

AMERISAFE INC  
Form 10-K  
March 06, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**

**FORM 10-K**

**ANNUAL REPORT PURSUANT TO SECTIONS 13 OR 15(d) OF THE**  
**SECURITIES EXCHANGE ACT OF 1934**  
**FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007**

**Commission File Number: 000-51520**

**AMERISAFE, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Texas**  
(State of Incorporation)

**75-2069407**  
(I.R.S. Employer

Identification Number)

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2301 Highway 190 West, DeRidder, Louisiana  
(Address of Principal Executive Offices)

70634  
(Zip Code)

Registrant's telephone number, including area code: (337) 463-9052

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of Each Exchange on Which Registered
Common Stock, par value \$0.01 per share	Nasdaq Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The aggregate market value of the voting common stock held by non-affiliates of the Registrant as of June 30, 2007 (the last business day of the Registrant's most recently completed second fiscal quarter) was approximately \$366.1 million, based upon the closing price of the shares on the NASDAQ Global Select Market on that date.

As of March 3, 2008, there were 18,822,238 shares of the Registrant's common stock, par value \$.01 per share, outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's Proxy Statement relating to the 2008 Annual Meeting of Shareholders are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III of this report.



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**FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and 21E of the Securities Exchange Act of 1934. You should not place undue reliance on these statements. These forward-looking statements include statements that reflect the current views of our senior management with respect to our financial performance and future events with respect to our business and the insurance industry in general. Statements that include the words expect, intend, plan, believe, project, forecast, estimate, may, anticipate and similar statements of a future or forward-looking nature identify forward-looking statements. Forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause our actual results to differ materially from those indicated in these statements. We believe that these factors include, but are not limited to, the following:

increased competition on the basis of premium rates, coverage availability, payment terms, claims management, safety services, policy terms, types of insurance offered, overall financial strength, financial ratings and reputation;

decreased level of business activity of our policyholders;

the cyclical nature of the workers' compensation insurance industry;

greater frequency or severity of claims and loss activity, including as a result of natural or man-made catastrophic events, than our underwriting, reserving or investment practices anticipate based on historical experience or industry data;

changes in general economic conditions, including interest rates, inflation and other factors;

negative developments in the workers' compensation insurance industry;

changes in the availability, cost or quality of reinsurance and the failure of our reinsurers to pay claims in a timely manner or at all;

changes in rating agency policies or practices;

loss of the services of any of our senior management or other key employees;

developments in capital markets that adversely affect the performance of our investments;

changes in regulations, laws, rates, or rating factors applicable to us, our policyholders or the agencies that sell our insurance;

changes in legal theories of liability under our insurance policies;

decreased demand for our insurance; and

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the effects of U.S. involvement in hostilities with other countries and large-scale acts of terrorism, or the threat of hostilities or terrorist acts.

The foregoing factors should not be construed as exhaustive and should be read together with the other cautionary statements included in this report, including under the caption "Risk Factors" in Item 1A of this report. If one or more events related to these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may differ materially from what we anticipate.

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**PART I**

**Item 1. Business.  
Overview**

We are a specialty provider of workers' compensation insurance focused on small to mid-sized employers engaged in hazardous industries, principally construction, trucking, logging, agriculture, oil and gas, maritime and sawmills. Since commencing operations in 1986, we have gained significant experience underwriting the complex workers' compensation exposures inherent in these industries. We provide coverage to employers under state and federal workers' compensation laws. These laws prescribe wage replacement and medical care benefits that employers are obligated to provide to their employees who are injured in the course and scope of their employment. Our workers' compensation insurance policies provide benefits to injured employees for, among other things, temporary or permanent disability, death and medical, and hospital expenses. The benefits payable and the duration of those benefits are set by state or federal law. The benefits vary by jurisdiction, the nature and severity of the injury, and the wages of the employee. The employer, who is the policyholder, pays the premiums for coverage.

Hazardous industry employers tend to have less frequent but more severe claims as compared to employers in other industries due to the nature of their businesses. Injuries that occur are often severe in nature including death, dismemberment, paraplegia, and quadriplegia. As a result, employers engaged in hazardous industries pay substantially higher than average rates for workers' compensation insurance compared to employers in other industries, as measured per payroll dollar. The higher premium rates are due to the nature of the work performed and the inherent workplace danger of our target employers. For example, our construction employers generally paid premium rates equal to \$7.45 per \$100 of payroll to obtain workers' compensation coverage for all of their employees in 2007.

