

D&O Liability Insurance

Negative Catalyst for Commercial Insurers Over the Next Several Years

Summary:

The negative effect of increasing directors' and officers' losses should become more visible over the next 12 to 24 months. The combination of deteriorating prices with significant losses from the credit crisis, recession and emerging areas of loss, such as employment practices liability (EPL), has and should continue to result in accelerating paid and incurred loss ratios. Given the prospects of increasing loss ratios, we recommend that investors be cautious on commercial insurers with material earnings exposure to the professional liability segment.

Factors to Watch:

Commercial Insurers to Exhibit Declining Fundamentals. Both HCC and Chubb have significant exposure to professional liability lines. While current loss ratios do not seem drastically affected by the credit crisis, we believe both companies will begin to see significant adverse development in the other liability line over the next year or two. The likely result should be a significant decline in future operating cash flow for the firms. Both companies are currently trading at a premium to their historical P/CF ratios, so any decline to cash flow would make the stocks even less attractive.

Pricing Remains Down. D&O liability insurance is entering the eighth year of soft pricing conditions, with pricing off more than 40% from its peak in late 2003. Longer-tail casualty lines tend to be more underpriced in a soft market, as the profit realization lag is the longest. This situation could cause a significant swing in profitability for commercial insurers if loss patterns are more severe than originally anticipated, which we believe to be the case. Excess capacity indicates that rates are unlikely to reverse course in the near term.

EPL Claims Picking Up. Increasing frequency and severity in the EPL line should be a disturbing trend for insurers. Stronger plaintiff support from Washington legislators, higher costs, and a very competitive pricing environment create little upside for the EPL line. The recession and high employment rates have also significantly contributed to the growing number of cases, as many studies have shown a strong statistical correlation between the unemployment rate and the number of cases being filed.

Credit Crisis Cases Still in Progress. The majority of claims that occurred during the credit crisis have yet to be settled, but data suggests that credit crisis settlements could be more frequent and more severe than other types of claims. As the typical settlement range is 48 months to 72 months for most professional liability claims, the true cost of the crisis, from a D&O perspective, is still unfolding.

Active Deal Environment Could Lead to Additional Exposure. Heightened activity in both the M&A and IPO markets has the potential to spur claim frequency, specifically in regard to shareholder litigation suits. Considering the decline in rates, the uptick in frequency could pose severe threats to accident-year loss ratios for 2010 and 2011.

Financial Services: Property & Casualty Insurance

August 01, 2011

Chubb Corporation (The)

Stock Rating:	Underperform
Company Profile:	Core Growth
Symbol:	CB (NYSE)
Price:	\$62.48 (52-Wk.: \$52-\$66)

HCC Insurance Holdings, Inc.

Stock Rating:	Underperform
Company Profile:	Core Growth
Symbol:	HCC (NYSE)
Price:	\$30.13 (52-Wk.: \$25-\$33)

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Bottom Line:

We are reaffirming our Underperform ratings on Chubb and HCC. Exposure to long-tail liability lines should cause a greater negative swing in cash flow over the next several years and ultimately lower ROE as the impact of the 2007-2010 accident years is better reflected in the operating results. For Chubb and HCC, negative results in the professional liability segment could result in a 10% to 15% swing on our 2012 EPS estimates and should drive ROE's below 10%. We believe that, taken as a whole, commercial insurers, particularly those with exposure to long-tailed liability markets, are somewhat overvalued in the short- to intermediate-term based on the continuing soft pricing environment and their declining fundamentals.

**Commercial P&C Underwriters
Cash Flow Valuation Comparison**

Category	Ticker	Rating	Current Price	Cash Flow Valuation				Earnings Valuation				Book Valuation	
				Cash Flow Per Share 2011	Cash Flow Per Share 2012	Price to Cash Flow ¹	Current Valuation vs. 5 Year Median (% Difference)	EPS 2011E	EPS 2012E	PE 2011	PE 2012	Current Price To Book	2012 ROE
Large Insurers	CB	U	\$62.48	\$6.58	\$6.39	9.1x	26%	\$5.64	\$5.42	11.1x	11.5x	1.2x	9%
	HCC	U	\$30.13	\$3.23	\$3.22	8.8x	54%	\$2.66	\$2.78	11.3x	10.8x	1.0x	9%
	TRV	M	\$55.13	\$6.24	\$8.11	7.4x	-1%	\$4.07	\$6.10	13.5x	9.0x	0.9x	9%
Average						8.4x	26%			12.0x	10.5x	1.1x	9%
Small-Mid Sized Insurers	AFSI	O	\$23.22	\$4.06	\$4.52	7.3x	46%	\$2.78	\$2.91	8.4x	8.0x	1.8x	19%
	NATL	M	\$22.41	\$5.39	\$5.48	4.9x	4%	\$1.97	\$2.19	11.4x	10.2x	1.4x	12%
	RLI	M	\$63.15	\$5.64	\$5.86	11.1x	17%	\$5.01	\$5.02	12.6x	12.6x	1.6x	11%
	TWGP	M	\$22.86	\$5.17	\$6.48	4.5x	-27%	\$2.65	\$3.03	8.6x	7.5x	0.9x	11%
Average						6.9x	10%			10.2x	9.6x	1.4x	13%

Note¹: Price to Cash Flow Based off Current Price Divided by 4 year cash flow: = -1,0,1,2

Note²: Travelers data only goes back through 2002

Note³: AFSI Cash flow affected in 2008 by change in reinsurance contracts, and affected in 2010 by accrued and prepaid expenses

Source: William Blair & L.L.C. estimates.

Professional Liability Results Should Hurt Commercial Insurance Profitability Going Forward

Industry Overview

The majority of large commercial insurers are involved to some extent in the D&O marketplace, but AIG (AIG \$28.70) and Chubb really dominate the industry. Together, the two companies write roughly 45% of what is now an insurance line with more than \$6 billion in gross written premium (GWP).

D&O Insurance Study D&O Market Share 2008

Rank	Insurer	Market Share
1	American International Group Inc.	29.71%
2	Chubb Corp.	14.10%
3	XL Insurance	8.66%
4	W.R. Berkley Corp.	5.00%
5	CNA Financial Corp	4.66%
6	Hartford Financial Services Group	4.43%
7	ACE Ltd.	4.39%
8	Lloyd's of London	3.92%
9	Travelers Cos. Inc.	2.24%
10	Zurich Insurance Co.	1.97%
11	Liberty International Underwriters	1.68%
12	Old Republic Insurance Co.	1.60%
13	Navigators Insurance Co.	1.45%
14	Great American Insurance Group	0.94%
15	Houston Casualty Co.	0.88%

Source: Towers Watson D&O Study 2008

With prices in the industry down for the last seven years, and huge loss expectations due to the credit crisis, one would expect to see companies moving their loss picks higher for the 2008-2010 period, and that appears to be the case. As shown in the following statutory incurred loss table, the incurred loss ratio for the "other liability: claims made" line moved from an average of 65% in 2003-2007 to 71% in 2008-2010. However, during the last major market swing, much of the adverse development took four years or more to materialize in the incurred loss ratio results. As shown in the table, little development has taken place in the major years of the credit crisis because most of the cases remain active. We believe it will be 12-24 months before material negative development becomes more visible. This should be a negative catalyst for commercial insurers as a whole, which is why we remain cautious on the majority of the sector, particularly names with any significant professional liability exposure.

D&O Insurance Study Other Liability: Claims Made Incurred Loss Ratio Development

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months	Adverse development
2001	74.2%	74.8%	82.3%	92.6%	102.8%	104.6%	105.1%	105.7%	106.6%	105.7%	42.5%
2002	68.9%	68.7%	77.8%	88.6%	92.9%	94.6%	94.8%	94.1%	93.9%		36.2%
2003	66.3%	63.9%	64.7%	64.4%	64.6%	64.6%	64.7%	64.8%			-2.2%
2004	65.9%	58.2%	55.6%	53.9%	49.3%	47.2%	46.9%				-28.8%
2005	63.1%	57.7%	55.7%	51.0%	48.1%	47.1%					-25.4%
2006	64.2%	63.3%	59.6%	55.6%	53.4%						-16.9%
2007	66.9%	66.0%	64.9%	62.2%							-6.9%
2008	72.4%	75.1%	72.6%								0.2%
2009	70.5%	72.0%									2.2%
2010	70.1%										0.0%

Source: SNL

The Chubb Corporation (CB)

Rating: Underperform

Company Profile: Core Growth

2011 EPS WB: \$5.64

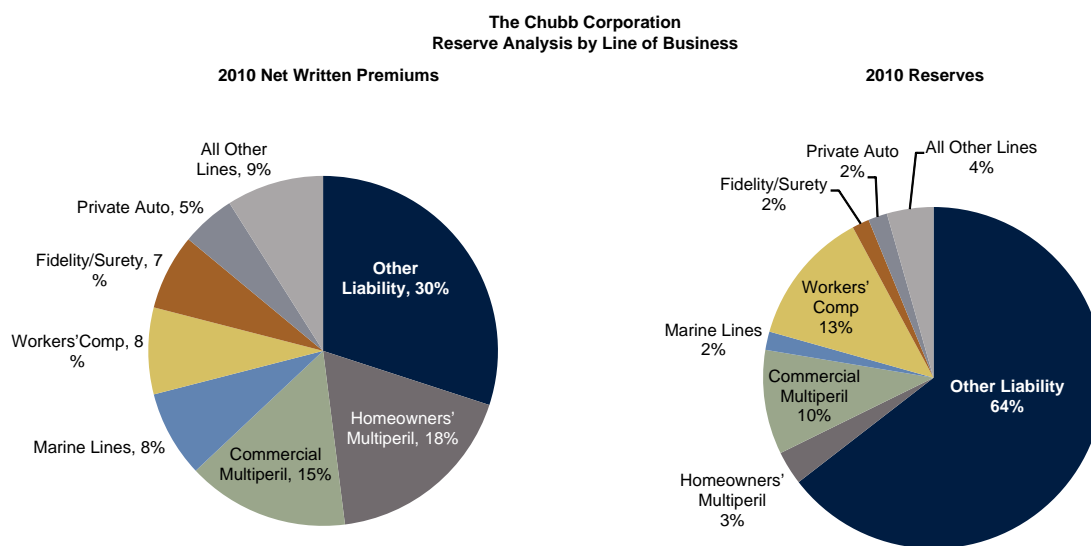
2011 EPS Consensus: \$5.64

2012 EPS WB: \$5.42

2012 EPS Consensus: \$5.98

Chubb's Large Exposure to Professional Liability Is One of the Keys to Our Underperform Rating

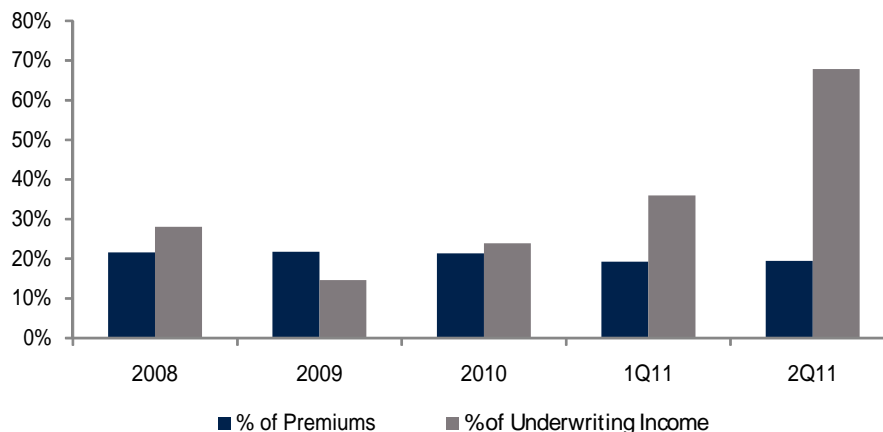
Longer-tail casualty lines tend to be more underpriced in a soft market, as the profit realization lag is the longest. Chubb has a relatively sizable exposure to these deeply cyclical lines. Professional lines, workers' compensation, and other casualty lines constitute more than half of premiums and, importantly, roughly \$15 billion of \$20 billion in total reserves.



Chubb is one of largest competitors in the professional liability market, with \$2.4 billion of premiums and \$7.4 billion of reserves. The company has a well-diversified book with a good contingent of small-to middle-market clients. However, as an anecdotal example of how wide-ranging professional liability claims can span, Chubb is one of the major insurers on the hook for what could be a settlement in excess of \$200 million for the News Corp. (NWSA \$16.02) phone hacking scandal. Even with a seemingly benign risk for a company that had nothing to do with the financial crisis and has had fairly strong performance over the last several years, exposure to D&O suits, and large ones at that, can still happen at any point, which is an inherent risk of longer-tail liability lines.

