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INSURANCE COMMISSIONER
COMPANY SUPERVISION

RLI

RLI Insurance Company

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P: 309-692-1000 | F: 309-692-1068 | www.rlicorp.com

February 4, 2011

Mr. Ronald Pastuch, CPA
Holding Company Manager, Company Supervision Division
Washington Office of Insurance Commissioner
5000 Capitol Blvd.
Tumwater, WA 98501

***Re: Form A dated December 22, 2010 – Proposed Acquisition of Control of Contractors Bonding & Insurance Company by RLI Insurance Company; RLI Response to WOIC Letter of January 19, 2011.***

Dear Mr. Pastuch:

We are in receipt of your letter dated January 19, 2011 ("*Comment Letter*") with comments and requests relating to the Form A filed by RLI Insurance Company ("*RLI*") in connection with its proposed acquisition of Contractors Bonding & Insurance Company ("*CBIC*") via acquisition of its parent company Data Staff & Service Company ("*DSS*").

Below we provide responses to the itemized requests in the Comment Letter. Certain items require further action, and we also enclose two exhibits with supplementary information. We will provide an executive summary of the transaction by separate letter/ filing.

**Section I**

**1.** Following is a description of the RLI subsidiaries and any business intended to be done by those subsidiaries and CBIC. This information supplements the information provided in the Form A.

RLI Group. The RLI group of insurance companies ("*RLI Group*") includes RLI Insurance Company ("*RLI*"), Mt. Hawley Insurance Company ("*Mt. Hawley*), and RLI Indemnity Company ("*RLIC*"). RLIC is a wholly-owned subsidiary of Mt. Hawley, which in turn is a wholly-owned subsidiary of RLI. Each of such entities is an Illinois corporation and domesticated in Illinois. RLI is a wholly-owned subsidiary of RLI Corp., a public company traded on the New York Stock Exchange. RLI Corp. and each of the RLI insurance companies have principal headquarters in our corporate offices in Peoria, Illinois. The RLI insurance companies conduct business through our branch offices in over 40 offices nationwide. None of the RLI insurance companies has international offices.

Mt. Hawley Insurance Company. Mt. Hawley is a surplus lines property and casualty insurance company operating in all 50 states and District of Columbia. Mt. Hawley writes property and casualty insurance on an excess and surplus basis. After the acquisition of CBIC, Mt. Hawley will continue to conduct business as currently done, with no expected material changes in strategy,

operations or personnel. Likewise we do not anticipate any material change in CBIC's business plan to coordinate business activities between Mt. Hawley and CBIC.

RLI Indemnity Company. RLIC is an admitted property and casualty insurance company operating in all states except Alaska. RLIC writes surety bonds, principally miscellaneous and contract bonds. After the acquisition of CBIC, RLIC will continue to conduct business as currently done, with no expected material changes in strategy, operations or personnel. However, in the near term following the acquisition, we expect to analyze the necessity of maintaining the RLIC entity. RLIC currently is not utilized at a significant level within the RLI Group, and if we determine that RLIC is redundant or otherwise not necessary in our post-acquisition corporate structure and strategy, we will consider selling the entity.

Safe Fleet Insurance Services, Inc. ("*Safe Fleet*"). Safe Fleet is a California corporation and is based out of RLI's Los Angeles office. Safe Fleet produces business for our transportation division (based in our Atlanta, Georgia office). Safe Fleet is also a licensed California surplus lines broker, doing business as RLI Insurance Services (RLIIS). In that capacity, Safe Fleet /RLIIS brokers mainly earthquake and difference in condition coverages provided by Mt. Hawley and in some cases other non-RLI carriers. After the acquisition of CBIC, Safe Fleet will continue to conduct business as currently done, with no expected material changes in strategy, operations or personnel. However, we expect to pursue opportunities to utilize Safe Fleet to enhance business for CBIC.

RLI Underwriting Services, Inc. ("*RLIUS*"). RLIUS is an Illinois corporation with agency and surplus lines broker licenses. This entity previously operated with a trade name of Target Market Specialists, acting as a producing and marketing front end for RLI program business, but is no longer operating in that capacity. RLIUS does not operate independently of RLI, and is currently utilized primarily for administrative activities such as countersignature, surplus lines stamping and related activities. We expect to pursue opportunities to utilize RLIUS to enhance business for CBIC.

RLI Insurance Ltd. ("*RLI Bermuda.*"). RLI Bermuda is a Bermuda corporation and licensed Bermuda insurance company. This entity is essentially dormant, and does not issue new policies. We do not currently anticipate activating this carrier for new business.

RLI Insurance Agency, Ltd. ("*RLI Canada*"). RLI Canada is Canadian corporation, and is dormant with no business activities. Although it was originally intended to pursue business in Canada, we do not currently anticipate activating this entity for business activities.

Underwriters Indemnity General Agency, Inc. This Texas corporation is dormant with no business activities, and we do not anticipate activating it in the near future.

RLI Aviation, Inc. This Illinois corporation is dormant with no business activities, and we do not anticipate activating it in the near future.

**2.** Following is our proposed list of directors and officers of CBIC and Data & Staff Service Company ("*DSS*"):

**CBIC**

| Directors | Officers | |
|---|---|---|
| Jonathan E. Michael | Jonathan E. Michael | Chairman / Chief Executive Officer |
| Michael J. Stone | Michael J. Stone | President / Chief Operating Officer |
| Joseph E. Dondanville | Joseph E. Dondanville | Sr. Vice President / Chief Financial Officer |
| Kirk Eland | Jean Stephenson | Asst. Vice President / Corporate Secretary |
| Robert Ogle | Craig Kliethermes | Sr. Vice President |
| Carol Denzer | Roy Die | Sr. Vice President |
| Roy Die | Dave Sandoz | Vice President |
| | Kirk Eland | Vice President |
| | Robert Ogle | Vice President |
| | Daniel O. Kennedy | Vice President / General Counsel |
| | John Robison | Vice President / Treasurer |
| | Todd Bryant | Vice President / Controller |
| | Don Driscoll | Vice President, Claim |

** The above lists are different from what was filed in the initial Form A*

**DSS**

| Directors | Officers | |
|---|---|---|
| Jonathan E. Michael | Jonathan E. Michael | Chairman / Chief Executive Officer |
| Michael J. Stone | Michael J. Stone | President / Chief Operating Officer |
| Joseph E. Dondanville | Joseph E. Dondanville | Sr. Vice President / Chief Financial Officer |
| Kirk Eland | Jean Stephenson | Asst. Vice President / Corporate Secretary |
| Robert Ogle | Craig Kliethermes | Sr. Vice President |
| | Daniel O. Kennedy | Vice President / General Counsel |
| | John Robison | Vice President / Treasurer |
| | Todd Bryant | Vice President / Controller |
| | Kirk Eland | Vice President |
| | Robert Ogle | Vice President |

Biographical affidavits for Kirk Eland and Robert Ogle are already on file with the WOIC, and affidavits for the other persons identified above are submitted with this letter.

**3.** We are utilizing General Information Services for background verification as requested, which company is NAIC approved and identified on the NAIC website. The reports will be sent directly to the OIC from such firm.

**4.** We are in the process of securing a disclaimer of control statement from State Street Corporation ("*State Street*") on behalf of each of the State Street affiliated entities including State Street Bank and Trust Company which is the trustee of RLI's Employee Stock Ownership Plan.

**5.** No entity or person other than State Street owns (beneficially or of record) ten percent or more of RLI Corp. capital stock.

**6.** Audited statutory financial statements of RLI from 2005 through 2009 are *enclosed with this letter.*

**7.** The Schedules and the Disclosure Schedule (the "*Schedules*") to the Stock Purchase Agreement, dated December 22, 2010, should be given confidential treatment and not be made available to the public as part of the Form A. These Schedules are attached to the Stock Purchase Agreement, which was provided as part of the Form A filing. We do not request confidential treatment for the Stock Purchase Agreement or Exhibits thereto or the Form A itself.

The Schedules contain highly sensitive, proprietary and confidential information about CBIC's business strategy, operations, material contracts, producer/agent/broker arrangements including compensation, personnel, compensation and benefits, information technology systems, litigation and disputes, liabilities and potential liabilities, intellectual property, key business partners, and other information not otherwise available to the public ("*Confidential Information*").

We believe the Confidential Information (the Schedules) qualify as Trade Secrets under RCW 19.108.010 (4), and as such should be accorded special treatment in this matter. Section 284-03-060 of the Washington Administrative Code specifically exempts Trade Secrets from public inspection. *"Trade Secrets"* are defined as: (a) deriving independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and (b) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy [RCW 19.108.010 (4) ]. The Schedules / Confidential Information clearly qualify under this definition.

First, the Confidential Information clearly has independent economic value from not being generally known by others who could obtain such economic value (competitors). The Confidential Information is confidential, proprietary and highly sensitive, and disclosure of it would place CBIC at a genuine competitive disadvantage to its competitors. Giving the Confidential Information to CBIC's competitors is not fair and not reciprocated by other carriers -- CBIC does not have similar access to analogous information and data on its competitors. All other competitor carriers carefully protect their analogous information, just like CBIC. CBIC's competitors could easily use this information to undercut its business, copy its business methods, identify and hire away its key executives / employees, interfere with its producer relations, interfere with its business partners, exploit perceived weaknesses, disseminate sensitive or harmful information about CBIC into the marketplace. Likewise, not only competitors but also persons/entities with which CBIC is in

dispute (litigation or otherwise) could unfairly harm CBIC by disseminating the information or otherwise use it to unfair or improper advantage. This information would clearly be valuable to CBIC competitors, and unfairly harmful to CBIC. CBIC is a successful insurance company with decades of profitable operation, excellent service to its policyholders and a first rate compliance record, and thus giving its proprietary and sensitive information away to competitors would be patently unfair and materially harmful to CBIC. Such competitive harm is clearly not in the best interests of CBIC's policyholders or the insurance markets in which it operates.

Secondly, this Confidential Information is the subject of efforts to maintain its secrecy. The Confidential Information in the Schedules is not disclosed to the public and is very carefully guarded by CBIC. In fact, in addition to company policies, codes and procedural safeguards mandating that the company's proprietary and trade secret information be kept strictly confidential, CBIC has taken the extra step of requiring executives, officers and certain other key employees to execute specific confidentiality agreements seeking to protect this information. The Schedule information was never intended to be available to the public, and is currently not disclosed as a matter of regular course by CBIC or other Washington domiciled insurance companies. Similarly, the Schedules were <u>not</u> disclosed to the public in RLI's filings with the Securities and Exchange Commission (SEC) in connection with this transaction, although the Stock Purchase Agreement itself was disclosed to the SEC. The SEC expressly (by rule) does not require the Schedules to be disclosed. The Schedules were prepared and provided to RLI in the context of an acquisition, and were not intended to be disclosed to the public.

We believe that the Confidential Information in the Schedules conversely is not material or necessary information for CBIC policyholders. This information is not of a nature that generally that is provided to policyholders, and thus is not necessary in this case.

In summary, we believe disclosure of the Schedules and the Confidential Information would be a disclosure of CBIC's Trade Secrets, would cause real competitive harm to CBIC and is not necessary for the reasonable protection or benefit of CBIC's policyholders or the public at large.

**<u>Section II</u>**

**1.** Mr. Gerald Stephens is currently the Chairman of the Board of Directors at RLI Corp., but is not on the Board of any of the RLI Group insurance companies or other RLI affiliates. Likewise, he is not an officer or employee of any of such companies. Mr. Stephens was the Chief Executive Officer of RLI Corp. until December 31, 2000. Mr. Stephens is not a member of any committee of the Board of Directors. Other than his position as Chairman, Mr. Stephens has no formal position or role at RLI Corp. and affiliates. Mr. Stephens has no contractual employment, voting, management or other arrangements with RLI Corp. and affiliates.

Regarding his power to direct or cause the direction of management and policies or RLI Corp. and affiliates, Mr. Stephens has the typical influence of a Chairman of the Board at the Board of Directors level. As Chairman, Mr. Stephens assists in setting Board meeting agendas and chairs

Board meetings, but otherwise does not have any extraordinary influence or power over the companies or their management or policies. Mr. Stephens is one of ten directors, and his vote counts as one vote along with all other directors. Other than Mr. Stephens and Mr. Jon Michael (CEO), the Board is comprised of independent directors with no current or previous affiliation with RLI outside their directorships.

2. Neither RLI Corp. nor any affiliate has any contractual or other arrangements of any type with any institutional (or other) investors. No board member of RLI Corp. or any affiliate was appointed by an institutional or other investor.

3. Following is a restatement of information provided in our initial Form A, supplemented with additional information.

Corporate Structures. RLI has no current plans to cause CBIC to liquidate, sell its assets, wind down operations, merge with RLI or any other entity, or make any other material change in its business operations or corporate structure. RLI's plans to integrate CBIC into the RLI corporate structure are described herein, with a "Best of Both Companies" approach. Overall, RLI intends to continue the business operations of CBIC as presently conducted, with selective modifications to bring CBIC into the RLI family of companies and coordinate with RLI's operating procedures as described herein. Regarding timing, we anticipate implementing our integration plans over a reasonable and sensible timeframe, taking steps in a process that minimizes disruption while maximizing continuity and business success. Certain aspects will be readily accomplished within a month, while others may take a year or more.

RLI has no present plans to make any material changes in the operations of the business of CBIC. However, RLI will blend the operations of CBIC with and into RLI Applicant over time so as to appropriately join CBIC into RLI's family of companies. Following acquisition, RLI and CBIC will begin exploring how to most effectively combine their operations with strict attention to not disrupting insureds, in force bonds and policies, or agent relations.

Business Integration. CBIC has had success in combining surety with a property/casualty product for contractors and Applicant hopes to continue this model by keeping this pairing under common product leadership. RLI is specifically interested in replicating the success of CBIC in cross-selling bonds and property/casualty coverages for contractors. Applicant and CBIC will collectively focus on identifying new markets and positioning our combined agency sales force to utilize CBIC's technology and underwriting expertise. CBIC's cross-selling will be significantly enhanced by expanding into geographic areas not previously explored but where RLI has a significant agent base. RLI holds in high regard the underwriting expertise of CBIC in this product and expects to capitalize on this knowledge as we position this product for geographic expansion. The combination of RLI and CBIC will create more surety opportunities for CBIC agents. We intend to work towards integrating system capabilities and offering more automated products to agents.

Location/Domicile; Personnel. RLI intends to maintain CBIC's principal home in Seattle, Washington. We do not currently have plans to redomesticate CBIC from Washington to Illinois or any other state in the near term following closing. However, we anticipate that certain support functions will be provided to CBIC through RLI's home office in Peoria, Illinois in connection with existing procedures in place at RLI. RLI's current business plan contemplates mapping responsibilities to our current organizational structure. We recognize that this migration needs to be done carefully and expects to apply several principles including the following: Appropriately balance the need for efficiencies that may exist by having "home office" versus "home market" employees; best employee for a position is considered without regard to RLI or CBIC background; and be open to alternative organizational structures that offer improvements with unique skill sets. We do not anticipate material reductions in the employee base at CBIC. Prior notice will be provided to the WOIC of any agreements involving any transactions between CBIC and RLI or any affiliates for the provisions of such support services, which would require notice to or prior approval of the WOIC.

Key Personnel. In the immediate term, the existing reporting structure within CBIC will remain the same, with certain exceptions. Mr. Don Sirkin, CEO and Chairman of the Board, will not remain with CBIC or DSS following the closing, and will not be joining RLI. Kirk Eland (CBIC officer) and Robert Ogle (CBIC officer) will enter into employment arrangements on terms acceptable to both parties. Mr. Eland and Mr. Ogle will remain in place at CBIC, and will report up through Roy Die at RLI. The employment agreements will insure a smooth transition of the management and operation of CBIC following the acquisition. In the longer term, RLI's business plan contemplates combining overall product management under one business leader but with underwriting expertise resident in two supporting roles.

**4.** Following is a description of the principal intercompany business arrangements between RLI and its insurance company affiliates within the holding company system.

(a) Tax Allocation Agreement. RLI, Mt. Hawley and RLIC are parties to a Tax Allocation Agreement for the purpose of allocating the consolidated federal income tax liability of the members of the holding company system among such members of the basis of the percentage of tax liability for which each member would be responsible if separate tax returns were filed. It is anticipated that CBIC will become a party to this agreement following consummation of the acquisition. This agreement was provided as part of the initial Form A filing.

(b) Intercompany Services Agreement. RLI, Mt. Hawley and RLIC are parties to a Restated Intercompany Services Agreement pursuant to which RLI provides certain administrative services to Mt. Hawley and RLIC, including reinsurance placements, investment and accounting services, claims supervision and handling, data processing, legal and regulatory compliance services, actuarial services, and payroll and human resource services. The costs for such services are shared among the companies on a pro rata basis based on earned premium. It is anticipated that CBIC will become a party to this agreement following consummation of the acquisition. This agreement is attached as Exhibit A hereto.

**5.** RLI will use cash to pay the purchase price set forth in the Stock Purchase Agreement. The cash will come from a combination of available cash plus funds raised from the sale of securities in its investment portfolio. No financing, loans or intercompany transfers will be required to raise the cash for the purchase price payment.

**6.** We do not currently have plans to redomesticate CBIC from Washington to Illinois or any other state in the near term following closing.

We appreciate your assistance in this matter, and we trust the above responds properly to your Comment Letter.

Please contact the undersigned with any further comments, questions or request.

Very truly yours,

Daniel O. Kennedy, General Counsel
On behalf of RLI Insurance Company

cc: Jonathan Michael (RLI)
Carol Denzer (RLI)
Jim Jorgensen (RLI)
Marc Tract (Katten Muchin Rosenman)

# Exhibit A

# RESTATED INTERCOMPANY SERVICES AGREEMENT

THIS AGREEMENT, dated this 27th day of December, 2002, by and between RLI Insurance Company, an Illinois corporation (hereinafter referred to as RLI), Mt. Hawley Insurance Company, an Illinois corporation (hereinafter referred to as MHI), Underwriters Indemnity Company, a Texas corporation (hereinafter referred to as UIC), and Planet Indemnity Company, an Illinois corporation (hereinafter referred to as PIC), (MHI, UIC and PIC together referred to as the Companies), hereby replaces in its entirety the Intercompany Services Agreement between RLI and the Companies dated July 26, 1999 and all amendments thereto.

## RECITALS

WHEREAS, RLI is the parent company of UIC and MHI, and MHI is the parent company of PIC; and

WHEREAS, all the companies have evaluated processes, staffing, procedures, accounting and other service related functions necessary for insurance company operations; and

WHEREAS, MHI, UIC and PIC have determined that there would be efficiencies in having RLI provide certain administrative services to MHI, UIC and PIC in exchange for a management fee:

Now therefore, it is agreed:

## I. RESPONSIBILITIES OF RLI

A. General. RLI shall be responsible for the day to day operation of the Companies and shall provide services with respect to all business of the Companies of a kind and quality necessary for the proper conduct of insurance business in compliance with applicable legislation and administrative regulations. It shall be the duty of RLI to use its best efforts to protect and safeguard the interests of the Companies in every particular and to make such recommendations to the Companies as, in the opinion of RLI, will be for the betterment of the affairs of the Companies with respect to the business serviced under this Agreement.

B. Services to be Performed. RLI shall provide the following services:

1. The placement of reinsurance treaties and facultative reinsurance
2. Investment and accounting services
3. Claims supervision and handling

4. Data processing and system development
5. Legal and regulatory compliance services
6. Actuarial services
7. Underwriting services and product facilities
8. Any other services needed to conduct the business of the Companies

## II. INTERNAL CONTROLS

A. Separate Accounting. RLI shall keep separate and proper books of account and shall record all transactions pertaining to the business of MHI, UIC and PIC and shall record all transactions in a form acceptable to the Companies and applicable governmental authorities.

B. Audits. Each year MHI, UIC and PIC shall have an audit of its respective books and records conducted by an independent accounting firm.

C. Maintenance of Books and Records. RLI shall maintain the books and records of MHI, UIC and PIC at its offices in Illinois.

D. Deposits. Required security deposits and security funds will be made from the Companies' funds by RLI. All checking accounts and security transactions will require two of the Companies' officer's signatures when a disbursement for any reason exceeds $10,000 or any smaller amount if required by law.

E. Committees. The Board of Directors of MHI, UIC and PIC shall establish investment and management committees to approve and review actions taken by RLI on behalf of the Companies. The authority of each committee shall be defined, limited and subject at all times to change by the Board. The respective Board of Directors of MHI, UIC and PIC shall approve all actions of the committee.

## III. COST SHARING

A. Shared Costs. All expenses of RLI, except for its non-insurance activities, and the expenses of MHI, UIC and PIC shall be shared. The basis of expense sharing shall be on a pro rata basis relative to the Companies' gross written premium to the total of gross written premiums of RLI, and any other company managed by RLI.

B. Individual Payments. The following services shall be paid by MHI, UIC and PIC as their interests appear respectively, and not shared with RLI:

1. Premium and income taxes.
2. Involuntary government assessments such as, but not limited to, insolvency assessments, FAIR Plan assessments, guarantee fund assessments, and joint underwriting association assessments.
3. Fines or penalties assessed by any governmental authority.

4. Commissions, contingent commissions, reinsurance costs, claims and adjustment expense.
5. Incorporation and licensing expenses.
6. Board of Director expenses.
7. Independent audit and outside legal costs.
8. Any other direct expense of UIC or PIC specifically approved by its respective Board of Directors.

## IV. TERM OF AGREEMENT

A. This Agreement shall remain in force for three (3) years from the date of execution, and shall be reviewed and renegotiated as the Companies deem appropriate every three (3) years. Termination during the initial term, or any subsequent renewal term, shall be made in accordance with the provisions below. Notwithstanding the foregoing, termination by MHI, PIC or UIC individually, shall apply solely to that company providing the termination. This Agreement shall be effective only for so long as MHI, UIC and PIC remain wholly owned subsidiaries of RLI.

B. This Agreement shall be terminated immediately without notice upon the occurrence of any of the following: a party has its certificate of authority revoked, withdrawn or suspended or is subject to an order of any government authority with respect to its bankruptcy, insolvency, rehabilitation or any other action taken, including the filing of a petition relating to liquidation.

C. This Agreement may be terminated by either party upon 90 days written notice to the other party, with or without cause.

## V. OBLIGATIONS AFTER TERMINATION

A. Upon termination of the Agreement, MHI, UIC and PIC shall have the right to "runoff" the business subject to this Agreement or continue the business. RLI shall deliver all books and records in a timely manner. From the final date of termination, MHI, UIC and PIC shall hold RLI harmless from all subsequent liability that may arise from any cause or reason due to alleged or actual actions or inactions by MHI, UIC or PIC or by its agents or others acting on behalf of MHI, UIC or PIC. RLI shall remain liable exclusively for its own actions.

B. In the event RLI is designated by MHI, UIC or PIC to "runoff" the business, each company so designating RLI shall pay a reasonable per employee hourly fee to RLI for its services, and RLI, in its sole discretion, may:

1. allow all in force policies to remain in force until they expire or until they may be legally non-renewed; and/or

2. arrange for reinsurance of the in force policies and/or loss reserves. The reinsurer shall be subject to the approval of MHI, UIC or PIC respectively; however, such approval shall not be unreasonably withheld.

## VI. ARBITRATION

A. As a condition precedent to any right of action hereunder, it is agreed that in the event of any dispute or difference hereafter arising with reference to any transaction under this Agreement, which cannot be amicably settled, the same shall be referred to arbitration. MHI, PIC and UIC may refer a matter to arbitration individually or jointly, but in either event may only pick one arbitrator. RLI shall pick one arbitrator, and the arbitrators shall choose an umpire within sixty (60) days of their appointment. In the event of either party refusing or neglecting to appoint an arbitrator or umpires as the case may be, upon the application of either party, the selection shall be made by the Director of Insurance of the State of Illinois. All expenses shall be shared equally by the parties to the arbitration.

B. The arbitrators shall abide (except in the appointment of the arbitrators and umpire) by the procedures of the American Arbitration Association. The final decision of the panel shall be binding upon the parties to the agreement without appeal. Any such arbitration shall take place in Peoria, Illinois, unless otherwise agreed.

## VII. LIMIATIONS OF LIABILITY

A. RLI shall not be liable for claims under MHI,UIC and PIC insurance policies including punitive or bad faith damage claims and any indirect or consequential loss, including allegations of loss of profits or anticipated profits.

B. RLI shall not be liable for any loss incurred as a result of the insolvency or failure of any broker, agent or any other person or firm, nor shall RLI be liable for any delay in payment for any reason, unless RLI is the direct cause. RLI shall not be liable for restrictions placed on the remittance of monies by any government or foreign currency fluctuations.

C. RLI shall not be liable for the failure of any reinsurer to post required letters of credit or establish trust funds in favor of MHI, UIC and/or PIC. RLI shall not be liable in the event a reinsurer becomes insolvent or fails for any reason to remit any balance due.

D. RLI shall not be liable for the purchase, retention, or sale of any security or securities whose value declines for any reason.

E. Except for the above provisions of this Section, RLI shall be responsible for its own actions to the extent loss or damages are not caused by third parties outside

the control of RLI and any loss or damage to MHI, UIC or PIC is caused by gross negligence on the part of RLI.

F. MHI, UIC and PIC shall each be responsible for its own actions to the extent loss or damages are not caused by third parties outside the control of MHI, UIC or PIC and any loss or damage to RLI is caused by gross negligence on the part of MHI, UIC or PIC.

## VIII. CONTROL OF THE COMPANY

A. The provision of this Agreement shall not transfer control of MHI,UIC or PIC or any of the powers vested in the Board of Directors of each company, by statute, articles of incorporation, or by-laws, or substantially all of the basic functions of the insurance company management.

B. This Agreement shall not be assigned to any other person without the agreement of each party and any necessary governmental approvals.

## IX. GENERAL

A. The failure of either party to exercise any or all of its rights under this Agreement shall in no way be deemed a waiver of those rights.

B. This Agreement shall be construed and enforced in accordance with the laws of the State of Texas.

IN WITNESS WHEREOF, the parties to this Agreement have caused it to be executed on the dates noted below.

RLI INSURANCE COMPANY

By: Joseph E. Dondelli

Its: SVP, CFO

Date: December 27, 2002

UNDERWRITERS INDEMNITY COMPANY

By: Joseph E. Dondelli

Its: SVP, CFO

Date: December 27, 2002

Attest: Denise Austin

Attest: Denise Austin

PLANET INDEMNITY COMPANY

By: Joseph E. Donelle

Its: SVP, CFO

Date: December 27, 2002

Attest: Denise Austin

MT. HAWLEY INSURANCE COMPANY

By: Joseph E. Donelle

Its: SVP, CFO

Date: December 27, 2002

Attest: Denise Austin

DEC 2 3 2002

STATE OF ILLINOIS
DEPARTMENT OF INSURANCE
320 WEST WASHINGTON STREET
SPRINGFIELD, ILLINOIS 62767-0001

GEORGE H. RYAN
GOVERNOR

NATHANIEL S. SHAPO
DIRECTOR

December 19, 2002

Ms. Mary Beth Nebel
Vice President & General Counsel
RLI Insurance Company
9025 N. Lindbergh Dr.
Peoria, IL 61615-1431

Re: Restated Intercompany Service Agreement

Dear Ms. Nebel:

Pursuant to Section 131.20a of the Illinois Insurance Code (215 ILCS 5/131/20a), the Restated Intercompany Services Agreement, between RLI Insurance Company, Planet Indemnity Company, Mt. Hawley Insurance Company and Underwriters Indemnity Company has been accepted and placed on file. This agreement shall be refiled with our Department in intervals not to exceed three years from the date of this letter unless earlier modified.

Be advised that pursuant to Section 131.20(d) (ILCS 5/131.20), the books, accounts and records of each party must be so maintained as to clearly and accurately disclose the precise nature and details of the contract, including accounting information necessary to support the reasonableness of the charges or fees to the respective parties.

If you have any questions on this matter, please feel free to contact Tom Lurkins of the Property and Casualty Financial Analysis Unit at (217) 524-5942.

Respectfully,

Jeffrey D. Pirmann
Assistant Deputy Director

JDP:kjd

# AMENDMENT I TO THE RESTATED INTERCOMPANY SERVICES AGREEMENT

The Restated Intercompany Services Agreement between RLI Insurance Company, Mt. Hawley Insurance Company, Underwriters Indemnity Company and Planet Indemnity Company dated December 27, 2002 is hereby amended as follows:

1. The parties to the Agreement shall be RLI Insurance Company, an Illinois corporation (hereinafter referred to as RLI), Mt. Hawley Insurance Company, an Illinois corporation (hereinafter referred to as MHI) RLI Indemnity Company, an Illinois corporation formerly known as Planet Indemnity Company (hereinafter referred to as RLI-IC), Safe Fleet Insurance Services, Inc. a California corporation (hereinafter referred to as Safe Fleet), and RLI Underwriting Services, Inc. an Illinois corporation (hereinafter referred to as RLI-US), MHI, RLI-IC, Safe Fleet and RLI-US hereinafter referred to as the Companies.)

