of claim reserves	\$ 31,797	\$32,728
Unearned premium offset	17,300	18,843
Deferred compensation	4,731	5,035
Stock option expense	2,558	1,548
Net unrealized depreciation of securities	—	4,912
Other	427	416
Deferred tax assets before allowance	56,813	63,482
Less valuation allowance	—	—
Total deferred tax assets	\$ 56,813	\$63,482
Deferred tax liabilities:		
Net unrealized appreciation of securities	\$ 41,044	\$ —
Deferred policy acquisition costs	26,558	27,482
Book/tax depreciation	1,649	1,823
Undistributed earnings of unconsolidated investee	11,721	9,773
Other	140	263
Total deferred tax liabilities	81,112	39,341
Net deferred tax asset (liability)	\$(24,299)	\$24,141

Income tax expense attributable to income from operations for the years ended December 31, 2009, 2008 and 2007, differed from the amounts computed by applying the U.S. federal tax rate of 35 percent to pretax income from continuing operations as demonstrated in the following table:

(in thousands)	2009	2008	2007
Provision for income taxes at the statutory federal tax rates	<b>\$46,353</b>	\$37,309	\$89,067
Increase (reduction) in taxes resulting from:			
Dividends received deduction	<b>(1,449)</b>	(1,830)	(1,815)
ESOP dividends paid deduction	<b>(563)</b>	(508)	(471)
Tax-exempt interest income	<b>(5,171)</b>	(6,418)	(6,276)
Non-recurring tax benefit	—	—	(2,356)
Other items, net	<b>(578)</b>	(631)	460
<b>Total</b>	<b>\$38,592</b>	\$27,922	\$78,609

Our effective tax rates were 29.1 percent, 26.2 percent and 30.9 percent for 2009, 2008 and 2007, respectively. Effective rates are dependent upon components of pretax earnings and the related tax effects. The effective rate for 2009 was higher than 2008 due to an increase in underwriting income and a significant reduction in net realized losses, which were taxed at 35.0 percent. In addition, changes in items that are non-taxable, such as tax-exempt interest income, impact the effective tax rate. Partially offsetting tax expense in 2007 was a \$2.4 million tax benefit recorded in the third quarter to reflect the benefit expected to be realized upon the future payment of certain accrued compensation.

Our net earnings include equity in earnings of unconsolidated investee. This investee does not have a policy or pattern of paying dividends. As a result, we record a deferred tax liability on the earnings at the corporate capital gains rate of 35 percent. In the third quarter of 2008, we received a \$4.0 million dividend from Maui Jim. In accordance with GAAP guidelines on income taxes, we recognized a \$1.1 million tax benefit in 2008 from applying the lower tax rate applicable to affiliated dividends as compared to the corporate capital gains rate on which the deferred tax liabilities were based. This benefit is included in the other items, net caption in the previous table. No dividends were received from Maui Jim during 2009, nor do we anticipate dividends in future periods as we expect to recover our investment through means other than receipt of dividends. We have recorded our deferred tax assets and liabilities using the statutory federal tax rate of 35 percent. We believe it is more-likely-than-not that all deferred tax assets will be recovered given the carry back availability as well as the results of future operations, which will generate sufficient taxable income to realize the deferred tax asset.

In addition, we believe when these deferred items reverse in future years, our taxable income will be taxed at an effective rate of 35 percent.

Federal and state income taxes paid in 2009, 2008 and 2007, amounted to \$30.8 million, \$31.6 million and \$87.8 million, respectively.

## 8. EMPLOYEE BENEFITS

### EMPLOYEE STOCK OWNERSHIP, 401(K) AND BONUS AND INCENTIVE PLANS

We maintain an Employee Stock Ownership Plan (ESOP), 401(k) and bonus and incentive plans covering executives, managers and associates. At the board's discretion, funding of these plans is primarily dependent upon reaching predetermined levels of operating return on equity and Market Value Potential (MVP). MVP is a compensation model that measures comprehensive earnings against a minimum required return on our capital. Bonuses are earned as we generate earnings in excess of this required return. While some management incentive plans may be affected somewhat by other performance factors, the larger influence of corporate performance ensures that the interests of our executives, managers and associates correspond with those of our shareholders.