Chubb is one of the few insurers to compete in primary lines, but it also goes up to other layers. The acquisition of Executive Risk, which was more of an excess player and middle-market competitor, augmented the company's diversification. Chubb takes large lines, as primarily a first-layer participant; the average size of its lines for public company risks tends to be over \$10 million (before reinsurance). The company has been more conservative in recent years. For example, the unit moved away from healthcare-related risks. However, given its size and presence in most market segments, we expect Chubb to accrue its share of losses in financial services from the recent financial crisis, the growing rash of claims from the middle-market segment (EPLI and other), and an increasing level of claims related to merger-and-acquisition activity. As shown in the following chart, professional liability is a key driver of both premium and earnings for Chubb. Particularly over the last few quarters, which have exhibited above-average catastrophe losses, Chubb draws a somewhat disproportionate amount of its earnings from the professional liability segment.

**The Chubb Corporation
Professional Liability as % of Premium and Income**



Sources: Company reports and William Blair & Company, L.L.C.

Chubb’s professional liability results are beginning to show some cracks, and we expect segment profitability to deteriorate materially over the next three years. For example, the paid loss ratio for 36 months in the other liability line went from 17% in 2004 and 2005 (i.e., before the crisis) to 26.5% in 2008, which is a key year because it was in the middle of the crisis. Our expectation is that the paid loss ratio trend will continue to rise in this line over the next two years.

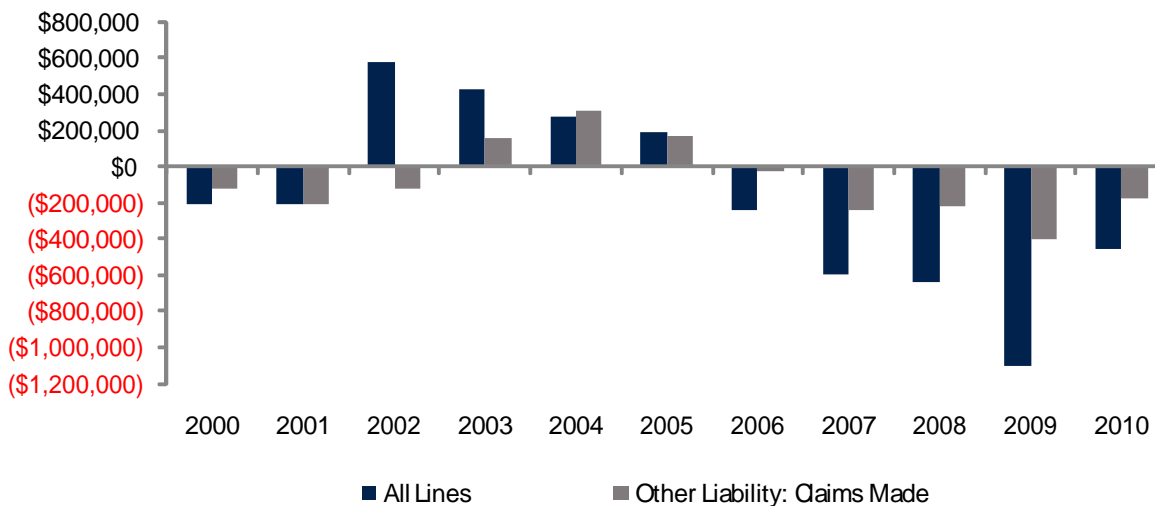
**The Chubb Corporation
Paid Loss Ratios (%) by Accident Year—Other Liability: Claims Made
Paid Losses (Schedule P, Part 3)/Net Premiums Earned (Schedule P, Part 1)**

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months
2001	5.74	21.49	37.91	56.26	75.80	83.20	90.05	95.75	100.67	103.87
2002	3.84	22.97	46.35	67.11	80.04	94.32	103.70	107.75	110.95	
2003	2.16	10.52	21.33	33.78	41.24	49.55	53.95	57.36		
2004	1.59	9.16	16.51	25.82	31.36	34.53	36.77			
2005	1.57	7.99	18.47	26.24	30.88	35.52				
2006	1.83	10.83	23.60	32.48	40.63					
2007	1.79	10.19	22.01	31.05						
2008	4.26	13.87	26.51							
2009	2.11	11.40								
2010	3.25									

Source: SNL

When looking at favorable reserve development, professional liability’s key role becomes even more apparent. The worst accident years for the “other liability: claims made” line were 2000 and 2001. As those claims began to settle in 2004 and 2005, the incurred loss began to move up rapidly, creating severe adverse development in those calendar years. As shown in the following chart, favorable development for the other liabilities line has been quite strong in recent years, and has been a big driver of overall favorable development. If historical patterns hold true, this trend is likely to begin to reverse, as it already appears to be doing in 2010. Claims from 2007 and 2008 should begin to settle over the next 12 to 36 months, increasing incurred losses for those accident years, and hurting calendar year 2012 and 2013 development, which has the potential to even turn adverse by that point.

**The Chubb Corporation
Reserve Development (\$000)**



Note: Negative = Favorable Development, Positive = Adverse Development

Source: SNL

With this prognosis for the professional liability segment, we believe it is useful to run a sensitivity impact on how much variability the professional liability line could add to the bottom line in 2012. Our estimate currently assumes that the professional liability loss ratio for calendar year 2012 will move up 10% from the 57% experienced in 2010, through a combination of lower favorable reserve development and a higher accident-year loss ratio. We are expecting the PL segment to contribute roughly \$0.08 to overall EPS for 2012. The bullish scenario assumes the PL loss ratio remains constant at its 2010 level, which leads to a \$0.72 EPS contribution; the bearish scenario suggests a drastic increase in the loss ratio, leading to a \$0.55 reduction in EPS.

**The Chubb Corporation
Professional Liability Effect on 2012 EPS Expectations**

	WB Expectation		
	Scenario 1	Scenario 2	Scenario 3
Calendar Year Loss Ratio for Professional Liability	57%	67%	77%
PL Premiums	\$2,270	\$2,270	\$2,270
PL Combined Ratio	89%	99%	109%
PL Underwriting Income	\$257	\$30	(\$197)
Tax Rate	25%	25%	25%
2012 EPS Contribution from PL	\$0.72	\$0.08	(\$0.55)
Total Company EPS for 2012	\$6.06	\$5.42	\$4.78

Sources: Company reports and William Blair & Company, L.L.C.

The Chubb Corporation

Earnings Model

William Blair & Company

222 West Adams Street Chicago, Illinois 60606
www.williamblair.com

(in Millions)

	2009	1Q'10	2Q'10	3Q'10	4Q'10	2010	1Q'11	2Q'11	3Q'11E	4Q'11E	2011E	2012E	2013E
Net premiums written	11,077	2,765	2,886	2,732	2,853	11,236	2,859	3,055	2,800	2,920	11,684	11,842	12,199
		1%	1%	1%	3%	1%	3%	6%	2.5%	2.4%	4%	2%	3%
Net premium earned	11,351	2,782	2,799	2,798	2,836	11,215	2,854	2,915	2,800	2,920	11,487	11,842	12,199
% Change	-4%	-2%	-1%	-1%	0%	-1%	3%	4%	0.1%	3.0%	2%	3%	3%
Non-catastrophe accident year losses	6,939	1,806	1,647	1,664	1,694	6,611	1,715	1,723	1,708	1,781	6,927	7,341	7,700
Non-catastrophe accident year loss ratio	61.2%	57.7%	58.8%	59.5%	59.7%	58.9%	60.1%	59.1%	61.0%	61.0%	60.3%	62.0%	63.1%
Favorable development	762	220	180	200	146	746	220	205	112	88	625	328	62
As % of loss ratio	6.7%	7.9%	6.4%	7.1%	5.1%	6.7%	7.7%	7.0%	4.0%	3.0%	5.4%	2.8%	0.5%
Catastrophe losses	91	344	193	58	39	634	270	329	137	0	736	482	484
As % of loss ratio	0.8%	12.3%	6.9%	2.1%	1.4%	5.7%	9.9%	11.3%	4.9%	0.0%	6.4%	4.1%	4.0%
Losses and Loss Expenses	6,268	1,730	1,660	1,522	1,587	6,499	1,765	1,847	1,753	1,694	7,059	7,495	8,122
Calendar Year Loss Ratio	55.3%	62.2%	59.3%	54.4%	56.0%	57.9%	61.8%	63.4%	61.9%	58.0%	61.3%	63.3%	66.6%
Change in Unpaid Losses and Loss Expenses	262	298	-26	-59	-63	145	298	104					
Paid Losses and Loss Expenses	6,006	1,432	1,686	1,581	1,655	6,354	1,467	1,745					
Paid Loss Ratio	53.0%	51.5%	60.2%	56.5%	58.4%	56.7%	51.4%	59.6%					
Operating Costs	3,577	862	889	864	881	3,496	904	953	882	906	3,646	3,729	3,765
Expense Ratio	30.5%	31.2%	30.8%	31.6%	30.9%	31.1%	31.6%	31.3%	31.5%	31.0%	31.7%	31.5%	30.9%
Change in Deferred Policy Acquisition Costs	27	-22	-21	7	6	-30	-25	-32	10	10	-37	-10	-10
Dividends to Policyholders	28	8	8	6	6	28	8	8	7	7	30	32	34
Underwriting Income	1,681	204	265	399	356	1,222	202	133	168	304	809	596	288
Combined Ratio	83.8%	93.4%	90.1%	86.0%	86.8%	89.1%	93.5%	94.7%	93.4%	89.0%	93.0%	94.8%	97.4%
Net investment income	1,549	387	385	390	396	1,558	381	394	391	392	1,558	1,592	1,681
Yield	3.8%	3.7%	3.6%	3.7%	3.7%	3.7%	3.6%	3.7%	3.7%	3.7%	3.6%	3.6%	3.8%
Other Income	-3	-7	4	-2	7	2	5	11	0	0	16	0	0
Property and Casualty Income	3,177	584	652	787	759	2,782	588	540	559	696	2,383	2,189	1,969
Corporate and Other	-25.8	-65	-40	-57	-60	-220	-63	-63	-60	-60	-246	-230	-260
Consolidated Income Before Tax	2,989	521	612	730	699	2,562	525	477	499	636	2,137	1,959	1,709
Tax Expense	771	140	152	195	180	666	120	103	125	159	507	485	427
Tax rate	26.2%	26.9%	24.8%	26.4%	25.8%	26.0%	22.9%	21.6%	25.0%	25.0%	23.7%	25.0%	25.0%
Consolidated Operating Income	2,168	381	460	537	519	1,897	405	374	374	477	1,630	1,454	1,281
Operating Earnings Per Share	\$6.14	\$1.14	\$1.41	\$1.69	\$1.69	\$5.90	\$1.35	\$1.27	\$1.32	\$1.71	\$5.64	\$5.42	\$5.06
Realized Investment gains after tax	15	83	58	35	101	277	104	45	20	20	189	80	80
Net Income	2,183	464	518	572	620	2,174	509	419	394	497	1,819	1,534	1,361
Net Income Per Share	\$6.18	\$1.39	\$1.59	\$1.80	\$2.02	\$6.76	\$1.70	\$1.42	\$1.39	\$1.79	\$6.29	\$5.72	\$5.38
Effect of Catastrophes Per Share	-\$0.17	-\$0.67	-\$0.38	-\$0.12	-\$0.08	-\$1.28	-\$0.59	-\$0.72					
Diluted weighted average shares outstanding	353.0	335.0	326.7	317.3	307.4	321.6	300.0	285.4	283.4	278.4	289.3	268.0	253.2
Common shares outstanding (Millions)	332.0	326.8	314.5	304.9	297.3	297.3	292.5	285.9	280.9	275.9	275.9	260.9	246.9
Average Book Value Per Share (Calculated)	\$44.29	\$46.99	\$47.55	\$50.36	\$50.52	\$48.29	\$51.98	\$52.23	\$54.29	\$53.50	\$53.41	\$58.09	\$61.29
Book Value Per Share (Reported)	\$47.09	\$48.17	\$49.39	\$52.41	\$52.24	\$52.24	\$53.26	\$55.23			\$0.00	\$0.00	\$0.00
Operating ROAE	13.9%	9.7%	11.8%	13.4%	13.4%	12.2%	10.4%	9.7%	9.7%	12.4%	10.6%	9.3%	8.3%

HCC Insurance Holdings, Inc. (HCC)