2. All references to Underwriters Indemnity Company (UIC) are deleted. All references to MHI, UIC and PIC shall be deleted and replaced with a reference to "the Companies."

3. The first "Whereas" clause shall state that RLI is the parent company of all the Companies.

4. The second "Whereas" clause shall refer to agency, broker and claims operations in addition to insurance company operations.

5. Section I. B. Services to be Performed is amended to include "payroll, employee benefits and human resources services" as item 9.

6. Section III. Cost Sharing is amended at Paragraph A. by deletion of the phrase, "gross written premium" and replacement with the phrase, "earned premium."

7. Section III. Cost Sharing is further amended by addition of Paragraph C., stating:

   C. Safe Fleet Costs. Notwithstanding Paragraph A., above, the costs of Safe Fleet Insurance Services, Inc. shall be allocated based on (a) reimbursement of actual amounts paid on Safe Fleet's behalf and (b) actual or estimated cost of services provided Safe Fleet.

8. Section IX., General B. is amended to provide that the Agreement shall be construed and enforced in accordance with the laws of the State of Illinois.

All other terms and conditions remain the same.

IN WITNESS WHEREOF, the parties to this Agreement have caused it to be executed on the dates noted below.

RLI Insurance Company

By: _____

Its: Chairman & CEO

Date: 12/22/04

Mt. Hawley Insurance Company

By: _____

Its: SVP, CFO

Date: 12/22/04

RLI Indemnity Company

By: _____

Its: VP, Reinsurance & Contingent

Date: 12/22/04

Safe Fleet Insurance Services, Inc.

By: _____

Its: President

Date: 12/22/04

RLI Underwriting Services, Inc.

By: _____

Its: AVP

Date: 12/22/04

# Illinois Department of Financial and Professional Regulation

## Division of Insurance

ROD R. BLAGOJEVICH
Governor

FERNANDO E. GRILLO
Secretary

DEIRDRE K. MANNA
Acting Director
Division of Insurance

RECEIVED
JAN 27 2005
By

January 25, 2005

Ms. Mary Beth Nebel
RLI Insurance Company
9025 N. Lindbergh Dr.
Peoria, IL 61615

Re: Amendment #1 to Restated Intercompany Services Agreement by and between Safe Fleet Insurance Services, Inc, RLI Insurance Company, RLI Indemnity Company, RLI Underwriting Services, Inc and Mt. Hawley Insurance Company.

Dear Ms. Nebel:

The aforementioned agreement has been received and placed on file pursuant to Section 131.20a of the Illinois Insurance Code (215 ILCS 5/131.20a).

If you have any questions, please feel free to contact Jason Eastep of the Property and Casualty Financial Analysis Unit at (217) 557-4638.

Sincerely,

James M. Hanson, CPA, CLU
Acting Assistant Deputy Director

AMENDMENT II TO THE RESTATED
INTERCOMPANY SERVICES AGREEMENT

The Restated Intercompany Services Agreement between RLI Insurance Company, Mt. Hawley Insurance Company, RLI Indemnity Company, Safe Fleet Insurance Services, Inc. and RLI Underwriting Services, Inc. is hereby amended as follows:

1. RLI Corp., an Illinois holding company, is added as a party to the Agreement.

2. Section I. Responsibilities of RLI, B., Services to be Performed., is amended by the addition of the following:

10. Cash Management services

3. Section I. Responsibilities of RLI, is amended by addition of the following:

C. Services of RLI Corp.

1. RLI Corp. shall perform investment services on behalf of all parties to this Agreement, and all parties do hereby authorize RLI Corp. to enter into certain investment management contracts. RLI Corp. shall retain control over investment duties pursuant to investment management contracts and shall establish written guidelines for investment managers. Notwithstanding the foregoing, the board of directors of each of the individual Companies shall retain ultimate control over all operations and guidelines for investments.

2. Cost allocations for RLI Corp. shall be based upon generally accepted accounting principles.

All other terms and conditions remain the same.

IN WITNESS WHEREOF, the parties to this Agreement have caused it to be executed on the dates noted below.

RLI Insurance Company

By: _____

Its: VP

Date: 4/20/05

Mt. Hawley Insurance Company

By: _____

Its: VP, Reinsurance

Date: 4/21/05

RLI Indemnity Company

By: Donald J Durcalle

Its: VP, Claim Dept.

Date: 4/21/05

Safe Fleet Insurance Services, Inc.

By: Kim J Heuser

Its: VP, CORPORATE SECY.

Date: 4/20/05

RLI Underwriting Services, Inc.

By: Jean M. Stephenson

Its.: Asst. Corp. Secretary

Date: 4/21/05

RLI Corp.

By: Jonathan Ellinhal

Its: President & CEO

Date: 4/23/05

AMENDMENT III TO THE RESTATED INTERCOMPANY SERVICES AGREEMENT

THE RESTATED INTERCOMPANY SERVICES AGREEMENT dated as of the 27th day of December, 2002, as amended, by and among Safe Fleet Insurance Services, Inc., Mt. Hawley Insurance Company, RLI Insurance Company, RLI Indemnity Company, RLI Corp. and RLI Underwriting Services, Inc. (the "Agreement") is hereby amended as follows:

WITNESSETH

1. Article IV, Section A of the Agreement is revised to read as follows:

This Agreement shall remain in force for three (3) years from the date of execution, and shall renew annually thereafter unless otherwise terminated by the parties in accordance with the terms hereof. Termination during the initial term, or any subsequent renewal term, shall be made in accordance with the provisions below. Notwithstanding the foregoing, termination by any party individually, shall apply solely to that company providing the termination. This Agreement shall be effective only for so long as the party remains wholly owned subsidiaries of RLI.

2. All other provisions of the Agreement shall continue in full force and effect as of the date first written.

WHEREFORE, the Parties have caused duplicate originals of this Amendment III to be signed by the Parties' respective duly authorized officers effective as of the ___day of April, 2007.

Safe Fleet Insurance Services, Inc.

By: _____
Its: _____
Date: _____

Mt. Hawley Insurance Company

By: _____
Its: _____
Date: _____

RLI Insurance Company

By: _____
Its: _____
Date: _____

RLI Indemnity Company

By: _____
Its: _____
Date: _____

RLI Underwriting Services, Inc.

By: _____
Its: _____
Date: _____

RLI Corp.

By: _____
Its: _____
Date: _____

# Illinois Department of Financial and Professional Regulation

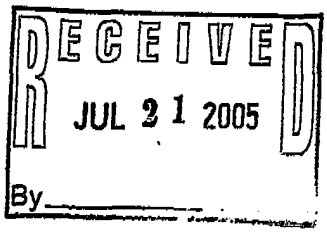
## Division of Insurance

ROD R. BLAGOJEVICH
Governor

FERNANDO E. GRILLO
Secretary

Michael T. McRaith
Director
Division of Insurance

April 29, 2005




Ms. Mary Beth Nebel
RLI Insurance Company
9025 N. Lindbergh Dr.
Peoria, IL 61615

Re: Form D-1 dated March 28, 2005 regarding Amendment # 2 to the restated intercompany services agreement.

Dear Ms. Nebel:

The aforementioned agreement has been received and placed on file pursuant to Section 131.20a of the Illinois Insurance Code (215 ILCS 5/131.20a).

If you have any questions, please feel free to contact Jason Eastep of the Property and Casualty Financial Analysis Unit at (217) 557-4638.

Sincerely,

James M. Hanson, CPA, CLU
Acting Assistant Deputy Director

# Illinois Department of Financial and Professional Regulation

**Division of Insurance**

ROD R. BLAGOJEVICH
Governor

April 12, 2007

RECEIVED
APR 18 2007
By

DEAN MARTINEZ
Secretary

MICHAEL T. McRAITH
Director
Division of Insurance

Daniel O. Kennedy
Vice President and General Counsel
RLI Insurance Company
9025 N. Lindbergh Dr.
Peoria, IL 61615

Re: Form D-1 dated March 30, 2007 regarding Amendment III to the Restated Inter-company Services Agreement between RLI Insurance Company, RLI Indemnity Company, Mt. Hawley Insurance Company, RLI Underwriting Services, Inc and RLI Corp.

Dear Mr. Kennedy:

The aforementioned agreement has been received and placed on file pursuant to Section 131.20a of the Illinois Insurance Code (215 ILCS 5/131.20a).

If you have any questions, please feel free to contact Jason Eastep of the Property and Casualty Financial Analysis Unit at (217) 557-4638.

Sincerely,

Jeff Jackson
Supervisor
Regulatory Action Unit

AMENDMENT IV TO THE RESTATED INTERCOMPANY SERVICES AGREEMENT

THE RESTATED INTERCOMPANY SERVICES AGREEMENT dated as of the 27th day of December, 2002, as amended, by and among Safe Fleet Insurance Services, Inc., Mt. Hawley Insurance Company, RLI Insurance Company, RLI Indemnity Company and RLI Underwriting Services, Inc. (the "Agreement") is hereby amended as follows:

WITNESSETH

1. Section I. Responsibilities of RLI, is amended by the addition of the following:

D. Settlement of Intercompany Balances

Any intercompany balance resulting from services performed or costs allocated in accordance with the terms of this Agreement shall be settled within 30 calendar days following the end of the calendar quarter in which such intercompany balance was created.

2. Underwriters Indemnity General Agency, Inc. a Texas stock corporation, is added as a party to the Agreement.

3. RLI Insurance Ltd., a Bermuda stock corporation, is added as a party to the Agreement.

4. All other provisions of the Agreement shall continue in full force and effect as of the date first written.

WHEREFORE, the Parties have caused duplicate originals of this Amendment IV to be signed by the Parties' respective duly authorized officers effective as of the 31st day of December, 2007.

Safe Fleet Insurance Services, Inc.
By:
Title: President/CFO
Date: 01/04/08

Mt. Hawley Insurance Company
By:
Title: Sr. VP/CFO
Date: 01/04/08

RLI Insurance Company
By:
Title: Sr. VP/CFO
Date: 01/04/08

RLI Indemnity Company
By:
Title: Sr. VP/CFO
Date: 01/04/08

RLI Underwriting Services, Inc.

By: _____
Title: Sr. VP/CFO
Date: 01/04/08

RLI Corp.

By: _____
Title: Sr. VP/CFO
Date: 01/04/08

Underwriters Indemnity General Agency

By: _____
Title: President/Secretary
Date: 01/04/08

RLI Insurance Ltd.

By: _____
Title: Sr. VP/CFO
Date: 01/04/08

**Illinois Department of Financial and Professional Regulation**
**Division of Insurance**

RECEIVED
DEC 03 2007
LAW DEPT

ROD R. BLAGOJEVICH
Governor

DEAN MARTINEZ
Secretary

MICHAEL T. McRAITH
Director
Division of Insurance

November 29, 2007

Daniel O. Kennedy
Vice President, General Counsel and Corporate Secretary
RLI Corp.
9025 N. Linbergh Dr.
Peoria, IL 61615

Re: Form D-1 dated November 20, 2007 regarding the amendment IV to the Restated Intercompany Services Agreement by and between RLI Insurance Company, Mt. Hawley Insurance Company, RLI Indemnity Company, RLI Corp., Safe Fleet Insurance Services, Inc, RLI Underwriting Services, Inc., RLI Insurance LTD and Underwriters Indemnity General Agency, Inc.

Dear Mr. Kennedy:

The aforementioned agreement has been received and placed on file pursuant to Section 5/131.20a of the Illinois Insurance Code (215 ILCS 5/131.20a).

If you have any questions, please contact Jason Eastep of the Property and Casualty Financial Analysis Unit at (217) 557-4638.

Respectfully,

Jeff Jackson
Acting Supervisor
Regulatory Action Unit

KPMG

# RLI INSURANCE COMPANY

Statutory Financial Statements and Schedules

December 31, 2005 and 2004

(With Independent Auditors' Report Thereon)

KPMG LLP
303 East Wacker Drive
Chicago, IL 60601-5212

# Independent Auditors' Report

The Board of Directors
RLI Insurance Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and capital and surplus of RLI Insurance Company (the Company) as of December 31, 2005 and 2004, and the related statutory statements of income and changes in capital and surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 1 to the statutory financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance, which practices differ from U.S. generally accepted accounting principles. The effects on the financial statements of the variances between the statutory accounting practices and U.S. generally accepted accounting principles also are described in note 1.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of RLI Insurance Company as of December 31, 2005 and 2004, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus of RLI Insurance Company as of December 31, 2005 and 2004, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

KPMG

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included on schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

May 24, 2006

## RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2005 and 2004

| Admitted Assets | 2005 | 2004 |
|---|---|---|
| Bonds | $ 571,645,536 | 551,856,161 |
| Common stocks | 207,330,372 | 201,224,606 |
| Preferred stocks | 104 | 26 |
| Investment in affiliates | 404,485,860 | 344,301,109 |
| Real estate occupied by the Company, at cost, less accumulated depreciation of $7,282,192 and $6,749,724 in 2005 and 2004, respectively | 6,081,232 | 5,604,304 |
| Cash and short-term investments | 14,035,782 | 10,771,795 |
| Other invested assets | 6,500,000 | 2,000,000 |
| Total cash and invested assets | 1,210,078,886 | 1,115,758,001 |
| Uncollected premiums and agents' balances | 54,880,790 | 63,505,707 |
| Funds held by or deposited with reinsured companies | 4,000 | 11,407 |
| Reinsurance recoverable on paid losses and loss adjustment expenses | 21,397,323 | 18,040,137 |
| Electronic data processing equipment, at cost less accumulated straight-line depreciation of $20,456,912 and $23,107,686 in 2005 and 2004, respectively | 1,490,986 | 2,570,820 |
| Investment income due and accrued | 7,330,537 | 7,443,307 |
| Other assets | 5,088,054 | 12,551,736 |
| Total admitted assets | $ 1,300,270,576 | 1,219,881,115 |

See accompanying notes to statutory financial statements.

| Liabilities and Capital and Surplus | 2005 | 2004 |
|---|---|---|
| Unpaid losses and loss adjustment expenses | $ 351,665,308 | 345,185,537 |
| Reinsurance payable on paid losses | 357,089 | 368,943 |
| Accrued expenses | 31,107,127 | 21,267,463 |
| Borrowed money including accrued interest | 6,254,554 | 32,241,219 |
| Unearned premiums | 128,759,357 | 135,645,884 |
| Advance premiums | 3,897,814 | 3,295,218 |
| Ceded reinsurance premiums payable | 30,710,750 | 13,562,643 |
| Funds held under reinsurance agreements | 605,482 | 1,113,094 |
| Amounts withheld | 18,299,338 | 19,383,218 |
| Provision for reinsurance | 4,779,400 | 2,555,400 |
| Payable to affiliates | 3,293,020 | 6,098,172 |
| Payable for securities | 1,990,357 | — |
| Federal income taxes including deferred tax liability of $7,413,465 and $10,277,007 in 2005 and 2004, respectively | 8,233,092 | 20,441,698 |
| Commissions payable, contingent commissions and other similar charges | 15,199,322 | 11,071,255 |
| Other liabilities | 1,400,919 | 1,684,568 |
| Total liabilities | 606,552,929 | 613,914,312 |
| Capital and surplus: | | |
| Capital stock, $125 par value. Authorized 1,000,000 shares; issued and outstanding 80,003 shares | 10,000,375 | 10,000,375 |
| Paid-in contributed capital | 242,451,084 | 242,422,846 |
| Unassigned surplus | 441,266,188 | 353,543,582 |
| Total capital and surplus | 693,717,647 | 605,966,803 |
| Total liabilities and capital and surplus | $ 1,300,270,576 | 1,219,881,115 |

## RLI INSURANCE COMPANY

Statutory Statements of Income and Changes in Capital and Surplus

Years ended December 31, 2005 and 2004

| | 2005 | 2004 |
|---|---|---|
| Premiums earned | $ 223,431,678 | 248,621,662 |
| Losses and underwriting expenses incurred: | | |
| Losses and loss adjustment expenses | 117,419,515 | 136,449,627 |
| Other underwriting expenses | 93,407,002 | 94,549,788 |
| Total losses and underwriting expenses incurred | 210,826,517 | 230,999,415 |
| Net underwriting gain | 12,605,161 | 17,622,247 |
| Net investment income | 33,204,519 | 27,047,190 |
| Net realized capital gains net of tax impact of $2,057,556 and $3,181,841 for 2005 and 2004, respectively | 3,821,176 | 5,909,133 |
| Total investment income | 37,025,695 | 32,956,323 |
| Other income, net | 897,572 | 696,723 |
| Income before Federal income taxes, net of realized gains tax | 50,528,428 | 51,275,293 |
| Federal income tax expense | 9,059,290 | 15,407,568 |
| Net income | 41,469,138 | 35,867,725 |
| Capital and surplus at beginning of year | 605,966,803 | 546,586,158 |
| Change in unrealized appreciation of investments (net of tax) | 63,127,536 | 39,527,191 |
| Change in net deferred income tax | 1,181,924 | 2,278,107 |
| Change in nonadmitted assets | 7,772,461 | (12,022,006) |
| Change in provision for reinsurance | (2,224,000) | (1,684,600) |
| Dividends to stockholder | (13,036,489) | (19,585,772) |
| Paid in surplus | 28,235 | 15,000,000 |
| Goodwill write-off to surplus | (10,567,961) | — |
| Capital and surplus at end of year | $ 693,717,647 | 605,966,803 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Cash Flow

Years ended December 31, 2005 and 2004

| | 2005 | 2004 |
|---|---|---|
| Operating activities: | | |
| Premiums collected, net of reinsurance | $ 244,677,272 | 241,050,152 |
| Investment income, net of investment expense | 36,583,974 | 29,001,143 |
| Other income, net | 904,979 | 747,948 |
| Benefits and loss related payments | (83,766,797) | (77,752,122) |
| Commissions and other expenses paid | (109,981,258) | (119,191,968) |
| Federal income taxes paid | (20,461,911) | (13,439,684) |
| Net cash provided from operating activities | 67,956,259 | 60,415,469 |
| Investing activities: | | |
| Cash provided from investments sold, matured, or repaid: | | |
| Bonds | 111,411,512 | 81,596,212 |
| Stocks | 19,977,240 | 23,850,167 |
| Other invested assets | 1,500,000 | 3,000,000 |
| Miscellaneous proceeds | 1,991,053 | 31,528 |
| Cost of investments acquired: | | |
| Bonds | (133,273,332) | (137,823,653) |
| Stocks | (19,604,736) | (39,194,178) |
| Real estate | (1,002,976) | (305,423) |
| Other invested assets | (6,000,000) | — |
| Net cash used for investments | (25,001,239) | (68,845,347) |
| Financing and miscellaneous activities: | | |
| Capital and surplus paid in | 28,235 | 15,000,000 |
| Borrowed funds repaid | (25,986,665) | (370,315) |
| Dividends to stockholders | (13,036,489) | (19,585,772) |
| Other cash applied | (696,114) | (1,996,484) |
| Net cash used for financing and miscellaneous activities | (39,691,033) | (6,952,571) |
| Net change in cash | 3,263,987 | (15,382,449) |
| Cash and short-term investments at beginning of year | 10,771,795 | 26,154,244 |
| Cash and short-term investments at end of year | $ 14,035,782 | 10,771,795 |

See accompanying notes to statutory financial statements.

## (1) Significant Accounting Policies

### *(a) Organization*

RLI Insurance Company (the Company or RLI) is a wholly owned subsidiary of RLI Corp. The Company is primarily engaged in writing selected property and casualty insurance, including difference in conditions, homeowners, general and product liability, directors and officers, commercial fire, commercial and personal umbrella, marine, employers' excess indemnity, commercial auto, and contract and miscellaneous surety bonds. The Company's principal market is the United States, with a concentration on the West Coast, where commercial earthquake coverage (difference in conditions) is significant.

### *(b) Basis of Presentation*

The accompanying statutory financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance. The National Association of Insurance Commissioners' *Accounting Practices and Procedures* (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the Illinois Department of Financial and Professional Regulation – Division of Insurance. The Illinois Department of Financial and Professional Regulation – Division of Insurance has adopted substantially all of the prescribed accounting practices as stated in the NAIC SAP. Statutory accounting practices differ in certain respects from accounting principles generally accepted in the United States of America (GAAP). The most significant differences include:

(a) Acquisition costs related to premiums written are expensed as incurred, rather than deferred to the extent recoverable and charged to operations ratably over the period covered by the related insurance policies as prescribed by GAAP.

(b) Investments in bonds are not classified as to the Company's intention to trade, hold to maturity, or make available for sale. Investments in bonds are generally carried at amortized cost rather than fair value. Accordingly, unrealized changes in fair value attributable to bonds are not reflected in the statutory statements of income and changes in capital and surplus.

(c) Certain assets are designated as nonadmitted assets and are charged to surplus, as opposed to being carried at amounts recoverable for GAAP purposes.

(d) The realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles No. 10 – *Income Taxes* (SSAP 10). Any gross deferred tax assets determined to be not realizable within one year are nonadmitted for statutory accounting purposes. Additionally, changes in the balances of deferred tax assets and liabilities may result in increases or decreases in tax expense under GAAP, whereas under statutory accounting principles, these changes directly impact surplus.

(e) A liability is established, which is not required under GAAP, by a direct charge to unassigned surplus for unsecured reinsurance recoverables from unauthorized reinsurers and certain past


(Continued)

due amounts from authorized reinsurers, rather than just providing for the estimated amounts deemed uncollectible.

(f) The liability for losses and loss adjustment expenses is reported net of reinsurance recoverables, and unearned premiums are reported net of prepaid reinsurance premiums, rather than presenting these amounts gross of the effects of reinsurance ceded.

(g) Wholly owned insurance subsidiaries are reflected at net statutory book value with changes reflected directly in capital and surplus, as opposed to consolidation of assets and liabilities and income on the financial statements.

(h) The statutory statement of cash flow differs in certain respects from the presentation required by Statement of Financial Accounting Standards No. 95, including the presentation of the changes in cash and short-term investments instead of cash and cash equivalents. Short-term investments include securities with original maturities of one year or less at the time of acquisition.

(i) Comprehensive income is not determined for statutory reporting purposes.

Under GAAP, for the years ended December 31, 2005 and 2004, the Company had net income of $50,757,877 and $45,434,046, respectively. The Company's GAAP shareholder's equity amounted to $784,088,769 and $708,800,976 at December 31, 2005 and 2004, respectively.

Significant statutory accounting policies are as follows:

*(c) Investments*

Bonds are generally stated at amortized cost, while all stocks are included at the NAIC-specified fair values. Short-term investments are valued at cost, which approximates fair value, and are considered cash equivalents in the statutory financial statements. Real estate is valued at cost less accumulated depreciation, which is computed on a straight-line basis over the estimated useful lives of the properties.

All of the Company's loan-backed securities were purchased subsequent to January 1, 1994. Loan-backed securities are stated at either amortized cost or the lower of amortized cost or fair value dependent upon NAIC designations. Loan-backed securities are revalued using currently estimated cash flows, including new prepayment assumptions, under the prospective methodology. Prepayment assumptions for single class and multi-class mortgage backed securities were obtained from external sources and through management estimates.

Unaffiliated common stocks are carried at values assigned by the NAIC. Stocks of affiliates in which the Company has an interest of 20% or more are carried on the equity basis. Dividends on stocks are credited to income on the ex-dividend date. Realized investment gains and losses are determined on the basis of the specific identification method and are reflected in net income. Unrealized gains or losses are charged or credited directly to unassigned surplus, net of provision for deferred income taxes.

The Company reviews the values of their investments in bonds and common stocks on a quarterly basis for other-than-temporary losses. Investments that have a fair value that is less than cost are evaluated for other-than-temporary impairment. If this review suggests that a decline in fair value is other than temporary, the carrying value in the investment is reduced to its fair market value through an adjustment to earnings.

*(d) Investment in Affiliates and Related Parties*

The Company owns 100% of the common stock of Mt. Hawley Insurance Company (Mt. Hawley), Safefleet Insurance Services, Inc. (Safefleet), RLI Insurance Ltd (RLI Ltd), Underwriters Indemnity General Agency (UIGA), and RLI Underwriting Services, Inc. (RLI US). The Company also owns approximately 41% of the common stock of Maui Jim, Inc., a noninsurance company. Mt. Hawley is engaged in writing excess and surplus lines of insurance. The Company's investment in Mt. Hawley is carried at cost plus equity in statutory net income and surplus adjustments since the date of formation, less dividends received. Changes in the carrying value of the Company's investment in Mt. Hawley are reflected directly in unassigned surplus. Mt. Hawley maintains an investment of 1,115,040 shares in its ultimate parent, RLI Corp. The estimated fair value of this common stock at December 31, 2005, after reduction of Mt. Hawley's reciprocal ownership, was $24,914,585.

Safefleet, RLI Ltd, UIGA, and RLI US are valued based on their underlying equity adjusted to a statutory basis of accounting under the provisions of SSAP No. 88, which supersedes SSAP No. 46 and was adopted as of January 1, 2005. The investment in Maui Jim is carried at GAAP equity in accordance with SSAP No. 88. SSAP No. 88 requires investments in noninsurance entities that have significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates to be recorded based on the audited GAAP equity of the investee. The adoption of SSAP No. 88 did not have an impact on the Company's recorded amount of investment in affiliates.

*(e) Revenue Recognition*

Premiums, net of reinsurance, are earned and recognized as revenue ratably over the period of the underlying policies. Unearned premiums, which are reflected net of reinsurance, represent the pro rata portion of premiums written which are applicable to the unexpired terms of the policies in force.

*(f) Acquisition Costs*

The costs of acquiring insurance premiums (principally commissions and premium taxes) are charged to current operations as incurred.

*(g) Liability for Unpaid Losses and Loss Adjustment Expenses*

The estimated liability for unpaid losses and loss adjustment expenses includes a provision for reported and unpaid losses as well as estimates of losses incurred but not reported, net of amounts covered by reinsurance. It is the Company's policy on certain underwriting programs not to recognize profits or losses until a sufficient amount of statistically reliable information has been obtained. Management periodically reviews estimates for unpaid losses and loss adjustment expenses and changes are recorded in income currently. As these amounts are determined based upon estimates, the ultimate liability may be more or less than such estimates. Based on the current


(Continued)

assumptions used in calculating reserves, management believes that the Company's overall reserve levels at December 31, 2005 make a reasonable provision to meet its future obligations.

***(h) Federal Income Taxes***

Federal income taxes are charged to operations based on current taxable income. Current year federal income tax expense is based on financial reporting income or loss adjusted for certain permanent and timing differences. The timing differences are the result of dissimilar financial reporting and tax basis accounting methods. A net deferred tax asset, representing the tax effect of timing differences between financial reporting and the tax basis of assets and liabilities, is only reported as an admitted asset to the extent that it will be realized within one year, subject to certain limitations, or to the extent that it offsets deferred tax liabilities. The change in net deferred tax asset or liability is reflected directly in surplus.

The Company files a consolidated federal income tax return with its parent and affiliates. The provision for federal income taxes is based on current taxable income. The method of allocation between the companies is subject to written agreement, approved by the board of directors. Allocation is based on the ratio of that portion of the separate company taxable income each member bears to the total taxable income of the group. Intercompany tax balances are settled annually.

***(i) Provision for Reinsurance***

A statutory reinsurance liability must be established for unsecured amounts ceded to unauthorized reinsurers and certain amounts of past due recoverables from authorized reinsurers. This amount is recorded through a direct charge to unassigned surplus.

***(j) Nonadmitted Assets***

Certain assets (principally direct premiums 90-days past due, office furniture and equipment, certain receivables, and deferred tax assets in excess of specified thresholds) are designated as nonadmitted assets and charged to unassigned surplus.

***(k) Allowance for Uncollectible Reinsurance***

Periodically an allowance representing an estimate of unrecoverable amounts on both paid and unpaid recoverables from troubled or insolvent reinsurers is provided through a charge to income. The Company believes that current reserve levels for uncollectible reinsurance are sufficient to cover the related exposure.

***(l) Depreciation and Amortization***

Currently all depreciation and amortization is calculated using the straight-line method. The useful lives are as follows: 3 years for computers and external operating software; and 5 to 40 years for tenant improvements and real estate. Depreciation and amortization expense for the Company totaled $1,721,848 and $5,013,123 for 2005 and 2004, respectively.