Our 401(k) plan allows voluntary contributions by employees and permits ESOP diversification transfers for employees meeting certain age or service requirements. We provide a basic 401(k) contribution of 3 percent of eligible compensation. Participants are 100 percent vested in both voluntary and basic contributions. Additionally, an annual discretionary profit-sharing contribution may be made to the ESOP and 401(k), subject to the achievement of certain overall financial goals. For plan years prior to 2007, profit-sharing contributions were subject to a five-year cliff vest. For plan year 2007 and later, contributions vest after three years of service.

Our ESOP and 401(k) cover all employees meeting eligibility requirements. ESOP and 401(k) profit-sharing contributions are determined annually by our board of directors and are expensed in the year earned. ESOP and 401(k)-related expenses (basic and profit-sharing) were \$8.7 million, \$8.8 million and \$9.8 million, respectively, for 2009, 2008 and 2007.

During 2009, the ESOP purchased 103,357 shares of RLI treasury stock at an average price of \$55.60 (\$5.7 million) relating to the contribution for plan year 2008. Shares held by the ESOP as of December 31, 2009, totaled 1,492,203 and are treated as outstanding in computing our earnings per share. During 2008, the ESOP purchased 118,902 shares of RLI stock on the open market at an average price of \$53.85 (\$6.4 million) relating to the contribution for

plan year 2007. During 2007, the ESOP purchased 90,561 shares of RLI stock on the open market at an average price of \$57.92 (\$5.2 million) relating to the contribution for plan year 2006.

Annual bonuses are awarded to executives, managers and associates through our incentive plans, provided certain financial and operational goals are met. Annual expenses for these incentive plans totaled \$15.5 million, \$4.6 million and \$15.8 million for 2009, 2008 and 2007, respectively.

#### DEFERRED COMPENSATION

We maintain rabbi trusts for deferred compensation plans for directors, key employees and executive officers through which our shares are purchased. GAAP guidelines prescribe an accounting treatment whereby the employer stock in the plan is classified and accounted for as equity, in a manner consistent with the accounting for treasury stock.

In 2009, the trusts purchased 13,580 shares of our common stock on the open market at an average price of \$51.96 (\$0.7 million). In 2008, the trusts purchased 18,496 shares of common stock on the open market at an average price of \$51.62 (\$1.0 million). In 2007, the trusts purchased 13,013 shares of our common stock on the open market at an average price of \$56.76 (\$0.7 million). At December 31, 2009, the trusts' assets were valued at \$17.4 million.

#### STOCK OPTION AND STOCK PLANS

During 1995, we adopted and the shareholders approved a tax-favored incentive stock option plan (the incentive plan). During 1997, the shareholders approved the Outside Directors' Stock Option Plan (the directors' plan). Normal vesting for options granted was pro rata over five years under the incentive plan and pro rata over three years under the directors' plan with a 10-year life for both plans. The plans provided for grants of up to 3,125,000 shares under the incentive plan and 500,000 shares under the directors' plan. Through May 5, 2005, we had granted 2,640,188 options under these plans.

In 2005, we adopted and shareholders approved the RLI Corp. Omnibus Stock Plan (omnibus plan). In conjunction with the adoption of this plan, effective May 5, 2005, options were no longer granted under the two other option plans previously in existence. The purpose of the omnibus plan is to promote our interests and those of our shareholders by providing our key personnel an opportunity to acquire a proprietary interest in the company and reward them for achieving a high level of corporate performance and to encourage our continued success and growth. Awards under the omnibus plan may be in the form of restricted stock, stock options (both incentive and non-qualified), stock appreciation rights, performance units, as well as other stock based awards. Eligibility under the omnibus plan is limited to our employees or employees of any affiliate and

to individuals or entities who are not employees but who provide services to us or an affiliate, including services provided in the capacity of consultant, advisor or director. The granting of awards under the plan is solely at the discretion of the executive resources committee and the board of directors. The total number of shares of common stock available for distribution under the omnibus plan may not exceed 1,500,000 shares (subject to adjustment for changes in our capitalization). Since 2005, we have granted 1,209,100 stock options under this plan, including 261,000 in 2009.