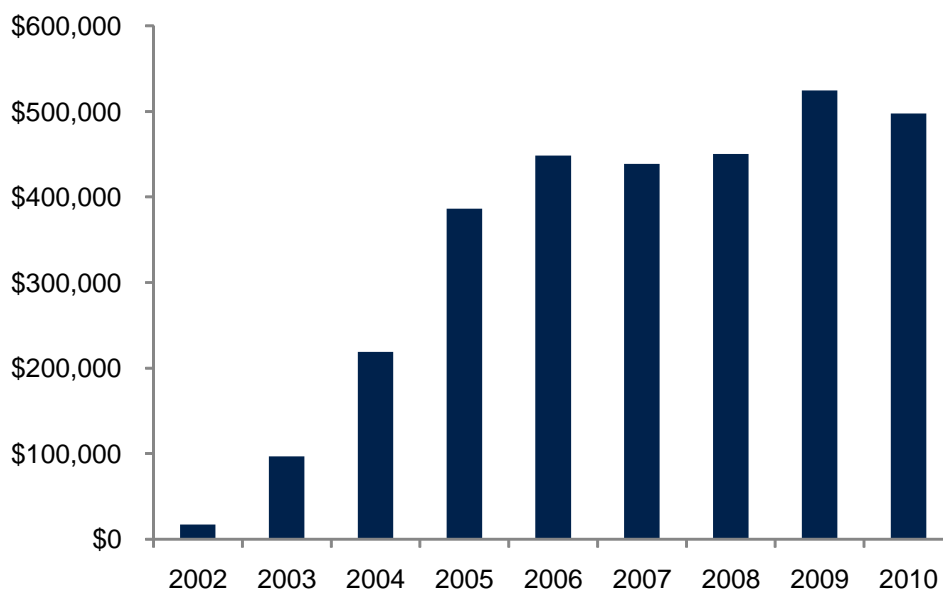
Rating: Underperform
Company Profile: Core Growth

2011 EPS WB: \$2.66
 2011 EPS Consensus: \$2.65
 2012 EPS WB: \$2.78
 2012 EPS Consensus: \$3.06

For HCC, Recent Premium Expansion in Professional Liability Could Significantly Hinder Future Profitability

Despite historically good underwriting standards, the professional liability segment is a major concern for HCC. Between 2005 and 2008, the older reporting segment of HCC called diversified financial products (largely represented by professional liability) had net written premiums increase from \$676 million to \$872 million. That is a 29% cumulative increase over three years, although recently it has been receding. The growth included expanding into the primary or other lower layers, which generally require higher limits and are more exposed to losses. The benefit of the lower layers is that premiums are higher and insurers can be more active in underwriting specific risks. Professional liability accounts for only 20% of premiums, but represents 43% of reserves.

HCC Insurance Holdings, Inc.
U.S. Other Liability Claims-Made Earned Premiums
 (dollars in thousands)



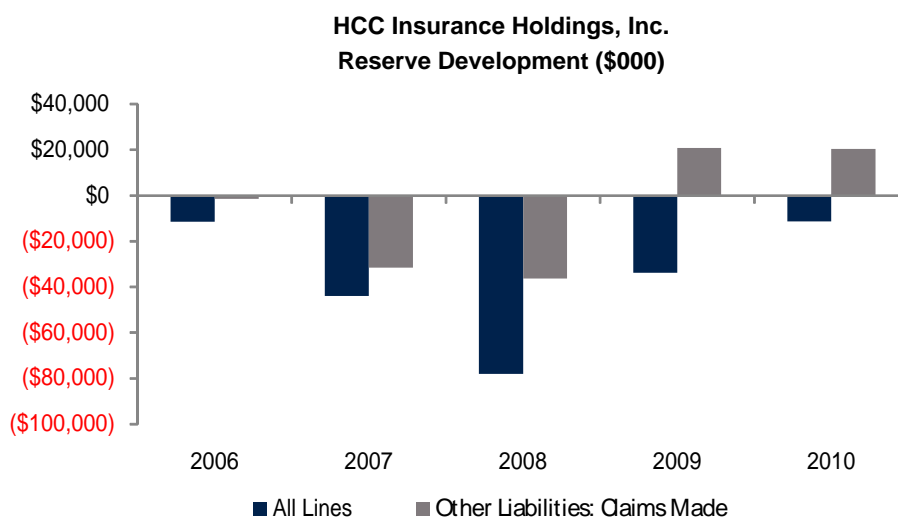
Source: SNL

HCC primarily underwrites directors' and officers' (D&O) insurance for public companies, although private entities make up a significant portion of the business. The company underwrites a fair amount of financial institution insurance, which carries a large limit. This unit focuses on investment banks, depository institutions, brokers, and investment advisors. In addition, HCC specializes in professional liability products for investment advisors, mutual funds, hedge funds, funds of funds, real estate investment trusts, private real estate funds, and private equity partnerships. Given the huge exposure to financial institutions during the recent credit crisis, we anticipate this part of the business to exhibit sharply deteriorating results over the next 12 to 36 months.

Another portion of the book is crime business coverage, including large-account errors and omissions (E&O) liability and employment practice liability insurance (EPLI) for some D&O policyholders. HCC also does low-limit E&O business for numerous classes of professional services, including engineers

and related construction practices, representing the largest concentration of insured professionals. The small to midsize professional liability market, once viewed as a safe haven, has experienced an increase in filed claims. This market was particularly hard hit by the recession, with bankruptcies and fraud moving to unprecedented levels. HCC has smaller exposure to the private market, but it is still significant.

We expect the industry as well as HCC to experience adverse development on prior underwriting years and increased accident years. Looking back on the last five years, a reversal in development trends for the “other liability: claims made” line has seriously limited the company’s overall reserve development levels.



Note: Negative = Favorable Development, Positive = Adverse Development

Source: SNL

In addition, paid loss trends for professional liability are beginning to show some cracks, and we expect segment profitability to deteriorate materially over the next three years. For example, the paid loss ratio for 36 months in the other liability line went from 16% in 2006 (i.e., before the crisis) to 25.8% in 2008, which is a key year because it was in the middle of the crisis. Our expectation is that the paid loss ratio trend will continue to rise in this line over the next two years.

**HCC Insurance Holdings, Inc.
Other Liability: Claims Made Paid Loss Ratio Development**

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months
2006	0.8%	7.3%	16.3%	23.9%	27.7%
2007	1.2%	8.1%	19.7%	28.6%	
2008	1.4%	10.9%	25.8%		
2009	3.4%	16.6%			
2010	2.3%				

Source: SNL

To see the effect that declining profitability in the professional liability segment will have on HCC as a whole, we ran a sensitivity impact on how much variability the professional liability line could add to the bottom line in 2012. Our estimate currently assumes that the professional liability loss ratio for calendar year 2012 will move up 8% from the 62% experienced in 2010, through a combination of lower favorable reserve development and a higher accident-year loss ratio. We are expecting the PL

segment to contribute roughly \$0.04 to overall EPS for 2012. The bullish scenario assumes the PL loss ratio decreases to 60%, which leads to a \$0.27 EPS contribution, while the bearish scenario suggests a drastic increase in the loss ratio, leading to a \$0.20 reduction in EPS.

**HCC Insurance Holdings, Inc.
Professional Liability Effect on 2012 EPS Expectations**

	WB Expectation		
	Scenario 1	Scenario 2	Scenario 3
Calendar Year Loss Ratio for Professional Liability	60%	70%	80%
PL Premiums	\$387,124	\$387,124	\$387,124
PL Combined Ratio	88%	98%	108%
PL Underwriting Income	\$44,906	\$6,194	(\$32,518)
Tax Rate	32%	32%	32%
2012 EPS Contribution from PL	\$0.27	\$0.04	(\$0.20)
Total Company Operating EPS for 2012	\$3.01	\$2.78	\$2.55

Sources: Company reports and William Blair & Company, L.L.C.

HCC Insurance Holdings, Inc.
Earnings Model
(dollars in thousands)

	2007	2008	2009	2010	1Q'11	2Q'11E	3Q'11E	4Q'11E	2011E	2012E	2013E
Gross written premium	2,451,179	2,498,761	2,559,791	2,578,901	649,208	718,144	656,291	621,451	2,645,098	2,753,221	2,868,561
Net written premium	1,985,609	2,060,611	2,046,281	2,026,191	538,884	571,131	509,591	487,238	2,106,850	2,205,351	2,297,261
Net earned premium	1,985,086	2,007,774	2,037,231	2,041,921	508,480	519,722	524,691	526,639	2,079,538	2,171,121	2,250,861
Net investment income	206,462	164,751	191,961	203,811	51,595	51,714	52,701	53,890	209,902	220,021	226,711
% yield		3.4%	3.6%	3.6%	3.6%	3.6%	3.6%	3.6%	3.5%	3.6%	3.6%
Other operating income	96,780	57,214	82,661	44,832	7,321	9,374	7,881	9,797	34,380	34,380	34,380
% change		-40.9%	44.5%	-45.8%	-59.2%	0.0%	0.0%	0.0%	-23.3%	0.0%	0.0%
Total revenue	2,288,328	2,229,731	2,311,861	2,290,571	567,396	580,811	585,281	590,326	2,323,819	2,425,521	2,511,951
Loss and loss adjustment expense, net	1,183,947	1,211,871	1,215,751	1,213,021	347,586	313,941	304,041	308,415	1,273,994	1,324,311	1,405,071
% loss ratio	59.6%	60.4%	59.7%	59.4%	68.4%	60.4%	57.9%	58.6%	61.3%	61.0%	62.4%
Policy acquisition costs, net	279,753	303,816	308,554	322,041	83,378	83,954	82,082	82,612	332,026	346,651	359,391
% policy acquisition cost ratio	14.1%	15.1%	15.1%	15.8%	16.4%	16.2%	15.6%	15.7%	16.0%	16.0%	16.0%
Other operating expense	241,642	233,509	259,481	256,004	64,312	64,161	61,774	68,235	258,482	269,871	279,801
% other operating expense ratio	12.2%	11.6%	12.7%	12.5%	12.6%	12.3%	11.8%	13.0%	12.4%	12.4%	12.4%
Interest expense	10,304	16,288	16,164	21,341	5,553	5,237	5,280	5,441	21,511	21,511	21,511
Total expense	1,715,646	1,765,481	1,799,961	1,812,421	500,829	467,291	453,181	464,702	1,886,014	1,962,351	2,065,791
Operating earnings before income tax expense	572,682	464,253	511,904	478,141	66,567	113,512	132,101	125,624	437,805	463,171	446,151
Income tax expense	185,825	141,323	162,351	140,641	17,180	35,756	41,612	39,572	134,120	145,891	140,541
Tax rate	32.4%	30.4%	31.7%	29.4%	25.8%	31.5%	31.5%	31.5%	30.6%	31.5%	31.5%
Operating earnings	386,857	322,930	349,554	337,501	49,387	77,756	90,490	86,052	303,685	317,271	305,611
Operating earnings per share	\$3.31	\$2.80	\$3.01	\$2.91	\$0.41	\$0.61	\$0.71	\$0.75	\$2.66	\$2.71	\$2.61
% change		-15.4%	10.5%	-4.3%	-27.8%	-4.9%	-2.2%	-9.1%	-10.0%	4.5%	-3.7%
Realized investment gains net of tax	8,572	-18,162	7,849	7,861	-363	1,950	1,950	1,950	5,487	7,800	7,800
OTT impairment credit losses net of tax			-3,529	-276	-2,034	0	0	0	-2,034	0	0
Net earnings	395,429	304,768	353,861	345,091	46,990	79,706	92,440	88,002	307,138	325,071	313,411
Net earnings per share	\$3.38	\$2.64	\$3.11	\$3.02	\$0.41	\$0.70	\$0.81	\$0.77	\$2.69	\$2.81	\$2.71
Basic average shares outstanding (millions)	112.9	114.1	112.2	113.9	113.8	113.8	113.1	113.8	113.1	113.8	113.1
Diluted average shares outstanding (millions)	117.0	115.1	113.1	114.1	114.1	114.1	114.1	114.1	114.1	114.1	114.1
Cash dividends per share	0.42	0.47	0.520	0.560	0.145	0.145	0.141	0.145	0.580	0.600	0.640
Operating ROE		12.7%	12.3%	10.6%	6.0%	9.3%	10.6%	9.9%	9.0%	8.7%	7.8%
Book value per average diluted share	20.86	22.81	26.80	28.81	28.99	29.55	30.21	30.84	30.84	33.09	35.20
GAAP net loss ratio	59.6%	60.4%	59.7%	59.4%	68.4%	60.4%	57.9%	58.6%	61.3%	61.0%	62.4%
GAAP net expense ratio	23.8%	25.0%	24.3%	25.2%	26.3%	26.3%	26.3%	26.3%	26.3%	26.3%	26.3%
GAAP combined ratio	83.4%	85.4%	84.0%	84.6%	94.7%	94.7%	94.7%	94.7%	94.7%	94.7%	94.7%
Paid loss ratio	47.9%	58.1%	55.8%	59.7%	58.4%	58.4%	58.4%	58.4%	58.4%	58.4%	58.4%
Accident year loss ratio	60.9%	64.5%	62.3%	60.4%	66.6%	66.6%	66.6%	66.6%	66.6%	66.6%	66.6%
Accident year combined ratio	84.7%	89.5%	86.6%	85.6%	92.9%	92.9%	92.9%	92.9%	92.9%	92.9%	92.9%