(Continued)

*(m) Risks and Uncertainties*

Certain risks and uncertainties are inherent to the Company's day-to-day operations and to the process of preparing its statutory financial statements. The more significant of those risks and uncertainties, as well as the Company's methods for mitigating, quantifying, and minimizing such risks and uncertainties, are presented below and throughout the notes to the statutory financial statements.

**Catastrophe Exposures**

The Company's past and present insurance coverages include exposure to catastrophic events. Certain of the Company's property policies cover catastrophic events such as earthquakes, floods, and windstorms. The Company has a concentration of such coverages in California (13% of total direct premiums written). Using computer-assisted techniques, the Company quantifies and monitors its exposure to catastrophic events. The Company limits its risk to such catastrophes through the purchase of reinsurance.

**Environmental Exposures**

The Company is subject to environmental claims and exposures through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, management has sought to mitigate or control the extent of this exposure through the following methods: 1) the Company's policies include pollution exclusions that have been continually updated to further strengthen the exclusion; 2) the Company's policies primarily cover moderate hazard risks; and 3) the Company began writing this business after the industry became aware of the potential pollution liability exposure.

The Company includes historical environmental loss experience with the remaining loss experience in the applicable line of business to project ultimate incurred losses and loss adjustment expenses and related incurred but not reported loss and loss adjustment expense reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, the Company has used this experience to record loss and loss adjustment expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 7.

**Reinsurance**

Reinsurance does not discharge the Company from its primary liability to policyholders and, to the extent that a reinsurer is unable to meet its obligations, the Company would be liable. The Company reviews and monitors the financial condition of prospective and existing reinsurers and currently attempts to purchase reinsurance from a limited number of financially strong reinsurers. As discussed above, the Company provides a reserve for reinsurance balances deemed uncollectible.



(Continued)

**Investments**

The Company is exposed to risks that issuers of securities owned by the Company will default, or that interest rates will change and cause a decrease in the value of its investments. Management mitigates these risks by conservatively investing in high-grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.

**Use of Estimates**

The preparation of statutory financial statements requires management to make estimates and assumptions that affect the reported financial statement balances as well as the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. The most significant of these amounts is the liability for unpaid losses and loss adjustment expenses. Management continually updates its estimates as additional data becomes available and adjusts the statutory financial statements as deemed necessary. Other estimates such as the recoverability of reinsurance balances are constantly monitored, evaluated, and adjusted. Although recorded estimates are supported by actuarial computations and other data, the estimates are ultimately based on management's expectations of future events. It is reasonably possible that expectations associated with these accounts can change in the near term (i.e., one year) and that the effect of these changes could be material to the statutory financial statements.

**External Factors**

The Company is highly regulated by the state in which it is domiciled, as well as states in which it does business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments, and regulate rates insurers may charge for various products. The Company is also subject to insolvency and guarantee fund assessments for policyholder losses covered by insolvent insurers. The Company generally accrues the full amount of the assessment as insolvencies occur.

The NAIC has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory capital and surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written, and unearned premium) risk. The NAIC model law calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. The Company continuously monitors its internal capital requirements and the NAIC's RBC developments. The Company has determined that its capital levels are well in excess of the minimum capital requirements for all RBC action levels. Management believes that the Company's capital levels are sufficient to support the level of risk inherent in its operations.



(Continued)

*(n) Fair Value Disclosures*

Equity securities are valued using NAIC fair value prices, if available. If a NAIC fair value is not available, fair value is estimated using quoted market prices of the security or similar securities. Fair values of bonds are disclosed in note 2. Equity securities are carried at NAIC fair value, whereas bonds are generally carried at amortized cost. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, and accounts payable, the carrying value of each is a reasonable estimate of fair value.

*(o) Reclassifications*

Certain line items in the accompanying statutory financial statements and schedules have been classified differently than as presented in the Company's annual statement filed with the regulatory agencies. These classifications have no impact on net income and surplus. Certain amounts in the accompanying 2004 financial statements have been reclassified to conform to the 2005 presentation. These reclassifications have no impact on net income or total capital and surplus.

*(p) Significant Events*

In January 1999, the Company acquired Lexon Holding Company (Lexon) (formerly known as Underwriters Indemnity Holding) located in Houston, Texas for $40.7 million. Goodwill recorded from this acquisition totaled $27.8 million and was scheduled to amortize over 10 years – the statutory maximum. On July 1, 2003, the Company sold 100% of its investment in Lexon to an unaffiliated entity for $25.6 million. The sale of Lexon resulted in a write-down of $1.1 million of goodwill from the original state licenses acquired as part of the acquisition. Goodwill amortization relating to the remaining value of the purchase of Lexon totaled $2.6 million for 2004. In June 2005, the Company took a write-down to unassigned funds for the remaining unamortized value of Lexon of $10.6 million biased on guidance set forth in SSAP 68 and SSAP 3 and discussions with the Illinois Department of Financial and Professional Regulation – Division of Insurance. During 2004, the Company had non-admitted this asset; therefore, there was no impact to the surplus from 2004 to 2005 as a result of this write-down.

The Company also had goodwill associated with the 2002 acquisition of Surety America Agency, LLC. Through impairment testing performed in 2004, the carrying value of unamortized goodwill was determined to be unrecoverable. As a result, the Company recorded $584,000 of additional amortization expense to write off the remaining goodwill during 2004. Subsequent to this write-down, the asset value was zero.



(Continued)

The Company received a total of forty claims related to the terrorist attacks of September 11, 2001. Of these, thirty-seven have been closed with incurred losses and loss adjustment expense of $257,364. The Company has established $14,506 of case reserves to close out the three remaining claims, two of which were reported in 2005.

The Company owns approximately 21% of Taylor Bean & Whitaker Mortgage Corp. (TBW), a non-insurance company. In 2004, the Company accounted for the investment in TBW as an affiliate according to SSAP No. 46, which was superseded by SSAP No. 88 in 2005. In April 2005, the Company received a disclaimer of affiliation regarding TBW from the Illinois Department of Financial and Professional Regulation – Division of Insurance. As a result, the Company no longer recognizes TBW as an affiliate valued based upon underlying equity for statutory reporting purposes, but instead carries TBW at fair value in accordance with SSAP No. 30. The treatment of recording net unrealized gains for TBW as a non-affiliate versus an affiliate did not have a net impact on total surplus as the net unrealized gain from the investment continues to be included in the Statement of Changes in Capital and Surplus along with the change in net unrealized gains and losses of all other investments.

## (2) Investments

The statement and estimated fair values of bonds at December 31, 2005 and 2004, respectively, are reflected below. No provision has been made for possible losses on bonds where amortized cost exceeds fair value, as the Company generally has the intent and ability to hold these bonds to maturity or until such time as it will not realize any significant losses. Estimated fair values are based on pricing information obtained from the Company's investment brokers which do not differ materially from those prescribed by the NAIC's Securities Valuation Office.

| | 2005 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 9,899,920 | 97,669 | (94,410) | 9,903,178 |
| Government agencies and government-backed securities | 92,909,328 | 770,192 | (705,525) | 92,973,996 |
| States, political subdivisions, and special revenue securities | 238,953,393 | 3,633,423 | (1,292,151) | 241,294,665 |
| Corporate and other securities | 101,575,565 | 1,558,376 | (1,880,901) | 101,253,039 |
| Mortgage-backed securities and CMOs | 128,307,330 | 393,655 | (2,316,207) | 126,384,777 |
| Totals | $ 571,645,536 | 6,453,315 | (6,289,195) | 571,809,656 |



(Continued)

| | 2004 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 9,958,286 | 329,437 | (26,069) | 10,261,654 |
| Government agencies and government-backed securities | 43,894,744 | 1,848,329 | (46,185) | 45,696,888 |
| States, political subdivisions, and special revenue securities | 229,231,901 | 7,615,896 | (184,513) | 236,663,284 |
| Corporate and other securities | 154,413,103 | 5,093,703 | (1,461,381) | 158,045,425 |
| Mortgage-backed securities and CMOs | 114,358,127 | 1,743,695 | (346,638) | 115,755,184 |
| Totals | $ 551,856,161 | 16,631,060 | (2,064,786) | 566,422,435 |

The statement and estimated fair value of bonds at December 31, 2005 by contractual maturity are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Statement value | Estimated fair value |
|---|---|---|
| Due in one year or less | $ 9,287,586 | 9,342,964 |
| Due after one year through five years | 137,254,437 | 138,148,804 |
| Due after five years through ten years | 266,413,825 | 267,736,263 |
| Due after ten years | 158,689,688 | 156,581,624 |
| | $ 571,645,536 | 571,809,656 |

Proceeds from sales of bonds during 2005 and 2004 were $68,356,931 and $33,637,523, respectively. Proceeds from maturities/calls of bonds during 2005 and 2004 were $43,054,581 and $47,958,689, respectively. Gross gains realized on those sales and maturities/calls totaled $1,772,772 and $409,551 in 2005 and 2004, respectively. Gross losses realized on those sales and maturities/calls totaled $1,111,918 and $115,531 in 2005 and 2004, respectively.

The book value of common and preferred stocks of nonaffiliates owned at December 31, 2005 and 2004 was $107,442,337 and $102,088,358, respectively. Gross unrealized gains and losses on such investments are as follows:

| | 2005 | 2004 |
|---|---|---|
| Unrealized gains | $ 97,356,909 | 99,220,774 |
| Unrealized losses | (413,786) | (84,500) |
| Net unrealized gain | $ 96,943,123 | 99,136,274 |



(Continued)

The unrealized gain on investments in affiliates is as follows:

| | 2005 | 2004 |
|---|---|---|
| Carrying value of investments in affiliates | $ 404,485,860 | 344,301,109 |
| Cost of investments in affiliates | 161,788,624 | 162,297,927 |
| Unrealized gain | $ 242,697,236 | 182,003,182 |

Proceeds from sales of equity securities during 2005 and 2004 were $19,977,240 and $23,850,167, respectively. Gross gains realized on those sales totaled $6,572,334 and $9,240,599 in 2005 and 2004, respectively. Gross losses realized on those sales totaled $1,354,456 and $475,173 in 2005 and 2004, respectively.

As of December 31, 2005 investments with a statement value of $2,350,297 were on deposit with governmental authorities or banks to comply with insurance laws. In addition, investments with a stated value of $5,893,074 as of December 31, 2005 were on deposit as collateral for reverse repurchase agreements (note 4).

The composition of net investment income is as follows:

| | 2005 | 2004 |
|---|---|---|
| Bonds | $ 25,670,757 | 24,472,256 |
| Stocks | 5,672,936 | 5,587,658 |
| Investments in affiliates | 4,000,000 | — |
| Real estate | 663,000 | 663,000 |
| Cash on deposit and short-term investments | 567,362 | 313,731 |
| Other | 757,747 | 524,359 |
| | 37,331,802 | 31,561,004 |
| Less investment expenses | 4,127,283 | 4,513,814 |
| Net investment income | $ 33,204,519 | 27,047,190 |

At December 31, 2005, we were party to a securities lending program whereby fixed-income securities are loaned to third parties, primarily major brokerage firms. At December 31, 2005 and 2004, fixed maturities with a fair value of $16.5 million and $15.5 were loaned respectively. Agreements with custodian banks facilitating such lending generally require 102% of the value of the loaned securities to be separately maintained as collateral for each loan. To further minimize the credit risks related to this lending program, we monitor the financial condition of other parties to these agreements.



(Continued)

The following tables illustrate the total value of securities that were in an unrealized loss position as of December 31, 2005 and 2004, respectively.

| | 2005 | | |
|---|---|---|---|
| | Less than 12 months | Greater than 12 months | Total |
| | (In thousands) | | |
| U.S. Government: | | | |
| Fair value | $ 4,782 | — | 4,782 |
| Cost or amortized cost | 4,876 | — | 4,876 |
| Unrealized loss | $ (94) | — | (94) |
| U.S. Agency: | | | |
| Fair value | $ 57,311 | 3,123 | 60,434 |
| Cost or amortized cost | 57,929 | 3,211 | 61,140 |
| Unrealized loss | (618) | (88) | (706) |
| Mortgage-backed: | | | |
| Fair value | $ 84,896 | 16,328 | 101,224 |
| Cost or amortized cost | 86,725 | 16,815 | 103,540 |
| Unrealized loss | (1,829) | (487) | (2,316) |
| Corporate: | | | |
| Fair value | $ 41,897 | 18,215 | 60,112 |
| Cost or amortized cost | 42,929 | 19,064 | 61,993 |
| Unrealized loss | $ (1,032) | (849) | (1,881) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 91,054 | 6,965 | 98,019 |
| Cost or amortized cost | 92,186 | 7,125 | 99,311 |
| Unrealized loss | $ (1,132) | (160) | (1,292) |
| Subtotal, debt securities: | | | |
| Fair value | $ 279,940 | 44,631 | 324,571 |
| Cost or amortized cost | 284,645 | 46,215 | 330,860 |
| Unrealized loss | $ (4,705) | (1,584) | (6,289) |
| Common stock: | | | |
| Fair value | $ 6,502 | — | 6,502 |
| Cost or amortized cost | 6,916 | — | 6,916 |
| Unrealized loss | $ (414) | — | (414) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 286,442 | 44,631 | 331,073 |
| Cost or amortized cost | 291,561 | 46,215 | 337,776 |
| Unrealized loss | $ (5,119) | (1,584) | (6,703) |



(Continued)

| | 2004 | | |
|---|---|---|---|
| | Less than 12 months | Greater than 12 months | Total |
| | | (In thousands) | |
| U.S. Government: | | | |
| Fair value | $ 1,863 | 242 | 2,105 |
| Cost or amortized cost | 1,881 | 250 | 2,131 |
| Unrealized loss | $ (18) | (8) | (26) |
| U.S. Agency: | | | |
| Fair value | $ 5,577 | 2,979 | 8,556 |
| Cost or amortized cost | 5,596 | 3,006 | 8,602 |
| Unrealized loss | (19) | (27) | (46) |
| Mortgage-backed: | | | |
| Fair value | $ 32,765 | 7,712 | 40,477 |
| Cost or amortized cost | 32,978 | 7,846 | 40,824 |
| Unrealized loss | (213) | (134) | (347) |
| Corporate: | | | |
| Fair value | $ 50,914 | 16,736 | 67,650 |
| Cost or amortized cost | 51,551 | 17,560 | 69,111 |
| Unrealized loss | $ (637) | (824) | (1,461) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 30,540 | 3,302 | 33,842 |
| Cost or amortized cost | 30,677 | 3,350 | 34,027 |
| Unrealized loss | $ (137) | (48) | (185) |
| Subtotal, debt securities: | | | |
| Fair value | $ 121,659 | 30,971 | 152,630 |
| Cost or amortized cost | 122,683 | 32,012 | 154,695 |
| Unrealized loss | $ (1,024) | (1,041) | (2,065) |
| Common stock: | | | |
| Fair value | $ 3,062 | — | 3,062 |
| Cost or amortized cost | 3,147 | — | 3,147 |
| Unrealized loss | $ (85) | — | (85) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 124,721 | 30,971 | 155,692 |
| Cost or amortized cost | 125,830 | 32,012 | 157,842 |
| Unrealized loss | $ (1,109) | (1,041) | (2,150) |



(Continued)

As of December 31, 2005 and 2004, 256 and 110 bonds, respectively, had an unrealized loss. These bonds represent a total fair value of $323.6 million and $152.6 million, respectively, and a total unrealized loss of $6.3 million and $2.1 million, respectively. All of the bonds in our portfolio are investment-grade and no individual bond has shown deterioration in price that is consistent with an inability to recover principal. As of December 31, 2005 and 2004, six and three equity securities, respectively, were in the RLI portfolio that had unrealized losses. These securities were all in unrealized loss positions of less than 20% for less than six consecutive months. The Company has the ability and intent to hold these investments until market price recovery or maturity. As a result, the Company does not consider any equity or bond securities to be other than temporarily impaired.

**(3) Related-party Transactions**

As described below and elsewhere in the notes to the statutory financial statements, the Company has engaged in transactions with its parent, affiliates, and subsidiaries during the normal course of business:

(a) During the normal course of business, the Company allocates various expenses resulting from services performed for the benefit of its affiliates. The Company allocated expenses of $35,899,815 and $33,197,383 during 2005 and 2004, respectively, as a result of services performed.

(b) The Company received no dividends from Mt. Hawley, Safefleet, RLI US, or UIGA in 2005 or 2004. In November 2005, RLI Ltd. paid a cash dividend to the Company of $4,000,000.

(c) The Company paid RLI Corp. cash dividends of $13,036,489 and $19,585,772 in 2005 and 2004, respectively.

(d) At December 31, 2005, the Company owns 100% of the common stock of its subsidiaries, Mt. Hawley, Safefleet, RLI Ltd, UIGA, and RLI US, having statement values of $367,091,517, $93,168, $1,096,113, $959,897, and $27,967, respectively. The Company also owns a 41% interest in Maui Jim, Inc., an affiliate, with a statement value of $35,217,198 which is reflected in common stocks.

(e) Based on the Company's ownership percentage of Mt. Hawley, the statement value of Mt. Hawley assets and liabilities as of December 31, 2005 were $940,322,991 and $573,231,474, respectively. The Company's share of net income of Mt. Hawley was $55,802,308 for the year ended December 31, 2005.

(f) The Company received a capital contribution totaling $28,235 from RLI Corp. in 2005. This contribution took the form of 9,621 shares of common stock in its wholly owned subsidiary, RLI US. The contribution resulted in the Company owning 100% of the outstanding shares of RLI US.

(g) At December 31, 2005 and 2004, the Company reported $3,293,020 and $6,098,172, respectively, as net amounts due to affiliates. Additionally, at December 31, 2005 and 2004, the Company reported $0 and $2,000,000, respectively, in notes receivable from a related party.

(h) On or about April 1, 2004, the Company entered into an intercompany guarantee with RLI Ltd. The Company has guaranteed the performance of RLI Ltd. with respect to a punitive damages wrap policy over an excess policy with the Company. The policy has an effective date of April 1, 2004


(Continued)

and was renewed with an effective date of April 1, 2005. The guarantee is in the amount of $20,000,000.

(i) The Company allocates certain expenses to RLI Corp. and affiliated companies based upon the accounting principles set forth in the NAIC Accounting Practices and Procedures Manual. The Company maintains an intercompany services agreement with RLI Indemnity Company (RIC). This agreement allows a portion of the expenses incurred by the Company for the benefit of RIC to be charged back to this company at a specified rate. The adequacy of this rate is reviewed and adjusted quarterly. The Company also maintains an intercompany services agreement with Safe Fleet. This agreement allows the expense incurred by Safefleet for the benefit of the Company to be charged back to the Company on a cost reimbursement basis.

(j) On December 14, 2001, RLI executed an unconditional guaranty in favor of RIC whereby RLI has guaranteed that, if RIC fails to maintain the minimum capital and surplus as needed to comply with New York insurance laws upon admission to do business in the state, that it shall pay such sums or deposits. This guaranty shall terminate after three years of successful operations as determined by the New York Insurance Commissioner. Correspondence was received July 27, 2005, from the state of New York releasing this guarantee.

(k) On June 16, 2000, RLI executed an unconditional guaranty in favor of RIC whereby RLI has guaranteed that, if RIC fails to maintain the minimum capital and surplus as needed to comply with New Jersey insurance laws upon admission to do business in the state, that it shall pay such sums or deposits. This guaranty shall terminate after five years of successful operations as determined by the New Jersey Insurance Commissioner. Correspondence was received April 21, 2005, from the state of New Jersey releasing this guarantee.

## (4) Borrowed Funds

The Company has a total outstanding liability for borrowed money in the amount of $6,218,750 payable in 2005 to Merrill Lynch as part of a reverse repurchase agreement. The Company is required to maintain a collateral security deposit with the lender. At December 31, 2005, assets having a par value of $6,000,000, an admitted asset value of $5,893,074, and a market value of $6,191,026 were on deposit with the lender. Interest paid on the outstanding debt for 2005 and 2004 totaled $757,571 and $353,185, respectively.

The weighted average interest rate on short-term borrowings outstanding as of December 31, 2005 was 4.41%.

## (5) Capital and Surplus

Dividend payments from the Company to its parent are restricted by state insurance laws as to the amount that may be paid without prior approval from the regulatory authorities of Illinois. The maximum dividend distribution that can be paid by the Company during 2006 without prior approval is $69,371,765.

State insurance laws also restrict dividend payments to the Company from Mt. Hawley. The maximum dividends that can be paid to the Company by Mt. Hawley during 2006 without prior approval are $55,802,308.

Unassigned surplus includes $63,814,387 in net unrealized gains on unaffiliated investments and has been reduced by $11,246,022 relating to nonadmitted assets. Additionally, surplus has been reduced by $4,779,400 for the provision for reinsurance.

## (6) Reinsurance

In the normal course of business, the Company assumes and cedes property and liability insurance exposures with other insurance companies, pools, and associations through various treaties and in certain instances by negotiation of individual risks. Generally, policies are reinsured with other insurance companies to limit the Company's risk on any individual loss to $2,000,000.

The following are summaries of the Company's reinsurance program:

| | 2005 | | |
|---|---|---|---|
| | Direct | Assumed | Ceded |
| Premiums written | $ 339,345,587 | 9,029,664 | 131,830,100 |
| Premiums earned | 340,306,923 | 8,630,429 | 125,505,674 |
| Losses and loss adjustment expenses incurred | 183,299,352 | 7,663,754 | 87,941,207 |
| Unearned premiums | 183,161,889 | 4,737,293 | 59,139,825 |
| Unpaid losses and loss adjustment expenses | 658,522,250 | 44,242,643 | 351,099,585 |

| | 2004 | | |
|---|---|---|---|
| | Direct | Assumed | Ceded |
| Premiums written | $ 353,348,459 | 8,936,701 | 117,392,248 |
| Premiums earned | 358,885,424 | 10,000,263 | 120,264,025 |
| Losses and loss adjustment expenses incurred | 249,882,949 | 6,045,413 | 119,478,735 |
| Unearned premiums | 184,123,224 | 4,338,059 | 52,815,399 |
| Unpaid losses and loss adjustment expenses | 605,304,444 | 44,204,365 | 304,323,272 |

At December 31, 2005, net balances recoverable from reinsurers (comprised of unearned premiums and losses and loss adjustment expenses paid and unpaid, including incurred but not reported amounts) having unsecured portions exceeding 3% of the Company's total capital and surplus were as follows:

| Name of reinsurer | Amount |
|---|---|
| American Reinsurance | $ 75,946,000 |
| Berkley Insurance Company | 21,969,000 |
| Employers Reinsurance | 27,158,000 |
| Everest Reinsurance | 22,614,000 |
| General Colonge Re | 60,496,000 |
| TOA Reinsurance | 28,352,000 |

The losses, loss adjustment expenses, and unearned premiums for business ceded to other insurers are recoverable and realizable to the extent that the assuming reinsurers fulfill their commitments. The Company has initiated arbitration or otherwise instituted legal actions where appropriate on certain outstanding recoverable balances.



(Continued)

In 2005 and 2004, our property underwriting was supported by $400 million and $350 million, respectively, in traditional catastrophe reinsurance protection, subject to certain restrictions by the Company. During January 2004, the Company modified its retention under a California earthquake event by increasing the retention in its first layer of reinsurance by $7.5 million, while purchasing an additional $35 million upper layer of catastrophe reinsurance. This change was accomplished for approximately the same reinsurance cost. At January 1, 2005, the Company restructured its reinsurance program increasing its traditional catastrophe reinsurance protection to $400 million, subject to certain retentions by the Company. At the same time, the Company reduced its limit available under its per risk excess of loss earthquake protection by the corresponding amount, while maintaining the same limit of coverage. The Company also increased its California earthquake attachment by $3.75 million. In total, these changes will result in an estimated $1.9 million reduction in the Company's catastrophe program ceded premium.

The Company recorded income of $380,085 related to favorable development on ceded reserves and subsequent recoveries of amounts previously written off. This benefit is reflected in losses incurred and loss reserves. The most significant components are a net write-off of $281,569 for balances due from Cherokee Insurance Co., offset by favorable reserve development of $556,917 for amounts due from Reliance Insurance Co.

The Company has recorded income in the current year of $34,019 for reinsurance balances commuted. This increase is reflected in losses incurred. The main component is a charge of $60,000 from Converium Reinsurance (North America) Inc., offset by commutations from other reinsurers totaling $94,019.

The total return commission which would have been due reinsurers if all reinsurance was cancelled with the return of unearned premium would be $12,530,473 and $10,309,519 as of December 31, 2005 and 2004, respectively. The amount of return commission, predicated on loss experience as a result of existing contracts, was $2,951,254 and $4,111,274 as of December 31, 2005 and 2004, respectively.

The Company participates in a quota share reinsurance agreement with RIC. The agreement is applied after all other external reinsurance cessions. Under the terms of the agreement, RIC cedes and RLI assumes 90% of the net premium and liabilities for policies effective January 1, 2003, and subsequent. The agreement, which was effective January 1, 2003, has been accepted and placed on file by the Illinois Department of Financial and Professional Regulation – Division of Insurance.

This agreement was amended in 2004 to include the assumption of 100% of RIC's existing net loss reserves and any future development on these reserves. The Illinois Department of Financial and Professional Regulation – Division of Insurance approved the loss portfolio transfer on June 29, 2004. In this transaction, $693,000 of loss reserves were assumed by RLI from RIC as were $693,000 of premium, with no net impact to the surplus of either company. Under the terms of SSAP 62, this transaction was afforded traditional reinsurance accounting treatment.


(Continued)

The following is a summary of the balances assumed under this agreement as of and for the year ended December 31, 2005 and 2004 (in thousands):

| | 2005 | 2004 |
|---|---|---|
| Premium written | $ 1,870 | 1,575 |
| Unearned premiums | 1,300 | 425 |
| Premium earned | 1,001 | 1,689 |
| Loss and loss adjustment expenses incurred | 314 | 1,089 |
| Reserve for loss and loss adjustment expenses | 1,612 | 1,303 |

## (7) Unpaid Losses and Loss Adjustment Expenses

The following table is a reconciliation of the Company's liability for unpaid losses and loss adjustment expenses (LAE) for the years ended December 31, 2005 and 2004. Since reserves are based on estimates, the ultimate net cost may vary from the original estimate. As adjustments to these estimates become necessary, they are reflected in current operations. As part of the reserving process, historical data is reviewed and consideration is given to the anticipated impact of various factors such as legal developments and economic conditions, including the effects of inflation. Changes in reserves from the prior year's estimates are calculated based on experience as of the end of each succeeding year (loss and LAE development).

| | 2005 | 2004 |
|---|---|---|
| | (In thousands) | |
| Net unpaid losses and LAE at beginning of year | $ 345,186 | 326,958 |
| Incurred losses and LAE related to: | | |
| Current accident year losses | 130,427 | 143,436 |
| Prior accident year losses | (13,007) | (6,986) |
| Total incurred | 117,420 | 136,450 |
| Paid loss and LAE payments related to: | | |
| Current accident year losses | (22,365) | (25,588) |
| Prior accident year losses | (88,576) | (92,634) |
| Total paid | (110,941) | (118,222) |
| Net unpaid losses and LAE at end of year | $ 351,665 | 345,186 |

### Reserve Development

During 2005, the Company experienced $13.0 million of favorable development related to prior accident years. Most of this favorable development occurred in the casualty segment, specifically Other Liability,


(Continued)

Products Liability, and Commercial Auto Liability. This development is primarily from accident years 2002-2004 for the Company's specialty programs and transportation products. The Company's experience in those years has been favorable due to lower than anticipated frequency and severity. During 2005, the emergence of losses lower than expected caused the Company's estimates to decrease. In response to this favorable development, the Company released approximately $5.4 million and $6.0 million of IBNR loss and LAE reserves for Specialty Programs and Transportation, respectively. These releases comprise a majority of the favorable development within the casualty segment. The property segment, specifically Inland Marine and Allied Lines, also experienced favorable development. A portion of this positive development is due to the release of IBNR held for the 2004 hurricanes. Overall, the surety segment experienced adverse development. Reserve additions on surety coverages for the 2002 accident year exceeded favorable experience on surety coverages for accident years prior to 2002.