Under the omnibus plan, we grant stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant. Options generally vest and become exercisable ratably over a five-year period. Beginning with the annual grant in May 2009, options granted have an eight-year life. Prior to this grant, options were granted with a 10-year life. The related compensation expense is recognized over the requisite service period. In most instances, the requisite service period and vesting period will be the same. For participants who are retirement eligible, defined by the plan as those individuals whose age and years of service equals 75, the requisite service period is deemed to be met and options are immediately expensed on the date of grant. For participants who will become retirement eligible during the vesting period, the requisite service period over which expense is recognized is the period between the grant date and the attainment of retirement eligibility. Shares issued upon option exercise are newly issued shares.

Shares issued may be less than the number of shares actually exercised, as our plan allows participants to swap shares to cover the option exercise price and taxes due upon option exercise. Shares swapped are valued at the closing stock price on the date of option exercise. In these instances, the actual number of shares issued will be less than the options exercised and can result in a decrease to shareholders' equity. Specifically, when options are exercised with significant intrinsic value (i.e. market value in excess of exercise price) and the exercise is facilitated via a stock swap, amounts withheld for taxes result in a decrease in shareholders' equity. During 2008, the aggregate intrinsic value of options exercised was \$16.6 million. A majority of these options were exercised via stock swaps with taxes withheld at the statutory minimum rate. As shown in the consolidated statements of shareholders' equity, the exercise of options in 2008 resulted in a decrease to paid-in-capital, as the taxes withheld pursuant to swaps exceeded amounts paid in for options that were exercised using cash. This was not the case in 2009 as the intrinsic value of the options exercised was not as significant (\$2.0 million). Therefore, the exercise of options in 2009 resulted in an increase to paid-in-capital.

The following tables summarize option activity in 2009, 2008 and 2007:

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000's)
Outstanding options at January 1, 2009	<b>1,429,128</b>	<b>\$43.35</b>		
Options granted	<b>261,000</b>	<b>\$47.97</b>		
Options exercised	<b>(82,415)</b>	<b>\$28.87</b>		<b>\$1,961</b>
Options cancelled/forfeited	<b>(23,910)</b>	<b>\$51.82</b>		
Outstanding options at December 31, 2009	<b>1,583,803</b>	<b>\$44.73</b>	<b>5.99</b>	<b>\$13,487</b>
Exercisable options at December 31, 2009	<b>906,172</b>	<b>\$40.17</b>	<b>4.78</b>	<b>\$11,850</b>

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000's)
Outstanding options at January 1, 2008	1,605,252	\$36.34		
Options granted	267,000	\$51.03		
Options exercised	(439,404)	\$22.37		\$16,616
Options cancelled/forfeited	(3,720)	\$50.04		
Outstanding options at December 31, 2008	1,429,128	\$43.35	6.46	\$23,999
Exercisable options at December 31, 2008	853,367	\$37.12	5.07	\$19,645

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in 000's)
Outstanding options at January 1, 2007	1,632,019	\$31.30		
Options granted	241,300	\$56.15		
Options exercised	(261,527)	\$22.76		\$9,255
Options cancelled/forfeited	(6,540)	\$49.83		
Outstanding options at December 31, 2007	1,605,252	\$36.34	5.84	\$32,822
Exercisable options at December 31, 2007	1,206,951	\$30.57	4.81	\$31,642

The majority of our options are granted annually at our regular board meeting in May. In 2009, 261,000 options were granted with an average exercise price of \$47.97 and an average fair value of \$11.40. Of these grants, 211,050 were granted at the board meeting in May with a calculated fair value of \$10.82. We recognized \$2.9 million of expense during 2009 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$1.0 million related to this compensation

expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.1 million, which will be recognized over the remainder of the vesting period.

In 2008, 267,000 options were granted with an average exercise price of \$51.03 and an average fair value of \$13.01. Of these grants, 218,000 were granted at the board meeting in May with a calculated fair value of \$12.38. We recognized \$2.6 million of expense during 2008 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$0.9 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$4.3 million, which will be recognized over the remainder of the vesting period.