Sources: Company reports and William Blair & Company, L.L.C. estimates

Directors' & Officers' Liability Insurance Overview

Background on D&O Liability

Professional liability insurance comes in three major forms:

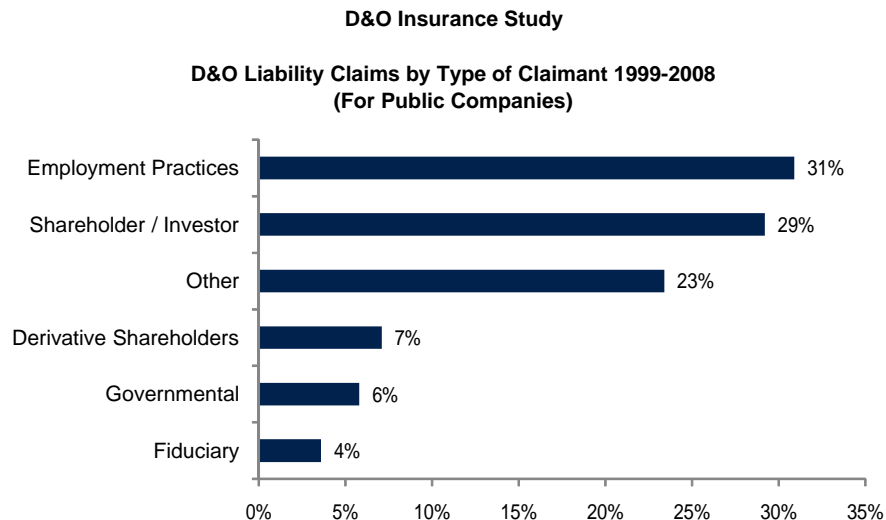
- Directors' and officers' (D&O) insurance covers the directors and officers of a company from a lawsuit stemming from negligent acts or misleading statements.
- Errors and omissions (E&O) insurance protects employees that give advice or make decisions when they do something they should not have or do not do something they should have
- Employment practices liability (EPL) insurance protects employees from allegations pertaining to the company's employment practices, particularly concerning discrimination and retaliation.

While these types of professional liability insurance may appear to overlap, the coverage provisions for each can be drastically different in who they cover, what the terms are, and when the policies are triggered. The policies are often combined for a larger company's professional liability program, but can also be issued on a stand-alone basis. Commercial carriers that are in the professional liability space tend to write a variety of different types of products within that business segment. For the majority of this note, we will focus on D&O, as it is the largest line and the one that we believe will create the most headwinds for commercial insurers over the next few years.

Directors' and officers' (D&O) liability insurance is a form of professional liability coverage that protects the officers and directors of a company from lawsuits that may arise from decisions or actions taken within the scope of their normal duties for the corporation. The coverage was created by Lloyd's of London in the 1930s in response to the 1934 Securities Exchange Act, but did not become popular until the 1980s as government regulation, the tort system, and a rise in M&A activity spurred a drastic increase in the number of lawsuits and class actions filed against corporations and their directors and officers. Today, the D&O market is one of the largest segments of professional liability insurance, with more than \$10 billion in global written premium on an annual basis, and more than \$6 billion of that within the United States. It is estimated that more than 95% of the *Fortune* 500 buy some form of D&O insurance on an annual basis. Importantly, given the recent credit crisis and current regulatory atmosphere, claims frequency for D&O appears to be picking up, according to the latest Towers Watson (TW \$61.15; Outperform) survey. Of companies with D&O policies, 31% reported having a claim against the policy over the last 10 years, versus 17% in 2008.

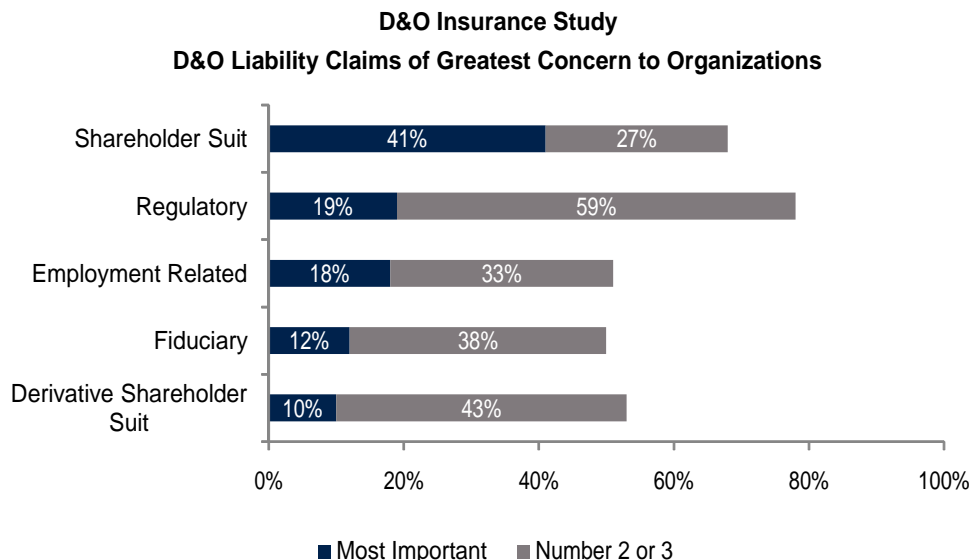
A D&O policy covers both legal costs and financial losses that stem from the settlement or trial verdict of a lawsuit that is brought against the directors and officers of a company. The policy was originally created so that directors and officers did not have to pay out of pocket for lawsuits when firms were unable or unwilling to indemnify the legal costs and losses borne by their employees. Like many other forms of liability coverage, D&O coverage has grown and morphed over the years and now covers a wide variety of entities and types of lawsuits. However, as insurers make very clear in the constraints of the policies, D&O insurance does not cover situations where directors and officers commit fraudulent, criminal, or intentionally noncompliant acts.

Lawsuits can take many forms, but the most common are employment practices and HR issues, shareholder actions, reporting errors, inaccurate or inadequate disclosures, and failure to comply with regulations or laws. A 2008 study done by Towers Watson shows that employment practices and shareholder investor claims were the two most frequent types of D&O claims that corporations had to deal with.



Source: Towers Watson D&O Study 2008

However, the two types of claims that organizations are most concerned with, principally due to the size of the settlements, are shareholder suits and regulatory filings. Regulatory filings in particular have seen a large increase in interest since the last Towers Watson study was done in 2008, attributable primarily to the credit crisis and heightened legislative environment that arose in its aftermath.



Source: Towers Watson D&O Study 2010

Types of Coverage

There are three major types of D&O liability coverage that corporations buy, and any comprehensive policy tends to be a combination of all three. Side A is the most common type, and the original coverage proposed when D&O insurance was created in the 1930s. Side A covers directors and officers in the case of a lawsuit when the company is not able to indemnify, or compensate for loss, those officers and directors. Possible reasons for a company not being able to indemnify include legal restrictions, regulatory concerns, or because the company is going through the bankruptcy process. This coverage insures that directors and officers will not be forced to pay legal fees or settlement losses out of pocket. The second type of coverage is known as Side B, which covers the entity, or corporation, for losses and legal fees in the case that they are able to indemnify the directors and officers involved in the lawsuit. The final coverage, Side C, covers the entity or corporation when that

entity itself is named as a co-defendant in a lawsuit. Recently, Side D coverage has been added to help defray the legal costs associated with class action lawsuits. A comprehensive D&O policy typically includes a combination of the following types of coverage.

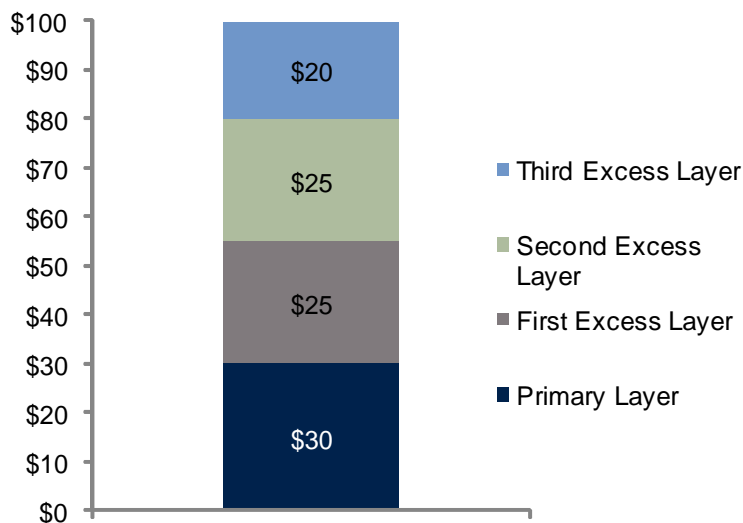
D&O Insurance Study
Definitions of D&O Insurance Coverage

Type of Coverage	Definition
Side A	Coverage for company directors and officers against losses, including defense costs, related to allegations that they committed unlawful acts while serving in their role at the corporation. Coverage is triggered if the company is not able to indemnify its directors and officers for the wrongdoing, whether due to legal complications or bankruptcy.
Side B	Coverage that reimburses a corporate entity for D&O losses that has paid for its directors and officers. Side B generally does not cover a company's own liabilities.
Side C	Coverage for a company's own liability when both the entity and the directors and officers are named in litigation.
Side D	Coverage for a company's costs of investigating shareholder litigation cases.

Source: D&O 2.0 Business Insurance White Paper

D&O coverage typically has too high of a limit for one insurance company to run a large D&O program by itself. Most D&O programs are split by using an excess layer structure, where a primary insurer pays the initial loss layer up to a certain threshold, and then additional insurers cover excess layers up to the policy limit. In this structure, the primary insurer receives the majority of the premiums because it is most likely to get hit with losses, and tends to have to cover legal costs and any small claims by itself. The other type of structure is proportional co-insurance, where a group of insurers pay a specific percentage of any losses that is equivalent to the amount of premium they receive.

D&O Insurance Study
Excess Layer Structure (\$100 MM Limit)



Source: Allianz Global Introduction to D&O Insurance

History of Coverage

Early forms of D&O coverage were around in the late 1800s, but D&O coverage as we know it today was created by Lloyd’s of London in the 1930s. The coverage was created in response to multiple pieces of legislation following the Great Depression, including the Securities Act of 1933 and the Securities Exchange Act of 1934. Corporations at that time were not able to indemnify their directors and officers, which prompted the creation of Side A D&O policies to cover the corporation’s directors and officers in the case of bankruptcy. Shareholder litigation really was not a large concern until the 1960s, as the U.S. tort system was slow to develop.

The first real crisis for shareholder litigation and D&O insurance occurred in the mid-1980s, during a period that included a rapid increase in M&A activity, LBOs, and the Savings and Loan Crisis, and was marked by numerous class action lawsuits that erased all excess capacity in the industry. Policyholders opted to form three new Bermuda-based insurers, XL Group (XL \$20.52), ACE (ACE \$66.98; Not Rated), and CODA, to create more capacity. These three insurers are big players in the D&O market to this day.

D&O liability developments began to pick up in 1995, when Congress passed the Private Securities Litigation Reform Act that attempted to curtail shareholder, and particularly class action, securities lawsuits. From a historical perspective, it is clear that the legislation had little effect, especially with the dot-com bubble and the accounting scandals that would mark the beginning of the next decade. The Enron and WorldCom scandals would mark the biggest shareholder lawsuits of all time, with both cases settling in excess of \$5 billion. These cases, combined with the dot-com meltdown and the subsequent recession, pushed D&O into a hard market cycle in 2000 in which it remained through 2004.

Several Supreme Court rulings during the mid-2000s helped make it more difficult for plaintiffs to win cases and caused the number of litigations to decrease over the subsequent few years. Rates eased after these decisions due to additional capacity entering the market, and we are now entering the eighth year of a soft market cycle, with rates down nearly 40% over that period.