During 2004, the Company experienced approximately $6.9 million of favorable development. Of this total, nearly $7.1 million of favorable development occurred in the property segment, specifically Inland Marine, Allied Lines, and Fire. A large portion of this favorable development within the property segment was due to a favorable settlement of an outstanding claim involved with the Northridge, California earthquake of 1994. The cumulative experience attributable to many of the casualty products for mature accident years has been materially lower than the IBNR reserves originally booked, specifically for Other Liability, Products Liability, Commercial Auto Liability, and Auto Physical Damage. Due to this positive emergence of loss and LAE experience, the Company released over $5 million during the fourth quarter of 2004 in the Personal Umbrella and Transportation product lines. These reserve releases comprise a majority of the favorable development within the casualty segment. The surety segment experienced approximately $5 million in adverse development. A portion of this development comes from contract bond coverages, where the Company increased IBNR reserves on bonds primarily written before 2003. Additionally, the Company experienced adverse development on reserves for other surety coverages, primarily related to the 2002 accident year.

The Company utilized estimates of salvage and subrogation for the surety book of business of $11,748,643 on a gross basis and $6,007,563 on a ceded basis in 2005. These amounts were $13,877,630 on a gross basis and $8,169,656 on a ceded basis in 2004.

**Environmental Exposure**

The Company has exposure to asbestos, and environmental claims through its commercial umbrella, general liability, and assumed reinsurance lines of business. The majority of the exposure is in the excess layers of the Company's commercial umbrella and assumed reinsurance books of business.

Although the Company's asbestos and environmental exposure is limited as a result of entering the liability lines after the industry had already recognized it as a problem, management cannot determine the Company's ultimate liability with any reasonable degree of certainty. The Company estimates the full impact of these exposures by establishing case basis reserves on all known losses. Reserves for related incurred but not reported losses (IBNR) are recorded based upon actuarial projections of ultimate expected losses.

This ultimate liability is difficult to assess due to evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, the Company participates primarily in the excess layers, making it difficult to assess the ultimate impact.

The Company's asbestos-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2005 and 2004 were as follows:

| | | 2005 | 2004 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 2,380,865 | 2,754,776 |
| Incurred losses and LAE | | — | (371,733) |
| Calendar year payments for losses and LAE | | (66,371) | (2,178) |
| Ending reserves | $ | 2,314,494 | 2,380,865 |
| Assumed: | | | |
| Beginning reserves | $ | 4,300,273 | 4,654,443 |
| Incurred losses and LAE | | 3,500,000 | 371,733 |
| Calendar year payments for losses and LAE | | (74,736) | (725,903) |
| Ending reserves | $ | 7,725,537 | 4,300,273 |
| Ceded: | | | |
| Beginning reserves | $ | 3,319,839 | 3,678,365 |
| Incurred losses and LAE | | 1,500,000 | — |
| Calendar year payments for losses and LAE | | (37,287) | (358,526) |
| Ending reserves | $ | 4,782,552 | 3,319,839 |
| Net: | | | |
| Beginning reserves | $ | 3,361,299 | 3,730,854 |
| Incurred losses and LAE | | 2,000,000 | — |
| Calendar year payments for losses and LAE | | (103,820) | (369,555) |
| Ending reserves | $ | 5,257,479 | 3,361,299 |

The Company holds incurred but not reported and/or bulk loss reserves related to asbestos exposure. It held such reserves in the amount of $814,239, on a gross basis and $472,436 on a net basis at December 31, 2005. At December 31, 2004, it held $1,186,715 on a gross basis and $498,510 on a net basis.

The Company held $90,471 on a gross basis and $52,493 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2005. At December 31, 2004, it held $131,857 on a gross basis and $55,390 on a net basis.



(Continued)

The Company's environmental-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2005 and 2004 were as follows:

| | | 2005 | 2004 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 14,505,358 | 21,101,898 |
| Incurred losses and LAE | | — | (2,624,442) |
| Calendar year payments for losses and LAE | | (718,547) | (3,972,098) |
| Ending reserves | $ | 13,786,811 | 14,505,358 |
| Assumed: | | | |
| Beginning reserves | $ | 1,966,957 | 2,749,058 |
| Incurred losses and LAE | | — | 962,723 |
| Calendar year payments for losses and LAE | | (53,007) | (1,744,824) |
| Ending reserves | $ | 1,913,950 | 1,966,957 |
| Ceded: | | | |
| Beginning reserves | $ | 10,115,339 | 20,479,950 |
| Incurred losses and LAE | | — | (8,736,353) |
| Calendar year payments for losses and LAE | | (173,704) | (1,628,258) |
| Ending reserves | $ | 9,941,635 | 10,115,339 |
| Net: | | | |
| Beginning reserves | $ | 6,356,975 | 3,371,006 |
| Incurred losses and LAE | | — | 7,074,634 |
| Calendar year payments for losses and LAE | | (597,849) | (4,088,665) |
| Ending reserves | $ | 5,759,126 | 6,356,975 |

The Company holds incurred but not reported and/or bulk loss reserves related to environmental exposure. It held such reserves in the amount of $7,382,439 on a gross basis and $2,543,811 on a net basis at December 31, 2005. At December 31, 2004, it held $6,800,000 on a gross basis and $2,550,000 on a net basis.

The Company held $1,302,783 on a gross basis and $448,908 on a net basis for future allocated loss adjustment expenses related to environmental exposure (including coverage dispute costs) at December 31, 2005. At December 31, 2004, it held $1,200,000 on a gross basis and $450,000 on a net basis.



(Continued)

## (8) Investment in Mt. Hawley

Condensed financial information for Mt. Hawley on a statutory basis is summarized below:

| | 2005 | 2004 |
|---|---|---|
| Balance sheet at December 31: | | |
| Assets | $ 940,322,991 | 787,782,832 |
| Liabilities | (573,231,474) | (478,692,273) |
| Total capital and surplus | $ 367,091,517 | 309,090,559 |
| Results of operations for year ended December 31: | | |
| Premium earned | $ 267,761,891 | 263,291,907 |
| Losses and underwriting expenses | 216,635,244 | 248,993,137 |
| Underwriting gain | 51,126,647 | 14,298,770 |
| Investment income, including realized gains and losses | 32,263,908 | 27,559,663 |
| Other income, net | 373,983 | 491,152 |
| Income before federal income taxes | 83,764,538 | 42,349,585 |
| Federal income tax expense | 27,962,230 | 17,112,235 |
| Net income | $ 55,802,308 | 25,237,350 |

## (9) Investment in Maui Jim

| | 2005 | 2004 |
|---|---|---|
| Balance sheet at December 31: | | |
| Total assets | $ 118,300,000 | 93,300,000 |
| Total liabilities | (32,400,000) | (28,400,000) |
| Total shareholder equity | $ 85,900,000 | 64,900,000 |
| Net income | $ 20,100,000 | 10,900,000 |



(Continued)

## (10) Federal Income Taxes

A reconciliation of federal income tax expense, computed by applying the statutory federal income tax rate of 35% in 2005 and 2004 to income before federal income taxes which includes net realized capital gains, to the income tax expense shown in the accompanying statutory financial statements is as follows:

| | | 2005 | 2004 |
|---|---|---|---|
| Computed "expected" tax expense | $ | 18,405,094 | 19,059,997 |
| Tax-exempt interest | | (2,833,889) | (2,605,557) |
| Dividends received deduction | | (2,438,498) | (1,137,981) |
| Discounting of liability for losses and loss adjustment expenses | | (379,079) | 135,317 |
| Change in unearned premiums | | 270,073 | (261,013) |
| Nondeductible goodwill | | — | 1,148,037 |
| Sale of investments | | 82,375 | 116,117 |
| Tax on net realized capital gains | | (2,057,556) | (3,181,841) |
| Tax settlement | | (3,170,975) | — |
| Other, net | | 1,181,745 | 2,134,492 |
| Federal income tax expense | $ | 9,059,290 | 15,407,568 |

Income taxes incurred in current and prior years that will be available for recoupment in the event of future net losses are $13,726,900 for 2005 and $13,153,400 for 2004.

The net deferred tax asset and the change from the prior year are comprised of the following components:

| | | December 31 | | |
|---|---|---|---|---|
| | | 2005 | 2004 | Change |
| Total gross deferred tax assets | $ | 31,417,420 | 29,783,826 | 1,633,594 |
| Total deferred tax liabilities | | (38,830,885) | (40,060,833) | 1,229,948 |
| Net deferred tax asset (liability) | $ | (7,413,465) | (10,277,007) | 2,863,542 |
| Tax effect of unrealized gains (losses) | | | | (1,681,618) |
| Change in deferred income tax | | | | $ 1,181,924 |

There are no temporary differences for which deferred tax liabilities are not recognized.



(Continued)

Deferred income tax assets and liabilities consist of the following major components:

| | December 31 | |
|---|---|---|
| | 2005 | 2004 |
| Deferred tax assets: | | |
| Loss reserves | $ 14,307,154 | 14,528,184 |
| Unearned premium reserve | 9,013,156 | 8,743,082 |
| Agents balances and other nonadmitted assets | 3,936,108 | 2,957,683 |
| Accrued expenses | 2,715,041 | 1,321,682 |
| Depreciable assets | — | 48,990 |
| Deferred compensation | 385,303 | 126,346 |
| Impairments | — | 44,643 |
| Capital loss carryforward | 703,918 | 1,717,967 |
| Defined benefit pension asset | 312,025 | 295,141 |
| Other | 44,715 | 108 |
| Total deferred tax assets | 31,417,420 | 29,783,826 |
| Nonadmitted deferred tax assets | — | — |
| Admitted deferred tax assets | 31,417,420 | 29,783,826 |
| Deferred tax liabilities: | | |
| Unrealized gains | 38,059,792 | 39,741,410 |
| Investments | 170,293 | 129,368 |
| Investment income | 145,441 | 88,785 |
| Goodwill amortization | 186,642 | 101,270 |
| Other | 268,717 | — |
| Total deferred tax liabilities | 38,830,885 | 40,060,833 |
| Net deferred tax liability | $ (7,413,465) | (10,277,007) |



(Continued)

The Company's income tax incurred and change in deferred income tax differs from the amount obtained by applying the federal statutory rate of 35% to income before income taxes as follows:

| | | 2005 | 2004 |
|---|---|---|---|
| Income before taxes, which includes net realized capital gains | $ | 52,585,984 | 54,457,134 |
| Income tax expense at 35% statutory rate | | 18,405,094 | 19,059,997 |
| Increase (decrease) in tax resulting from: | | | |
| Dividends received deduction | | (2,438,498) | (1,137,981) |
| Nondeductible expenses | | 132,232 | 170,944 |
| Tax-exempt income | | (2,833,889) | (2,605,557) |
| Goodwill amortization | | — | 1,148,037 |
| Tax settlement | | (3,170,975) | — |
| Other | | (159,042) | (324,138) |
| Total statutory income taxes | $ | 9,934,922 | 16,311,302 |
| Current income taxes incurred | $ | 9,059,290 | 15,407,568 |
| Change in deferred income tax (without tax on unrealized gains and losses) | | (1,181,924) | (2,278,107) |
| Tax on net realized capital gains | | 2,057,556 | 3,181,841 |
| Total statutory income taxes | $ | 9,934,922 | 16,311,302 |

## (11) Employee Benefits

The Company participates with its parent and other affiliates in a noncontributory defined benefit pension plan covering substantially all employees meeting the age and service eligibilities. The plan provides a benefit based on service and the highest five consecutive years' average compensation out of the last ten years of service of a participant. Compensation income included in the calculation was limited to $205,000 in 2004, as prescribed in the Internal Revenue Code. In 2005, the compensation limit was increased to $210,000. It is the Company's policy to fund pension costs as accrued, except that in no case will the Company contribute amounts less than the minimum contribution required under the Employee Retirement Income Security Act of 1974, or more than the maximum tax deductible contribution for the year. Contributions of $1,825,000 and $500,000 were made in 2005 and 2004, respectively, to fund the plan by all participating companies.

The Company has made various amendments to the plan in order to comply with certain Internal Revenue Code changes.

Additionally, on December 31, 2003, the Company's pension plan was amended to freeze benefit accruals as of March 1, 2004. As a result, the Company expensed the entire unrecognized service cost as of December 31, 2003. The plan was also closed to new participants after December 31, 2003. Participants' benefits may increase in the future based on changes in their final average earnings. Future pay increases are indexed to a maximum of 5% annually. Increases in excess of 5% will not be reflected in the determination of participants' final average earnings.



(Continued)

Effective December 31, 2005, all participant's benefits were frozen and future pay will not alter a participant's accrued benefit. In 2005, the Company shortened the amortization of the plan's unfunded gain/loss to fully amortize it over the next two years. The Company intends to terminate the plan in 2006. Given the necessary regulatory approval process, the Company expects the entire plan termination process to be completed by the close of 2007.

A breakdown of pension information by participating company is not available. However, such information on a consolidated basis is provided below.

The following table sets forth the change in the projected benefit obligation at December 31, 2005 and 2004:

| | | 2005 | 2004 |
|---|---|---|---|
| Projected benefit obligation at January 1 | $ | 13,780,874 | 12,568,183 |
| Service cost | | — | — |
| Interest cost | | 756,613 | 716,992 |
| Actuarial losses | | 1,669,392 | 821,145 |
| Benefit payments | | (1,456,761) | (325,446) |
| Curtailment cost | | (3,384,638) | — |
| Projected benefit obligation at December 31 | $ | 11,365,480 | 13,780,874 |

The following table sets forth the change in plan assets at December 31, 2005 and 2004:

| | | 2005 | 2004 |
|---|---|---|---|
| Fair value plan assets at January 1 | $ | 10,728,843 | 9,546,193 |
| Actual return on plan assets | | 416,990 | 1,008,096 |
| Employer contributions | | 1,825,000 | 500,000 |
| Benefit payments | | (1,456,761) | (325,446) |
| Fair value plan assets at December 31 | $ | 11,514,072 | 10,728,843 |



(Continued)

The following table sets forth the plan's funded status at December 31, 2005 and 2004:

| | | 2005 | 2004 |
|---|---|---|---|
| Actuarial present value of benefit obligation: | | | |
| Accumulated benefit obligation: | | | |
| Vested | $ | 11,091,207 | 10,015,356 |
| Nonvested | | 274,273 | 532,423 |
| | $ | 11,365,480 | 10,547,779 |
| Projected benefit obligation | $ | 11,365,480 | 13,780,874 |
| Plan assets at fair market value | | 11,514,072 | 10,728,843 |
| Excess (deficiency) of plan assets over projected benefit obligation | | 148,592 | (3,052,031) |
| Unrecognized net loss | | 683,789 | 4,515,262 |
| Accrued pension asset | $ | 832,381 | 1,463,231 |

The accrued pension asset is nonadmitted at December 31, 2005 and 2004.

The following table sets forth net periodic pension cost as follows:

| | | 2005 | 2004 |
|---|---|---|---|
| Interest cost | $ | 756,613 | 716,992 |
| Expected return on plan assets | | (459,791) | (698,324) |
| Recognized net loss | | 1,760,575 | 731,506 |
| Net amortization and deferral | | — | (6,517) |
| Settlement expense | | 398,453 | — |
| Net pension expense | $ | 2,455,850 | 743,657 |

The pension plan had benefit payments in excess of the sum of service cost and interest cost. This resulted in the recognition of settlement expense in 2005 as shown above.

The fair value of plan assets exceeds the actuarial present value of accumulated benefit obligations. As a result, the Company has no minimum pension liability adjustment.

The expenses of this plan are shared between the Company and its affiliates in accordance with an intercompany cost sharing arrangement. The Company's share of the net pension expense was $1,370,926 and $464,546 for 2005 and 2004, respectively.

At December 31, 2005, plan assets at fair market value are comprised of approximately 87% equity securities and 13% invested cash.



(Continued)

RLI Corp.'s investment strategy is to actively invest to optimize the return on plan assets by investing in stocks of large cap companies. The trust keeps a small percentage of assets in cash or cash equivalents for paying benefits and expenses.

RLI Corp. used the following rates to determine its projected benefit obligation: 5.5% and 5.75% settlement rate in 2005 and 2004, respectively; 0.0% and 5.0% increase in salary in 2005 and 2004, respectively, and 4.75% and 8% expected long-term return on plan assets in 2005 and 2004, respectively.

The expected long-term rate of return on plan assets is reviewed at least annually, taking into account asset allocation, historical returns on the types of assets in the trust, and the current economic environment. As the plan is scheduled to terminate in 2006, the expected long-term rate of return on plan assets was reduced to 4.75% as this more closely reflects the return on assets that the Company anticipates earning from the reinvested assets.

The ERISA required minimum contribution during the fiscal year ending December 31, 2005, is $0. Management will likely contribute the amount necessary to terminate the plan in 2006 and distribute benefits in 2007.

The Company, along with its affiliates and ultimate parent, participates in an Employee Stock Ownership Plan (ESOP), which covers substantially all employees meeting service eligibility requirements. The contributions accrued on a consolidated basis for 2005 and 2004 were $4,799,184 and $4,676,939, respectively. ESOP contributions are accrued in the year earned. The Company's share of this plan's expense was $3,001,614 and $2,977,982, respectively, for the years ended 2005 and 2004.

The Company's total expenditures for employee benefits, including ESOP and 401k contributions but excluding the cost of incentive plans discussed below, were $8,410,711 and $7,818,151 for 2005 and 2004, respectively.

The Company also participates with its parent and affiliates in management and executive incentive plans for key employees of the Company. Beginning in 1997, the Company established an additional provision allowing for employee bonus participation. The management incentive plan is subject to limitations and is based on minimum profit levels and varying percentages of managers' salaries. Executive and employee bonuses are based on a requirement that RLI Corp. generate a return on equity in excess of its cost of capital before either the funding of the ESOP or the payment of officer bonuses. Total consolidated amounts expensed under these plans for 2005 and 2004 were $9,173,458 and $6,833,012, respectively. The Company's share of this plan's expense was $5,037,792 and $3,428,128, respectively, for the years ended 2005 and 2004.

In August 2002, the Company, along with its affiliates and ultimate parent, began offering certain eligible employees post-employment medical coverage. Under the Company's plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under the Company's health plan. Employees who elect continuation of coverage pay the full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. The Company expects a relatively small number of employees will become eligible for this benefit. The Company receives an allocation for its share of these costs, which is not material. The Company does not provide compensated absences.



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RLI Corp., the Company's ultimate parent, grants to officers and directors stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant. Through December 31, 2005, RLI Corp. accounted for stock option grants in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and accordingly recognized no compensation expense for the stock option grants. During 2005, RLI Corp. modified the plan to allow accelerated vesting of unvested stock options, including directors' stock options. As a result of this modification, $850,000 of accelerated stock option expense was recorded in 2005. The Company received an allocation for its share of these expenses, which was not material.

Beginning January 1, 2004, the Company began offering a 401(k) plan, which covers substantially all employees. The Company provides a base contribution of 3% of the participants' wages, with an additional discretionary contribution made, subject to the achievement of certain overall financial goals. The consolidated amount expensed under this plan in 2005 and 2004 was $2,577,606 and $1,994,413, respectively. A 3.0% discretionary contribution was made to the 401k plan in 2005.

**(12) Commitments and Contingent Liabilities**

The Company has an accrual for assessments at December 31, 2005 of $1,800,000. A related asset for premium tax credits has been established in the amount of $180,000. It is not possible at this time to determine the periods over which the assessments are expected to be paid, or the period over which the recorded premium tax offsets are expected to be realized.

The Company is the plaintiff in an action captioned RLI Insurance Co. v. Commercial Money Center, et al., which was filed in U.S. District Court, Southern District of California (San Diego) on February 1, 2002. Other defendants in that action are Commercial Servicing Corporation (CSC), Sterling Wayne Pirtle, Anita Pirtle, Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, and Sky Bank. The Company filed a similar complaint against the Bank of Waukegan in San Diego, California Superior Court. Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, Sky Bank, and Bank of Waukegan are referred to as the Investor Banks. The litigation arises out of the equipment and vehicle leasing program of Commercial Money Center (CMC). CMC would originate leases, procure bonds pertaining to the performance of obligations of each lessee under each lease, then formed "pools" of such leases that it marketed to banks and other institutional investors. The Company sued for rescission and/or exoneration of the bonds the Company issued to CMC and sale and servicing agreements the Company entered into with CMC and the Investor Banks, which had invested in CMC's equipment leasing program. The Company contends that it was fraudulently induced to issue the bonds and enter into the agreements by CMC, who misrepresented and concealed the true nature of its program and the underlying leases originated by CMC (for which bonds were procured). The Company also sued for declaratory relief to determine its rights and obligations, if any, under the instruments. Each Investor Bank disputes the Company's claims for relief. CMC is currently in Chapter 7 bankruptcy proceedings.



(Continued)

Between the dates of April 4 and April 18, 2002, each Investor Bank subsequently filed a complaint against the Company in various state courts, which the Company removed to U.S. District Courts. Each Investor Bank sued the Company on certain bonds the Company issued to CMC as well as a sale and servicing agreement between the Investor Banks, CMC, and the Company. Each Investor Bank sued for breach of contract, bad faith, and other extra-contractual theories. The Company has answered and denies each Investor Bank's entitlement to relief. The Investor Banks claim entitlement to aggregate payment of approximately $53 million under either the surety bonds or the sale and servicing agreements, plus unknown extra-contractual damages, attorney's fees, and interest. On October 25, 2002, the judicial panel for multi district litigation (MDL panel) transferred 23 actions pending in five federal districts involving numerous Investor Banks, five insurance companies, and CMC to the Northern District of Ohio for consolidated pretrial proceedings, assigning the litigation to The Honorable Kathleen O'Malley. In the third quarter of 2005, the Company reached a confidential settlement agreement with Lakeland Bank. This settlement ends our litigation with Lakeland, but does not resolve our pending litigation with the four other investor banks. The settlement with Lakeland relates to surety bonds representing approximately 17% of the amount to which the five investor banks had claimed entitlement. The settlement did not have a material adverse effect on our financial statements taken as a whole. In addition, in August 2005, the Federal District Court denied outright the investor banks' motion for judgment on the pleadings as to the Company and subsequently ordered all remaining cases to mandatory mediation. Mediations held in January 2006 between the Company and each of the four remaining investor banks did not resolve the claims of those investor banks. While we cannot predict the ultimate outcome of the pending litigation between the Company and the remaining four investor banks at this time, the Company continues to believe it has meritorious defenses with respect to each of the banks making claims against it and will continue to vigorously assert those defenses in the pending litigation.

The Company's financial statements contain an appropriate accrual for defense costs related to this matter, included in unpaid losses and settlement expenses, as well as an accrual to cover rescission of the collected premiums related to this program. In the opinion of management, final resolution of this matter will not have a material adverse effect of the Company's financial condition, results of operations, or cash flows. However, litigation is subject to inherent uncertainties, and if there were an outcome unfavorable to the Company, there exists the possibility of a material adverse impact on the Company's financial condition, results of operations, or cash flows in the period in which the outcome occurs.

The Company is party to numerous claims and losses that arise in the normal course of the Company's business. Many of such claims or losses involve claims under policies that the Company underwrites as an insurer. The Company believes that the resolution of these claims and losses will not have a material adverse effect on the Company's financial condition, results of operations, or cash flows.



(Continued)

## (13) Leases

The Company leases regional office facilities and computers under operating leases. These leases expire in various years through 2010. Minimum future rental payments under noncancelable leases are as follows:

| | | |
|---|---|---|
| 2006 | $ | 2,883,054 |
| 2007 | | 2,415,586 |
| 2008 | | 1,907,616 |
| 2009 | | 1,598,618 |
| 2010 | | 1,302,581 |
| Total minimum future rental payments | $ | 10,107,455 |

The Company shares rental expense with its affiliate, Mt. Hawley, through an intercompany cost sharing agreement. The Company's portion of rental expense for 2005 and 2004 was $1,496,990 and $1,032,140, respectively.

## (14) Events Subsequent

On January 7, 2006, an affiliate of the Company, Maui Jim, Inc., declared a dividend payable in the first quarter of 2006 to shareholders of record on January 23, 2006. The Company's share of the Maui Jim dividend was $16.5 million. The Company, therefore, recognized a statutory deferred tax benefit in December 2005 in the amount of $3.9 million from applying the lower tax rate applicable to affiliated dividends, as compared to the corporate capital gains rate on which the deferred tax liabilities were previously estimated. On January 23, 2006, the Company paid a dividend of shares from the Company to its parent, RLI Corp., as approved by the Illinois Department of Financial and Professional Regulation – Division of Insurance, for 100% of the carrying value of its investment in Maui Jim which was valued at $35.2 million.

In May 2006, the Company entered into a closing agreement with respect to an exam conducted by the Internal Revenue Service which reduces current income tax liability and income tax expense and increases surplus by $3,170,975. This reduction relates to a change in estimate for a tax exposure item for prior audit years, specifically 2000 through 2004. The Company has reflected this change in estimate in the 2005 audited Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus, and the Statutory Statements of Income and Changes to Capital and Surplus, in accordance with SSAP No.3 and SSAP No. 9.



(Continued)

## (15) Reconciliation to the Annual Statement

Subsequent to filing of the 2005 annual statement, the Company made adjustments for differences between the Annual Statement filed with the Illinois Department of Financial and Professional Regulation – Division of Insurance and other regulatory authorities and the accompanying 2005 audited statutory financial statements. These adjustments were the result of a Type I subsequent event with respect to an income tax settlement from an exam conducted by the Internal Revenue Service for which the Company entered into a closing agreement in May 2006. The following is a summary of those adjustments:

| | | 2005 |
|---|---|---|
| Net income per Annual Statement | $ | 38,298,163 |
| Adjustment to reduce income tax expense for tax settlement | | 3,170,975 |
| Net income as reported herein | $ | 41,469,138 |
| Total liabilities per Annual Statement | $ | 609,723,904 |
| Adjustment to reduce income tax liability for tax settlement | | (3,170,975) |
| Total liabilities as reported herein | $ | 606,552,929 |
| Unassigned surplus per Annual Statement | $ | 438,095,213 |
| Adjustment for tax settlement | | 3,170,975 |
| Unassigned surplus as reported herein | $ | 441,266,188 |
| Total capital and surplus per Annual Statement | $ | 690,546,672 |
| Adjustment for tax settlement | | 3,170,975 |
| Total capital and surplus as reported herein | $ | 693,717,647 |

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risks Interrogatories

December 31, 2005

1.) Total admitted assets: $ 1,300,270,576

2.) 10 largest exposures to a single issuer/borrower/investment:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Co. | $ 367,091,517 | 28.2% |
| Maui Jim, Inc. | 35,217,198 | 2.7% |
| Bear Stearns Comm Mtg | 7,440,698 | 0.6% |
| Bank of America Corp | 7,190,286 | 0.6% |
| Maryland State | 6,136,076 | 0.5% |
| Portand Oregon Swr Sys Rev | 5,963,394 | 0.5% |
| Morgan Stanley Capital | 5,823,437 | 0.4% |
| Citibank Credit Card Trust | 5,776,466 | 0.4% |
| Louisiana State | 5,035,958 | 0.4% |
| Pennsylvania State | 4,990,335 | 0.4% |

3.) Total admitted assets held in bonds by NAIC rating:

| Bonds | Amount | Percentage |
|---|---|---|
| NAIC-1 | $ 548,082,561 | 42.2% |
| NAIC-2 | 23,562,975 | 1.8% |
| NAIC-3 | — | — |
| NAIC-4 | — | — |
| NAIC-5 | — | — |
| NAIC-6 | — | — |

The Company holds one preferred stock rated P/RP-1 in the amount of $104.

4.) Assets held in foreign investments:

| | |
|---|---|
| Total admitted assets held in foreign investments | None |
| Foreign-currency denominated investments | None |
| Insurance liabilities denominated in that same foreign currency | None |

5.) Assets held in foreign investments represent less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatories 5 – 10.

11.) Assets held in Canadian investments and unhedged Canadian currency exposure is less than 2.5% of the reporting entity's total admitted assets, therefore, detail not required.

12.) There were no admitted assets held in investments with contractual sales restrictions.

13.) Admitted assets held in the largest 10 equity interests:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Co. | $ 367,091,517 | 28.2% |
| Maui Jim, Inc. | 35,217,198 | 2.7% |
| Bank of America Corp | 5,538,000 | 0.4% |
| Exxon Mobil Corporation | 4,718,280 | 0.4% |
| J.P. Morgan Chase & Co. | 4,285,329 | 0.3% |
| Wachovia Corporation | 4,032,161 | 0.3% |
| Monsanto | 3,876,500 | 0.3% |
| Johnson & Johnson | 3,726,200 | 0.3% |
| Caterpillar Inc | 3,697,280 | 0.3% |
| Citigroup | 3,688,280 | 0.3% |

14.) There were no assets held in nonaffiliated, privately placed equities, exceeding 2.5% of the Company's total admitted assets.



