AMERISAFE INC
Form 10-K
March 09, 2009
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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, 2008

Commission File Number: 000-51520

AMERISAFE, INC.

(Exact Name of Registrant as Specified in Its Charter)

Texas	**75-2069407**
(State of Incorporation)	**(I.R.S. Employer**

Identification Number)

2301 Highway 190 West, DeRidder, Louisiana **70634**
(Address of Principal Executive Offices) **(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 x

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 x

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 x 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. x

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 x
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 x

The aggregate market value of the voting common stock held by non-affiliates of the Registrant as of June 30, 2008 (the last business day of the Registrant s most recently completed second fiscal quarter) was approximately $298.6 million, based upon the closing price of the shares on the NASDAQ Global Select Market on that date.

As of March 1, 2009, there were 18,856,602 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 2009 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:

- decreased level of business activity of our policyholders caused by decreased business activity in the industries we target;
- changes in general economic conditions, including recession, inflation, performance of financial markets, interest rates, unemployment rates and fluctuating asset values;
- decreased demand for our insurance;
- 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;
- negative developments in economic, competitive or regulatory conditions within the workers compensation insurance industry;
- 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;
- developments in capital markets that adversely affect the performance of our investments;
- the cyclical nature of 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 regulations, laws, rates, or rating factors applicable to us, our policyholders or the agencies that sell our insurance;
- changes in rating agency policies or practices;
- loss of the services of any of our senior management or other key employees;

changes in legal theories of liability under our insurance policies;

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; and

other risks and uncertainties described from time to time in the Company s filings with the Securities and Exchange Commission (SEC).

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, agriculture, logging, 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 on average paid premium rates equal to $6.84 per $100 of payroll to obtain workers compensation coverage for all of their employees in 2008.

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 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.

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 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 91.7% in 2008, 90.8% in 2007 and 91.1% in 2006.

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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 sizes, types of operations, mobile workforces 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 23-year history of insuring employers engaged in hazardous industries, we have developed industry specific risk analysis and rating tools that support 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 safer workplaces by deploying experienced field safety professionals, or FSPs, to our policyholders worksites. In 2008, more than 88% of our new voluntary business policyholders were subject to pre-quotation safety inspections. Additionally, 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 intensive claims management practices that emphasize a personal approach and quality, cost-effective medical treatment. As of December 31, 2008, the open indemnity claims per field case manager, or FCM, averaged 50 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 claim costs.

Strategy

We intend to increase our 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.

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. As a result, we believe we have the opportunity to increase market penetration in those states. Competition in our target markets is fragmented by state and industry. 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, 53.0% of our voluntary in-force premiums were generated in the seven states where we derived 5% or more of our gross premiums written in 2008. We are licensed in an additional 17 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.

Leverage Existing Information Technology. We believe our customized operational system, ICAMS, along with the analytical data warehouse that ICAMS feeds, significantly enhances our ability to select risk, write profitable business, and cost-effectively administer our billing, claims, and audit functions.

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Maintain Capital Strength. We plan to manage our capital to achieve our profitability goals while maintaining optimal 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 produce 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 temporary or 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 2007, according to A.M. Best. Direct premiums written in 2007 for the workers compensation insurance industry were $52 billion, and direct premiums written for the property and casualty industry as a whole were $441 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 were $15 billion.

Outlook. We believe that current economic conditions will adversely affect our reported gross premiums written and revenues in 2009. In 2008, 73.5% of our gross premiums written were derived from policyholders in the construction, trucking, agriculture and logging industries. As a result, our gross premiums written are, to a significant 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 the decline accelerated in 2008, negatively affecting the construction, trucking, agriculture and logging industries, along with others. We believe that the slowdown in economic activity will continue in 2009. We further believe that the challenges presented by this slowing economic activity will be aggravated 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. Lower loss costs are part of the normal cyclicality of our industry, and we believe they will eventually reverse themselves. However, we cannot predict the timing of any changes in loss costs. Notwithstanding current market conditions, we will continue to focus on market segmentation, effective risk selection, expense management and overall underwriting profitability.