We employ a proactive, disciplined approach in underwriting employers and providing comprehensive services intended to lessen the overall incidence and cost of workplace injuries. We provide safety services at employers' workplaces as a vital component of our underwriting process and to promote safer workplaces. We utilize intensive claims management practices that we believe permit us to reduce the overall cost of our claims. In addition, our audit services ensure that our policyholders pay the appropriate premiums required under the terms of their policies and enable us to monitor payroll patterns or aberrations that cause underwriting, safety, or fraud concerns.

We believe that the higher premiums typically paid by our policyholders, together with our disciplined underwriting and safety, claims, and audit services, provide us with the opportunity to earn attractive returns on equity.

We completed our initial public offering in November 2005. In the offering, we issued 8,000,000 shares of common stock at \$9.00 per share. Upon the completion of the offering, we issued an additional 9,120,948 shares of common stock in exchange for shares of our Series A preferred stock. Of the \$63.2 million of net proceeds from this offering, we contributed \$45.0 million to our insurance subsidiaries and used \$10.2 million to redeem shares of our preferred stock. We expect to use the balance of the net proceeds for general corporate purposes.

In November 2006, we completed a public offering of 9,071,576 shares of common stock. All of these shares were offered by existing shareholders. We did not receive any of the proceeds from this offering.

AMERISAFE is an insurance holding company and was incorporated in Texas in 1985. We began operations in 1986 by focusing on workers' compensation insurance for logging contractors in the southeast United States. In 1994, we expanded our focus to include the other hazardous industries we serve today. Two of

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our three insurance subsidiaries, American Interstate Insurance Company and Silver Oak Casualty, are domiciled in Louisiana. Our other insurance subsidiary, American Interstate Insurance Company of Texas, is domiciled in Texas.

### **Competitive Advantages**

We believe we have the following competitive advantages:

*Focus on Hazardous Industries.* We have extensive experience insuring employers engaged in hazardous industries and have a history of profitable underwriting in these industries. Our specialized knowledge of these hazardous industries helps us better serve our policyholders, which leads to greater employer loyalty and policy retention. Our policy renewal rate on voluntary business that we elected to quote for renewal was 90.8% in 2007, 91.1% in 2006 and 90.6% in 2005.

*Focus on Small to Mid-Sized Employers.* We believe large insurance companies generally do not target small to mid-sized employers in hazardous industries due to their smaller premium size, type of operations, mobile workforce, and extensive service needs. We provide enhanced customer services to our policyholders. For example, unlike many of our competitors, our premium payment plans enable our policyholders to better match their premium payments with their payroll costs and cash flow.

*Specialized Underwriting Expertise.* Based on our 22-year underwriting history of insuring employers engaged in hazardous industries, we have developed industry specific risk analysis and rating tools to assist our underwriters in risk selection and pricing. We are highly disciplined when quoting and binding new business. We do not delegate underwriting authority to agencies that sell our insurance or to any other third party.

*Comprehensive Safety Services.* We provide proactive safety reviews of employers' worksites, which are often located in rural areas. These safety reviews are a vital component of our underwriting process and also assist our policyholders in loss prevention and encourage the safest workplaces possible by deploying experienced field safety professionals, or FSPs, to our policyholders' worksites. In 2007, more than 90.0% of our new voluntary business policyholders were subject to pre-quotation safety inspections. We perform periodic on-site safety surveys on all of our voluntary business policyholders.

*Proactive Claims Management.* Our employees manage substantially all of our open claims in-house utilizing our intensive claims management practices that emphasize a personal approach and quality, cost-effective medical treatment. As of December 31, 2007, the open indemnity claims per field case manager, or FCM, averaged 53 claims, which we believe is significantly less than the industry average. We believe our claims management practices allow us to achieve a more favorable claim outcome, accelerate an employee's return to work, lessen the likelihood of litigation, and more rapidly close claims, all of which ultimately lead to lower overall costs.