In 2007, 241,300 options were granted with an average exercise price of \$56.15 and an average fair value of \$15.15. Of these grants, 202,600 were granted at the board meeting in May with a calculated fair value of \$15.11. We recognized \$1.8 million of expense during 2007 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of \$0.6 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was \$3.5 million, which will be recognized over the remainder of the vesting period.

The fair value of options were estimated using a Black-Scholes based option pricing model with the following weighted-average grant-date assumptions and weighted average fair values as of December 31:

	2009	2008	2007
Weighted-average fair value of grants	<b>\$11.40</b>	\$13.01	\$15.15
Risk-free interest rates	<b>2.10%</b>	3.29%	4.56%
Dividend yield	<b>1.61%</b>	1.53%	1.47%
Expected volatility	<b>26.19%</b>	24.01%	21.78%
Expected option life	<b>5.73 years</b>	6.40 years	6.95 years

The risk-free rate is determined based on U.S. treasury yields that most closely approximate the option's expected life. The dividend yield is calculated based on the average annualized dividends paid during the most recent five-year period. The expected volatility is calculated based on the mean reversion of RLI's stock. In previous years, it was calculated by computing the weighted average of the most recent one-year volatility, the most recent volatility based on expected life and the median of the rolling volatilities based on the expected life of RLI stock. The expected option life is determined based on historical exercise behavior and the assumption that all outstanding options will be exercised at the midpoint of the current date and remaining contractual term, adjusted for the demographics of the current year's grant.

During 2004, the shareholders approved the Non-Employee Directors' Stock Plan (stock plan). An aggregate

of 200,000 shares of common stock is reserved under the stock plan. The stock plan is designed to provide compensation to each non-employee director in the form of a stock grant at the time of such director's election or appointment to the board of directors, and future stock grants based on continued service as a director. In conjunction with the shareholders' approval of the omnibus plan in May 2005, no further awards will be issued under the stock plan. Awards to outside directors will be made under the omnibus plan.

Total shares granted to outside directors under the omnibus plan were 4,852 in 2009, 4,700 in 2008 and 2,949 in 2007. Shares were granted at an average share price of \$51.83 in 2009, \$53.83 in 2008 and \$57.51 in 2007. We recognized \$0.3 million of expense relating to grants in 2009, compared to \$0.3 million in 2008 and \$0.2 million in 2007.

#### POST-RETIREMENT BENEFITS OTHER THAN PENSION

In 2002, we began offering certain eligible employees post-employment medical coverage. Under our plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under our health plan. Former employees who elect continuation of coverage pay the full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. We expect a relatively small number of employees will become eligible for this benefit. The COBRA rate established for participating employees has historically covered the cost of providing this coverage.

#### 9. STATUTORY INFORMATION AND DIVIDEND RESTRICTIONS

Our insurance subsidiaries maintain their accounts in conformity with accounting practices prescribed or permitted by state insurance regulatory authorities that vary in certain respects from GAAP. In converting from statutory to GAAP, typical adjustments include deferral of policy acquisition costs, the inclusion of statutory nonadmitted assets and the inclusion of net unrealized holding gains or losses in shareholders' equity relating to fixed maturities.

Year-end statutory surplus presented in the table below includes \$26.0 million of RLI stock (cost basis of \$64.6 million) held by Mt. Hawley Insurance Company. The Securities Valuation Office provides specific guidance for valuing this investment, which is eliminated in our consolidated financial statements.

The following table includes selected information for our insurance subsidiaries for the year ending and as of December 31:

(in thousands)	2009	2008	2007
Consolidated net income, statutory basis	\$116,332	\$ 74,478	\$177,307
Consolidated surplus, statutory basis	\$784,161	\$678,041	\$752,004

Dividend payments to us from our principal insurance subsidiary are restricted by state insurance laws as to the amount that may be paid without prior approval of the regulatory authorities of Illinois. The maximum dividend distribution in a rolling 12-month period is limited by Illinois law to the greater of 10 percent of RLI Ins. policyholder surplus as of December 31 of the preceding year or the net income of RLI Ins. for the 12-month period ending December 31 of the preceding year. Stand-alone net income for RLI Ins. was \$28.9 million for 2009. Therefore, the maximum dividend distribution that can be paid by RLI Ins. during 2010 without prior approval is \$78.4 million which represents 10 percent of RLI Ins.'s policyholder surplus at December 31, 2009. The 12-month rolling limitation for 2009, based on the above criteria, was \$67.8 million. In 2009, total cash dividends of \$40.0 million were paid by RLI Ins. These dividends were paid to provide additional capital to RLI Corp. and used for the share repurchase plan, shareholder dividends, interest on senior notes and general corporate expenses. In 2008, total cash dividends of \$70.0 million were paid by RLI Ins.