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Policyholders

As of December 31, 2008, we had more than 7,700 voluntary business policyholders with an average annual workers compensation policy premium of $36,653. As of December 31, 2008, our ten largest voluntary business policyholders accounted for 2.2% of our in-force premiums. Our policy renewal rate on voluntary business that we elected to quote for renewal was 91.7% in 2008, 90.8% in 2007 and 91.1% in 2006.

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 four states. See Regulation Residual Market Programs below. For the year ended December 31, 2008, our assigned risk business accounted for 1.4% of our gross premiums written, and our assumed premiums from mandatory pooling arrangements accounted for 1.4% of our gross premiums written. Our general liability insurance business accounted for less than 0.5% of our gross premiums written for the year ended December 31, 2008.

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 2008, our average policy premium for voluntary workers compensation within the construction industry was $37,298, or $6.84 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 long-haul operations. In 2008, our average policy premium for voluntary workers compensation within the trucking industry was $39,102, or $7.36 per $100 of payroll.

Agriculture. Includes crop maintenance and harvesting, grain and produce operations, nursery operations, meat processing, and livestock feed and transportation. In 2008, our average policy premium for voluntary workers compensation within the agriculture industry was $23,341, or $5.66 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 2008, our average policy premium for voluntary workers compensation within the logging industry was $18,552, or $15.79 per $100 of payroll.

Oil and Gas. Includes various oil and gas activities including gathering, transportation, processing, production, and field service operations. In 2008, our average policy premium for voluntary workers compensation within the oil and gas industry was $46,602, or $5.91 per $100 of payroll.

Maritime. Includes ship building and repair, pier and marine construction, inter-coastal construction, and stevedoring. In 2008, our average policy premium for voluntary workers compensation within the maritime industry was $73,769, or $8.02 per $100 of payroll.

Sawmills. Includes sawmills and various other lumber-related operations. In 2008, our average policy premium for the sawmill industry was $27,131, or $8.41 per $100 of payroll.

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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, 2008, less than 0.6% of our voluntary in-force premiums were derived from general liability policies.

Gross premiums written during the years ended December 31, 2008, 2007 and 2006, 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		
	2008	2007	2006	2008	2007	2006
	(In thousands)					
Voluntary business:						
Construction	$ 127,667	$ 136,834	$ 132,083	41.5%	41.7%	39.7%
Trucking	67,072	73,064	70,221	21.8%	22.3%	21.1%
Agriculture	16,487	15,778	13,681	5.3%	4.8%	4.1%
Logging	14,983	17,209	24,553	4.9%	5.3%	7.4%
Oil and Gas	13,308	12,505	10,578	4.3%	3.8%	3.2%
Maritime	8,642	8,526	9,180	2.8%	2.6%	2.8%
Sawmills	3,915	5,389	4,260	1.3%	1.6%	1.3%
Other	47,131	46,766	51,547	15.3%	14.3%	15.5%
Total voluntary business	299,205	316,071	316,103	97.2%	96.4%	95.1%
Assigned risk business	4,344	7,554	11,936	1.4%	2.3%	3.6%
Assumed premiums	4,291	4,136	4,452	1.4%	1.3%	1.3%
Total	$ 307,840	$ 327,761	$ 332,491	100.0%	100.0%	100.0%

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Geographic Distribution

We are licensed to provide workers compensation insurance in 47 states, the District of Columbia and the U.S. Virgin Islands. We operate on a geographically diverse basis with no more than 9.6% of our gross premiums written in 2008 derived from any one state. The table below identifies, for the years ended December 31, 2008, 2007 and 2006, the states in which the percentage of our gross premiums written exceeded 3.0% for any of the three years presented.