D&O Insurance Study
D&O Insurance Timeline

Years	Events
1930's	Lloyd's of London introduced D&O coverage into the marketplace after the Securities Act of 1934 is passed, but it does not become popular until shareholder litigation became a bigger threat in the 1960's.
1985-1986	Increasing M&A activity spurs surge in class action securities lawsuits and absorbs all excess capacity. Policyholders formed 3 Bermuda based insurers, XL Group, Ace Ltd., and CODA (now part of ACE), in response.
1995	Congress passes Private Securities Litigation Reform Act, in an attempt to curtail frivolous investor lawsuits, with mixed results
1995	Nordstrom vs. Chubb Insurance case rules that liabilities of a company and its directors and officers could not be separated and allocated 100% of settlement to the insured employees, and 0% to the uninsured companies. Insurance companies began to integrate Side Coverage into their new policies in response.
2000	Cedant Corp. settles first \$1 BN + securities lawsuit after accounting irregularities were discovered after a recent merger
2001	Hardening market after the September 11th terrorist attacks, dot-com bust and subsequent losses, spawns several new Bermuda insurers including Allied World Assurance Co., Arch Reinsurance Ltd., Axis Specialty Ltd., and Endurance Specialty Insurance Ltd.
2002	In response to collapses of Enron Corp. and WorldCom Inc. , Congress passes Sarbanes-Oxley Act establishing much stricter corporate governance standards
2005	U.S. Supreme court case involving Dura Pharmaceuticals Inc. increases standards for assessing damages in securities litigation cases, ruling that plaintiff must prove that the unlawful acts had a direct effect on the stock price drop.
2005	WorldCom settles for \$6.1 billion
2006	Enron settles for \$7.2 billion
2007	Supreme Court rules that the plaintiff must show compelling evidence that the defendant's conduct is based on fraudulent intent rather than lawful explanations.
2008	Supreme Court rules that the Securities Act of 1934 does not allow for plaintiffs to include 3rd party defendants in class action suits, protecting accountants, bankers and lawyers who were not directly involved with the fraud or misleading investors

Source: D&O 2.0 Business Insurance White Paper

Profile of D&O Insured Companies

Typically, larger public companies are the most at risk for securities litigation, regulatory scrutiny, and employment issues, and are thus the most likely buyers of D&O insurance. However, private companies and nonprofits have also become regular buyers of D&O insurance, as their directors and officers still have exposure to lawsuits in response to their actions. As illustrated in the following table, as market cap increases, it is more likely that a company will have D&O coverage. Interestingly, insurers also believe that a larger company carries more risk of potential litigation, and they price their D&O policies accordingly; \$5 million of coverage costs less than \$50,000 for a company with a market cap under \$100 million, compared with more than \$135,000 for a company worth more than \$5 billion.

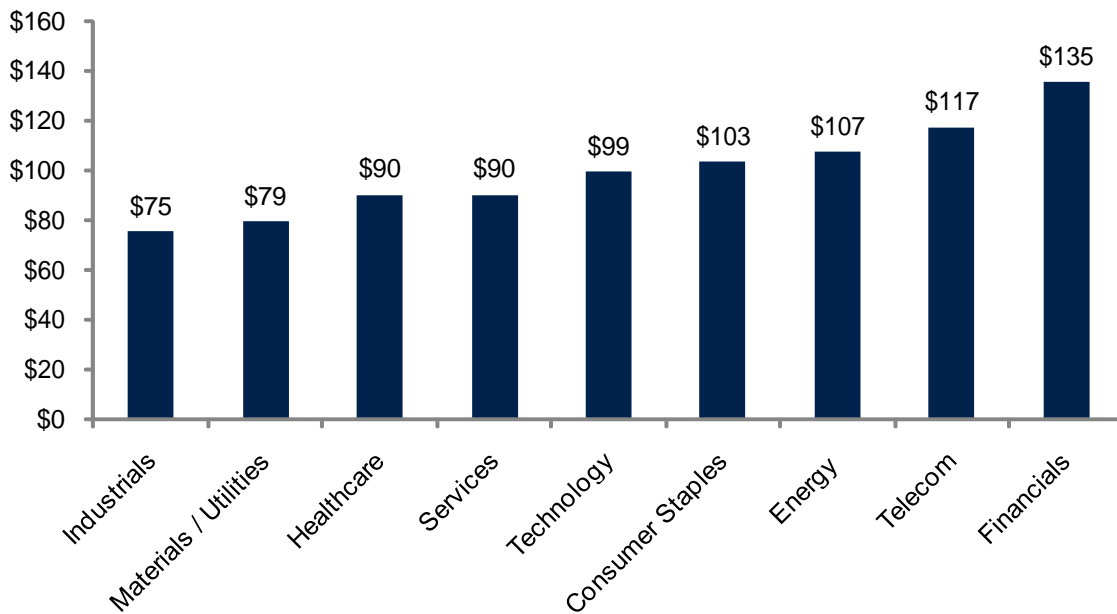
**D&O Insurance Study
D&O Market Share 2008**

Market Cap	% of Companies with Side A Coverage	Average Limit (\$MM)	Median Limit (\$MM)	Median Cost for \$5 MM Coverage
\$0 - \$100 MM	67%	\$17.1	\$15.0	\$48,675
\$100 MM - \$250 MM	70%	\$24.4	\$20.0	\$74,635
\$250 MM - \$500 MM	79%	\$34.1	\$30.0	\$78,915
\$500 MM - \$1 BN	81%	\$47.1	\$40.0	\$103,250
\$1 BN - \$2.5 BN	86%	\$48.3	\$45.0	\$105,160
\$2.5 BN - \$5 BN	90%	\$66.2	\$52.5	\$108,780
\$5 BN +	96%	\$83.2	\$100.0	\$135,915
Overall	79%	\$40.8	\$35.0	\$89,220

Source: AH&T Insurance Survey

Insurers are also cautious about what industries the insured are in when it comes to selecting risks and pricing D&O policies. On average, it costs nearly double to insure a financial institution, the riskiest industry group, versus an industrial firm. This inequality is a result not only of historical industry loss patterns, but also of the regulatory environment that governs the different industry groups.

**D&O Insurance Study
Average Cost of \$5 MM of D&O Coverage by Industry (\$000)**



Source: AH&T Insurance Survey

D&O Market Conditions

Last Market Cycle

Examining the last market cycle for D&O insurance proves to be invaluable because it bears a striking resemblance to the period we are currently in. With 10 years of hindsight, we can look back on that period and examine what happened with industry loss ratios to hopefully get a sense for what will occur down the road from the most recent credit crisis, which we believe will create similarly severe losses for the 2007-2010 accident years. 2011 marks the eighth year of the soft commercial pricing cycle and chances are good that an inflection point is on the horizon.

2000 and 2001 marked the start of the last hard market for commercial insurance. Heavy losses from the dot-com meltdown and subsequent recession, combined with the September 11, 2001, terrorist attacks, took out most of the excess capacity in the marketplace, forcing insurers to begin raising rates. D&O was particularly hard hit during this period by dot-com lawsuits, followed soon after by the accounting scandals at Enron, Tyco, WorldCom, and others. Prices for D&O insurance soared from 2000 to 2003 and spurred the creation of several startup insurers like Arch Insurance Group and Endurance Specialty Holdings Ltd. (ENH \$40.74).

To measure how these events affected commercial insurers, we need to examine historical loss ratios for the period in question. Importantly, professional liability results tend to have a significant lag. It typically takes four to six years to have material data that will provide an accurate measure of underwriting profitability. This is mainly because professional liability–related litigation is complex and takes time to work through the courts and move to settlement. The profitability lag is further compounded by the severity nature of the line. Because settlements can be large, the predictability of losses can vary widely until enough claims have settled. This means that accident-year profitability can vary materially from the original estimation—positively or negatively.

As a side note, professional liability is categorized by statutory standards as part of other liability, for which there are two different types of policies that companies can issue. An occurrence policy goes into effect if the event occurs during the policy period, regardless of when the claim is filed, while a claims made policy is triggered in the year the actual claim is reported to the insurance company, which could be several years after the actual occurrence. For D&O, the majority of policies are written on a claims made basis, so we will focus on those results.

The following tables help illustrate the variability of the professional liability marketplace during the last cycle. On an industrywide basis, the 1999 to 2002 accident years averaged 34 points of adverse development. This period was before large-scale pricing increases had been taken by the industry, inflating the loss ratios even further. Once pricing began to see substantial increases and insurers became more selective in their risk taking, the results began to improve substantially over the following few years. The 2003 to 2006 period is currently averaging 11.8 points of favorable development. As shown in the tables, much of the development for other liability claims from the initial loss pick occurred four or more years after the accident year, which means that for the 2007-2008 credit crisis events, there could still be a substantial amount of development ahead.

D&O Insurance Study
Other Liability: Claims Made Incurred Loss Ratio Development

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months	Adverse development
1999	68.4%	70.1%	79.4%	87.5%	94.0%	97.1%	102.7%	106.9%	107.4%	108.9%	40.5%
2000	71.1%	69.5%	75.9%	83.2%	92.8%	102.4%	106.9%	108.1%	110.0%	110.2%	39.1%
2001	74.2%	74.8%	82.3%	92.6%	102.8%	104.6%	105.1%	105.7%	106.6%	105.7%	31.5%
2002	68.9%	68.7%	77.8%	88.6%	92.9%	94.6%	94.8%	94.1%	93.9%		24.9%
2003	66.3%	63.9%	64.7%	64.4%	64.6%	64.6%	64.7%	64.8%			-1.5%
2004	65.9%	58.2%	55.6%	53.9%	49.3%	47.2%	46.9%				-19.0%
2005	63.1%	57.7%	55.7%	51.0%	48.1%	47.1%					-16.1%
2006	64.2%	63.3%	59.6%	55.6%	53.4%						-10.8%

Source: SNL

D&O Insurance Study
Other Liability: Occurrence Incurred Loss Ratio Development

Accident Year	12 Months	24 Months	36 Months	48 Months	60 Months	72 Months	84 Months	96 Months	108 Months	120 Months	Adverse development
1999	79.1%	81.0%	82.8%	89.0%	91.7%	95.5%	99.9%	101.9%	101.9%	105.4%	33.2%
2000	79.2%	79.6%	84.2%	90.2%	96.5%	98.2%	99.0%	100.3%	100.6%	101.0%	27.6%
2001	89.4%	91.0%	91.5%	94.7%	98.6%	100.7%	102.1%	101.5%	102.2%	102.8%	15.0%
2002	72.1%	71.8%	73.9%	77.0%	78.5%	79.0%	79.2%	79.7%	80.4%		11.5%
2003	69.7%	66.6%	66.4%	65.5%	63.8%	63.1%	63.1%	63.3%			-9.3%
2004	68.1%	60.4%	57.5%	55.5%	54.3%	54.1%	53.4%				-21.5%
2005	65.1%	60.9%	59.0%	56.0%	55.3%	54.2%					-16.7%
2006	63.6%	61.4%	58.1%	56.5%	55.5%						-12.6%

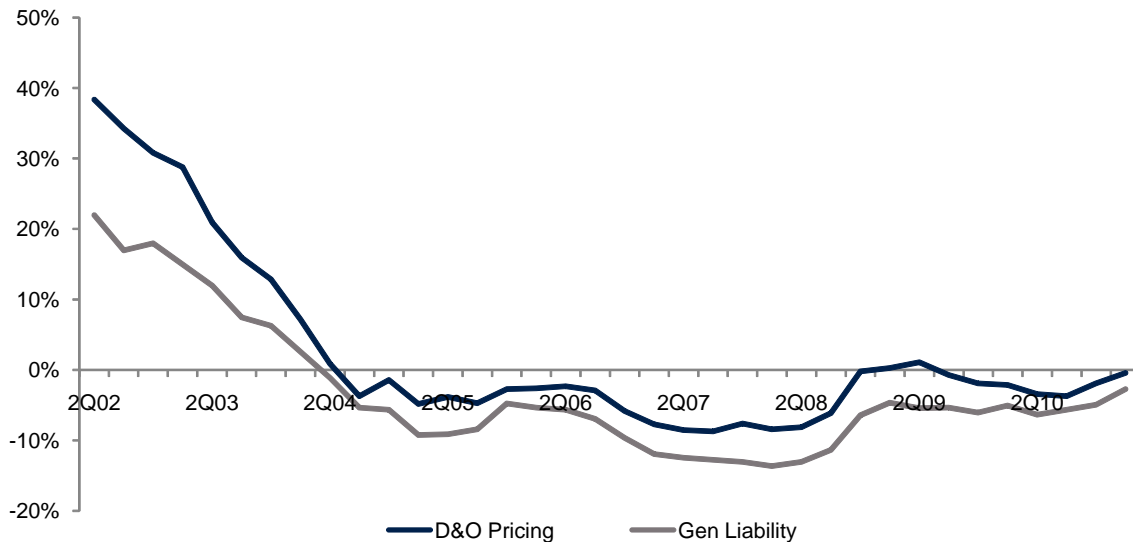
Source: SNL

Current D&O Market Trends

On the surface, professional liability loss ratios remain palatable on a historical basis. Calendar-year loss ratios are averaging around 70% for 2008 to 2010 on an industrywide basis, well below historical highs. The pendulum, however, appears to be swinging in the other direction. Several factors are contributing to our bearish outlook on the current D&O market:

Pricing. Professional liability has experienced a significant rate of price decline in the last decade and has the potential for a substantial swing in profitability. Pricing improved with the 2000 to 2003 hard market, after the segment had experienced significant losses from the tech bubble of 1999 to 2000. However, pricing since 2004 has declined materially and has not yet turned positive. The declines for D&O have been slightly less severe than general liability, probably due to large settlements in the middle of the decade related to the accounting and options backdating scandals.