#### 10. COMMITMENTS AND CONTINGENT LIABILITIES

We are party to numerous claims and losses that arise in the normal course of our business. Many of such claims or losses involve claims under policies that we underwrite as an insurer. We believe that the resolution of these claims and losses will not have a material adverse effect on our financial condition, results of operations or cash flows. We are also involved in various other legal proceedings and litigation unrelated to our insurance business that arise in the ordinary course of business operations. Management believes that any liabilities that may arise as a result of these legal matters will not have a material adverse effect on our financial condition or operating results.

We have capital lease obligations for leased computers and operating lease obligations for regional office facilities. These leases expire in various years through 2018. Expense associated with these leases totaled \$4.1 million in 2009, \$3.9 million in 2008 and \$3.7 million in 2007. Minimum future rental payments under noncancellable leases are as follows:

(in thousands)	
2010	\$ 2,785
2011	3,146
2012	2,950
2013	1,995
2014	1,700
2015-2018	3,124
<b>Total minimum future rental payments</b>	<b>\$15,700</b>

## 11. OPERATING SEGMENT INFORMATION

The following table summarizes our segment data based on the internal structure and reporting of information as it is used by management.

The segments of our insurance operations include casualty, property and surety. The casualty portion of our business consists largely of general liability, personal umbrella, transportation, executive products, commercial umbrella, multi-peril program business and other specialty coverage, such as our professional liability for architects and engineers. In addition, we provide employers' indemnity and in-home business owner's coverage. The casualty business is subject to the risk of estimating losses and related loss reserves because the ultimate settlement of a casualty claim may take several years to fully develop. The casualty segment is also subject to inflation risk and may be affected by evolving legislation and court decisions that define the extent of coverage and the amount of compensation due for injuries or losses.

Our property segment primarily includes commercial fire, earthquake, difference in conditions, marine, facultative reinsurance and, in the state of Hawaii, select personal lines policies. Property insurance results are subject to the variability introduced by perils such as earthquakes, fires and hurricanes. Our major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Our

second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes we insure in Hawaii. We limit our net aggregate exposure to a catastrophic event by limiting the total policy limits written in a particular region, by purchasing reinsurance and through extensive use of computer-assisted modeling techniques. These techniques provide estimates of the concentration of risks exposed to catastrophic events.

The surety segment specializes in writing small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical and refining industries. We offer miscellaneous bonds, including license and permit, notary and court bonds. We also offer fidelity and crime coverage for commercial insureds and select financial institutions. Often, our surety coverages involve a statutory requirement for bonds. While these bonds have maintained a relatively low loss ratio, losses may fluctuate due to adverse economic conditions that may affect the financial viability of an insured. The contract surety marketplace guarantees the construction work of a commercial contractor for a specific project. Generally, losses occur due to adverse economic conditions or the deterioration of a contractor's financial condition. As such, this line has historically produced marginally higher loss ratios than other surety lines.

Net investment income is the by-product of the interest and dividend income streams from our investments in fixed income and equity securities. Interest and general corporate expenses include the cost of debt and other director and shareholder relations costs incurred for the benefit of the corporation, but not attributable to the operations of our insurance segments. Investee earnings represent our share in Maui Jim earnings. We own approximately 40 percent of Maui Jim, which operates in the sunglass and optical goods industries; Maui Jim is privately held.

The following table provides financial data used by management. The net earnings of each segment are before taxes, and include revenues (if applicable), direct product or segment costs (such as commissions, claims costs, etc.), as well as allocated support costs from various support departments. While depreciation and amortization charges have been included in these measures via our expense

allocation system, the related assets are not allocated for management use and, therefore, are not included in this schedule.