### **Strategy**

We intend to grow book value and produce favorable returns on equity using the following strategies:

*Focus on Underwriting Profitability.* We intend to maintain our underwriting discipline and profitability throughout market cycles. Our strategy is to focus on underwriting workers' compensation insurance in hazardous industries and to maintain adequate rate levels commensurate with the risks we underwrite. We will also continue to strive for improved risk selection and pricing, as well as reduced frequency and severity of claims through comprehensive workplace safety reviews, effective medical cost containment measures, and rapid closing of claims through personal, direct contact with our policyholders and their employees.



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*Increase market penetration.* Based on data received from the National Association of Insurance Commissioners, or the NAIC, we do not have more than 5.0% of the market share in any state we serve. Therefore, we have the ability to increase market penetration in those states. Competition in our target markets is fragmented by state and employer industry focus. We believe that our specialized underwriting expertise and safety, claims, and audit services position us to profitably increase our market share in our existing principal markets, with minimal increase in field service employees.

*Prudent and Opportunistic Geographic Expansion.* While we actively market our insurance in 30 states and the District of Columbia, 40.7% of our voluntary in-force premiums were generated in the five states where we derived 5% or more of our gross premiums written in 2007. We are licensed in an additional 15 states and the U.S. Virgin Islands. Our existing licenses and rate filings will expedite our ability to write policies in these markets when we decide it is prudent to do so. In late 2006, we expanded our operations into selected areas of Nevada and Colorado.

*Leverage Existing Information Technology.* We believe our customized information system, ICAMS, significantly enhances our ability to select risk, write profitable business, and cost-effectively administer our billing, claims, and audit functions.

*Maintain Capital Strength.* We plan to manage our capital to achieve our profitability goals while maintaining prudent operating leverage for our insurance company subsidiaries. To accomplish this objective, we intend to maintain underwriting profitability throughout market cycles, optimize our use of reinsurance and maximize an appropriate risk adjusted return on our growing investment portfolio.

**Industry**

*Overview.* Workers' compensation is a statutory system under which an employer is required to pay for its employees' medical, disability, vocational rehabilitation, and death benefit costs for work-related injuries or illnesses. Most employers satisfy this requirement by purchasing workers' compensation insurance. The principal concept underlying workers' compensation laws is that employees injured in the course and scope of their employment have only the legal remedies available under workers' compensation laws and do not have any other recourse against their employer. An employer's obligation to pay workers' compensation does not depend on any negligence or wrongdoing on the part of the employer and exists even for injuries that result from the negligence or fault of another person, a co-employee, or, in most instances, the injured employee.

Workers' compensation insurance policies generally provide that the insurance carrier will pay all benefits that the insured employer may become obligated to pay under applicable workers' compensation laws. Each state has a regulatory and adjudicatory system that quantifies the level of wage replacement to be paid, determines the level of medical care required to be provided and the cost of permanent impairment, and specifies the options in selecting medical providers available to the injured employee or the employer. These state laws generally require two types of benefits for injured employees: (1) medical benefits, which include expenses related to diagnosis and treatment of the injury, as well as any required rehabilitation, and (2) indemnity payments, which consist of temporary wage replacement, permanent disability payments, and death benefits to surviving family members. To fulfill these mandated financial obligations, virtually all employers are required to purchase workers' compensation insurance or, if permitted by state law or approved by the U.S. Department of Labor, to self-insure. The employers may purchase workers' compensation insurance from a private insurance carrier, a state-sanctioned assigned risk pool, or a self-insurance fund, which is an entity that allows employers to obtain workers' compensation coverage on a pooled basis, typically subjecting each employer to joint and several liability for the entire fund.

Workers' compensation was the fourth-largest property and casualty insurance line in the United States in 2006, according to A.M. Best. Direct premiums written in 2006 for the workers' compensation insurance industry were \$54 billion, and direct premiums written for the property and casualty industry as a whole were

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\$489 billion, according to A.M. Best. According to the most recent market data reported by the National Council on Compensation Insurance, Inc., or the NCCI, which is the official ratings bureau in the majority of states in which we are licensed, total premiums reported for the specific occupational class codes for which we underwrite business was \$15 billion.