D&O Insurance Study
% Change in Pricing 2002 - 2010

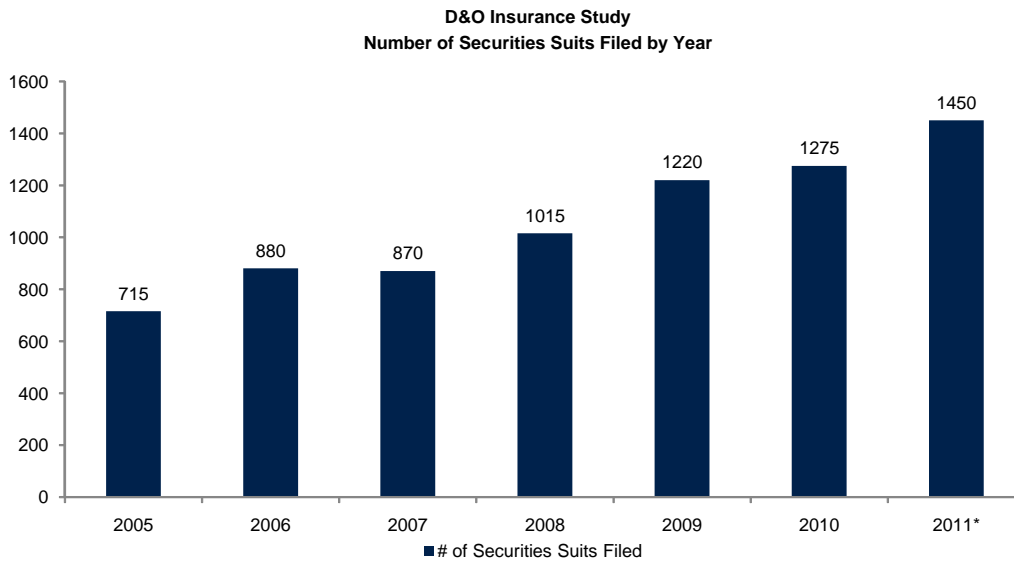


Source: CIAB Pricing Study

It appears that pricing is not likely to turn positive any time soon, though. Many industry sources have concluded that there is still far too much overcapacity in the marketplace to see a turn in the near future. According to Endurance Specialty Insurance Limited, a Bermuda-based insurer, more than \$300 million of new capacity entered the D&O marketplace in the wake of the financial crisis, and these carriers are ready to compete on price to use their underwriting capacity.

The lower pricing environment has also had an additional effect on the D&O market: companies have been buying more coverage, particularly excess Side A coverage. This action has been in response to a costly number of shareholder suits over the last several years, as companies want to make sure that if settlements surpass the limits of their standard D&O policies, the directors and officers have an additional level of coverage to fall back on.

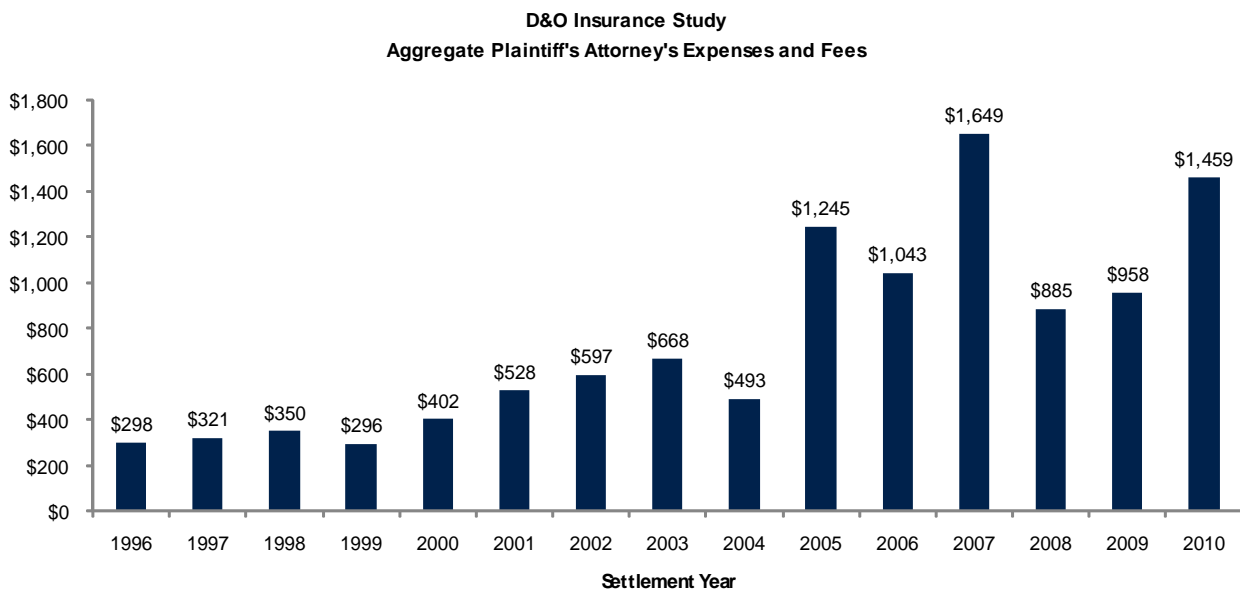
Frequency and Severity of Claims. In addition to lower pricing, claim activity has the potential to rise. Regulatory changes in the beginning of the decade made it harder to get class action status, and the bar was raised for securities-related lawsuits. The result is that the number of securities-related class action suits declined from 2002 to 2006. As premiums began to slide in 2007, claim activity began to pick up for the first time in over five years due to the financial crisis and ensuing recession. The nature of the claims has also begun to change. One shift is an increase toward larger potential claims. The plaintiff bar is focused on the larger cases with better chance of success. On an anecdotal basis, there are a number of cases where the legal costs have exhausted the first-layer limits. In addition, plaintiff lawyers have shifted away from federal and into state courts; in certain areas, the state courts have been more flexible.



Note*: 2011 Q1 Data Annualized
Source: Advisen Q1 2011 Study

The other factor is that the nature of claims being lobbed at professional liability policies has shifted. Securities class action suits on larger public companies still remain significant, but EPL claims have also increased significantly in recent years (see our discussion of EPLI in the following section). In addition, the small to midsize professional liability market, once viewed as a safe haven, has experienced an increase in filed claims. This market was particularly hard hit by the recession, with bankruptcies and fraud moving to unprecedented levels. For example, more than 150 small banks went bankrupt in both 2008 and 2009. As both M&A and IPO activity have picked up since the beginning of 2010, shareholder claims related to these types of events are becoming of increasing concern.

Litigation Costs. On top of losses being up and policy pricing continuing to decline, litigation costs have soared over the last 15 years. We hypothesize the increase is due to a confluence of factors, including larger, more complex cases and higher legal billing rates.



Source: NERA 2010 Trends in Security Class Action Filings

Other liability claims in particular are the fourth most expensive type of liability case in terms of litigation costs as a percentage of incurred losses, but are by the far the largest liability type in terms of total spent on litigation. Part of the reason for that discrepancy is the sheer size of the incurred losses that can result from securities class action lawsuits. Legal fees can often be a significant portion of the total losses that insurers are paying out, as policyholders incur legal costs for all of the dismissed cases, as well as those that end in settlements or go to trial.

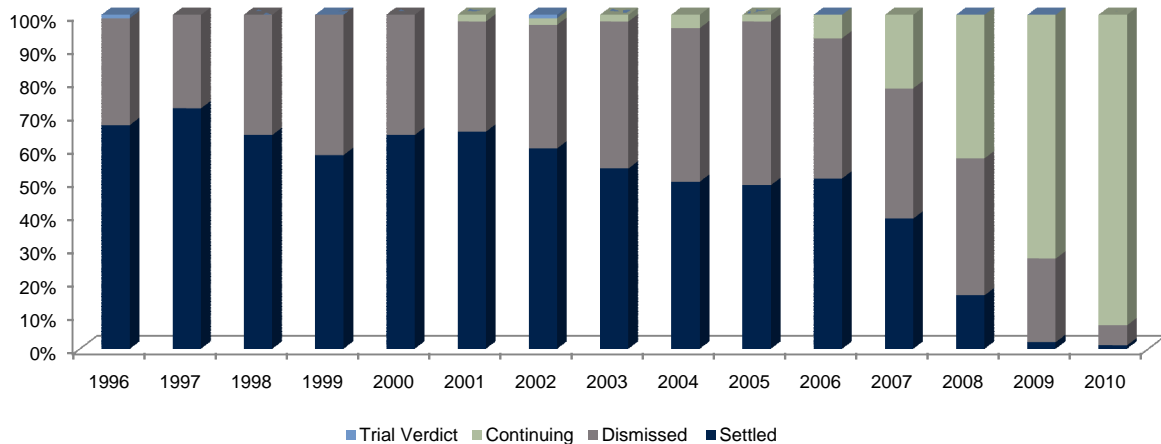
D&O Insurance Study
Litigation Costs by Type of Liability

Liability Category	Total Amount Spent on Litigation (\$'000)	As % of Incurred Losses
Other Liability	\$5,174,214	24.8%
Private Passenger Auto Liability	\$3,928,911	6.3%
Workers Compensation	\$2,407,144	10.8%
Medical Malpractice	\$1,886,591	57.3%
Commercial Multiple Peril	\$1,799,507	43.7%
Products Liability	\$1,029,911	86.2%
Commercial Auto Liability	\$963,574	10.3%
All Liability Lines	\$17,189,852	13.90%

Source: SNL Financial

Credit Crisis and Security Class Action Lawsuits. As the credit crisis finally begins to unwind, the destruction from a D&O perspective is starting to come into clearer focus. However, it will still be several years before we know the true extent of the claims and the subsequent effect on profitability for many of the largest commercial insurers. As evident in the following chart, a vast number of security class action filings remain open from 2007, 2008, and 2009. Roughly 30%-40% of cases are dismissed during an average year, levels that 2007 and 2008 have already surpassed. One can draw the conclusion that mainly the easiest or most clean-cut cases have reached settlement or dismissal to this point, and that settlement rates and losses could mount quickly over the next few years if the settlement pattern is consistent for the remainder of the cases outstanding.

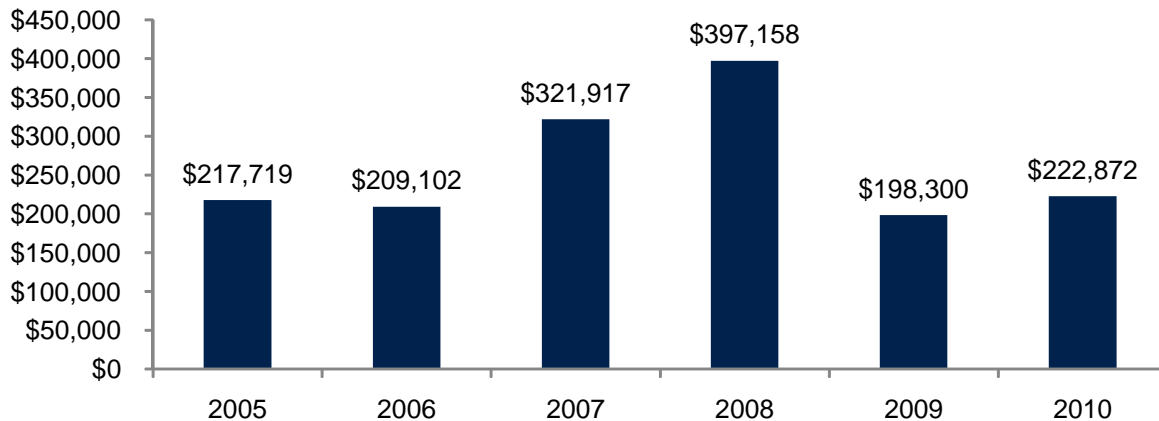
D&O Insurance Study
Status of Securities Class Action Filings by Year Filed



Source: Cornerstone Class Action Settlements Study 2010

It is also clear based on the following chart that 2007 and 2008 were historically terrible years in terms of aggregate investor losses, with losses near 1.5 to 2 times the amount in other years. This would indicate that future settlements could end up at historically high levels, which does not seem to be fully taken into account by the majority of commercial insurers.