#### REVENUES

(in thousands)	2009	2008	2007
Casualty	\$265,021	\$313,481	\$343,402
Property	155,303	146,863	138,367
Surety	71,637	68,420	62,709
Segment totals before income taxes	\$491,961	\$528,764	\$544,478
Net investment income	67,346	78,986	78,901
Net realized gains (losses)	(12,755)	(46,738)	28,966
Total	\$546,552	\$561,012	\$652,345

#### DEPRECIATION AND AMORTIZATION

(in thousands)	2009	2008	2007
Casualty	\$1,417	\$1,648	\$1,825
Property	836	872	891
Surety	560	604	588
Segment totals before income taxes	\$2,813	\$3,124	\$3,304

#### NET EARNINGS (LOSSES)

(in thousands)	2009	2008	2007
Casualty	\$ 51,488	\$ 46,507	\$101,863
Property	23,261	15,813	30,569
Surety	12,036	20,743	23,333
Net Underwriting Income	\$ 86,785	\$ 83,063	\$155,765
Net investment income	67,346	78,986	78,901
Realized gains (losses)	(12,755)	(46,738)	28,966
General corporate expense and interest on debt	(13,991)	(13,557)	(16,471)
Equity in earnings of unconsolidated investees	5,052	4,844	7,315
Total earnings before income taxes	\$132,437	\$106,598	\$254,476
Income taxes	38,592	27,922	78,609
Total	\$ 93,845	\$ 78,676	\$175,867

The following table further summarizes revenues by major product type within each segment:

(in thousands)	2009	2008	2007
<b>CASUALTY</b>			
General liability	\$115,439	\$140,891	\$167,876
Commercial and personal umbrella	62,388	65,091	66,281
Commercial transportation	42,185	46,710	49,119
Specialty program business	21,577	38,340	38,510
Executive products	15,553	13,846	12,029
Other	7,879	8,603	9,587
Total	\$265,021	\$313,481	\$343,402
<b>PROPERTY</b>			
Commercial property	\$ 81,828	\$ 85,271	\$ 92,634
Marine	52,470	48,166	32,868
Other property	21,005	13,426	12,865
Total	\$155,303	\$146,863	\$138,367
<b>SURETY</b>			
Grand total	\$491,961	\$528,764	\$544,478

## 12. UNAUDITED INTERIM FINANCIAL INFORMATION

Selected quarterly information is as follows:

(in thousands, except per share data)	First	Second	Third	Fourth	Year
<b>2009</b>					
Net premiums earned	\$125,682	\$122,492	\$122,736	\$121,051	\$491,961
Net investment income	17,703	16,496	16,295	16,852	67,346
Net realized investment gains (losses)	(33,528)	5,754	6,985	8,034	(12,755)
Earnings (loss) before income taxes	(2,381)	46,503	43,663	44,652	132,437
Net earnings (loss)	(1,816)	34,080	31,019	30,562	93,845
Basic earnings (loss) per share <sup>(1)</sup>	\$(0.08)	\$1.58	\$1.43	\$1.42	\$4.35
Diluted earnings (loss) per share <sup>(1)</sup>	\$(0.08)	\$1.57	\$1.42	\$1.41	\$4.32
<b>2008</b>					
Net premiums earned	\$135,965	\$132,295	\$130,850	\$129,654	\$528,764
Net investment income	19,258	19,605	19,844	20,279	78,986
Net realized investment gains (losses)	3,741	8,075	(24,212)	(34,342)	(46,738)
Earnings before income taxes	35,961	57,121	7,696	5,820	106,598
Net earnings	25,459	38,650	8,586	5,981	78,676
Basic earnings per share <sup>(1)</sup>	\$1.16	\$1.80	\$0.40	\$0.28	\$3.65
Diluted earnings per share <sup>(1)</sup>	\$1.14	\$1.77	\$0.40	\$0.28	\$3.60

<sup>(1)</sup> Since the weighted-average shares for the quarters are calculated independently of the weighted-average shares for the year, quarterly earnings per share may not total to annual earnings per share.