*Outlook.* We believe that current economic conditions will adversely affect our reported gross premiums written and revenues in 2008. Insofar as, in 2007, almost 70% of our gross premiums written were derived from policyholders in the construction, trucking, and logging industries, our gross premiums written are, to a great extent, dependent upon economic conditions in those industries, as well as upon economic conditions generally. Economic activity began to decline in the latter part of 2007 and we believe this slowdown in work activity will continue in 2008, negatively affecting the construction, trucking, and logging industries, along with others. We further believe that the challenges presented by this slowing economic activity will be aggravated by increased price competition caused by excess underwriting capacity within the workers compensation insurance industry, and by the impact of lower estimated loss costs adopted by a number of states in which we do business. Estimated loss costs provide the basis upon which we calculate the premiums we charge for the insurance we write. The challenges presented by price competition and lower loss costs are part of the normal cyclical nature of our industry, and we believe they will eventually reverse themselves. However, we have no way of predicting the timing of such reversal with any degree of certainty. Notwithstanding current market conditions, we will continue to focus on market segmentation, effective risk selection, expense management, and overall underwriting profitability.

**Policyholders**

As of December 31, 2007, we had more than 7,300 voluntary business policyholders with an average annual workers compensation policy premium of \$39,426. As of December 31, 2007, our ten largest voluntary business policyholders accounted for 2.9% of our in-force premiums. Our policy renewal rate on voluntary business that we elected to quote for renewal was 90.8% in 2007, 91.1% in 2006, and 90.6% in 2005.

In addition to our voluntary workers compensation business, we underwrite workers compensation policies for employers assigned to us and assume reinsurance premiums from mandatory pooling arrangements, in each case to fulfill our obligations under residual market programs implemented by the states in which we operate. We separately underwrite general liability insurance policies for our workers compensation policyholders in the logging industry on a select basis. Our assigned risk business fulfills our statutory obligation to participate in residual market plans in six states. See Regulation Residual Market Programs below. For the year ended December 31, 2007, our assigned risk business accounted for 2.3% of our gross premiums written, and our assumed premiums from mandatory pooling arrangements accounted for 1.3% of our gross premiums written. Our general liability insurance business accounted for 0.5% of our gross premiums written for the year ended December 31, 2007.

**Targeted Industries**

We provide workers compensation insurance primarily to employers in the following targeted hazardous industries:

*Construction.* Includes a broad range of operations such as highway and bridge construction, building and maintenance of pipeline and powerline networks, excavation, commercial construction, roofing, iron and steel erection, tower erection, and numerous other specialized construction operations. In 2007, our average policy premium for voluntary workers compensation within the construction industry was \$40,003, or \$7.37 per \$100 of payroll.

*Trucking.* Includes a large spectrum of diverse operations including contract haulers, regional and local freight carriers, special equipment transporters, and other trucking companies that conduct a variety of short- and

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long-haul operations. In 2007, our average policy premium for voluntary workers compensation within the trucking industry was \$42,961, or \$7.66 per \$100 of payroll.

*Logging.* Includes tree harvesting operations ranging from labor intensive chainsaw felling and trimming to sophisticated mechanized operations using heavy equipment. In 2007, our average policy premium for voluntary workers compensation within the logging industry was \$19,221, or \$17.42 per \$100 of payroll.

*Agriculture.* Includes crop maintenance and harvesting, grain and produce operations, nursery operations, meat processing, and livestock feed and transportation. In 2007, our average policy premium for voluntary workers compensation within the agriculture industry was \$27,901, or \$5.68 per \$100 of payroll.

*Oil and Gas.* Includes various oil and gas activities including gathering, transportation, processing, production, and field service operations. In 2007, our average policy premium for voluntary workers compensation within the oil and gas industry was \$52,337, or \$6.19 per \$100 of payroll.

*Maritime.* Includes ship building and repair, pier and marine construction, inter-coastal construction, and stevedoring. In 2007, our average policy premium for voluntary workers compensation within the maritime industry was \$101,503, or \$9.82 per \$100 of payroll.

*Sawmills.* Includes sawmills and various other lumber-related operations. In 2007, our average policy premium for the sawmill industry was \$32,782, or \$8.84 per \$100 of payroll.

Our gross premiums are derived from:

*Direct Premiums.* Includes premiums from workers compensation and general liability insurance policies that we issue to:

employers who seek to purchase insurance directly from us and who we voluntarily agree to insure, which we refer to as our voluntary business; and

employers assigned to us under residual market programs implemented by some of the states in which we operate, which we refer to as our assigned risk business.

*Assumed Premiums.* Includes premiums from our participation in mandatory pooling arrangements under residual market programs implemented by some of the states in which we operate.