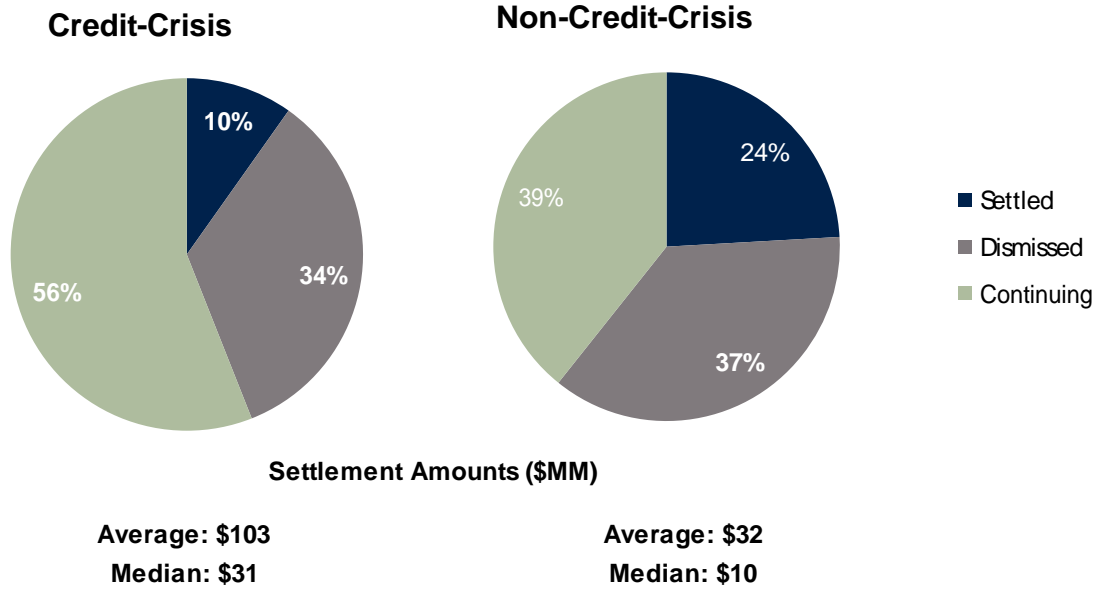
D&O Insurance Study
Aggregate Investor Losses (\$MM) by Filing Year



Source: NERA 2010 Trends in Security Class Action Filings

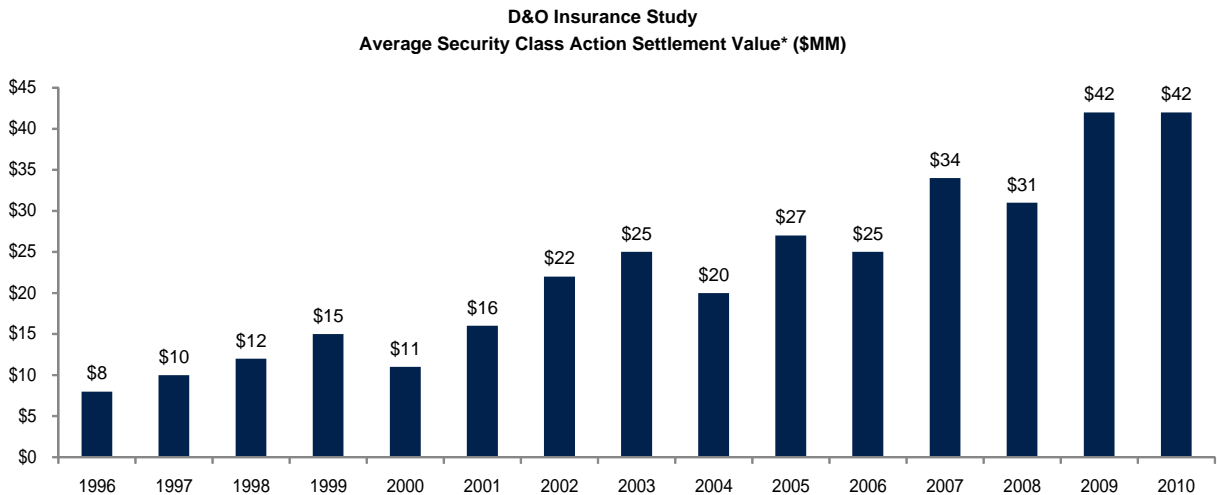
Additionally, there is evidence that claims filed during the 2007-2009 recession differ based on whether they were directly related to the credit crisis or not. A recent Cornerstone research piece suggests that not only are credit crisis claims taking longer to settle, they are also settling for nearly triple the amount of non-credit-crisis claims.

**D&O Insurance Study
Credit-Crisis vs. Non-Credit-Crisis Filings (2007-2009)**



Source: Cornerstone Class Action Filings Study 2010, Cornerstone Class Action Settlements Study 2010

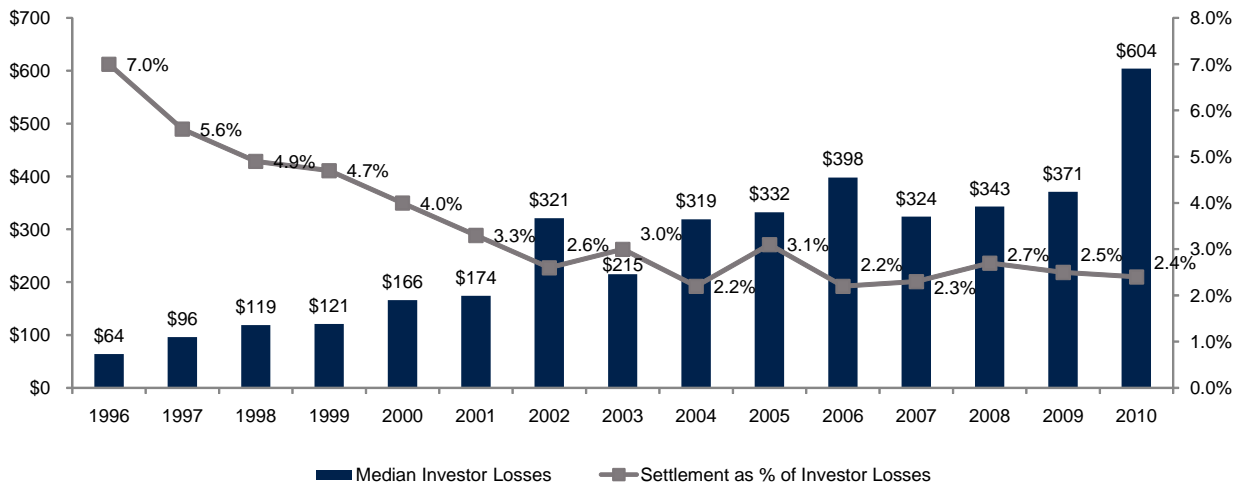
In fact, average settlement values have been increasing for security class action lawsuits since 1996. Much of this increase can be explained by the sheer amount investors are losing in the market, especially with two particularly harsh bear markets over the last decade.



Note*: Excludes Settlements over \$1 BN and IPO Litigation
Source: NERA 2010 Trends in Security Class Action Filings

As a percentage of total investor losses, settlements have actually been on the decline over the last 15 years. So it is not that companies have suddenly become more sympathetic to the plight of the shareholder; rather, it is that securities class action suits have become that much larger and the losses that companies are experiencing have been that much more severe.

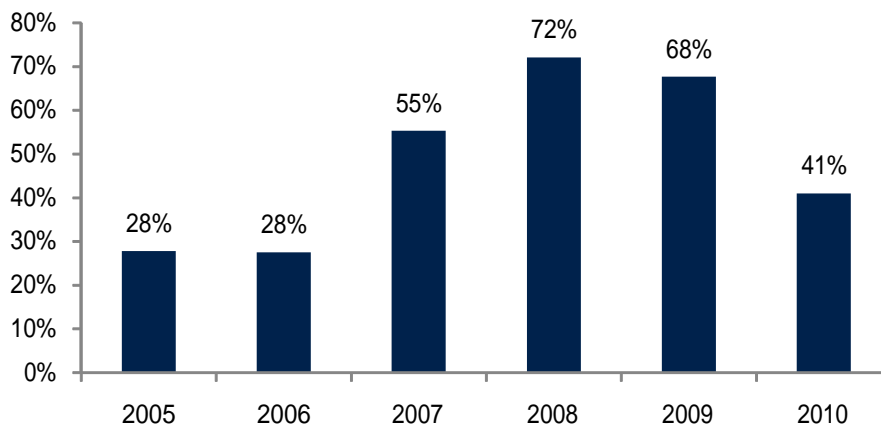
D&O Insurance Study
Settlement Value as a % of Median Investor Losses



Note*: Excludes Settlements over \$1 BN and IPO Litigation
 Source: NERA 2010 Trends in Security Class Action Filings

Financial institutions have been especially hard hit during the credit crisis. As mentioned above, insurance companies went into the crisis realizing that this industry was the most prone to D&O claims, particularly class action securities suits, and priced their insurance coverage at a premium in response. However, the credit crisis was probably more severe for financial institutions than even the insurers realized, as claims were nearly three times more likely to involve financial firms between 2007 and 2009.

D&O Insurance Study
% of Securities Class Action Filings Involving Financial Institutions



Source: NERA 2010 Trends in Security Class Action Filings

In looking at the largest settlements to date stemming from the credit crisis, financial institutions make up the majority of the list:

D&O Insurance Study
Top 10 Credit-Crisis-Related Settlements

Rank	Case	Settlement Amount (\$MM)
1	Countrywide Financial Corp.	\$624
2	Merrill Lynch & Co., Inc.	\$475
3	New Century Financial Corp.	\$13
4	MoneyGram International, Inc.	\$80
5	Amercian Home Mortgage Investment	\$37
6	Ambac Financial Group, Inc.	\$33
7	RAIT Financial Trust	\$32
8	The PMI Group, Inc.	\$31
9	Beazer Homes USA, Inc.	\$31
10	Toll Brothers	\$25

Source: Cornerstone Class Action Settlements Study 2010

Additionally, the problems have spread to the smaller banks, which are still facing bankruptcy concerns even as the larger banks have been largely bailed out by government intervention. Bank failures continue to mount in the years post-crisis, especially with the deteriorating economic environment and continued unwinding of credit leverage. These smaller exposures can become a huge problem for the industry over time if the bankruptcy trend continues unabated.

Future D&O Market Trends

Though the credit crisis has passed and the majority of claims from that period have already been filed, D&O insurance claims evolve over time and new threats are already seen on the horizon. Looking back over the last decade, from the tech bubble bursting, to accounting scandals and then options back-dating, and finally to the credit crisis, it is clear that new issues will continue to develop facing directors and officers of companies and the insurers that provide D&O coverage for them. D&O policies themselves change quite frequently as new types of coverage are needed to protect corporations, potentially increasing the exposure for many insurers. The recent News Corp. phone-hacking scandal is a prime example of a company's ever-evolving exposures to risks in the marketplace.

According to several insurers, the following issues appear to inspire the most concern from policyholders (as reported recently by *Business Insurance*):

1. **Global Climate Change:** This liability has been around for a few years, but few claims have actually occurred to this point. Potential liabilities could be related to management's failure to disclose or respond to risks associated with climate change, with environmental regulations, or failure to comply with environmental law. Energy and utility companies are probably most at risk, and the litigation could be especially severe in other parts of the world where environmental regulations are much more stringent than in the United States.
2. **Cyber Attacks:** As evidenced by all the news headlines over the last several months, cyber attacks have become a huge issue for many of the largest corporations in the world. If any such attack were to have a dramatic effect on a company's stock price or performance, it would be conceivable that management could be alleged to have not taken satisfactory measures to protect the company against an attack.
3. **Healthcare Reform Legislation:** The huge change in the healthcare industry could prompt subsequent claims for companies that failed to adapt to the new legislations, or failed to comply with the new policies.

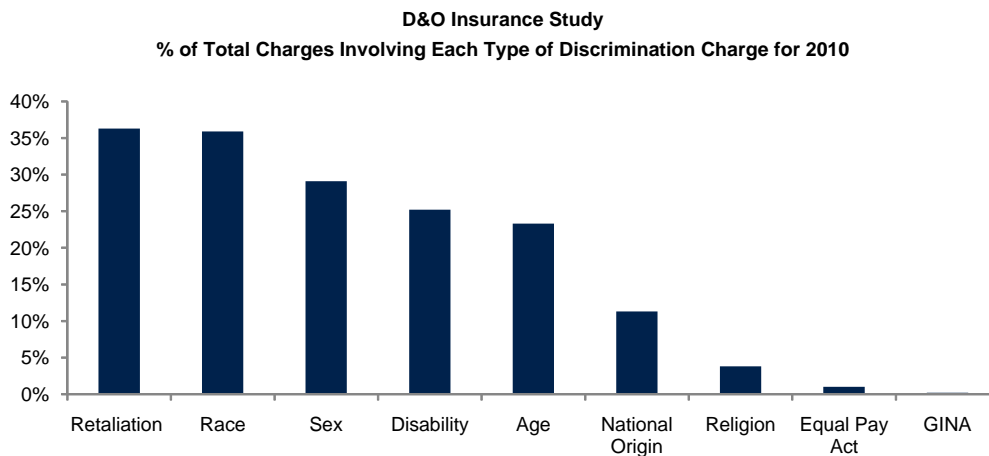
- 4. *Bribery Legislation:*** With the recent passage of the Foreign Corrupt Practices Act, it is clear that a heightened regulatory environment will also pose additional liability risk for corporations, particularly as it relates to corruption. While D&O coverage does not tend to pay losses or fines stemming from illegal activity, it usually pays the legal fees associated with these trials, which can still be quite burdensome. If and when the Dodd-Frank legislation gets enacted, there could also be a significant exposure for corporations who have to operate under these new regulatory guidelines.
- 5. *Increasingly Hostile Foreign Legal Environment:*** While the United States has historically had strong corporate governance and shareholder laws and a legal system that is more favorable to the plaintiff and class action lawsuits, other countries are now starting to follow suit. Not only are the countries developing stronger regulatory environments, but the legal environments are also becoming friendlier to lawsuits. The D&O industry has adapted quickly to these changes; for major corporations, many policies now integrate a master global policy with locally issued foreign policies that can help protect against lawsuits in other countries where a corporation might operate. International exposure should remain a top concern among large companies.