(Continued)

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risks Interrogatories

December 31, 2005

15.) There were no admitted assets held in general partnership interests that exceeded 2.5% of the Company's total admitted assets.

16.) There were no mortgage loans reported on the Company's Annual Statement Schedule B; therefore, detail not required for interrogatories 16 and 17.

18.) Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in the Annual Statement Schedule A, less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatory 18.

19.) Total admitted assets subject to the following types of agreements:

| | At year end | | At end of each quarter | | |
|---|---|---|---|---|---|
| Agreement type | Amount | Percentage | 1st Qtr | 2nd Qtr | 3rd Qtr |
| Securities lending | $ 16,500,713 | 1.3% | $ 22,934,931 | 14,598,327 | 14,857,532 |
| Repurchase | — | — | — | — | — |
| Reverse repurchase | 6,218,750 | 0.5% | 32,258,750 | 22,205,250 | 6,501,250 |
| Dollar repurchase | — | — | — | — | — |
| Dollar reverse repurchase | — | — | — | — | — |

20.) The Company owns no warrants not attached to other financial instruments, options, caps, and floors.

21.) The Company has no exposure to collars, swaps, or forwards.

22.) The Company has no exposure for future contracts.

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2005

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Bonds: | | | | |
| U.S. Treasury Securities | $ 9,899,920 | 0.82% | $ 9,899,920 | 0.82% |
| U.S. Government agency and corporate obligations: | | | | |
| Issued by U.S. Government agencies | 5,184,896 | 0.43 | 5,184,896 | 0.43 |
| Issued by U.S. Government-sponsored agencies | 87,724,432 | 7.25 | 87,724,432 | 7.25 |
| Foreign government: | | | | |
| Securities issued by states, territories, and political subdivisions in the U.S.: | | | | |
| State, territory, and possession general obligations | 43,253,386 | 3.57 | 43,253,386 | 3.57 |
| Political subdivisions of states, territories, and possessions' political subdivisions' general obligations | 55,267,051 | 4.57 | 55,267,051 | 4.57 |
| Revenue and assessment obligations | 140,432,956 | 11.60 | 140,432,956 | 11.61 |
| Industrial development and similar obligations | — | 0.00 | — | 0.00 |
| Mortgage-backed securities: | | | | |
| Pass-through securities: | | | | |
| Guaranteed by GNMA | 6,806,895 | 0.56 | 6,806,895 | 0.56 |
| Issued by FNMA and FHLMC | 42,879,111 | 3.54 | 42,879,111 | 3.54 |
| All other | 51,906,401 | 4.29 | 51,906,401 | 4.29 |
| CMOs and REMICs: | | | | |
| Issued by FNMA, FHLMC, GNMA or VA | 22,801,893 | 1.88 | 22,801,893 | 1.88 |
| Issued by non-U.S. Government issuers and collateralized by mortgage backed securities issued or guaranteed by above agencies | 1,500,000 | 0.12 | 1,500,000 | 0.12 |
| All other | 2,413,030 | 0.20 | 2,413,030 | 0.20 |
| Other debt and other fixed income securities: | | | | |
| Unaffiliated domestic securities | 101,550,589 | 8.39 | 101,550,589 | 8.39 |
| Unaffiliated foreign securities | 24,976 | 0.00 | 24,976 | 0.00 |
| Affiliated securities | — | 0.00 | — | 0.00 |
| Equity interests: | | | | |
| Investments in mutual funds | — | 0.00 | — | 0.00 |
| Preferred stocks: | | | | |
| Affiliated | — | 0.00 | — | 0.00 |
| Unaffiliated | 104 | 0.00 | 104 | 0.00 |
| Publicly traded equity securities: | | | | |
| Affiliated | | | | |
| Unaffiliated | 203,847,814 | 16.84 | 203,847,814 | 16.85 |
| Tangible personal property under lease: | | | | |
| Affiliated | — | 0.00 | — | 0.00 |
| Unaffiliated | — | 0.00 | — | 0.00 |
| Other equity securities: | | | | |
| Affiliated | 404,485,860 | 33.42 | 404,485,860 | 33.43 |
| Unaffiliated | 3,482,558 | 0.29 | 3,482,558 | 0.29 |



(Continued)

Schedule 2

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2005

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Mortgage loans: | | | | |
| Construction and land development | $ — | 0.00% | $ — | 0.00% |
| Agricultural | — | 0.00% | — | 0.00 |
| Single family residential properties | — | 0.00% | — | 0.00 |
| Multifamily residential properties | — | 0.00% | — | 0.00 |
| Commercial loans | — | 0.00% | — | 0.00 |
| Real estate investments: | | | | |
| Property occupied by company | 6,285,336 | 0.52 | 6,081,232 | 0.50 |
| Property held for production of income | — | 0.00 | — | 0.00 |
| Property held for sale | — | 0.00 | — | 0.00 |
| Policy loans | — | 0.00 | — | 0.00 |
| Receivable for securities | — | 0.00 | — | 0.00 |
| Cash and short term investments | 14,035,782 | 1.16 | 14,035,782 | 1.16 |
| Write-in invested assets | 6,500,000 | 0.54 | 6,500,000 | 0.54 |
| Total invested assets | $ 1,210,282,990 | 100.00% | $ 1,210,078,886 | 100.00% |

See accompanying independent auditors' report.

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# RLI INSURANCE COMPANY

Statutory Financial Statements and Schedules

December 31, 2006 and 2005

(With Independent Auditors' Report Thereon)

KPMG LLP
303 East Wacker Drive
Chicago, IL 60601-5212

## Independent Auditors' Report

The Board of Directors
RLI Insurance Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and capital and surplus of RLI Insurance Company (the Company) as of December 31, 2006 and 2005, and the related statutory statements of income and changes in capital and surplus, and cash flow for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 1 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance (Division), which practices differ from U.S. generally accepted accounting principles. The effects on the statutory financial statements of the variances between the statutory accounting practices and U.S. generally accepted accounting principles also are described in note 1.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of RLI Insurance Company as of December 31, 2006 and 2005, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus of RLI Insurance Company as of December 31, 2006 and 2005, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

KPMG

Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included on the Schedule of Supplemental Investment Risks Interrogatories, the Summary Investment Schedule and the Supplemental Schedule of Reinsurance Interrogatories is presented for purposes of additional analysis and is not a required part of the basic statutory financial statements, but is information required to be presented by the Division. Such information has been subjected to the auditing procedures applied in the audits of the basic statutory financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole.

KPMG LLP

May 28, 2007

## RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2006 and 2005

| Admitted Assets | 2006 | 2005 |
|---|---|---|
| Bonds | $ 570,395,254 | 571,645,536 |
| Common stocks | 238,129,061 | 207,330,372 |
| Preferred stocks | — | 104 |
| Investment in affiliates | 417,531,543 | 404,485,860 |
| Real estate occupied by the Company, at cost, less accumulated depreciation of $7,837,411 and $7,282,192 in 2006 and 2005, respectively | 6,083,219 | 6,081,232 |
| Cash and short-term investments | 26,933,093 | 14,035,782 |
| Other invested assets | 9,500,000 | 6,500,000 |
| Total cash and invested assets | 1,268,572,170 | 1,210,078,886 |
| Uncollected premiums and agents' balances | 50,176,886 | 54,880,790 |
| Funds held by or deposited with reinsured companies | 4,000 | 4,000 |
| Reinsurance recoverable on paid losses and loss adjustment expenses | 33,767,293 | 21,397,323 |
| Electronic data processing equipment, at cost less accumulated straight-line depreciation of $21,846,272 and $20,456,912 in 2006 and 2005, respectively | 1,067,717 | 1,490,986 |
| Investment income due and accrued | 8,008,485 | 7,330,537 |
| Other assets | 4,713,544 | 5,088,054 |
| Total admitted assets | $ 1,366,310,095 | 1,300,270,576 |

| Liabilities and Capital and Surplus | 2006 | 2005 |
|---|---|---|
| Unpaid losses and loss adjustment expenses | $ 359,017,609 | 351,665,308 |
| Reinsurance payable on paid losses | 256,554 | 357,089 |
| Accrued expenses | 33,921,591 | 31,107,127 |
| Borrowed money including accrued interest | — | 6,254,554 |
| Unearned premiums | 130,212,740 | 128,759,357 |
| Advance premiums | 3,500,752 | 3,897,814 |
| Ceded reinsurance premiums payable | 30,883,761 | 30,710,750 |
| Funds held under reinsurance agreements | 918,936 | 605,482 |
| Amounts withheld | 13,485,228 | 18,299,338 |
| Provision for reinsurance | 3,847,000 | 4,779,400 |
| Payable to affiliates | 1,024,009 | 3,293,020 |
| Payable for securities | 1,082,820 | 1,990,357 |
| Federal income taxes including deferred tax liability of $19,846,085 and $7,413,465 in 2006 and 2005, respectively | 23,911,534 | 8,233,092 |
| Commissions payable, contingent commissions, and other similar charges | 15,825,241 | 15,199,322 |
| Other liabilities | 1,516,905 | 1,400,919 |
| Total liabilities | 619,404,680 | 606,552,929 |
| Capital and surplus: | | |
| Capital stock, $125 par value. Authorized 1,000,000 shares; issued and outstanding 80,003 shares | 10,000,375 | 10,000,375 |
| Paid-in contributed capital | 242,451,084 | 242,451,084 |
| Unassigned surplus | 494,453,956 | 441,266,188 |
| Total capital and surplus | 746,905,415 | 693,717,647 |
| Total liabilities and capital and surplus | $ 1,366,310,095 | 1,300,270,576 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Income and Changes in Capital and Surplus

Years ended December 31, 2006 and 2005

| | 2006 | 2005 |
|---|---|---|
| Premiums earned | $ 227,970,972 | 223,431,678 |
| Losses and underwriting expenses incurred: | | |
| Losses and loss adjustment expenses | 104,746,105 | 117,419,515 |
| Other underwriting expenses | 100,130,312 | 93,407,002 |
| Total losses and underwriting expenses incurred | 204,876,417 | 210,826,517 |
| Net underwriting gain | 23,094,555 | 12,605,161 |
| Net investment income | 32,235,270 | 33,204,519 |
| Net realized capital gains, net of tax impact of $13,629,952 and $2,057,556 for 2006 and 2005, respectively | 25,312,767 | 3,821,176 |
| Total investment income | 57,548,037 | 37,025,695 |
| Other income, net | 724,733 | 897,572 |
| Income before federal income taxes, net of tax on realized gains | 81,367,325 | 50,528,428 |
| Federal income tax expense | 8,827,800 | 9,059,290 |
| Net income | 72,539,525 | 41,469,138 |
| Capital and surplus at beginning of year | 693,717,647 | 605,966,803 |
| Change in unrealized appreciation of investments (net of tax) | 45,421,257 | 63,127,536 |
| Change in net deferred income tax | (5,392,352) | 1,181,924 |
| Change in nonadmitted assets | (817,254) | 7,772,461 |
| Change in provision for reinsurance | 932,400 | (2,224,000) |
| Dividends to stockholder | (59,495,808) | (13,036,489) |
| Paid-in surplus | — | 28,235 |
| Goodwill write-off to surplus | — | (10,567,961) |
| Capital and surplus at end of year | $ 746,905,415 | 693,717,647 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Cash Flow

Years ended December 31, 2006 and 2005

| | 2006 | 2005 |
|---|---|---|
| Operating activities: | | |
| Premiums collected, net of reinsurance | $ 233,477,057 | 244,677,272 |
| Investment income, net of investment expense | 34,509,282 | 36,583,974 |
| Other income, net | 724,733 | 904,979 |
| Benefits and loss related payments | (83,682,416) | (83,766,797) |
| Commissions and other expenses paid | (122,871,822) | (109,981,258) |
| Federal income taxes paid | (19,211,930) | (20,461,911) |
| Net cash flow from operations | 42,944,904 | 67,956,259 |
| Investing activities: | | |
| Cash provided from investments sold, matured, or repaid: | | |
| Bonds | 150,832,163 | 111,411,512 |
| Stocks | 75,172,615 | 19,977,240 |
| Other invested assets | 2,000,000 | 1,500,000 |
| Miscellaneous proceeds | 11,995 | 1,991,053 |
| Cost of investments acquired: | | |
| Bonds | (154,986,257) | (133,273,332) |
| Stocks | (25,779,237) | (19,604,736) |
| Real estate | (688,390) | (1,002,976) |
| Other invested assets | (5,000,000) | (6,000,000) |
| Miscellaneous applications | (907,536) | — |
| Net cash flow from investing activities | 40,655,353 | (25,001,239) |
| Financing and miscellaneous activities: | | |
| Capital and surplus paid in | — | 28,235 |
| Borrowed funds repaid | (6,254,554) | (25,986,665) |
| Dividends to stockholders | (59,495,808) | (13,036,489) |
| Other cash applied | (4,952,584) | (696,114) |
| Net cash flow from financing and miscellaneous activities | (70,702,946) | (39,691,033) |
| Net change in cash | 12,897,311 | 3,263,987 |
| Cash and short-term investments at beginning of year | 14,035,782 | 10,771,795 |
| Cash and short-term investments at end of year | $ 26,933,093 | 14,035,782 |

See accompanying notes to statutory financial statements.

## (1) Background and Significant Accounting Policies

### *(a) Organization*

RLI Insurance Company (the Company or RLI) is a wholly owned subsidiary of RLI Corp. The Company is primarily engaged in writing selected property and casualty insurance, including difference in conditions, homeowners, general and product liability, directors and officers, commercial fire, commercial and personal umbrella, marine, employers' excess indemnity, commercial auto, and contract and miscellaneous surety bonds. The Company's principal market is the United States, with a concentration on the West Coast, where commercial earthquake coverage (difference in conditions) is significant.

### *(b) Basis of Presentation*

The accompanying statutory financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance (Division). The National Association of Insurance Commissioners' *Accounting Practices and Procedures* (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the Division. The Division has adopted substantially all of the prescribed accounting practices as stated in the NAIC SAP and the Company has no material permitted accounting practices. Statutory accounting practices differ in certain respects from U.S. generally accepted accounting principles (GAAP). The most significant differences include:

(1) Acquisition costs related to premiums written are expensed as incurred, rather than deferred to the extent recoverable and charged to operations ratably over the period covered by the related insurance policies as prescribed by GAAP.

(2) Investments in bonds are not classified as to the Company's intention to trade, hold to maturity, or make available for sale. Investments in bonds are generally carried at amortized cost rather than fair value. Accordingly, unrealized changes in fair value attributable to bonds are not reflected in the statutory statements of income and changes in capital and surplus.

(3) Certain assets are designated as nonadmitted assets and are charged to surplus, as opposed to being carried at amounts recoverable for GAAP purposes.

(4) The realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles No. 10 – *Income Taxes* (SSAP 10). Any gross deferred tax assets determined to be not realizable within one year are nonadmitted for statutory accounting purposes. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in tax expense under GAAP, whereas under statutory accounting principles, these changes directly impact surplus.

(5) A liability is established, which is not required under GAAP, by a direct charge to unassigned surplus for unsecured reinsurance recoverables from unauthorized reinsurers and certain past



(Continued)

due amounts from authorized reinsurers, rather than just providing for the estimated amounts deemed uncollectible.

(6) The liability for unpaid losses and loss adjustment expenses is reported net of reinsurance recoverables, and unearned premiums are reported net of prepaid reinsurance premiums, rather than presenting these amounts gross of the effects of reinsurance ceded for GAAP.

(7) Wholly owned insurance subsidiaries are reflected at net statutory book value with changes reflected directly in capital and surplus, as opposed to consolidation of assets and liabilities and income on the financial statements for GAAP.

(8) The statutory statement of cash flow differs in certain respects from the presentation required by Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows,* including the presentation of the changes in cash and short-term investments instead of cash and cash equivalents. Short-term investments include securities with original maturities of one year or less at the time of acquisition.

(9) Comprehensive income, which is required under GAAP, is not determined for statutory reporting purposes.

Under GAAP, for the years ended December 31, 2006 and 2005, the Company had net income of $51,177,955 and $50,757,877, respectively. The Company's GAAP shareholder's equity amounted to $867,995,226 and $784,088,769 at December 31, 2006 and 2005, respectively.

Significant statutory accounting policies are as follows:

*(c) Investments*

Bonds are generally stated at amortized cost with the discount or premium on bonds amortized using the scientific method. Short-term investments are valued at cost, which approximates fair value, and are considered cash equivalents in the statutory financial statements. Real estate is valued at cost less accumulated depreciation, which is computed on a straight-line basis over the estimated useful lives of the properties.

All of the Company's loan-backed securities were purchased subsequent to January 1, 1994. Loan-backed securities are stated at either amortized cost or the lower of amortized cost or fair value dependent upon NAIC designations. Loan-backed securities are revalued using currently estimated cash flow, including new prepayment assumptions, under the retrospective methodology. Prepayment assumptions for single class and multiclass mortgage-backed securities were obtained from external sources.

Unaffiliated common stocks are carried at values assigned by the NAIC. Stocks of affiliates in which the Company has an interest of 20% or more are carried based upon the affiliate's audited statutory surplus. Dividends on stocks are credited to income on the ex-dividend date. Realized investment gains and losses are determined at the trade date on the basis of the specific-identification method and are reflected in net income. Unrealized gains or losses are charged or credited directly to unassigned surplus, net of provision for deferred income taxes.


(Continued)

The Company reviews the values of their investments in bonds and common stocks on a quarterly basis for other-than-temporary losses. Investments that have a fair value that is less than cost or amortized cost are evaluated for other-than-temporary impairment. If this review suggests that a decline in fair value is other than temporary, the carrying value in the investment is reduced to its fair value through an adjustment to earnings.

***(d) Investment in Affiliates and Related Parties***

The Company owns 100% of the common stock of Mt. Hawley Insurance Company (Mt. Hawley), Safefleet Insurance Services, Inc. (Safefleet), RLI Insurance Ltd (RLI Ltd), Underwriters Indemnity General Agency (UIGA), and RLI Underwriting Services, Inc. (RLI US). Mt. Hawley is engaged in writing excess and surplus lines of insurance. The Company's investment in Mt. Hawley is carried at cost plus equity in statutory net income and surplus adjustments since the date of formation, less dividends received. Changes in the carrying value of the Company's investment in Mt. Hawley are reflected directly in unassigned surplus. Mt. Hawley maintains at December 31, 2006 an investment of 1,996,058 shares in its ultimate parent, RLI Corp. The estimated fair value of this common stock at December 31, 2006, after reduction of Mt. Hawley's reciprocal ownership, was $43,961,773.

Safefleet, RLI Ltd, UIGA, and RLI US are valued based on their underlying audited GAAP equity adjusted to a statutory basis of accounting under the provisions of SSAP No. 88, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46,* which supersedes SSAP No. 46, *Investments in Subsidiary, Controlled and Affiliated Entities,* and was adopted as of January 1, 2005. Per SSAP No. 88, the Company has nonadmitted its investment in Safefleet, UIGA, and RLI US since external audits are not conducted individually for these subsidiaries.

***(e) Revenue Recognition***

Premiums, net of reinsurance, are earned and recognized as revenue ratably over the period of the underlying policies. Unearned premiums, which are reflected net of reinsurance, represent the pro rata portion of premiums written, which are applicable to the unexpired terms of the policies in force.

***(f) Acquisition Costs***

The costs of acquiring insurance premiums (principally commissions and premium taxes) are charged to current operations as incurred.

***(g) Liability for Unpaid Losses and Loss Adjustment Expenses***

The estimated liability for unpaid losses and loss adjustment expenses includes a provision for reported and unpaid losses as well as estimates of losses incurred but not reported, net of amounts covered by reinsurance. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social, and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. As these amounts are determined based upon estimates, the ultimate liability may be more or less than such estimates. Based on the current assumptions used in calculating reserves, management


(Continued)

believes that the Company's overall reserve levels at December 31, 2006 make a reasonable provision to meet its future obligations.

***(h) Federal Income Taxes***

The Company files a consolidated federal income tax return with its parent and affiliates. The provision for federal income taxes is based on current taxable income. The method of allocation between the companies is subject to written agreement and approved by the board of directors. Allocation is based on the ratio of that portion of the separate company taxable income each member bears to the total taxable income of the group. Intercompany tax balances are settled annually.

Current year federal income tax expense is based on financial reporting income or loss adjusted for certain permanent and timing differences. The timing differences are the result of dissimilar financial reporting and tax basis accounting methods. A net deferred tax asset, representing the tax effect of timing differences between financial reporting and the tax basis of assets and liabilities, is only reported as an admitted asset to the extent that it will be realized within one year, subject to certain limitations, or to the extent that it offsets deferred tax liabilities. The change in net deferred tax asset or liability is reflected directly in surplus.

***(i) Provision for Reinsurance***

A statutory reinsurance liability must be established for unsecured amounts ceded to unauthorized reinsurers and certain amounts of past due recoverables from authorized reinsurers. This amount is recorded through a direct charge to unassigned surplus.

***(j) Nonadmitted Assets***

Certain assets (principally direct premiums 90-days past due, office furniture and equipment, certain receivables, certain investments in affiliates, and deferred tax assets in excess of specified thresholds) are designated as nonadmitted assets and charged to unassigned surplus.

***(k) Allowance for Uncollectible Reinsurance***

Periodically an allowance representing an estimate of unrecoverable amounts on both paid and unpaid recoverables from troubled or insolvent reinsurers is provided through a charge to income. The Company believes that current reserve levels for uncollectible reinsurance are sufficient to cover the related exposure.

***(l) Depreciation and Amortization***

Currently all depreciation and amortization is calculated using the straight-line method. The useful lives are as follows: 3 years for computers and external operating software; and 5 to 40 years for tenant improvements and real estate. Depreciation and amortization expense for the Company totaled $1,836,502 and $1,721,848 for 2006 and 2005, respectively.

***(m) Risks and Uncertainties***

Certain risks and uncertainties are inherent to the Company's day-to-day operations and to the process of preparing its statutory financial statements. The more significant of those risks and

uncertainties, as well as the Company's methods for attempting to mitigate, quantify, and minimize such risks and uncertainties, are presented below and throughout the notes to the statutory financial statements.

**Catastrophe Exposures**

The Company's past and present insurance coverages include exposure to catastrophic events. Certain of the Company's property policies cover catastrophic events such as earthquakes, floods, and windstorms. The Company has a concentration of such coverages in California (15% of total property direct premiums written). Using computer-assisted techniques, the Company quantifies and monitors its exposure to catastrophic events. The Company limits its risk to such catastrophes through the purchase of reinsurance.

**Environmental Exposures**

The Company is subject to environmental claims and exposures through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, management has attempted to mitigate or control the extent of this exposure through the following methods: 1) the Company's policies include pollution exclusions that have been continually updated to further strengthen the exclusion; 2) the Company's policies primarily cover moderate hazard risks; and 3) the Company began writing this business after the industry became aware of the potential pollution liability exposure.

The Company includes historical environmental loss experience with the remaining loss experience in the applicable line of business to project ultimate incurred losses and loss adjustment expenses and related incurred but not reported loss and loss adjustment expense reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, the Company has used this experience to record loss and loss adjustment expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 7.

**Reinsurance**

Reinsurance does not discharge the Company from its primary liability to policyholders and, to the extent that a reinsurer is unable to meet its obligations, the Company would be liable. The Company reviews and monitors the financial condition of prospective and existing reinsurers and currently attempts to purchase reinsurance from a limited number of financially strong reinsurers. As discussed above, the Company provides a reserve for reinsurance balances deemed uncollectible.

**Investments**

The Company is exposed to risks that issuers of securities owned by the Company will default, or that interest rates will change and cause a decrease in the value of its investments. Management attempts to mitigate these risks by investing in high grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.



(Continued)

**Use of Estimates**

The preparation of statutory financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ from those estimates. The most significant of these amounts is the liability for unpaid losses and loss adjustment expenses. Management continually updates its estimates as additional data becomes available and adjusts the statutory financial statements as deemed necessary. Other estimates such as the recoverability of reinsurance balances are constantly monitored, evaluated, and adjusted. Although recorded estimates are supported by actuarial computations and other data, the estimates are ultimately based on management's expectations of future events. It is reasonably possible that expectations associated with these accounts can change in the near term (i.e., one year) and that the effect of these changes could be material to the statutory financial statements.

**External Factors**

The Company is regulated by the State in which it is domiciled, as well as states in which it does business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments, and regulate rates, insurers may charge for various products. The Company is also subject to insolvency and guarantee fund assessments for policyholder losses covered by insolvent insurers. The Company generally accrues the full amount of the assessment as insolvencies occur.

The NAIC has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory capital and surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written, and unearned premium) risk. The NAIC calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. The Company continuously monitors its internal capital requirements and the NAIC's RBC developments. The Company has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that the Company's capital levels are sufficient to support the level of risk inherent in its operations.

***(n) Fair Value Disclosures***

Equity securities are valued using NAIC fair value prices, if available. If a NAIC fair value is not available, fair value is estimated using quoted market prices of the security or similar securities. Equity securities are carried at NAIC fair value, whereas bonds are generally carried at amortized cost. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, and accounts payable, the carrying value of each is a reasonable estimate of fair value. Fair values of bonds are disclosed in note 2.



(Continued)

*(o) Significant Events*

On January 7, 2006, an affiliate of the Company, Maui Jim, Inc., (Maui Jim) declared a dividend payable in the first quarter of 2006 to shareholders of record on January 23, 2006. The Company's share of the Maui Jim dividend was $16.5 million. In determining the related tax impact, as of December 2005, the Company recognized a statutory deferred tax benefit in the amount of $3.9 million from applying the lower tax rate applicable to affiliated dividends, as compared to the corporate capital gains rate on which the deferred tax liabilities were previously estimated.

On January 23, 2006, the Company paid a dividend of shares from the Company to its parent, RLI Corp., as filed with the Division, for 100% of the carrying value of its investment in Maui Jim, which was valued at $35.2 million.

On April 28, 2006, the Company paid a dividend of shares from the Company to its parent, RLI Corp., as filed with the Division, for 100% of the carrying value of its investment in Taylor, Bean and Whitaker Mortgage Corp., which was valued at $13.4 million.

*(p) September 11 Events*

The Company received a total of forty-four claims related to the terrorist attacks of September 11, 2001. Of these, forty-three have been closed with incurred losses and loss adjustment expense of $287,161. The Company has established $14,504 of case reserves and $43,208 has been paid relating to loss adjustment expense to close out the one remaining claim.

**(2) Investments**

The statement and estimated fair values of bonds at December 31, 2006 and 2005, respectively, are reflected below. Estimated fair values are based on pricing information obtained from the NAIC's Securities Valuation Office (SVO). For any securities not priced by the NAIC, the Company uses a third-party vendor.

| | 2006 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 8,774,376 | 32,951 | (104,003) | 8,703,324 |
| Government agencies and government-backed securities | 101,060,565 | 516,969 | (574,689) | 101,002,845 |
| States, political subdivisions, and special revenue securities | 222,011,260 | 2,599,075 | (739,401) | 223,870,934 |
| Corporate and other securities | 106,564,060 | 907,892 | (1,758,326) | 105,713,626 |
| Mortgage-backed securities and CMOs | 131,984,993 | 599,465 | (1,633,409) | 130,951,049 |
| Totals | $ 570,395,254 | 4,656,352 | (4,809,828) | 570,241,778 |



(Continued)

| | 2005 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 9,899,920 | 97,669 | (94,410) | 9,903,178 |
| Government agencies and government-backed securities | 92,909,328 | 770,192 | (705,525) | 92,973,996 |
| States, political subdivisions, and special revenue securities | 238,953,393 | 3,633,423 | (1,292,151) | 241,294,665 |
| Corporate and other securities | 101,575,565 | 1,558,376 | (1,880,901) | 101,253,039 |
| Mortgage-backed securities and CMOs | 128,307,330 | 393,655 | (2,316,207) | 126,384,777 |
| Totals | $ 571,645,536 | 6,453,315 | (6,289,195) | 571,809,656 |

The statement and estimated fair value of bonds at December 31, 2006 by contractual maturity are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties and because most mortgage-backed and asset-backed securities provide for periodic payments throughout their lives. Such securities have been classified in the table below based upon contractual maturities.

| | Statement value | Estimated fair value |
|---|---|---|
| Due in one year or less | $ 12,104,280 | 12,157,843 |
| Due after one year through five years | 150,793,820 | 151,266,263 |
| Due after five years through ten years | 239,778,201 | 240,384,140 |
| Due after ten years | 167,718,953 | 166,433,532 |
| | $ 570,395,254 | 570,241,778 |

Proceeds from sales of bonds during 2006 and 2005 were $97,834,144 and $68,356,931, respectively. Proceeds from maturities/calls of bonds during 2006 and 2005 were $52,998,019 and $43,054,581, respectively. Gross gains realized on those sales and maturities/calls totaled $404,296 and $1,772,772 in 2006 and 2005, respectively. Gross losses realized on those sales and maturities/calls totaled $3,412,488 and $1,111,918 in 2006 and 2005, respectively.