In addition to workers compensation insurance, we also offer general liability insurance coverage only to our workers compensation policyholders in the logging industry on a select basis. As of December 31, 2007, less than 0.6% of our voluntary in-force premiums were derived from general liability policies.

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Gross premiums written during the years ended December 31, 2007, 2006, and 2005 and the allocation of those premiums among the hazardous industries we target are presented in the table below.

	Gross Premiums Written			Percentage of Gross Premiums Written		
	2007	2006	2005	2007	2006	2005
	(In thousands)					
<b>Voluntary business:</b>						
Construction	\$ 136,834	\$ 132,083	\$ 117,134	41.7%	39.7%	40.3%
Trucking	73,064	70,221	59,348	22.3%	21.1%	20.4%
Logging	17,209	24,553	26,324	5.3%	7.4%	9.0%
Agriculture	15,778	13,681	13,119	4.8%	4.1%	4.5%
Oil and Gas	12,505	10,578	8,035	3.8%	3.2%	2.8%
Maritime	8,526	9,180	7,262	2.6%	2.8%	2.5%
Sawmills	5,389	4,260	4,441	1.6%	1.3%	1.5%
Other	46,766	51,547	34,382	14.3%	15.5%	11.8%
<b>Total voluntary business</b>	<b>316,071</b>	<b>316,103</b>	<b>270,045</b>	<b>96.4%</b>	<b>95.1%</b>	<b>92.8%</b>
Assigned risk business	7,554	11,936	13,924	2.3%	3.6%	4.8%
Assumed premiums	4,136	4,452	6,922	1.3%	1.3%	2.4%
<b>Total</b>	<b>\$ 327,761</b>	<b>\$ 332,491</b>	<b>\$ 290,891</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

**Geographic Distribution**

We are licensed to provide workers' compensation insurance in 45 states, the District of Columbia and the U.S. Virgin Islands. We operate on a geographically diverse basis with no more than 10.6% of our gross premiums written in 2007 derived from any one state. The table below identifies, for the years ended December 31, 2007, 2006 and 2005, the states in which the percentage of our gross premiums written exceeded 3.0% for any of the years presented.

State	Percentage of Gross Premiums Written Year Ended December 31,		
	2007	2006	2005
Louisiana	10.6%	8.9%	8.3%
Georgia	9.9%	9.1%	10.5%
North Carolina	9.5%	7.5%	6.7%
Virginia	5.8%	6.1%	5.3%
Illinois	5.2%	4.6%	5.4%
Oklahoma	4.9%	4.4%	4.1%
South Carolina	4.8%	4.5%	4.9%
Pennsylvania	4.7%	4.8%	5.3%
Florida	4.6%	6.5%	5.9%
Mississippi	4.6%	4.2%	3.5%
Texas	4.1%	5.8%	5.0%
Tennessee	3.9%	4.2%	4.2%
Minnesota	3.8%	4.4%	4.2%
Alaska	3.5%	4.4%	5.3%
Wisconsin	3.4%	2.9%	3.5%
Arkansas	2.9%	3.8%	3.9%



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### **Sales and Marketing**

We sell our workers' compensation insurance through agencies. As of December 31, 2007, our insurance was sold through more than 2,800 independent agencies and our wholly owned insurance agency subsidiary, Amerisafe General Agency, which is licensed in 24 states. We are selective in establishing and maintaining relationships with independent agencies. We establish and maintain relationships only with those agencies that provide quality application flow from prospective policyholders that are reasonably likely to accept our quotes. We compensate these agencies by paying a commission based on the premium collected from the policyholder. Our average commission rate for our independent agencies was 7.0% for the year ended December 31, 2007. We pay our insurance agency subsidiary a commission rate of 8.0%. Neither our independent agencies nor our insurance agency subsidiary has authority to underwrite or bind coverage. We do not pay contingent commissions.

As of December 31, 2007, independent agencies accounted for 87.5% of our voluntary in-force premiums, and no independent agency accounted for more than 1.5% of our voluntary in-force premiums at that date.

### **Underwriting**

Our underwriting strategy is to focus on employers in certain hazardous industries that operate in those states where our underwriting efforts are the most profitable and efficient. We analyze each prospective policyholder on its own merits relative to known industry trends and statistical data. Our underwriting guidelines specify that we do not write workers' compensation insurance for certain hazardous activities, including sub-surface mining and manufacturing of ammunition or fireworks.