	Percentage of Gross Premiums Written Year Ended December 31,		
State	**2008**	**2007**	**2006**
Georgia	9.6%	9.9%	9.1%
Louisiana	8.8%	10.6%	8.9%
North Carolina	8.7%	9.5%	7.5%
Oklahoma	7.5%	4.9%	4.4%
Illinois	6.8%	5.2%	4.6%
Virginia	5.9%	5.8%	6.1%
Pennsylvania	5.6%	4.7%	4.8%
Texas	4.5%	4.1%	5.8%
South Carolina	4.1%	4.8%	4.5%
Minnesota	3.9%	3.8%	4.4%
Mississippi	3.6%	4.6%	4.2%
Tennessee	3.5%	3.9%	4.2%
Alaska	3.3%	3.5%	4.4%
Wisconsin	3.3%	3.4%	2.9%
Florida	3.0%	4.6%	6.5%
Arkansas	2.8%	2.9%	3.8%

Sales and Marketing

We sell our workers compensation insurance through agencies. As of December 31, 2008, 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 27 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 policyholders in our target industries and classes 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 7.4% for the year ended December 31, 2008. 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, 2008, independent agencies accounted for 89.8% of our voluntary in-force premiums, and no independent agency accounted for more than 1.0% 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.

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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 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.

We obtain approval of our rates, including our LCMs, from state regulatory authorities. To maintain rates at profitable levels, we regularly monitor and adjust our LCMs. The effective LCM for our voluntary business was 1.46 for policy year 2008, 1.51 for policy year 2007, 1.54 for policy year 2006, 1.56 for policy year 2005 and 1.53 for policy year 2004. 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. These initial in-depth analyses allow 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 2008, more than 88% 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 fact that the policyholder was previously a policyholder subject to our safety inspections.

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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 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.

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. Such providers comprise 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, a 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 provided. The FCM 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, 2008, we averaged 50 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

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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 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 23 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 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;
- severity of the injury or damage;
- age and occupation of the injured employee;
- estimated length of temporary disability;
- anticipated permanent disability;
- expected medical procedures, costs and duration;
- our knowledge of the circumstances surrounding the claim;

insurance policy provisions related to the claim, including coverage;

jurisdiction of the occurrence; and

other benefits defined by applicable statute.

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The case incurred amount varies over time due to uncertainties with respect to medical treatment and outcome, length and degree of disability, recurrence of injury, employment availability and wage levels and judicial determinations. As changes occur, the case incurred amount is adjusted. The initial estimate of the case incurred amount can vary significantly from the amount ultimately paid, especially in circumstances involving severe injuries with comprehensive medical treatment. Changes in case incurred amounts is an important component of our historical claim data.

In addition to case reserves, we establish reserves on an aggregate basis for loss and DCC expenses that have been incurred but not reported, or IBNR. Our IBNR reserves are also intended to provide for aggregate changes in case incurred amounts as well as the unpaid cost of recently reported claims for which an initial case reserve has not been established.

The third component of our reserves for loss and loss adjustment expenses is our adjusting and other reserve, or AO reserve. Our AO reserve is established for the costs of future unallocated loss adjustment expenses for all reported and unreported claims. Our AO reserve covers primarily the estimated cost of administering claims. The final component of our reserves for loss and loss adjustment expenses is the reserve for mandatory pooling arrangements.

In establishing reserves, we rely on the analysis of the more than 161,000 claims in our 23-year history. Using statistical analyses and actuarial methods, we estimate reserves based on historical patterns of case development, payment patterns, mix of business, premium rates charged, case reserving adequacy, operational changes, adjustment philosophy and severity and duration trends.

We review our reserves by industry and state on a quarterly basis. Individual open claims are reviewed more frequently and adjustments to case incurred amounts are made based on expected outcomes. The number of claims reported or occurring during a period, combined with a calculation of average case incurred amounts, and measured over time, provide the foundation for our reserve estimates. In establishing our reserve estimates, we use historical trends in claim reporting timeliness, frequency of claims in relation to earned premium or covered payroll, premium rate levels charged and case development patterns. However, the number of variables and judgments involved in establishing reserve estimates, combined with some random variation in loss development patterns, results in uncertainty regarding projected ultimate losses. As a result, our ultimate liability for loss and loss adjustment expenses may be more or less than our reserve estimate.