(Continued)

The cost of common and preferred stocks of nonaffiliates owned at December 31, 2006 and 2005 was $116,091,631 and $107,442,337, respectively. Gross unrealized gains and losses on such investments are as follows:

| | 2006 | 2005 |
|---|---|---|
| Unrealized gains | $ 122,355,933 | 97,356,909 |
| Unrealized losses | (318,503) | (413,786) |
| Net unrealized gains | $ 122,037,430 | 96,943,123 |

The unrealized gains on investments in affiliates are as follows:

| | 2006 | 2005 |
|---|---|---|
| Carrying value of investments in affiliates | $ 418,698,094 | 404,485,860 |
| Cost of investments in affiliates | 145,688,624 | 161,788,624 |
| Unrealized gains | $ 273,009,470 | 242,697,236 |

The carrying value of investments in affiliates for 2006 is net of $1,166,551 of nonadmitted assets. Proceeds from sales of equity securities during 2006 and 2005 were $75,172,615 and $19,977,240, respectively. Gross gains realized on those sales totaled $42,391,424 and $6,572,334 in 2006 and 2005, respectively. Gross losses realized on those sales totaled $440,513 and $1,354,456 in 2006 and 2005, respectively.

Investments with a statement value of $4,921,678 and $4,953,097, as of December 31, 2006 and December 31, 2005 respectively, were on deposit with governmental authorities or banks to comply with insurance laws.

The composition of net investment income is as follows:

| | 2006 | 2005 |
|---|---|---|
| Bonds | $ 26,885,328 | 25,670,757 |
| Stocks | 6,118,055 | 5,672,936 |
| Investments in affiliates | — | 4,000,000 |
| Real estate | 1,105,800 | 663,000 |
| Cash on deposit and short-term investments | 1,051,430 | 567,362 |
| Other | 706,015 | 757,747 |
| | 35,866,628 | 37,331,802 |
| Less investment expenses | 3,631,358 | 4,127,283 |
| Net investment income | $ 32,235,270 | 33,204,519 |



(Continued)

At December 31, 2006, the Company was party to a securities lending program whereby fixed-income securities are loaned to third parties, primarily major brokerage firms. At December 31, 2006 and 2005, fixed maturities with a fair value of $26.1 million and $16.5 were loaned respectively. Agreements with custodian banks facilitating such lending generally require 102% of the value of the loaned securities to be separately maintained as collateral for each loan. To further minimize the credit risks related to this lending program, we monitor the financial condition of other parties to these agreements.



(Continued)

The following tables illustrate the total value of securities that were in an unrealized loss position as of December 31, 2006 and 2005, respectively.

| | 2006 | | |
|---|---|---|---|
| | Less than 12 months | Greater than 12 months | Total |
| | | (In thousands) | |
| U.S. government: | | | |
| Fair value | $ 1,543 | 3,265 | 4,808 |
| Cost or amortized cost | 1,550 | 3,362 | 4,912 |
| Unrealized loss | $ (7) | (97) | (104) |
| U.S. agency: | | | |
| Fair value | $ 28,926 | 33,847 | 62,773 |
| Cost or amortized cost | 28,993 | 34,354 | 63,347 |
| Unrealized loss | $ (67) | (507) | (574) |
| Mortgage-backed: | | | |
| Fair value | $ 31,711 | 59,571 | 91,282 |
| Cost or amortized cost | 31,861 | 61,054 | 92,915 |
| Unrealized loss | $ (150) | (1,483) | (1,633) |
| Corporate: | | | |
| Fair value | $ 28,414 | 36,152 | 64,566 |
| Cost or amortized cost | 28,712 | 37,612 | 66,324 |
| Unrealized loss | $ (298) | (1,460) | (1,758) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 48,474 | 38,655 | 87,129 |
| Cost or amortized cost | 48,659 | 39,209 | 87,868 |
| Unrealized loss | $ (185) | (554) | (739) |
| Subtotal, debt securities: | | | |
| Fair value | $ 139,066 | 171,490 | 310,556 |
| Cost or amortized cost | 139,775 | 175,591 | 315,366 |
| Unrealized loss | $ (709) | (4,101) | (4,810) |
| Common stock: | | | |
| Fair value | $ 8,773 | — | 8,773 |
| Cost or amortized cost | 9,092 | — | 9,092 |
| Unrealized loss | $ (319) | — | (319) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 147,839 | 171,490 | 319,329 |
| Cost or amortized cost | 148,867 | 175,591 | 324,458 |
| Unrealized loss | $ (1,028) | (4,101) | (5,129) |



(Continued)

| | 2005 | | |
|---|---|---|---|
| | Less than 12 months | Greater than 12 months | Total |
| | (In thousands) | | |
| U.S. government: | | | |
| Fair value | $ 4,782 | — | 4,782 |
| Cost or amortized cost | 4,876 | — | 4,876 |
| Unrealized loss | $ (94) | — | (94) |
| U.S. agency: | | | |
| Fair value | $ 57,311 | 3,123 | 60,434 |
| Cost or amortized cost | 57,929 | 3,211 | 61,140 |
| Unrealized loss | (618) | (88) | (706) |
| Mortgage-backed: | | | |
| Fair value | $ 84,896 | 16,328 | 101,224 |
| Cost or amortized cost | 86,725 | 16,815 | 103,540 |
| Unrealized loss | $ (1,829) | (487) | (2,316) |
| Corporate: | | | |
| Fair value | $ 41,897 | 18,215 | 60,112 |
| Cost or amortized cost | 42,929 | 19,064 | 61,993 |
| Unrealized loss | $ (1,032) | (849) | (1,881) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 91,054 | 6,965 | 98,019 |
| Cost or amortized cost | 92,186 | 7,125 | 99,311 |
| Unrealized loss | $ (1,132) | (160) | (1,292) |
| Subtotal, debt securities: | | | |
| Fair value | $ 279,940 | 44,631 | 324,571 |
| Cost or amortized cost | 284,645 | 46,215 | 330,860 |
| Unrealized loss | $ (4,705) | (1,584) | (6,289) |
| Common stock: | | | |
| Fair value | $ 6,502 | — | 6,502 |
| Cost or amortized cost | 6,916 | — | 6,916 |
| Unrealized loss | $ (414) | — | (414) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 286,442 | 44,631 | 331,073 |
| Cost or amortized cost | 291,561 | 46,215 | 337,776 |
| Unrealized loss | $ (5,119) | (1,584) | (6,703) |



(Continued)

As of December 31, 2006 and 2005, 273 and 256 bonds, respectively, had an unrealized loss. These bonds represent a total fair value of $310.6 million and $324.6 million, respectively, and a total unrealized loss of $4.8 million and $6.3 million, respectively. All of the bonds in the Company's portfolio are investment grade and no individual bond has shown deterioration in price that is consistent with an inability to recover principal.

The fixed-income unrealized losses can be primarily attributed to changes in interest rates from the time of purchase. The Company continually monitors the credit quality of its fixed-income investments to gauge its ability to be repaid principal and interest under the contractual terms. The Company considers price declines of securities in our other-than-temporary-impairment analysis where such price declines provide evidence of declining credit quality, and the Company distinguishes between price changes caused by credit deterioration, as opposed to rising interest rates.

Factors that are considered in the evaluation of credit quality include:

1. Credit ratings from major rating agencies, including Moody's and Standard and Poor's,
2. Business and operating performance trends,
3. Management quality/turnover,
4. Industry competitive analysis, and
5. Changes in business model/strategy.

As of December 31, 2006 and 2005, six equity securities were in the RLI portfolio that had unrealized losses. These securities were all in unrealized loss positions of less than 20% for less than six consecutive months. The Company has the ability and intent to hold these investments until market price recovery or maturity. As a result, the Company does not consider any equity or bond securities to be other than temporarily impaired.

**(3) Related-Party Transactions**

As described below and elsewhere in the notes to the statutory financial statements, the Company has engaged in transactions with its parent, affiliates, and subsidiaries during the normal course of business:

(a) The Company allocates certain expenses to RLI Corp. and affiliated companies, Mt. Hawley, RLI Indemnity Company (RIC), RLI US, and Safefleet, based upon the accounting principles set forth in the NAIC Accounting Practices and Procedures Manual. The intercompany services agreement allows a portion of the expenses incurred by the Company for the benefit of these affiliates to be allocated on a pro rata basis relative to the affiliate companies' gross earned premium to the total of gross earned premiums of the Company, and any other affiliate managed by the Company. This agreement further allows the expenses incurred by Safefleet for the benefit of the Company to be charged back to the Company on a cost reimbursement basis. The Company allocated expenses of $43,331,172 and $35,899,815 during 2006 and 2005, respectively, as a result of services performed.

(b) The Company received no dividends from Mt. Hawley, Safefleet, RLI Ltd, RLI US, or UIGA in 2006. In November 2005, RLI Ltd paid a cash dividend to the Company of $4,000,000.

(c) The Company paid RLI Corp. dividends of $59,495,808 and $13,036,489 in 2006 and 2005, respectively. For 2006, this includes dividends of shares of $35.2 million for the 100% carrying value of the Company's investment in Maui Jim and $13.4 million for the 100% carrying value of the Company's investment in Taylor, Bean and Whitaker Mortgage Corp., as approved by the Division, as well as a cash dividend of $10.9 million.

(d) At December 31, 2006, the Company owns 100% of the common stock of its subsidiaries, Mt. Hawley, Safefleet, RLI Ltd, UIGA, and RLI US, having statement values of $416,424,635, $71,979, $1,106,908, $980,995, and $113,577, respectively. The Company nonadmitted its investment in Safefleet, UIGA, and RLI US, per SSAP 88, since external audits are not conducted individually for these subsidiaries.

(e) Based on the Company's ownership percentage of Mt. Hawley, the statement value of Mt. Hawley's assets and liabilities as of December 31, 2006 were $1,024,693,618 and $608,268,983, respectively. The Company's share of net income of Mt. Hawley was $59,807,492 for the year ended December 31, 2006.

(f) The Company received a capital contribution totaling $0 and $28,235 from RLI Corp. in 2006 and 2005, respectively. The 2005 contribution took the form of 9,621 shares of common stock in its wholly owned subsidiary, RLI US. The contribution resulted in the Company owning 100% of the outstanding shares of RLI US.

(g) At December 31, 2006 and 2005, the Company reported $1,024,009 and $3,293,020, respectively, as net amounts due to affiliates.

(h) On or about April 1, 2004, the Company entered into an intercompany guarantee with RLI Ltd. The Company has guaranteed the performance of RLI Ltd with respect to a punitive damages wrap policy over an excess policy with the Company. The policy has been renewed with an effective date of April 1, 2006. The guarantee is in the amount of $20,000,000.

**(4) Borrowed Funds**

The Company has no outstanding liability for borrowed money at December 31, 2006. Interest paid on outstanding debt for 2006 and 2005 totaled $249,859 and $757,571, respectively.

**(5) Capital and Surplus**

Dividend payments from the Company to its parent are restricted by state insurance laws as to the amount that may be paid without prior approval from the regulatory authorities of Illinois. The maximum dividend distribution that can be paid by the Company during 2007 without prior approval is $74,690,542.

State insurance laws also restrict dividend payments to the Company from Mt. Hawley. The maximum dividends that can be paid to the Company by Mt. Hawley during 2007 without prior approval are $59,087,493.

Unassigned surplus includes $79,938,540 in net unrealized gains on unaffiliated investments and has been reduced by $12,063,276 relating to nonadmitted assets. Additionally, surplus has been reduced by $3,847,000 for the provision for reinsurance.

## (6) Reinsurance

In the normal course of business, the Company assumes and cedes property and liability insurance exposures with other insurance companies, pools, and associations through various treaties and in certain instances by negotiation of individual risks. Generally, policies are reinsured with other insurance companies to limit the Company's risk on any individual loss to $7,000,000.

The following are summaries of the impact of the Company's reinsurance program on the statutory financial statements:

| | 2006 | | |
|---|---|---|---|
| | Direct | Assumed | Ceded |
| Premiums written | $ 331,709,060 | 10,302,481 | 112,587,186 |
| Premiums earned | 339,074,390 | 10,276,226 | 121,379,644 |
| Losses and loss adjustment expenses paid | 211,961,064 | 11,422,032 | 134,264,804 |
| Unearned premiums | 175,796,559 | 4,763,548 | 50,347,367 |
| Unpaid losses and loss adjustment expenses | 613,353,594 | 43,153,140 | 297,489,125 |

| | 2005 | | |
|---|---|---|---|
| | Direct | Assumed | Ceded |
| Premiums written | $ 339,345,587 | 9,029,664 | 131,830,100 |
| Premiums earned | 340,306,923 | 8,630,429 | 125,505,674 |
| Losses and loss adjustment expenses paid | 183,299,352 | 7,663,754 | 87,941,207 |
| Unearned premiums | 183,161,889 | 4,737,293 | 59,139,825 |
| Unpaid losses and loss adjustment expenses | 658,522,250 | 44,242,643 | 351,099,585 |

At December 31, 2006, net balances recoverable from reinsurers (comprised of unearned premiums and losses and loss adjustment expenses paid and unpaid, including incurred but not reported amounts) having unsecured portions exceeding 3% of the Company's total capital and surplus were as follows:

| Name of reinsurer | Amount |
|---|---|
| Berkley Insurance Company | $ 24,645,000 |
| Everest Reinsurance | 23,816,000 |
| General Rein Corp | 47,328,000 |
| Munich Re American | 67,921,000 |
| TOA Reinsurance | 31,048,000 |

The losses, loss adjustment expenses, and unearned premiums for business ceded to other insurers are recoverable and realizable to the extent that the assuming reinsurers fulfill their commitments. The Company has initiated arbitration or otherwise instituted legal actions where appropriate on certain outstanding recoverable balances.



(Continued)

In 2006 and 2005, our property underwriting was supported by $450 million and $400 million, respectively, in traditional catastrophe reinsurance protection, subject to certain retentions by the Company. At January 1, 2005, the Company restructured its reinsurance program increasing its traditional catastrophe reinsurance protection to $400 million, subject to certain retentions by the Company. At the same time, the Company reduced its limit available under its per risk excess of loss earthquake protection by the corresponding amount, while maintaining the same limit of coverage. The Company also increased its California earthquake attachment by $3.75 million. At January 1, 2006, the Company restructured its reinsurance program increasing its traditional catastrophe reinsurance protection to $450 million, subject to certain retentions by the company. The Company increased its California earthquake attachment by $25 million and the limit by $50 million.

The Company recorded a charge to income in 2006 of $507,905 for reinsurance balances deemed uncollectible. This charge is reflected in losses and loss adjustment expenses incurred. The most significant component is a net write-off of $120,117 for balances due from Reliance Insurance Co.

The Company has recorded a charge to income in 2006 of $1,954,180 for reinsurance balances commuted from Continental Casualty Company. This expense is reflected in losses and loss adjustment expenses incurred.

The total return commission, which would have been due reinsurers if all reinsurance was canceled with the return of unearned premium would be $11,335,136 and $12,530,473 as of December 31, 2006 and 2005, respectively. The amount of return commission, predicated on loss experience as a result of existing contracts, was $366,950 and $2,951,254 as of December 31, 2006 and 2005, respectively.

The Company participates in a quota share reinsurance agreement with RIC. The agreement is applied after all other external reinsurance cessions. Under the terms of the agreement, RIC cedes and RLI assumes 90% of the net premium and liabilities for policies effective January 1, 2003, and subsequent. The agreement, which was effective January 1, 2003, has been accepted and placed on file by the Division.

This agreement was amended in 2004 to include the assumption of 100% of RIC's existing net loss reserves and any future development on these reserves. The Division approved the loss portfolio transfer on June 29, 2004. In this transaction, $693,000 of loss reserves were assumed by RLI from RIC as were $693,000 of premium, with no net impact to the surplus of either company. Under the terms of SSAP No. 62, *Increased Disclosures for Property and Casualty Reinsurance Contracts,* this transaction was afforded traditional reinsurance accounting treatment.

The following is a summary of the balances assumed under this agreement as of and for the year ended December 31, 2006 and 2005 (in thousands):

| | 2006 | 2005 |
|---|---|---|
| Premium written | $ 5,383 | 1,870 |
| Unearned premiums | 2,387 | 1,300 |
| Premium earned | 4,295 | 1,001 |
| Loss and loss adjustment expenses incurred | 1,618 | 314 |
| Reserve for loss and loss adjustment expenses | 2,552 | 1,612 |



(Continued)

## (7) Unpaid Losses and Loss Adjustment Expenses

The following table is a reconciliation of the Company's liability for unpaid losses and loss adjustment expenses (LAE) for the years ended December 31, 2006 and 2005. Since reserves are based on estimates, the ultimate net cost may vary from the original estimate. As adjustments to these estimates become necessary, they are reflected in current operations. As part of the reserving process, historical data is reviewed and consideration is given to the anticipated impact of various factors such as legal developments and economic conditions, including the effects of inflation. Changes in reserves from the prior year's estimates are calculated based on experience as of the end of each succeeding year (loss and LAE development).

| | 2006 | 2005 |
|---|---|---|
| | (In thousands) | |
| Net unpaid losses and LAE at beginning of year, net of reinsurance recoverable of $351,099 and $304,324 as of January 1 | $ 351,665 | 345,186 |
| Incurred losses and LAE related to: | | |
| Current accident year losses | 112,890 | 130,427 |
| Prior accident years losses | (8,144) | (13,007) |
| Total incurred | 104,746 | 117,420 |
| Paid loss and LAE payments related to: | | |
| Current accident year losses | (17,624) | (22,365) |
| Prior accident years losses | (79,769) | (88,576) |
| Total paid | (97,393) | (110,941) |
| Net unpaid losses and LAE at end of year, net of reinsurance recoverable of $297,488 and $351,099 as of December 31 | $ 359,018 | 351,665 |

**Reserve Development**

During 2006, the Company continued to experience favorable loss development and reduced its estimates for loss reserves for prior years. Much of the reduction was due to adjustments made to recognize the extent of the favorable insurance market conditions that existed from 2001 to 2004. This was difficult to quantify at the time the original estimates were made for those years. In 2006, we reviewed the expected loss ratios used in several of our reserving methods and made adjustments so they more closely reflect the apparent level of losses. This drove 35-40% of the favorable development with the remainder coming from continued favorable emergence and the common practice of, as accident years get older, giving less weight to the results of methods that rely on expected loss ratios. Overall favorable development was $8.1 million and it came primarily from the Other Liability, Auto, and Surety lines. There was some adverse development on property caused by our construction product which is in run-off. There was also some adverse development on ceded reserves, which was driven by the adoption of a survival ratio reserving methodology and which was also impacted by the assumptions used in the survival ratio reserving methodology.



(Continued)

During 2005, the Company experienced $13.0 million of favorable development related to prior accident years. Most of this favorable development occurred in the casualty segment, specifically Other Liability, Products Liability, and Commercial Auto Liability. This development is primarily from accident years 2002-2004 for the Company's specialty programs and transportation products. The Company's experience in those years has been favorable due to lower than anticipated frequency and severity. During 2005, the emergence of losses lower than expected caused the Company's estimates to decrease. In response to this favorable development, the Company released approximately $5.4 million and $6.0 million of incurred-but-not-reported (IBNR) loss and LAE reserves for Specialty Programs and Transportation, respectively. These releases comprise a majority of the favorable development within the casualty segment. The property segment, specifically Inland Marine and Allied Lines, also experienced favorable development. A portion of this positive development is due to the release of IBNR held for the 2004 hurricanes. Overall, the surety segment experienced adverse development. Reserve additions on surety coverages for the 2002 accident year exceeded favorable experience on surety coverages for accident years prior to 2002.

The Company utilized estimates of salvage and subrogation for the surety book of business of $11,933,969 on a gross basis and $5,926,790 on a ceded basis in 2006. These amounts were $11,748,643 on a gross basis and $6,007,563 on a ceded basis in 2005.

**Environmental Exposure**

The Company has exposure to asbestos, and environmental claims through its commercial umbrella, general liability, and assumed reinsurance lines of business. The majority of the exposure is in the excess layers of the Company's commercial umbrella and assumed reinsurance books of business.

Although the Company's asbestos and environmental exposure is limited as a result of entering the liability lines after the industry had already recognized it as a problem, management cannot determine the Company's ultimate liability with any reasonable degree of certainty. The Company estimates the full impact of these exposures by establishing case basis reserves on all known losses. Reserves for related IBNR are recorded based upon actuarial projections of ultimate expected losses.

This ultimate liability is difficult to assess due to evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, the Company participates primarily in the excess layers, making it difficult to assess the ultimate impact.



(Continued)

The Company's asbestos-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2006 and 2005 were as follows:

| | | 2006 | 2005 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 2,314,494 | 2,380,865 |
| Incurred losses and LAE | | 1,907,197 | — |
| Calendar year payments for losses and LAE | | (27,291) | (66,371) |
| Ending reserves | $ | 4,194,400 | 2,314,494 |
| Assumed: | | | |
| Beginning reserves | $ | 7,725,537 | 4,300,273 |
| Incurred losses and LAE | | 3,656,632 | 3,500,000 |
| Calendar year payments for losses and LAE | | (1,513,841) | (74,736) |
| Ending reserves | $ | 9,868,328 | 7,725,537 |
| Ceded: | | | |
| Beginning reserves | $ | 4,782,552 | 3,319,839 |
| Incurred losses and LAE | | (1,180,695) | 1,500,000 |
| Calendar year payments for losses and LAE | | (461,929) | (37,287) |
| Ending reserves | $ | 3,139,928 | 4,782,552 |
| Net: | | | |
| Beginning reserves | $ | 5,257,479 | 3,361,299 |
| Incurred losses and LAE | | 6,744,524 | 2,000,000 |
| Calendar year payments for losses and LAE | | (1,079,203) | (103,820) |
| Ending reserves | $ | 10,922,800 | 5,257,479 |

The Company holds IBNR and/or case loss reserves related to asbestos exposure. During 2006, the Company reviewed its reserves for these exposures relative to industry benchmarks and reevaluated its emergence patterns. In conjunction with reserves, the Company also analyzed the collectibility of reinsurance and reduced its ceded reserves accordingly. As a result, net reserves for these exposures were increased. Of the total reserves, the Company held IBNR reserves in the amount of $5,845,315, on a gross basis and $5,440,804 on a net basis at December 31, 2006. At December 31, 2005, it held $814,239 on a gross basis and $472,436 on a net basis.

The Company held $570,513 on a gross basis and $533,644 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2006. At December 31, 2005, it held $90,471 on a gross basis and $52,493 on a net basis.



(Continued)

The Company's environmental-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2006 and 2005 were as follows:

| | | 2006 | 2005 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 13,786,812 | 14,505,358 |
| Incurred losses and LAE | | (4,765,638) | — |
| Calendar year payments for losses and LAE | | (4,130,006) | (718,547) |
| Ending reserves | $ | 4,891,168 | 13,786,811 |
| Assumed: | | | |
| Beginning reserves | $ | 1,913,950 | 1,966,957 |
| Incurred losses and LAE | | 969,574 | — |
| Calendar year payments for losses and LAE | | (21,958) | (53,007) |
| Ending reserves | $ | 2,861,566 | 1,913,950 |
| Ceded: | | | |
| Beginning reserves | $ | 9,941,636 | 10,115,339 |
| Incurred losses and LAE | | (5,246,009) | — |
| Calendar year payments for losses and LAE | | (2,076,105) | (173,704) |
| Ending reserves | $ | 2,619,522 | 9,941,635 |
| Net: | | | |
| Beginning reserves | $ | 5,759,126 | 6,356,975 |
| Incurred losses and LAE | | 1,449,945 | — |
| Calendar year payments for losses and LAE | | (2,075,859) | (597,849) |
| Ending reserves | $ | 5,133,212 | 5,759,126 |

The Company holds IBNR and/or case loss reserves related to environmental exposure. As was done with asbestos reserves, the Company reviewed its reserves for its environmental exposures relative to industry benchmarks and reevaluated its emergence patterns in 2006. In conjunction with reserves, the Company also analyzed the collectibility of reinsurance and reduced its ceded reserves accordingly. Of the total reserves, the Company held IBNR reserves in the amount of $3,660,106 on a gross basis and $2,821,917 on a net basis at December 31, 2006. At December 31, 2005, it held $7,382,439 on a gross basis and $2,543,811 on a net basis.

The Company held $519,306 on a gross basis and $313,457 on a net basis for future allocated loss adjustment expenses related to environmental exposure (including coverage dispute costs) at December 31, 2006. At December 31, 2005, it held $1,302,783 on a gross basis and $448,908 on a net basis.



(Continued)

## (8) Investment in Mt. Hawley

Condensed financial information for Mt. Hawley on a statutory basis is summarized below:

| | 2006 | 2005 |
|---|---|---|
| Balance sheet at December 31: | | |
| Assets | $ 1,024,693,618 | 940,322,991 |
| Liabilities | (608,268,983) | (573,231,474) |
| Total capital and surplus | $ 416,424,635 | 367,091,517 |
| Results of operations for the year ended December 31: | | |
| Premium earned | $ 301,848,521 | 267,761,891 |
| Losses and underwriting expenses | 247,428,656 | 216,635,244 |
| Underwriting gains | 54,419,865 | 51,126,647 |
| Investment income, including realized gains and losses | 37,783,651 | 32,263,908 |
| Other income, net | 321,365 | 373,983 |
| Income before federal income taxes | 92,524,881 | 83,764,538 |
| Federal income tax expense | 33,437,389 | 27,962,230 |
| Net income | $ 59,087,492 | 55,802,308 |

## (9) Federal Income Taxes

A reconciliation of federal income tax expense, computed by applying the statutory federal income tax rate of 35% in 2006 and 2005 to income before federal income taxes, which includes net realized capital gains, to the income tax expense shown in the accompanying statutory financial statements is as follows:

| | 2006 | 2005 |
|---|---|---|
| Computed "expected" tax expense | $ 33,249,047 | 18,405,094 |
| Tax-exempt interest | (2,730,869) | (2,833,889) |
| Dividends received deduction | (1,190,173) | (2,438,498) |
| Discounting of liability for losses and loss adjustment expenses | (79,195) | (379,079) |
| Change in unearned premiums | (101,737) | 270,073 |
| Intercompany transactions | (5,970,544) | — |
| Sale of investments | — | 82,375 |
| Tax on net realized capital gains | (13,629,952) | (2,057,556) |
| Tax settlement | — | (3,170,975) |
| Other, net | (718,777) | 1,181,745 |
| Federal income tax expense | $ 8,827,800 | 9,059,290 |

Income taxes incurred in current and prior years that will be available for recoupment in the event of future net losses are $24,196,700 for 2006 and $12,146,062 for 2005.



(Continued)

The net deferred tax asset and the change from the prior year are comprised of the following components:

| | December 31 2006 | 2005 | Change |
|---|---|---|---|
| Total gross deferred tax assets | $ 31,855,839 | 31,417,420 | 438,419 |
| Total deferred tax liabilities | (51,701,924) | (38,830,885) | (12,871,039) |
| Net deferred tax liabilities | $ (19,846,085) | (7,413,465) | (12,432,620) |
| Tax effect of unrealized gains (losses) | | | 7,040,268 |
| Change in deferred income tax | | | $ (5,392,352) |

There are no temporary differences for which deferred tax liabilities are not recognized.