Underwriting is a multi-step process that begins with the receipt of an application from one of our agencies. We initially review the application to confirm that the prospective policyholder meets certain established criteria, including that it is engaged in one of our targeted hazardous industries and industry classes and operates in the states we target. If the application satisfies these criteria, the application is forwarded to our underwriting department for further review.

Our underwriting department reviews the application to determine if the application meets our underwriting criteria and whether all required information has been provided. If additional information is required, the underwriting department requests additional information from the agency. This initial review process is generally completed within three days after the application is received by us. Once this initial review process is complete, our underwriting department requests that a pre-quotation safety inspection be performed.

After the pre-quotation safety inspection has been completed, our underwriting professionals review the results of the inspection to determine if a rate quote should be made and, if so, prepare the quote. The rate quote must be reviewed and approved by our underwriting department before it is delivered to the agency. All decisions by our underwriting department, including decisions to decline applications, are subject to review and approval by our management-level underwriters.

Our underwriting professionals participate in an incentive compensation program under which bonuses are paid quarterly based upon achieving premium underwriting volume and loss ratio targets. The determination of whether targets have been satisfied is made 30 months after the relevant incentive compensation period.

### **Pricing**

In the majority of states, workers' compensation insurance rates are based upon the published loss costs. Loss costs are derived from wage and loss data reported by insurers to the state's statistical agent, which in most states is the NCCI. The state agent then promulgates loss costs for specific job descriptions or class codes. Insurers file requests for adoption of a loss cost multiplier, or LCM, to be applied to the loss costs to support operating costs and profit margins. In addition, most states allow pricing flexibility above and below the filed LCM, within certain limits.

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We obtain approval of our rates, including our LCMs, from state regulatory authorities. To maintain rates at profitable levels and we regularly monitor and adjust our LCMs. The effective LCM for our voluntary business was 1.51 for policy year 2007, 1.54 for policy year 2006, 1.56 for policy year 2005, 1.53 for policy year 2004, and 1.43 for policy year 2003. If we are unable to charge rates in a particular state or industry to produce satisfactory results, we seek to control and reduce our premium volume in that state or industry and redeploy our capital in other states or industries that offer greater opportunity to earn an underwriting profit.

### **Safety**

Our safety inspection process begins with a request from our underwriting department to perform a pre-quotation safety inspection. Our safety inspections focus on a prospective policyholder's operations, loss exposures, and existing safety controls to prevent potential losses. The factors considered in our inspection include employee experience, turnover, training, previous loss history and corrective actions, and workplace conditions, including equipment condition and, where appropriate, use of fall protection, respiratory protection, or other safety devices. Our field safety professionals, or FSPs, travel to employers' worksites to perform these safety inspections. This initial in-depth analysis allows our underwriting professionals to make decisions on both insurability and pricing. In certain circumstances, we will agree to provide workers compensation insurance only if the employer agrees to implement and maintain the safety management practices that we recommend. In 2007, more than 90% of our new voluntary business policyholders were inspected prior to our offering a premium quote. The remaining voluntary business policyholders were not inspected prior to a premium quote for a variety of reasons, including small premium size or the policyholder was previously a policyholder subject to our safety inspections.

After an employer becomes a policyholder, we continue to emphasize workplace safety through periodic workplace visits, assisting the policyholder in designing and implementing enhanced safety management programs, providing safety-related information, and conducting rigorous post-accident management. Generally, we may cancel or decline to renew an insurance policy if the policyholder does not implement or maintain reasonable safety management practices that we recommend.

Our FSPs participate in an incentive compensation program under which bonuses are paid semi-annually based upon an FSP's production and their policyholders' aggregate loss ratios. The results are measured 33 months after the inception of the subject policy period.

### **Claims**

We have structured our claims operation to provide immediate, intensive, and personal management of all claims to guide injured employees through medical treatment, rehabilitation, and recovery with the primary goal of returning the injured employee to work as promptly as practicable. We seek to limit the number of claim disputes with injured employees through early intervention in the claims process.