Our analysis of our historical data provides the factors we use in our statistical and actuarial analysis in estimating our loss and DCC expense reserve. These factors are primarily measures over time of claims reported, average case incurred amounts, case development, duration, severity and payment patterns. However, these factors cannot be solely used as these factors do not take into consideration changes in business mix, claims management, regulatory issues, medical trends, medical inflation, employment and wage patterns, and other subjective factors. We use this combination of factors and subjective assumptions in the use of six well-accepted actuarial methods, as follows:

Paid Development Method uses historical, cumulative paid loss patterns to derive estimated ultimate losses by accident year based upon the assumption that each accident year will develop to estimated ultimate cost in a manner that is analogous to prior years.

Paid Weighted Severity (Generalized Cape Cod) Method multiplies estimated ultimate claims for each accident year by a weighted average, trended and developed severity. The ultimate claims estimate is based on paid claim count development. The selected severity for a given accident year is derived by giving some weight to all of the accident years in the experience history rather than treating each accident year independently.

Paid Bornhuetter-Ferguson (B-F) Method a combination of the Paid Development Method and the Paid Weighted Severity Method, the Paid B-F Method estimates ultimate losses by adding the current actual paid losses to projected unpaid losses.

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Incurred Development Method uses historical, cumulative incurred loss patterns to derive estimated ultimate losses by accident year based upon the assumption that each accident year will develop to estimated ultimate cost in a manner that is analogous to prior years.

Incurred Weighted Severity (Generalized Cape Cod) Method multiplies estimated ultimate claims for each accident year by a weighted average, trended and developed severity. The ultimate claims estimate is based on incurred claim count development. The selected severity for a given accident year is derived by giving some weight to all of the accident years in the experience history rather than treating each accident year independently.

Incurred B-F Method a combination of the Incurred Development Method and the Incurred Weighted Severity Method, the Incurred B-F Method projects ultimate losses by adding the current actual incurred losses to the projected unreported losses.

These six methods are applied to both net and gross data. Due to the volatility and unpredictability of excess losses, several B-F estimates of excess losses are also used to estimate the ultimate losses gross of reinsurance. We then analyze the results and may emphasize or de-emphasize some or all of the outcomes to reflect our judgment of their reasonableness in relation to supplementary information and operational and industry changes. These outcomes are then aggregated to produce a single weighted average point estimate that is the base estimate for loss and DCC expense reserves.

In determining the level of emphasis that may be placed on some or all of the methods, we review statistical information as to which methods are most appropriate, whether adjustments are appropriate within the particular methods, and if results produced by each method include inherent bias reflecting operational and industry changes. This supplementary information may include:

open and closed claim counts;

statistics related to open and closed claim count percentages;

claim closure rates;

changes in average case reserves and average loss and DCC expenses incurred on open claims;

reported and ultimate average case incurred changes;

reported and projected ultimate loss ratios; and

loss payment patterns.

In establishing our AO reserves, we review our past adjustment expenses in relation to paid claims as well as estimated future costs based on expected claims activity and duration.

The sum of our net loss and DCC expense reserve, our AO reserve, and our reserve for mandatory pooling arrangements is our total net reserve for loss and loss adjustment expenses.

As of December 31, 2008, our best estimate of our ultimate liability for loss and loss adjustment expenses, net of amounts recoverable from reinsurers, was $474.7 million, which includes $9.2 million in reserves for mandatory pooling arrangements as reported by the pool administrators. This estimate was derived from the process and methodology described above, which relies on substantial judgment. There is inherent uncertainty in estimating our reserves for loss and loss adjustment expenses. It is possible that our actual loss and loss adjustment expenses incurred may vary significantly from our estimates.

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As noted above, our reserve estimate is developed based upon our analysis of historical data, and factors derived from that data, including claims reported, average claim amount incurred, case development, duration, severity and payment patterns, as well as subjective assumptions. We view our estimate of loss and DCC expenses as the most significant component of our reserve for loss and loss adjustment expenses.