Deferred income tax assets and liabilities consist of the following major components:

| | December 31 2006 | 2005 |
|---|---|---|
| Deferred tax assets: | | |
| Loss reserves | $ 14,386,349 | 14,307,154 |
| Unearned premium reserve | 9,114,892 | 9,013,156 |
| Agents balances and other nonadmitted assets | 3,813,854 | 3,936,108 |
| Accrued expenses | 3,656,612 | 2,715,041 |
| Deferred compensation | 249,154 | 385,303 |
| Capital loss carryforward | — | 703,918 |
| Defined benefit pension asset | 128,499 | 312,025 |
| Other | 506,479 | 44,715 |
| Total deferred tax assets | 31,855,839 | 31,417,420 |
| Nonadmitted deferred tax assets | — | — |
| Admitted deferred tax assets | 31,855,839 | 31,417,420 |
| Deferred tax liabilities: | | |
| Unrealized gains | 45,100,060 | 38,059,792 |
| Intercompany transactions | 5,970,544 | — |
| Investments | 207,553 | 170,293 |
| Investment income | 184,747 | 145,441 |
| Goodwill amortization | 46,640 | 186,642 |
| Other | 192,380 | 268,717 |
| Total deferred tax liabilities | 51,701,924 | 38,830,885 |
| Net deferred tax liabilities | $ (19,846,085) | (7,413,465) |



(Continued)

The Company's income tax incurred and change in deferred income tax differs from the amount obtained by applying the federal statutory rate of 35% to income before income taxes as follows:

| | 2006 | 2005 |
|---|---|---|
| Income before taxes, which includes net realized capital gains | $ 94,997,277 | 52,585,984 |
| Income tax expense at 35% statutory rate | 33,249,047 | 18,405,094 |
| Increase (decrease) in tax resulting from: | | |
| Dividends received deduction | (1,190,173) | (2,438,498) |
| Nondeductible expenses | 125,661 | 132,232 |
| Tax-exempt income | (2,730,869) | (2,833,889) |
| Tax settlement | — | (3,170,975) |
| Other | (1,603,562) | (159,042) |
| Total statutory income taxes | $ 27,850,104 | 9,934,922 |
| Current income taxes incurred | $ 8,827,800 | 9,059,290 |
| Change in deferred income tax (without tax on unrealized gains and losses) | 5,392,352 | (1,181,924) |
| Tax on net realized capital gains | 13,629,952 | 2,057,556 |
| Total statutory income taxes | $ 27,850,104 | 9,934,922 |

## (10) Employee Benefits

The Company historically participated with its parent and other affiliates in a noncontributory defined benefit pension plan, which covered substantially all employees meeting the age and service eligibilities.

The plan was closed to new participants after December 31, 2003. Effective December 31, 2005, all participant's benefits were frozen and future pay will not alter a participant's accrued benefit. In 2005, the Company shortened the amortization of the plan's unfunded gain/loss to fully amortize it over the next two years. The Company terminated the plan in 2006. All participants either elected and were paid lump-sum amounts or had an insurance contract for their benefit purchased on their behalf during 2006. Contributions of $1,809,000 and $1,825,000 were made in 2006 and 2005, respectively, to fund the plan by all participating companies prior to its termination.

A breakdown of pension information by participating company is not available. However, such information on a consolidated basis is provided below.



(Continued)

The following table sets forth the change in the projected benefit obligation at December 31, 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| Projected benefit obligation at January 1 | $ 11,365,480 | 13,780,874 |
| Service cost | — | — |
| Interest cost | 582,589 | 756,613 |
| Actuarial losses | 1,537,718 | 1,669,392 |
| Benefit payments | (14,420,152) | (1,456,761) |
| Curtailment cost | — | (3,384,638) |
| Special Termination Benefit Cost | 934,365 | — |
| Projected benefit obligation at December 31 | $ — | 11,365,480 |

The following table sets forth the change in plan assets at December 31, 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| Fair value plan assets at January 1 | $ 11,514,072 | 10,728,843 |
| Actual return on plan assets | 1,099,148 | 416,990 |
| Employer contributions | 1,808,500 | 1,825,000 |
| Benefit payments | (14,420,152) | (1,456,761) |
| Fair value plan assets at December 31 | $ 1,568 | 11,514,072 |

The following table sets forth the plan's funded status at December 31, 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| Actuarial present value of benefit obligation: | | |
| Accumulated benefit obligation: | | |
| Vested | $ — | 11,091,207 |
| Nonvested | — | 274,273 |
| | $ — | 11,365,480 |
| Projected benefit obligation | $ — | 11,365,480 |
| Plan assets at fair market value | 1,568 | 11,514,072 |
| Excess (deficiency) of plan assets over projected benefit obligation | 1,568 | 148,592 |
| Unrecognized net loss | — | 683,789 |
| Accrued pension asset | $ 1,568 | 832,381 |



(Continued)

The following table sets forth net periodic pension cost as follows:

| | | 2006 | 2005 |
|---|---|---|---|
| Interest cost | $ | 582,589 | 756,613 |
| Expected return on plan assets | | (481,123) | (459,791) |
| Recognized net loss | | 1,603,482 | 1,760,575 |
| FAS 88 Events | | 934,365 | 398,453 |
| Net pension expense | $ | 2,639,313 | 2,455,850 |

The pension plan had benefit payments in excess of the sum of service cost and interest cost. This resulted in the recognition of settlement expense in 2006 as shown above.

The fair value of plan assets exceeds the actuarial present value of accumulated benefit obligations. As a result, the Company has no minimum pension liability adjustment.

The expenses of this plan are shared between the Company and its affiliates in accordance with an intercompany cost sharing arrangement. The Company's share of the net pension expense was $1,461,479 and $1,370,926 for 2006 and 2005, respectively.

At December 31, 2006, plan assets at fair value are comprised of 100% invested cash.

RLI Corp. used the following rates to determine its projected benefit obligation: 4.75% and 5.50% settlement rate in 2006 and 2005, respectively; 0.0% increase in salary in 2006 and 2005, and 4.75% expected long-term return on plan assets in 2006 and 2005.

The Company, along with its affiliates and ultimate parent, participates in an Employee Stock Ownership Plan (ESOP) and a 401(k) plan, which covers substantially all employees. The Company provides a base contribution to the 401(k) plan of 3% of eligible compensation and allows voluntary contributions by employees. Additionally, annual discretionary profit sharing contributions may be made to both plans, subject to the achievement of certain overall financial goals. The total amount of expense for these plans for 2006 and 2005 was $7,983,865 and $7,376,790, respectively. The Company's share of this expense was $3,106,223 and $3,001,614, respectively, for the years ended 2006 and 2005.

The Company's total expenditures for employee benefits, including ESOP and 401(k) contributions but excluding the cost of incentive plans discussed below, were $9,571,576 and $8,410,711 for 2006 and 2005, respectively.

The Company, along with its affiliate and ultimate parent, also has bonus and incentive plans covering executives, management, and associates. These plans are subject to the achievement of certain overall financial targets, and to a lesser extent, management incentive plans are affected by other performance measures. The total amount of expense for these plans for 2006 and 2005 was $15,079,864 and $9,173,458, respectively. The Company's share of these plans' expense was $10,739,789 and $5,037,792, respectively, for the years ended 2006 and 2005.



(Continued)

In August 2002, the Company, along with its affiliates and ultimate parent, began offering certain eligible employees post-employment medical coverage. Under the Company's plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under the Company's health plan. Employees who elect continuation of coverage pay the full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. The Company expects a relatively small number of employees will become eligible for this benefit. The COBRA rate established for participating employees covers the cost of providing this coverage. The Company does not provide compensated absences.

**(11) Commitments and Contingent Liabilities**

The Company has an accrual for assessments at December 31, 2006 of $2,500,000. A related asset for premium tax credits has been established in the amount of $180,000. It is not possible at this time to determine the periods over which the assessments are expected to be paid, or the period over which the recorded premium tax offsets are expected to be realized.

The following is a description of a complex set of litigation wherein the Company is both a plaintiff and a defendant. While it is impossible to ascertain the ultimate outcome of this matter at this time, the Company believes, based upon facts known to date, that its position is meritorious. The Company's opinion is that the final resolution of these matters will not have a material adverse effect on its financial statements taken as a whole.

The Company is the plaintiff in an action captioned RLI Insurance Co. v. Commercial Money Center, et al., which was filed in U.S. District Court, Southern District of California (San Diego) on February 1, 2002. Other defendants in that action are Commercial Servicing Corporation (CSC), Sterling Wayne Pirtle, Anita Pirtle, Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, and Sky Bank. The Company filed a similar complaint against the Bank of Waukegan in San Diego, California Superior Court. Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, Sky Bank, and Bank of Waukegan are referred to as the Investor Banks. The litigation arises out of the equipment and vehicle leasing program of Commercial Money Center (CMC). CMC would originate leases, procure bonds pertaining to the performance of obligations of each lessee under each lease, then formed "pools" of such leases that it marketed to banks and other institutional investors. The Company sued for rescission and/or exoneration of the bonds the Company issued to CMC and sale and servicing agreements the Company entered into with CMC and the Investor Banks, which had invested in CMC's equipment leasing program. The Company contends that it was fraudulently induced to issue the bonds and enter into the agreements by CMC, who misrepresented and concealed the true nature of its program and the underlying leases originated by CMC (for which bonds were procured). The Company also sued for declaratory relief to determine its rights and obligations, if any, under the instruments. Each Investor Bank disputes the Company's claims for relief. CMC is currently in Chapter 7 bankruptcy proceedings.

Between the dates of April 4 and April 18, 2002, each Investor Bank subsequently filed a complaint against the Company in various state courts, which the Company removed to U.S. District Courts. Each Investor Bank sued the Company on certain bonds the Company issued to CMC as well as a sale and servicing agreement between the Investor Banks, CMC, and the Company. Each Investor Bank sued for breach of contract, bad faith, and other extra-contractual theories. The Company has answered and denies each Investor Bank's entitlement to relief. The Investor Banks claim entitlement to aggregate payment of


(Continued)

approximately $53 million under either the surety bonds or the sale and servicing agreements, plus unknown extra-contractual damages, attorney's fees, and interest. On October 25, 2002, the judicial panel for multi district litigation (MDL panel) transferred 23 actions pending in five federal districts involving numerous investor banks, five insurance companies, and CMC to the Northern District of Ohio for consolidated pretrial proceedings, assigning the litigation to The Honorable Kathleen O'Malley.

In the third quarter of 2005, the Company reached a confidential settlement agreement with Lakeland Bank Lakeland. This settlement ends our litigation with Lakeland, but does not resolve our pending litigation with the four other investor banks. The settlement with Lakeland relates to surety bonds representing approximately 17% of the amount to which the five investor banks had claimed entitlement. The settlement did not have a material adverse effect on our financial statements taken as a whole. In addition, in August 2005, the Federal District Court denied outright the investor banks' motion for judgment on the pleadings as to the Company and subsequently ordered all remaining cases to mandatory mediation. Mediations held in January 2006 between the Company and each of the four remaining investor banks did not resolve the claims of those investor banks. In September 2006, the Court issued a case management order governing expert witness discovery and future motion practice. While we cannot predict the ultimate outcome of the pending litigation between the Company and the remaining four investor banks at this time, the Company continues to believe it has meritorious defenses with respect to each of the banks making claims against it and will continue to vigorously assert those defenses in the pending litigation.

The Company's financial statements contain an appropriate accrual for defense costs related to this matter, included in unpaid losses and settlement expenses, as well as an accrual to cover rescission of the collected premiums related to this program. In the opinion of management, final resolution of this matter will not have a material adverse effect on the Company's financial condition, results of operations, or cash flows. However, litigation is subject to inherent uncertainties, and if there were an outcome unfavorable to the Company, there exists the possibility of a material adverse impact on the Company's financial condition, results of operations, or cash flows in the period in which the outcome occurs.

The Company is also party to numerous claims and losses that arise in the normal course of the Company's business. Many of such claims or losses involve claims under policies that the Company underwrites as an insurer. The Company believes that the resolution of these claims and losses will not have a material adverse effect on the Company's financial condition, results of operations, or cash flows.



(Continued)

## (12) Leases

The Company leases regional office facilities and computers under operating leases. These leases expire in various years through 2011. Minimum future rental payments under noncancelable leases are as follows:

| | |
|---|---|
| 2007 | $ 3,515,581 |
| 2008 | 2,737,086 |
| 2009 | 2,454,811 |
| 2010 | 2,148,837 |
| 2011 | 1,539,488 |
| Total minimum future rental payments | $ 12,395,803 |

The Company shares rental expense with its affiliate, Mt. Hawley, through an intercompany cost sharing agreement. The Company's portion of rental expense for 2006 and 2005 was $1,363,061 and $1,496,990, respectively.

## (13) Reconciliation to the Annual Statement

Subsequent to the filing of the 2005 annual statement, the Company made adjustments for differences between the Annual Statement filed with the Illinois Department of Financial and Professional Regulation – Division of Insurance and other regulatory authorities and the accompanying 2005 audited statutory financial statements. These adjustments were the result of a Type I subsequent event with respect to an income tax settlement from an exam conducted by the Internal Revenue Service for which the Company entered into a closing agreement in May 2006. The following is a summary of those adjustments for 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| Net Income per Annual Statement | $ 75,710,500 | 38,298,163 |
| Adjustment for tax settlement | (3,170,975) | 3,170,975 |
| Net income as reported herein | $ 72,539,525 | 41,469,138 |
| Total liabilities per Annual Statement | $ 619,404,680 | 609,723,904 |
| Adjustment for tax settlement | — | (3,170,975) |
| Total liabilities as reported herein | $ 619,404,680 | 606,552,929 |
| Unassigned surplus per Annual Statement | $ 494,453,956 | 438,095,213 |
| Adjustment for tax settlement | — | 3,170,975 |
| Unassigned surplus as reported herein | $ 494,453,956 | 441,266,188 |
| Total capital and surplus per Annual Statement | $ 746,905,415 | 690,546,672 |
| Adjustment for tax settlement | — | 3,170,975 |
| Total capital and surplus as reported herein | $ 746,905,415 | 693,717,647 |

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risks Interrogatories

December 31, 2006

1) Total admitted assets: $ 1,366,310,095

2) 10 largest exposures to a single issuer/borrower/investment:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Co. | $ 416,424,635 | 30.5% |
| Taylor,Bean and Whitaker | 9,500,000 | 0.7 |
| Bank of America Corp | 7,924,858 | 0.6 |
| Exxon Mobil Corporation | 6,436,920 | 0.5 |
| Maryland State | 6,095,233 | 0.4 |
| Portland Oregon Swr Sys Rev | 5,954,044 | 0.4 |
| Wells Fargo | 5,899,401 | 0.4 |
| Morgan Stanley Capital | 5,507,182 | 0.4 |
| Deere & Company | 5,282,938 | 0.4 |
| Citigroup | 5,230,339 | 0.4 |

3) Total admitted assets held in bonds by NAIC rating:

| Bonds | Amount | Percentage |
|---|---|---|
| NAIC-1 | $ 575,000,169 | 42.1% |
| NAIC-2 | 25,697,577 | 1.9 |
| NAIC-3 | — | — |
| NAIC-4 | — | — |
| NAIC-5 | — | — |
| NAIC-6 | — | — |

4) Assets held in foreign investments:

| | |
|---|---|
| Total admitted assets held in foreign investments | None |
| Foreign currency denominated investments | None |
| Insurance liabilities denominated in that same foreign currency | None |

5) Assets held in foreign investments represent less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatories 6 – 10.

11) Assets held in Canadian investments and unhedged Canadian currency exposure is less than 2.5% of the reporting entity's total admitted assets, therefore, detail not required.

12) There were no admitted assets held in investments with contractual sales restrictions.

13) Admitted assets held in the largest 10 equity interests:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Co. | $ 416,424,635 | 30.5% |
| Taylor, Bean and Whitaker | 9,500,000 | 0.7 |
| Exxon Mobil Corporation | 6,436,920 | 0.5 |
| Bank of America Corp | 6,406,800 | 0.5 |
| JP Morgan Chase & Co | 5,214,951 | 0.4 |
| Bear Stearns Companies, Inc | 4,883,400 | 0.4 |
| Wachovia Corporation | 4,344,146 | 0.3 |
| Citigroup | 4,233,200 | 0.3 |
| Sempra Energy | 4,202,159 | 0.3 |
| Hewlett-Packard Co | 4,119,000 | 0.3 |

14) There were no assets held in nonaffiliated, privately placed equities, exceeding 2.5% of the Company's total admitted assets.



(Continued)

**RLI INSURANCE COMPANY**

Schedule of Supplemental Investment Risks Interrogatories

December 31, 2006

15.) There were no admitted assets held in general partnership interests that exceeded 2.5% of the Company's total admitted assets.

16.) There were no mortgage loans reported on the Company's Annual Statement Schedule B; therefore, detail not required for interrogatories 16 and 17.

18.) Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in the Annual Statement Schedule A, less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatory 18

19.) There were no admitted assets held in investments held in mezzaniane real estate loans.

20.) Total admitted assets subject to the following types of agreements:

| Agreement type | At year end | | At end of each quarter | | |
|---|---|---|---|---|---|
| | Amount | Percentage | 1st Qtr | 2nd Qtr | 3rd Qtr |
| Securities lending | $ 26,111,768 | 1.9% | $ 9,498,589 | 18,145,517 | 27,886,994 |
| Repurchase | — | — | 5,896,371 | 5,899,778 | — |
| Reverse repurchase | — | — | — | — | — |
| Dollar repurchase | — | — | — | — | — |
| Dollar reverse repurchase | — | — | — | — | — |

21.) The Company owns no warrants not attached to other financial instruments, options, caps, and floors.

22.) The Company has no exposure to collars, swaps, or forwards.

23.) The Company has no exposure for future contracts.

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2006

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Bonds: | | | | |
| U.S. Treasury Securities | $ 8,774,376 | 0.69% | $ 8,774,376 | 0.69% |
| U.S. government agency and corporate obligations: | | | | |
| Issued by U.S. government agencies | 4,697,789 | 0.37 | 4,697,789 | 0.37 |
| Issued by U.S. government-sponsored agencies | 96,362,776 | 7.59 | 96,362,776 | 7.60 |
| Foreign government: | | | | |
| Securities issued by states, territories, and political subdivisions in the U.S.: | | | | |
| State, territory, and possession and general obligations | 36,715,008 | 2.89 | 36,715,008 | 2.89 |
| Political subdivisions of states, territories, and possessions' political subdivisions' general obligations | 60,984,463 | 4.80 | 60,984,463 | 4.81 |
| Revenue and assessment obligations | 124,311,789 | 9.79 | 124,311,789 | 9.80 |
| Industrial development and similar obligations | — | — | — | — |
| Mortgage-backed securities: | | | | |
| Pass-through securities: | | | | |
| Guaranteed by GNMA | 5,753,630 | 0.45 | 5,753,630 | 0.45 |
| Issued by FNMA and FHLMC | 53,383,401 | 4.20 | 53,383,401 | 4.21 |
| All other | — | — | — | — |
| CMOs and REMICs: | | | | |
| Issued by FNMA, FHLMC, GNMA, or VA | 15,670,280 | 1.23 | 15,670,280 | 1.24 |
| Issued by non-U.S. government issuers and collateralized by mortgage-backed securities issued or guaranteed by above agencies | 35,979,960 | 2.83 | 35,979,960 | 2.84 |
| All other | 21,197,722 | 1.67 | 21,197,722 | 1.67 |
| Other debt and other fixed-income securities: | | | | |
| Unaffiliated domestic securities | 96,799,184 | 7.62 | 96,799,184 | 7.63 |
| Unaffiliated foreign securities | 9,764,876 | 0.77 | 9,764,876 | 0.77 |
| Affiliated securities | — | — | — | — |
| Equity interests: | | | | |
| Investments in mutual funds | — | — | — | — |
| Preferred stocks: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | — | — | — | — |
| Publicly traded equity securities: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | 238,129,061 | 18.75 | 238,129,061 | 18.77 |
| Tangible personal property under lease: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | — | — | — | — |
| Other equity securities: | | | | |
| Affiliated | 418,698,094 | 32.97 | 417,531,543 | 32.91 |
| Unaffiliated | — | — | — | — |
| Mortgage loans: | | | | |
| Construction and land development | — | — | — | — |
| Agricultural | — | — | — | — |
| Single family residential properties | — | — | — | — |
| Multifamily residential properties | — | — | — | — |
| Commercial loans | — | — | — | — |



(Continued)

Schedule 2

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2006

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Real estate investments: | | | | |
| Property occupied by company | $ 6,414,189 | 0.51% | $ 6,083,219 | 0.48% |
| Property held for production of income | — | — | — | — |
| Property held for sale | — | — | — | — |
| Policy loans | — | — | — | — |
| Receivable for securities | — | — | — | — |
| Cash and short-term investments | 26,933,093 | 2.12 | 26,933,093 | 2.12 |
| Write-in invested assets | 9,500,000 | 0.75 | 9,500,000 | 0.75 |
| Total invested assets | $ 1,270,069,691 | 100.00% | $ 1,268,572,170 | 100.00% |

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year Ended December 31, 2006

7.1 Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit, or any similar provisions)? Yes[] No[X]

7.2 If yes, indicate the number of reinsurance contracts containing such provisions. N/A [X]

7.3 If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)? Yes[] No[] N/A[X]

8.1 Has this reporting entity reinsured any risk with any other entity and agreed to release such entity from liability, in whole or in part, from any loss that may occur on this risk, or portion thereof, reinsured? Yes[X] No[]

8.2 If yes, give full information.
A commutation releasing Continental Casualty Company of certain reinsurance treaty liabilities was completed in 2006.

9.1 Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 3% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of prior year-end surplus as regards policyholders (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

(a) A contract term longer than two years and the contract is noncancellable by the reporting entity during the contract term;

(b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

(c) Aggregate stop loss reinsurance coverage;

(d) An unconditional or unilateral right by either party to commute the reinsurance contract except for such provisions, which are only triggered by a decline in the credit status of the other party;

(e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

(f) Payment schedule, accumulating retentions from multiple years, or any features inherently designed to delay timing of the reimbursement to the ceding entity Yes[] No[X]



(Continued)

## RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year Ended December 31, 2006

9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member where:

(a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

(b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates — Yes[] No[X]

9.3 If yes to 9.1 or 9.2, please provide the following information in the Reinsurance Summary Supplemental Filing for general interrogatory 9:

(a) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

(b) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 9.1 or 9.2; and

(c) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved.

9.4 Except for transactions meeting the requirements of paragraph 30 of SSAP No. 62, *Property and Casualty Reinsurance* , has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

(a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principals ("SAP") and as a deposit under generally accepted accounting principals ("GAAP");or

(b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP? — Yes[] No[X]

9.5 If yes to 9.4, explain in the Reinsurance Summary Supplemental Filing for general interrogatory 9 (section D) why the contract(s) is treated differently for GAAP and SAP. — N/A [X]

See accompanying independent auditors' report.

KPMG

# RLI INSURANCE COMPANY

Statutory Financial Statements and Schedules

December 31, 2007 and 2006

(With Independent Auditors' Report Thereon)

KPMG LLP
303 East Wacker Drive
Chicago, IL 60601-5212

# Independent Auditors' Report

The Board of Directors
RLI Insurance Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and capital and surplus of RLI Insurance Company (the Company) as of December 31, 2007 and 2006, and the related statutory statements of income and changes in capital and surplus, and cash flow for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 1 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance (Division), which practices differ from U.S. generally accepted accounting principles. The effects on the statutory financial statements of the variances between the statutory basis of accounting and U.S. generally accepted accounting principles also are described in note 1.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of RLI Insurance Company as of December 31, 2007 and 2006, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus of RLI Insurance Company as of December 31, 2007 and 2006, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

KPMG

Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included on the schedule of supplemental investment risk interrogatories, the summary investment schedule, and the supplemental schedule of reinsurance interrogatories is presented for purposes of additional analysis and is not a required part of the basic statutory financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic statutory financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole.

KPMG LLP

May 23, 2008

## RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2007 and 2006

| Admitted Assets | 2007 | 2006 |
|---|---|---|
| Bonds | $ 554,826,330 | 570,395,254 |
| Common stocks | 227,218,784 | 238,129,061 |
| Preferred stocks | 17,752,800 | — |
| Investment in affiliates | 454,153,779 | 417,531,543 |
| Real estate occupied by the Company, at cost, less accumulated depreciation of $8,383,949 and $7,837,411 in 2007 and 2006, respectively | 6,174,137 | 6,083,219 |
| Cash and short-term investments | 29,143,595 | 26,933,093 |
| Receivable for securities | 1,710,930 | — |
| Other invested assets | — | 9,500,000 |
| Total cash and invested assets | 1,290,980,355 | 1,268,572,170 |
| Uncollected premiums and agents' balances | 33,873,966 | 50,176,886 |
| Funds held by or deposited with reinsured companies | 4,000 | 4,000 |
| Current federal and foreign income tax recoverable | 1,385,987 | — |
| Reinsurance recoverable on paid losses and loss adjustment expenses | 14,984,528 | 33,767,293 |
| Electronic data processing equipment, at cost less accumulated straight-line depreciation of $23,252,910 and $21,846,272 in 2007 and 2006, respectively | 638,781 | 1,067,717 |
| Investment income due and accrued | 7,336,257 | 8,008,485 |
| Receivable from affiliates | 144,304 | — |
| Other assets | 2,536,924 | 4,713,544 |
| Total admitted assets | $ 1,351,885,102 | 1,366,310,095 |



(Continued)

## RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2007 and 2006

| Liabilities and Capital and Surplus | 2007 | 2006 |
|---|---|---|
| Unpaid losses and loss adjustment expenses | $ 341,096,591 | 359,017,609 |
| Reinsurance payable on paid losses | 544,184 | 256,554 |
| Accrued expenses | 38,452,163 | 33,921,591 |
| Borrowed money including accrued interest | 28,022,985 | — |
| Unearned premiums | 139,049,214 | 130,212,740 |
| Advance premiums | 3,954,125 | 3,500,752 |
| Ceded reinsurance premiums payable | 8,941,408 | 30,883,761 |
| Funds held under reinsurance agreements | 537,795 | 918,936 |
| Amounts withheld | 13,934,729 | 13,485,228 |
| Provision for reinsurance | 903,200 | 3,847,000 |
| Payable to affiliates | — | 1,024,009 |
| Payable for securities | — | 1,082,820 |
| Federal income taxes including deferred tax liability of $7,935,766 and $19,846,085 in 2007 and 2006, respectively | 7,935,766 | 23,911,534 |
| Commissions payable, contingent commissions, and other similar charges | 15,122,083 | 15,825,241 |
| Other liabilities | 1,386,534 | 1,516,905 |
| Total liabilities | 599,880,777 | 619,404,680 |
| Capital and surplus: | | |
| Capital stock, $125 par value. Authorized 1,000,000 shares; issued and outstanding 80,003 shares | 10,000,375 | 10,000,375 |
| Paid-in contributed capital | 242,451,084 | 242,451,084 |
| Unassigned surplus | 499,552,866 | 494,453,956 |
| Total capital and surplus | 752,004,325 | 746,905,415 |
| Total liabilities and capital and surplus | $ 1,351,885,102 | 1,366,310,095 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Income and Changes in Capital and Surplus

Years ended December 31, 2007 and 2006

| | 2007 | 2006 |
|---|---|---|
| Premiums earned | $ 244,443,167 | 227,970,972 |
| Losses and underwriting expenses incurred: | | |
| Losses and loss adjustment expenses | 89,965,966 | 104,746,105 |
| Other underwriting expenses | 111,352,486 | 100,130,312 |
| Total losses and underwriting expenses incurred | 201,318,452 | 204,876,417 |
| Net underwriting gain | 43,124,715 | 23,094,555 |
| Net investment income | 89,508,960 | 32,235,270 |
| Net realized capital gains, less capital gains tax of $8,745,164 and $13,629,952 for 2007 and 2006, respectively | 16,241,019 | 25,312,767 |
| Total investment income | 105,749,979 | 57,548,037 |
| Other income | 192,179 | 724,733 |
| Income before federal income taxes, net of tax on realized gains | 149,066,873 | 81,367,325 |
| Federal income tax expense | 22,861,220 | 8,827,800 |
| Net income | 126,205,653 | 72,539,525 |
| Capital and surplus at beginning of year | 746,905,415 | 693,717,647 |
| Change in unrealized appreciation of investments (net of tax) | 25,554,010 | 45,421,257 |
| Change in net deferred income tax | 2,043,104 | (5,392,352) |
| Change in nonadmitted assets | (1,925,230) | (817,254) |
| Change in provision for reinsurance | 2,943,800 | 932,400 |
| Dividends to stockholder | (149,722,427) | (59,495,808) |
| Capital and surplus at end of year | $ 752,004,325 | 746,905,415 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Cash Flow

Years ended December 31, 2007 and 2006

| | 2007 | 2006 |
|---|---|---|
| Operating activities: | | |
| Premiums collected, net of reinsurance | $ 247,878,190 | 233,477,057 |
| Investment income, net of investment expense | 92,788,159 | 34,509,282 |
| Other income | 192,181 | 724,733 |
| Benefits and loss related payments | (63,779,649) | (83,682,416) |
| Commissions and other expenses paid | (132,562,012) | (122,871,822) |
| Federal income taxes paid | (37,057,820) | (19,211,930) |
| Net cash flow from operations | 107,459,049 | 42,944,904 |
| Investing activities: | | |
| Cash provided from investments sold, matured, or repaid: | | |
| Bonds | 135,050,789 | 150,832,163 |
| Stocks | 58,411,121 | 75,172,615 |
| Other invested assets | 9,500,000 | 2,000,000 |
| Miscellaneous proceeds | 100,974 | 11,995 |
| Cost of investments acquired: | | |
| Bonds | (122,104,264) | (154,986,257) |
| Stocks | (62,135,532) | (25,779,237) |
| Real estate | (609,563) | (688,390) |
| Other invested assets | — | (5,000,000) |
| Miscellaneous applications | (2,793,753) | (907,536) |
| Net cash flow from investing activities | 15,419,772 | 40,655,353 |
| Financing activities and miscellaneous sources: | | |
| Borrowed funds received (repaid) | 28,022,985 | (6,254,554) |
| Dividends to stockholders | (149,722,427) | (59,495,808) |
| Other cash provided (applied) | 1,031,123 | (4,952,584) |
| Net cash flow from financing activities and miscellaneous sources | (120,668,319) | (70,702,946) |
| Net change in cash and short-term investments | 2,210,502 | 12,897,311 |
| Cash and short-term investments at beginning of year | 26,933,093 | 14,035,782 |
| Cash and short-term investments at end of year | $ 29,143,595 | 26,933,093 |

See accompanying notes to statutory financial statements.