We have claims offices located throughout the markets we serve. Our field case managers, or FCMs, are located in the geographic areas where our policyholders are based. We believe the presence of our FCMs in the field enhances our ability to guide an injured employee to the appropriate conclusion in a friendly, dignified, and supportive manner. Our FCMs have broad authority to manage claims from occurrence of a workplace injury through resolution, including authority to retain many different medical providers at our expense, including not only our recommended medical providers but also nurse case managers, independent medical examiners, vocational specialists, rehabilitation specialists, and other specialty providers of medical services necessary to achieve a quality outcome.

Following notification of a workplace injury, an FCM will contact the policyholder, the injured employee, and/or the treating physician to determine the nature and severity of the injury. If a serious injury occurs, the FCM will promptly visit the injured employee or the employee's family members to discuss the benefits.

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provided and will also visit the treating physician to discuss the proposed treatment plan. Our FCM assists the injured employee in receiving appropriate medical treatment and encourages the use of our recommended medical providers and facilities. For example, our FCM may suggest that a treating physician refer an injured worker to another physician or treatment facility that we believe has had positive outcomes for other workers with similar injuries. We actively monitor the number of open cases handled by a single FCM in order to maintain focus on each specific injured employee. As of December 31, 2007, we averaged 53 open indemnity claims per FCM, which we believe is significantly less than the industry average.

Locating our FCMs in the field also allows us to build professional relationships with local medical providers. In selecting medical providers, we rely, in part, on the recommendations of our FCMs who have developed professional relationships within their geographic areas. We also seek input from our policyholders and other contacts in the markets that we serve. While cost factors are considered in selecting medical providers, we consider the most important factor in the selection process to be the medical provider's ability to achieve a quality outcome. We define quality outcome as the injured worker's rapid, conclusive recovery and return to sustained, full capacity employment.

While we seek to promptly settle valid claims, we also aggressively defend against claims we consider to be non-meritorious. Where possible, we purchase annuities on longer life claims to close the claim while still providing an appropriate level of benefits to an injured employee.

### **Premium Audits**

We conduct premium audits on all of our voluntary business policyholders annually, upon the expiration of each policy, including when the policy is renewed. The purpose of these audits is to verify that policyholders have accurately reported their payroll expenses and employee job classifications, and therefore have paid us the premium required under the terms of their policies. In addition to annual audits, we selectively perform interim audits on certain classes of business if significant or unusual claims are filed or if the monthly reports submitted by a policyholder reflect a payroll pattern or other aberrations that cause underwriting, safety, or fraud concerns. We also mitigate against potential losses from under-reporting of premium or delinquent premium payment by collecting a deposit from the policyholder at the inception of the policy, typically representing 15% of the total estimated annual premium, which deposit can be utilized to offset losses from non-payment of premium.

### **Loss Reserves**

We record reserves for estimated losses under insurance policies that we write and for loss adjustment expenses related to the investigation and settlement of policy claims. Our reserves for loss and loss adjustment expenses represent the estimated cost of all reported and unreported loss and loss adjustment expenses incurred and unpaid at a given point in time.

In establishing our reserves, we review the results of analyses using actuarial methodologies that utilize historical loss data from our more than 22 years of underwriting workers' compensation insurance. In evaluating the results of those analyses, our management also uses substantial judgment in considering other factors that are not considered in these actuarial analyses. These actuarial methodologies and subjective factors are described in more detail below. Our process and methodology for estimating reserves applies to both our voluntary and assigned risk business but does not include our reserves for mandatory pooling arrangements. We record reserves for mandatory pooling arrangements as those reserves are reported to us by the pool administrators. We do not use loss discounting when we determine our reserves, which would involve recognizing the time value of money and offsetting estimates of future payments by future expected investment income.

When a claim is reported, we establish an initial case reserve for the estimated amount of our loss based on our estimate of the most likely outcome of the claim at that time. Generally, that case reserve is established within 14 days after the claim is reported and consists of anticipated medical costs, indemnity costs, and specific



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adjustment expenses, which we refer to as defense and cost containment expenses, or DCC expenses. The most complex claims, involving severe injuries, may take a considerable period of time for us to establish a more precise estimate of the most likely outcome of the claim. At any point in time, the amount paid on a claim, plus the reserve for future amounts to be paid, represents the estimated total cost of the claim, or the case incurred amount. The estimated amount of loss for a reported claim is based upon various factors, including:

type of loss;