Additional information regarding our reserve for unpaid loss and loss adjustment expenses as of December 31, 2008, 2007, and 2006 is set forth below:

	2008	2007	2006
		(In thousands)	
Gross case loss and DCC reserves	$ 375,098	$ 392,540	$ 375,783
AO reserves	16,732	16,794	18,903
Gross IBNR reserves	139,463	128,069	124,492
Gross unpaid loss, DCC and AO reserves	531,293	537,403	519,178
Reinsurance recoverables on unpaid loss and LAE	(56,596)	(74,925)	(106,810)
Net unpaid loss, DCC and AO reserves	$ 474,697	$ 462,478	$ 412,368

We performed sensitivity analyses to show how our net loss and DCC expense reserve, including IBNR, would be impacted by changes in certain critical assumptions. For our paid and incurred Development methods, we varied both the cumulative paid and incurred loss development factors (LDFs) by plus and minus 20%, both individually and in combination with one another. The results of this sensitivity analysis, using December 31, 2008 data, are summarized below.

Change in Paid LDFs	Change in Incurred LDFs	Resultant Change in Net Loss and DCC Reserve	
		Amount ($) (In thousands)	Percentage
+20%	+20%	19,738	4.4%
+20%	0%	8,812	2.0%
+20%	20%	(1,990)	(0.4)%
0%	+20%	11,555	2.6%
0%	0%		0.0%
0%	20%	(10,776)	(2.4)%
20%	+20%	5,926	1.3%
20%	0%	(6,581)	(1.5)%
20%	20%	(18,033)	(4.0)%

For our paid and incurred Weighted Severity methods, we varied our year-end selected trend factor (for medical costs, defense costs, wage inflation, etc.) by plus and minus 20%. The results of this sensitivity analysis, using December 31, 2008 data, are summarized below.

Change in Severity Trend	Resultant Change in Net Loss and DCC Reserve	
	Amount ($) (In thousands)	Percentage
+20%	8,544	1.9%
20%	(6,858)	(1.5)%

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The Bornhuetter-Ferguson method estimates ultimate loss by averaging Weighted Severity paid or incurred losses and expected future paid or incurred development. To measure sensitivity, we changed this average by plus and minus 20%. The results of this sensitivity analysis, using December 31, 2008 data, are summarized below.

Change in Expected Losses	Resultant Change in Net Loss and DCC Reserve	
	Amount ($) (In thousands)	Percentage
+20%	10,493	2.3%
20%	(6,890)	(1.5)%

Reconciliation of Loss Reserves

The table below shows the reconciliation of loss reserves on a gross and net basis for the years ended December 31, 2008, 2007 and 2006, reflecting changes in losses incurred and paid losses.

	Year Ended December 31,		
	2008	2007	2006
		(In thousands)	
Balance, beginning of period	$ 537,403	$ 519,178	$ 484,485
Less amounts recoverable from reinsurers on unpaid loss and loss adjustment expenses	74,925	106,810	120,232
Net balance, beginning of period	462,478	412,368	364,253
Add incurred related to:			
Current year	196,776	208,021	201,711
Prior years	(20,387)	(9,490)	(2,227)
Total incurred	176,389	198,531	199,484
Less paid related to:			
Current year	47,539	43,012	41,002
Prior years	116,631	105,409	110,367
Total paid	164,170	148,421	151,369
Net balance, end of period	474,697	462,478	412,368
Add amounts recoverable from reinsurers on unpaid loss and loss adjustment expenses	56,596	74,925	106,810
Balance, end of period	$ 531,293	$ 537,403	$ 519,178

Our gross reserves for loss and loss adjustment expenses of $531.3 million as of December 31, 2008 are expected to cover all unpaid loss and loss adjustment expenses as of that date. As of December 31, 2008, we had 4,793 open claims, with an average of $110,848 in unpaid loss and loss adjustment expenses per open claim. During the year ended December 31, 2008, 6,324 new claims were reported, and 6,831 claims were closed.

As of December 31, 2007, our gross reserves for loss and loss adjustment expenses were $537.4 million. Our reserves decreased from December 31, 2007 to December 31, 2008 as a result of an increase in the current accident year loss ratio combined with a decrease in amounts recoverable from reinsurers, offset by $20.4 million of favorable development in prior accident years. As of December 31, 2007, we had 5,300 open claims, with an average of $101,397 in unpaid loss and loss adjustment expenses per open claim. During the year ended December 31, 2007, 6,899 new claims were reported, and 7,293 claims were closed.