EPLI Frequency and Severity Trends Should Continue to Affect the Professional Liability Marketplace

Summary

Employment practices liability insurance is another major form of professional liability insurance available to corporations to help protect the entity and the employees from lawsuits. While D&O is concerned specifically with the actions of the directors and officers, EPL insurance generally covers all employees' actions in the workplace, including managers, executives, and regular employees. The insurance provides coverage, including both defense costs and settlements, against discrimination in the workplace, harassment, and other wrongful termination suits that are undertaken by any past, present, or future employee of the firm. The coverage has evolved over the last few decades as employers historically attempted to roll employment practices lawsuits into their other types of liability insurance like GL or workers' compensation programs. But with a drastic increase in litigation following the passage of the 1991 Civil Rights Act, which gave employees the right to trial by jury and provided the opportunity for both compensatory and punitive damages to be awarded, employers realized they need a separate form of insurance that was meant to protect against employment practices claims specifically.

EPL insurance covers claims related to many specific governmental anti-discrimination statutes that have been passed by legislators over the last several decades, including the Civil Rights Act of 1964 and 1991 (Title VII), the Equal Pay Act of 1963, the Age Discrimination in Employment Act of 1967, the Americans with Disabilities Act of 1990, and the Pregnancy Discrimination Act of 1978. Violations today can run the gamut of race, bullying, unethical hiring practices, and sexual discrimination, among others. The following chart details the breakdown of the claims brought to the U.S. Equal Employment Opportunity Commission (EEOC) in 2010.

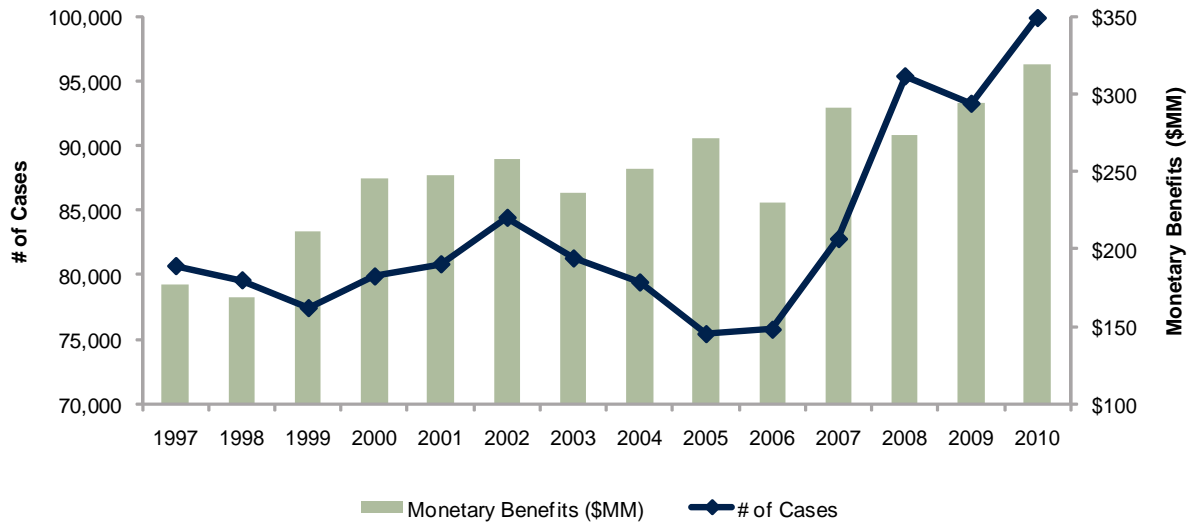


Source: EEOC

Race, sex, disability, and age are the most frequent types of discrimination faced in the workplace. Interestingly, retaliation has for the first time in history overtaken race as the claim type with the highest percentage of charges brought, and frequency has nearly doubled over the last 10 years. This has occurred for the simple reason that it is an easy add-on charge for any other type of discrimination—someone acted in a certain way to get retribution for a previous action.

The U.S. EEOC is the main government organization tasked with handling employment-related lawsuits. It has kept statistics on claims and settlement amounts for the last 20 years that are very useful for analyzing the trends and exposures that companies face with regard to employment practices. Though the EEOC does not deal with all claims filed, and it does not keep track of court decided settlement figures, a clear trend of higher frequency and severity emerges when examining the data since 1997.

D&O Insurance Study
Total Number of Charges Filed With the U.S. Equal Employment Opportunity Commission



Note: Monetary Benefits do not include benefits obtained through litigation
 Source: EEOC

Increasing frequency and severity in the EPL line should be a worrying trend for insurers; however, according to several sources, industry capacity for EPL still remains above \$750 million, which ensures a very competitive pricing environment, akin to the D&O marketplace. The recession and high unemployment rates have significantly contributed to the growing number of cases, as many studies have shown a strong statistical correlation between the unemployment rate and the number of cases being filed. Thus, we expect these trends to continue, as the country continues to struggle creating new jobs.

EPL Purchasing Profile

While private companies and nonprofits are far less likely to encounter shareholder lawsuits than their public company brethren, statistics show they are just as likely, if not more likely, to be involved with other types of lawsuits. One could conjecture that, in general, private companies and nonprofits tend to be smaller companies with less rigid operating structures and more flexible work environments. This type of company and environment has the potential to lead to a less diligent or less comprehensive risk management system, especially as it comes to employment practices. As the table below illustrates, nonprofit and private entities are far more likely to have employment related charges brought against them than any other type of charge. Thus, private and nonprofit firms are a significant market for EPL carriers looking to expand their business, as many of these companies do not already own D&O policies.

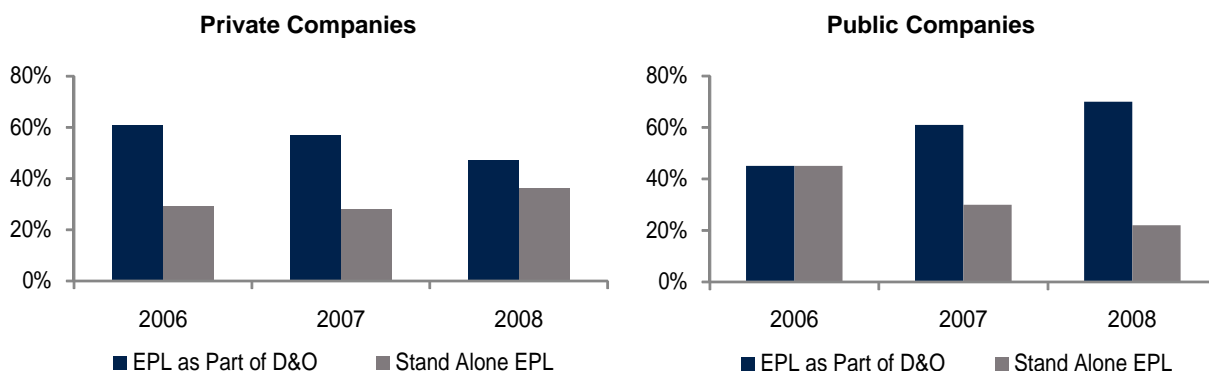
D&O Insurance Study
Types of Claims Experienced over Last 10 Years

Ownership Structure	Type of Claim					
	Shareholder Suit	Derivative Shareholder Suit	Employment Related	Fiduciary	Regulatory	Other
Nonprofits	7%	7%	67%	19%	19%	26%
Private	29%	7%	45%	16%	13%	19%
Public	66%	65%	13%	26%	19%	8%
All Groups	46%	40%	30%	21%	16%	15%

Source: Towers Watson D&O Study 2010

In terms of purchasing habits, public and private enterprises also tend to buy EPL insurance in different ways. It is far more likely for a public entity to buy EPL in some sort of packaged form, while private companies are more likely to buy the insurance as a stand-alone policy.

**D&O Insurance Study
EPL Buying Patterns**



Source: Towers Watson D&O Study 2008

Trends in EPL Insurance

Stronger support from Washington: The Obama administration has provided significant additional funding for the EEOC over the past two years, enabling it to hire more staff, handle more class action cases, and more efficiently handle the backlog of cases. Current estimates put the number of outstanding cases at more than 100,000. One of the biggest changes that the funding has provided is the ability for plaintiffs to more easily file their complaint via the Internet, and the processing and resolution of charges can all be done electronically. These developments are likely to bolster frequency of claims.

In addition, the current administration and several states have proposed bills, yet to be passed, that would further expand employee rights and the remedies available to them. Specifically, the Paycheck Fairness Act would force employers to turn over compensation data, destroy caps on compensatory and punitive damages, and allow employees to share salary information with other employees without retaliation. This bill and others of a similar vein still have the chance to pass over the next several years, and several states have taken it on themselves to make their own employment practice statutes that are more generous than federal guidelines. Companies have more exposure than ever before to EPL claims, which should at some point start to appear in the results of the commercial carriers.

Rising costs to make EPL less profitable: Recent estimates for legal costs associated with employment practices lawsuits are:

- \$40,000 average out of court settlement amount
- \$50,000 average legal fees, regardless of trial
- \$220,000+ average settlement
- 10% of settlements are over \$1 million

These figures show the huge potential liabilities that corporations face over their employment practices and why EPL is such a crucial part of any risk management plan. Legal costs especially have been increasing at rates far outpacing inflation, particularly with the country becoming more open to tort legislation. And unlike some other forms of insurance, carriers are on the hook for paying legal fees even if the claim does not go to trial or is declared frivolous. These cost increases do not even factor in class action settlements, which can go into the hundreds of millions of dollars, like the \$175 million class action settlement against Novartis (NVS \$61.20) for sexual discrimination in its pay and promotion practices in 2010.

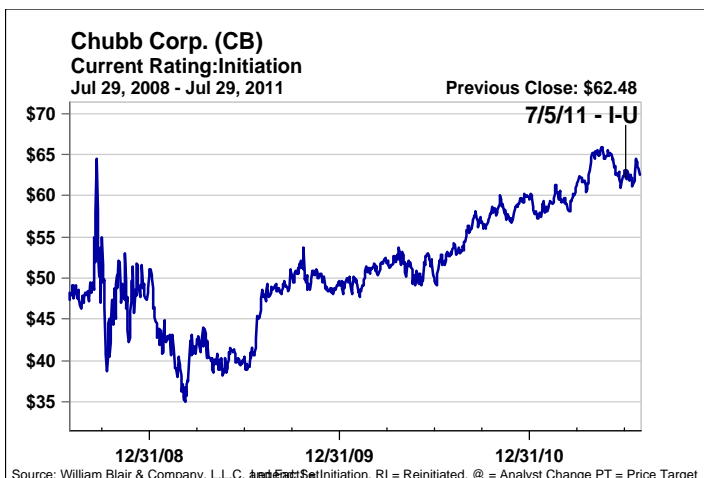
Supreme Court decision in Wal-Mart case makes class actions more difficult: In July of this year, the Supreme Court ruled against a decade-old class action lawsuit alleging that the company had a policy that promoted sexual discrimination. Wal-Mart (WMT \$52.71; Market Perform) was potentially on the line for billions of dollars in liability on a class action that would potentially cover up to 1.5

million past and present female employees, so the Supreme Court decision was a huge victory for the company. The decision was based on the judges' determination that the class action was far too broad to be prosecuted, and that the potential 1.5 million plaintiffs didn't share enough commonality to be considered in one class-action lawsuit. This precedent should provide stricter guidelines and more severe boundaries for future class actions and should help curtail future class action settlements.

Social media to exacerbate claims frequency: The prevalence of social media both in and out of the workplace is creating added risk exposure for companies on the employment practices front. Companies can be held accountable not only for what is said about other employees on social networks, but also for their own activities, such as recruiting people through social media sites like LinkedIn (LNKD \$101.03; Market Perform). Companies must develop strong internal risk controls over their own activities as well as their technology usage policies for employees.

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Market Perform (Hold)	29	Market Perform (Hold)	1
Underperform (Sell)	1	Underperform (Sell)	0

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