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As of December 31, 2006, our gross reserves for loss and loss adjustment expenses were $519.2 million. Our reserves increased from December 31, 2006 to December 31, 2007 as a result of an increase in the current accident year loss ratio combined with a decrease in the amounts recoverable from reinsurers, offset by $9.5 million of favorable development in prior accident years. As of December 31, 2006, we had 5,694 open claims, with an average of $91,180 in unpaid loss and loss adjustment expenses per open claim. During the year ended December 31, 2006, 6,581 new claims were reported, and 6,942 claims were closed.

Loss Development

The table below shows the net loss development for business written each year from 1998 through 2008. The table reflects the changes in our loss and loss adjustment expense reserves in subsequent years from the prior loss estimates based on experience as of the end of each succeeding year on a GAAP basis.

The first line of the table shows, for the years indicated, our liability including the incurred but not reported loss and loss adjustment expenses as originally estimated, net of amounts recoverable from reinsurers. For example, as of December 31, 1998, it was estimated that $43.6 million would be sufficient to settle all claims not already settled that had occurred on or prior to December 31, 1998, whether reported or unreported. The next section of the table sets forth the re-estimates in later years of incurred losses, including payments, for the years indicated. The next section of the table shows, by year, the cumulative amounts of loss and loss adjustment expense payments, net of amounts recoverable from reinsurers, as of the end of each succeeding year. For example, with respect to the net loss reserves of $43.6 million as of December 31, 1998, by December 31, 2008 (ten years later) $61.7 million had actually been paid in settlement of the claims that relate to liabilities as of December 31, 1998.

The cumulative redundancy/(deficiency) represents, as of December 31, 2008, the difference between the latest re-estimated liability and the amounts as originally estimated. A redundancy means that the original estimate was higher than the current estimate. A deficiency means that the current estimate is higher than the original estimate.

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Analysis of Loss and Loss Adjustment Expense Reserve Development

	Year Ended December 31,										
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	(In thousands)										
Reserve for loss and loss adjustment expenses, net of reinsurance recoverables	$ 43,625	$ 72,599	$ 86,192	$ 119,020	$ 152,908	$ 183,001	$ 243,256	$ 364,253	$ 412,366	$ 462,478	$ 474,697
Net reserve estimated as of:											
One year later	49,098	75,588	96,801	123,413	155,683	196,955	265,138	362,026	402,876	442,091	
Two years later	50,764	82,633	98,871	116,291	168,410	217,836	262,601	361,181	372,520		
Three years later	57,750	86,336	92,740	119,814	187,225	218,217	262,427	346,914			
Four years later	59,800	86,829	93,328	132,332	189,098	219,114	256,790				
Five years later	60,074	87,088	101,417	134,836	190,161	214,304					
Six years later	61,297	90,156	104,716	136,277	186,829						
Seven years later	61,578	91,170	105,391	133,588							
Eight years later	62,484	91,765	100,225								
Nine years later	62,377	90,444									
Ten years later	61,749										
Net cumulative redundancy (deficiency)	$ (18,124)	$ (17,845)	$ (14,033)	$ (14,568)	$ (33,921)	$ (31,303)	$ (13,534)	$ 17,339	$ 39,846	$ 20,387	
Cumulative amount of reserve paid, net of reserve recoveries, through:											
One year later	26,140	45,095	51,470	51,114	66,545	73,783	40,514	110,369	105,408	116,631	
Two years later	37,835	62,141	62,969	71,852	101,907	65,752	97,091	164,354	167,852		
Three years later	45,404	67,267	70,036	84,341	73,391	99,829	124,785	201,393			
Four years later	48,184	70,894	73,680	42,919	96,884	114,594	154,799				
Five years later	50,045	72,744	38,939	59,194	110,475	136,497					
Six years later	50,831	58,809	49,141	76,547	128,629						