## (1) Background and Significant Accounting Policies

### *(a) Organization*

RLI Insurance Company (the Company or RLI) is a wholly owned subsidiary of RLI Corp. The Company is primarily engaged in writing selected property and casualty insurance, including difference in conditions, homeowners, general and product liability, directors and officers, commercial fire, commercial and personal umbrella, marine, employers' excess indemnity, commercial auto, and contract and miscellaneous surety bonds. The Company's principal market is the United States, with a concentration on the West Coast, where commercial earthquake coverage (difference in conditions) is significant.

### *(b) Basis of Presentation*

The accompanying statutory financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance (Division). The National Association of Insurance Commissioners' *Accounting Practices and Procedures* (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the Division. The Division has adopted all of the prescribed accounting practices as stated in the NAIC SAP and the Company has no material permitted accounting practices. Statutory accounting practices differ in certain respects from U.S. generally accepted accounting principles (GAAP). The most significant differences include:

(1) Acquisition costs related to premiums written are expensed as incurred, rather than deferred to the extent recoverable and charged to operations ratably over the period covered by the related insurance policies as prescribed by GAAP.

(2) Investments in bonds are not classified as to the Company's intention to trade, hold to maturity, or make available for sale. Investments in bonds are generally carried at amortized cost rather than fair value. Accordingly, unrealized changes in fair value attributable to bonds are not reflected in the statutory statements of income and changes in capital and surplus.

(3) Certain assets are designated as nonadmitted assets and are charged to surplus, as opposed to being carried at amounts recoverable for GAAP purposes.

(4) The realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles (SSAP) No. 10, *Income Taxes*. Any gross deferred tax assets determined to be not realizable within one year are nonadmitted for statutory accounting purposes. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in tax expense under GAAP, whereas under statutory accounting principles, these changes directly impact surplus. For contingent tax liabilities, GAAP also used a "more likely than not" threshold for measurement purposes whereas SSAP uses a measurement threshold in accordance with SSAP No. 5, *Liabilities, Contingencies and Impairments of Assets*.



(Continued)

(5) A liability is established, which is not required under GAAP, by a direct charge to unassigned surplus for unsecured reinsurance recoverables from unauthorized reinsurers and certain past due amounts from authorized reinsurers, rather than just providing for the estimated amounts deemed uncollectible.

(6) The liability for unpaid losses and loss adjustment expenses is reported net of reinsurance recoverables, and unearned premiums are reported net of prepaid reinsurance premiums, rather than presenting these amounts gross of the effects of reinsurance ceded for GAAP.

(7) Wholly owned insurance subsidiaries are reflected at net statutory book value with changes reflected directly in capital and surplus, as opposed to consolidation of assets and liabilities and income on the financial statements for GAAP.

(8) The statutory statement of cash flow differs in certain respects from the presentation required by Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows,* including the presentation of the changes in cash and short-term investments instead of cash and cash equivalents. Short-term investments include securities with original maturities of one year or less at the time of acquisition.

(9) Comprehensive income, which is required under GAAP, is not determined for statutory reporting purposes.

Under GAAP, for the years ended December 31, 2007 and 2006, the Company had net income of $131,970,678 and $51,177,955, respectively. The Company's GAAP shareholder's equity amounted to $889,998,337 and $867,995,226 at December 31, 2007 and 2006, respectively.

Significant statutory accounting policies are as follows:

***(c) Investments***

Bonds are generally stated at amortized cost with the discount or premium on bonds amortized using the scientific method. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on bonds acquired and the addition of discount accrual. Short-term investments are valued at cost, which approximates fair value, and are considered cash equivalents in the statutory financial statements. Real estate is valued at cost less accumulated depreciation, which is computed on a straight-line basis over the estimated useful lives of the properties.

Loan-backed securities are stated at either amortized cost or the lower of amortized cost or fair value dependent upon NAIC designations. All of the Company's loan-backed securities were purchased subsequent to January 1, 1994. Loan-backed securities are revalued using currently estimated cash flow, including new prepayment assumptions, under the retrospective methodology. Prepayment assumptions for single class and multiclass mortgage-backed securities were obtained from external sources.



(Continued)

Unaffiliated common stocks are carried at values assigned by the NAIC. Stocks of affiliates in which the Company has an interest of 20% or more are carried based upon the affiliate's audited statutory surplus. Dividends on stocks are credited to income on the ex-dividend date. Realized investment gains and losses are determined at the trade date on the basis of the specific-identification method and are reflected in net income. Unrealized gains or losses are charged or credited directly to unassigned surplus, net of provision for deferred income taxes.

Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2) that have characteristics of debt securities are valued at cost or amortized cost. Highest-quality or high-quality perpetual preferred stocks (NAIC designations 1 and 2) that have characteristics of equity securities are valued using unit prices as reported in the NAIC *Valuations of Securities* manual. Dividends on preferred stock, other than mandatorily redeemable preferred stock, are recorded as investment income on the ex-dividend date. Dividends on mandatorily redeemable preferred stock are accrued to the redemption price, even if not declared, using the interest method over the period ending on the redemption date. The Company did not have any preferred stock investments with NAIC ratings lower than 2 as of December 31, 2007.

The Company reviews the values of their investments in bonds and common stocks on a quarterly basis for other-than-temporary losses. Investments that have a fair value that is less than cost or amortized cost are evaluated for other-than-temporary impairment. The Company's methodology of assessing other-than-temporary impairments is based on security-specific facts and circumstances as of the date of the reporting period. Management considers the length of time and the extent to which the fair value has been less than cost, the financial condition and short-term prospects of the issuer including any specific events that may influence the operations of the issuer, and the intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in value. If this review suggests that a decline in fair value is other than temporary, the carrying value in the investment is reduced to its fair value through an adjustment to earnings.

***(d) Investment in Affiliates and Related Parties***

The Company owns 100% of the common stock of Mt. Hawley Insurance Company (Mt. Hawley), Safefleet Insurance Services, Inc. (Safefleet), RLI Insurance Ltd (RLI Ltd), Underwriters Indemnity General Agency (UIGA), and RLI Underwriting Services, Inc. (RLI US). Mt. Hawley is engaged in writing excess and surplus lines of insurance. The Company's investment in Mt. Hawley is carried at cost plus equity in statutory net income and surplus adjustments since the date of formation, less dividends received. Changes in the carrying value of the Company's investment in Mt. Hawley are reflected directly in unassigned surplus. Mt. Hawley maintains at December 31, 2007 an investment of 2,022,086 shares in its ultimate parent, RLI Corp. The estimated fair value of this common stock at December 31, 2007, after reduction of Mt. Hawley's reciprocal ownership, was $37,387,223.



(Continued)

Safefleet, RLI Ltd, UIGA, and RLI US are valued based on their underlying audited GAAP equity adjusted to a statutory basis of accounting under the provisions of SSAP No. 97, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88,* which supersedes SSAP No. 88, *Investments in Subsidiary, Controlled and Affiliated Entities,* and was adopted as of December 31, 2007. Per SSAP No. 97, the Company has nonadmitted its investment in Safefleet, RLI Ltd, UIGA, and RLI US since GAAP audits are not conducted individually for these subsidiaries.

***(e) Revenue Recognition***

Premiums, net of reinsurance, are earned and recognized as revenue ratably over the period of the underlying policies. Unearned premiums, which are reflected net of reinsurance, represent the pro rata portion of premiums written, which are applicable to the unexpired terms of the policies in force.

***(f) Acquisition Costs***

The costs of acquiring insurance premiums (principally commissions and premium taxes) are charged to current operations as incurred.

***(g) Liability for Unpaid Losses and Loss Adjustment Expenses***

The estimated liability for unpaid losses and loss adjustment expenses includes a provision for reported and unpaid losses as well as estimates of losses incurred but not reported, net of amounts covered by reinsurance. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social, and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. As these amounts are determined based upon estimates, the ultimate liability may be more or less than such estimates. Based on the current assumptions used in calculating reserves, management believes that the Company's overall reserve levels at December 31, 2007 make a reasonable provision to meet its future obligations.

***(h) Federal Income Taxes***

The Company files a consolidated federal income tax return with its parent and affiliates. The provision for federal income taxes is based on current taxable income. The method of allocation between the companies is subject to written agreement and approved by the board of directors. Allocation is based on the ratio of that portion of the separate company taxable income each member bears to the total taxable income of the group. Intercompany tax balances are settled within 30 days of filing the consolidated income tax return.



(Continued)

Current year federal income tax expense is based on financial reporting income or loss adjusted for certain permanent and timing differences. The timing differences are the result of dissimilar financial reporting and tax basis accounting methods. A net deferred tax asset, representing the tax effect of timing differences between financial reporting and the tax basis of assets and liabilities, is only reported as an admitted asset to the extent that it will be realized within one year, subject to certain limitations, or to the extent that it offsets deferred tax liabilities. The change in net deferred tax asset or liability is reflected directly in surplus.

The Company records liabilities for potential tax contingencies only when it is probable the position will not be sustainable upon audit by taxing authorities. These liabilities are reevaluated routinely and are adjusted appropriately based upon changes in facts or law. Penalties and interest, in the event they are incurred, are included in tax expense. The level of uncertain tax items is not significant as of December 31, 2007 and 2006, respectively.

***(i) Provision for Reinsurance***

A statutory reinsurance liability must be established for unsecured amounts ceded to unauthorized reinsurers and certain amounts of past due recoverables from authorized reinsurers. This amount is recorded through a direct charge to unassigned surplus.

***(j) Nonadmitted Assets***

Certain assets (principally direct premiums 90 days past due, office furniture and equipment, EDP equipment, real estate, and certain investments in affiliates) are designated as nonadmitted assets and charged to unassigned surplus.

***(k) Allowance for Uncollectible Reinsurance***

Periodically an allowance representing an estimate of unrecoverable amounts on both paid and unpaid recoverables from troubled or insolvent reinsurers is provided through a charge to income. The Company believes that current allowance levels for uncollectible reinsurance are sufficient to cover the related exposure.

***(l) Depreciation and Amortization***

Currently all depreciation and amortization is calculated using the straight-line method. The useful lives are as follows: 3 years for computers and external operating software and 5 to 40 years for tenant improvements and real estate. Depreciation and amortization expense for the Company totaled $2,848,157 and $1,836,502 for 2007 and 2006, respectively.

***(m) Risks and Uncertainties***

Certain risks and uncertainties are inherent to the Company's day-to-day operations and to the process of preparing its statutory financial statements. The more significant of those risks and uncertainties, as well as the Company's methods for attempting to mitigate, quantify, and minimize such risks and uncertainties, are presented below and throughout the notes to the statutory financial statements.



(Continued)

**Catastrophe Exposures**

The Company's past and present insurance coverages include exposure to catastrophic events. Certain of the Company's property policies cover catastrophic events such as earthquakes, floods, and windstorms. The Company has a concentration of such coverages in California (7% of total property direct premiums written). Using computer-assisted techniques, the Company quantifies and monitors its exposure to catastrophic events. The Company limits its risk to such catastrophes through the purchase of reinsurance.

**Environmental Exposures**

The Company is subject to environmental claims and exposures through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, management has attempted to mitigate or control the extent of this exposure through the following methods: 1) the Company's policies include pollution exclusions that have been continually updated to further strengthen the exclusion and 2) the Company's policies primarily cover moderate hazard risks. The Company includes historical environmental loss experience with the remaining loss experience in the applicable line of business to project ultimate incurred losses and loss adjustment expenses and related incurred but not reported loss and loss adjustment expense reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, the Company has used this experience to record loss and loss adjustment expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 7.

**Reinsurance**

Reinsurance does not discharge the Company from its primary liability to policyholders and, to the extent that a reinsurer is unable to meet its obligations, the Company would be liable. The Company reviews and monitors the financial condition of prospective and existing reinsurers and currently attempts to purchase reinsurance from a limited number of financially strong reinsurers. As discussed above, the Company provides an allowance for reinsurance balances deemed uncollectible.

**Investments**

The Company is exposed to risks that issuers of securities owned by the Company will default, or that interest rates will change and cause a decrease in the value of its investments. Management attempts to mitigate these risks by investing in high-grade securities and by matching maturities of its investments with the anticipated payouts of its liabilities.



(Continued)

**Use of Estimates**

The preparation of statutory financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ from those estimates. The most significant of these amounts is the liability for unpaid losses and loss adjustment expenses. Management continually updates its estimates as additional data becomes available and adjusts the statutory financial statements as deemed necessary. Other estimates such as the recoverability of reinsurance balances are constantly monitored, evaluated, and adjusted. Although recorded estimates are supported by actuarial computations and other data, the estimates are ultimately based on management's expectations of future events. It is reasonably possible that expectations associated with these accounts can change in the near term (i.e., one year) and that the effect of these changes could be material to the statutory financial statements.

**External Factors**

The Company is regulated by the State of Illinois, in which it is domiciled, as well as states in which it does business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments, and regulate rates insurers may charge for various products. The Company is also subject to insolvency and guarantee fund assessments for policyholder losses covered by insolvent insurers. The Company generally accrues an assessment during the period in which it becomes probable that a liability has been incurred from an insolvency and the amount of the related assessment can be reasonably estimated.

The NAIC has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory capital and surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written, and unearned premium) risk. The NAIC calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. The Company continuously monitors its internal capital requirements and the NAIC's RBC developments. The Company has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that the Company's capital levels are sufficient to support the level of risk inherent in its operations.

***(n) Fair Value Disclosures***

Equity securities are valued using NAIC fair value prices, if available. If a NAIC fair value is not available, fair value is estimated using quoted market prices of the security or similar securities. Equity securities are carried at NAIC fair value, whereas bonds are generally carried at amortized cost based upon NAIC designations. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, and accounts payable, the carrying value of each is a reasonable estimate of fair value. Fair values of bonds are disclosed in note 2.



(Continued)

*(o) Significant Events*

During 2007, the Company paid cash dividends to its parent, RLI Corp., of which $85 million were extraordinary dividends. A need existed to move additional capital to RLI Corp; therefore, permission for the extraordinary dividends was sought and obtained from the Division. During the same period in 2006, the Company paid dividends to its parent of $59.5 million. The 2006 amount included dividends of shares of $35.2 million for 100% of the carrying value of the Company's investment in Maui Jim, Inc. and $13.4 million for 100% of the carrying value of the Company's investment in Taylor Bean and Whitaker Mortgage Corp., as well as a cash dividend of $10.9 million.

**(2) Investments**

The statement value and estimated fair value of bonds at December 31, 2007 and 2006, respectively, are reflected below. Estimated fair values are based on pricing information obtained from the NAIC's Securities Valuation Office (SVO). For any securities not priced by the NAIC, fair values are based on quoted market prices, where available. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services.

| | 2007 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 6,379,243 | 159,357 | (46) | 6,538,554 |
| Government agencies and government-backed securities | 105,680,402 | 1,767,129 | — | 107,447,531 |
| States, political subdivisions, and special revenue securities | 192,832,681 | 3,207,033 | (137,114) | 195,902,600 |
| Corporate and other securities | 122,781,500 | 1,307,855 | (1,657,614) | 122,431,741 |
| Mortgage-backed securities and CMOs | 127,152,504 | 1,181,911 | (745,450) | 127,588,965 |
| Totals | $ 554,826,330 | 7,623,285 | (2,540,224) | 559,909,391 |



(Continued)

| | 2006 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 8,774,376 | 32,951 | (104,003) | 8,703,324 |
| Government agencies and government-backed securities | 101,060,565 | 516,969 | (574,689) | 101,002,845 |
| States, political subdivisions, and special revenue securities | 222,011,260 | 2,599,075 | (739,401) | 223,870,934 |
| Corporate and other securities | 106,564,060 | 907,892 | (1,758,326) | 105,713,626 |
| Mortgage-backed securities and CMOs | 131,984,993 | 599,465 | (1,633,409) | 130,951,049 |
| Totals | $ 570,395,254 | 4,656,352 | (4,809,828) | 570,241,778 |

The statement value and estimated fair value of bonds at December 31, 2007 by contractual maturity are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties and because most mortgage-backed and asset-backed securities provide for periodic payments throughout their lives. Such securities have been classified in the table below based upon contractual maturities.

| | Statement value | Estimated fair value |
|---|---|---|
| Due in one year or less | $ 13,857,488 | 13,946,655 |
| Due after one year through five years | 127,545,295 | 129,801,790 |
| Due after five years through ten years | 223,328,002 | 225,725,772 |
| Due after ten years | 190,095,545 | 190,435,174 |
| | $ 554,826,330 | 559,909,391 |

Proceeds from sales of bonds during 2007 and 2006 were $57,972,521 and $97,834,144, respectively. Proceeds from maturities/calls of bonds during 2007 and 2006 were $77,078,268 and $52,998,019, respectively. Gross gains realized on bond sales totaled $318,288 and $342,673 in 2007 and 2006, respectively. Gross losses realized on bond sales totaled $942,345 and $3,412,355 in 2007 and 2006, respectively.



(Continued)

The cost of common and preferred stocks of nonaffiliates owned at December 31, 2007 and 2006 was $145,263,218 and $116,091,631, respectively. Gross unrealized gains and losses on such investments are as follows:

| | 2007 | 2006 |
|---|---|---|
| Unrealized gains | $ 104,718,962 | 122,355,933 |
| Unrealized losses | (5,010,596) | (318,503) |
| Net unrealized gains | $ 99,708,366 | 122,037,430 |

The unrealized gains on investments in affiliates are as follows:

| | 2007 | 2006 |
|---|---|---|
| Carrying value of investments in affiliates, gross of nonadmitted assets | $ 456,713,953 | 418,698,094 |
| Cost of investments in affiliates | 145,688,624 | 145,688,624 |
| Unrealized gains | $ 311,025,329 | 273,009,470 |

The carrying value of investments in affiliates for 2007 and 2006 as reported in the statutory statements of admitted assets, liabilities, and capital and surplus is net of $2,560,174 and $1,166,551, respectively, of nonadmitted assets.

Proceeds from sales of equity securities during 2007 and 2006 were $58,411,121 and $75,172,615, respectively. Gross gains realized on those sales totaled $26,843,567 and $42,391,424 in 2007 and 2006, respectively. Gross losses realized on those sales totaled $1,336,546 and $440,513 in 2007 and 2006, respectively.

Investments with a statement value of $32,827,545 and $4,921,678, as of December 31, 2007 and 2006, respectively, were on deposit with governmental authorities or banks to comply with insurance laws or were pledged as collateral for borrowing arrangements.



(Continued)

The composition of net investment income is as follows:

| | 2007 | 2006 |
|---|---|---|
| Bonds | $ 28,915,188 | 26,885,328 |
| Stocks | 7,074,062 | 6,118,055 |
| Dividends from affiliate | 55,000,000 | — |
| Real estate | 1,105,800 | 1,105,800 |
| Cash on deposit and short-term investments | 1,155,745 | 1,051,430 |
| Other | 584,897 | 706,015 |
| | 93,835,692 | 35,866,628 |
| Less investment expenses | 4,326,732 | 3,631,358 |
| Net investment income | $ 89,508,960 | 32,235,270 |

The Company is party to a securities lending program whereby fixed-income securities are loaned to third parties, primarily major brokerage firms. At December 31, 2007 and 2006, fixed maturities with a fair value of $16.3 million and $26.1 million were loaned, respectively. Agreements with custodian banks facilitating such lending generally require 102% of the value of the loaned securities to be separately maintained as collateral for each loan. The collateral received pursuant to the securities lending transactions is restricted as governed by the lending agreements. To further minimize the credit risks related to this lending program, we monitor the financial condition of other parties to these agreements.



(Continued)

The following tables illustrate the total value of securities that were in an unrealized loss position as of December 31, 2007 and 2006, respectively.

| | 2007 | | |
|---|---|---|---|
| | Less than 12 months | Greater than 12 months | Total |
| | | (In thousands) | |
| U.S. government: | | | |
| Fair value | $ 204 | — | 204 |
| Cost or amortized cost | 204 | — | 204 |
| Unrealized loss | $ — | — | — |
| U.S. agency: | | | |
| Fair value | $ — | — | — |
| Cost or amortized cost | — | — | — |
| Unrealized loss | $ — | — | — |
| Mortgage-backed: | | | |
| Fair value | $ 3,243 | 37,206 | 40,449 |
| Cost or amortized cost | 3,286 | 37,908 | 41,194 |
| Unrealized loss | $ (43) | (702) | (745) |
| Corporate: | | | |
| Fair value | $ 24,085 | 35,021 | 59,106 |
| Cost or amortized cost | 24,779 | 35,985 | 60,764 |
| Unrealized loss | $ (694) | (964) | (1,658) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 15,560 | 14,862 | 30,422 |
| Cost or amortized cost | 15,665 | 14,894 | 30,559 |
| Unrealized loss | $ (105) | (32) | (137) |
| Subtotal, debt securities: | | | |
| Fair value | $ 43,092 | 87,089 | 130,181 |
| Cost or amortized cost | 43,934 | 88,787 | 132,721 |
| Unrealized loss | $ (842) | (1,698) | (2,540) |
| Common stock: | | | |
| Fair value | $ 19,273 | — | 19,273 |
| Cost or amortized cost | 23,014 | — | 23,014 |
| Unrealized loss | $ (3,741) | — | (3,741) |
| Preferred stock: | | | |
| Fair value | $ 5,183 | — | 5,183 |
| Cost or amortized cost | 6,453 | — | 6,453 |
| Unrealized loss | $ (1,270) | — | (1,270) |
| Subtotal, equity securities: | | | |
| Fair value | $ 24,456 | — | 24,456 |
| Cost or amortized cost | 29,467 | — | 29,467 |
| Unrealized loss | $ (5,011) | — | (5,011) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 67,548 | 87,089 | 154,637 |
| Cost or amortized cost | 73,401 | 88,787 | 162,188 |
| Unrealized loss | $ (5,853) | (1,698) | (7,551) |



(Continued)

| | 2006 | | |
|---|---|---|---|
| | Less than 12 months | Greater than 12 months | Total |
| | (In thousands) | | |
| U.S. government: | | | |
| Fair value | $ 1,543 | 3,265 | 4,808 |
| Cost or amortized cost | 1,550 | 3,362 | 4,912 |
| Unrealized loss | $ (7) | (97) | (104) |
| U.S. agency: | | | |
| Fair value | $ 28,926 | 33,847 | 62,773 |
| Cost or amortized cost | 28,993 | 34,354 | 63,347 |
| Unrealized loss | $ (67) | (507) | (574) |
| Mortgage-backed: | | | |
| Fair value | $ 31,711 | 59,571 | 91,282 |
| Cost or amortized cost | 31,861 | 61,054 | 92,915 |
| Unrealized loss | $ (150) | (1,483) | (1,633) |
| Corporate: | | | |
| Fair value | $ 28,414 | 36,152 | 64,566 |
| Cost or amortized cost | 28,712 | 37,612 | 66,324 |
| Unrealized loss | $ (298) | (1,460) | (1,758) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 48,474 | 38,655 | 87,129 |
| Cost or amortized cost | 48,659 | 39,209 | 87,868 |
| Unrealized loss | $ (185) | (554) | (739) |
| Subtotal, debt securities: | | | |
| Fair value | $ 139,066 | 171,490 | 310,556 |
| Cost or amortized cost | 139,775 | 175,591 | 315,366 |
| Unrealized loss | $ (709) | (4,101) | (4,810) |
| Common stock: | | | |
| Fair value | $ 8,773 | — | 8,773 |
| Cost or amortized cost | 9,092 | — | 9,092 |
| Unrealized loss | $ (319) | — | (319) |
| Preferred stock: | | | |
| Fair value | $ — | — | — |
| Cost or amortized cost | — | — | — |
| Unrealized loss | $ — | — | — |
| Subtotal, equity securities: | | | |
| Fair value | $ 8,773 | — | 8,773 |
| Cost or amortized cost | 9,092 | — | 9,092 |
| Unrealized loss | $ (319) | — | (319) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 147,839 | 171,490 | 319,329 |
| Cost or amortized cost | 148,867 | 175,591 | 324,458 |
| Unrealized loss | $ (1,028) | (4,101) | (5,129) |



(Continued)

As of December 31, 2007 and 2006, 137 and 273 bonds, respectively, had an unrealized loss. These bonds represent a total fair value of $130.2 million and $310.6 million, respectively, and a total unrealized loss of $2.5 million and $4.8 million, respectively. All of the bonds in the Company's portfolio are investment grade and no individual bond has shown deterioration in price that is consistent with an inability to recover principal.

The fixed-income unrealized losses can be primarily attributed to changes in interest rates and market conditions since the time of purchase. The Company continually monitors the credit quality of its fixed-income investments to gauge its ability to be repaid principal and interest under the contractual terms. The Company considers price declines of securities in its other-than-temporary-impairment analysis where such price declines provide evidence of declining credit quality, and the Company distinguishes between price changes caused by credit deterioration, as opposed to rising interest rates.

Factors that are considered in the evaluation of credit quality include:

1. Credit ratings from major rating agencies, including Moody's and Standard and Poor's,
2. Business and operating performance trends,
3. Management quality/turnover,
4. Industry competitive analysis, and
5. Changes in business model/strategy.

As of December 31, 2007 and 2006, 20 and 6 equity securities, respectively, were in the RLI portfolio that had unrealized losses. These securities were all in unrealized loss positions of less than 20% for less than six consecutive months. The Company has the ability and intent to hold these investments until market price recovery or maturity. As a result, the Company does not consider any equity or bond securities to be other than temporarily impaired.

The Company does not engage in subprime residential mortgage lending. The Company evaluates many characteristics when classifying collateral as subprime, including credit quality of the borrower as defined by Fair Isaac Credit Organization (FICO) scores, as well as other factors, such as loan-to-value ratios and type of real estate. Relating to investments, the Company's exposure to subprime lending is limited to the fixed maturity investment portfolio, which contains securities collateralized by mortgages that have characteristics of subprime lending such as home equity mortgages. These investments are in the form of asset-backed securities collateralized by subprime mortgages and collateralized mortgage obligations backed by alternative documentation mortgages. The total carrying value of these investments is approximately $4.9 million comprising less than 1% of the Company's total fixed maturity portfolio. The average credit rating of all of these securities was AAA as of December 31, 2007 and reflects the Company practice of minimizing exposure to low quality (subprime type) credit risk. In addition, all of the securities containing subprime collateral were originated before 2005. The Company did not recognize any impairment charges in its investment portfolio, including subprime mortgages, during 2007 and 2006.

The following table presents the Company's exposure to securities backed by subprime residential mortgage loans as of December 31, 2007.

| Credit quality | Book/adjusted carrying value | Fair value |
|---|---|---|
| NAIC 1 | $ 4,856,924 | 4,813,775 |
| NAIC 2 | — | — |
| NAIC 3 | — | — |
| NAIC 4 | — | — |
| | $ 4,856,924 | 4,813,775 |

From an insurance standpoint, the Company has exposure to subprime market issues through the Company's other liability (directors and officers) coverages. The Company's exposure to subprime, however, is minimal. The Company has a limited number of claims and expects net exposure to subprime related risks to be less than $5 million. Surety coverage is another area that the Company can have direct exposure to subprime. The Company writes a few mortgage broker bonds, but believes this exposure to be minimal. In addition, the Company does not have a significant exposure from a surety standpoint to the home building industry.

**(3) Related-Party Transactions**

As described below and elsewhere in the notes to the statutory financial statements, the Company has engaged in transactions with its parent, affiliates, and subsidiaries during the normal course of business:

(a) The Company allocates certain expenses to RLI Corp. and affiliated companies, Mt. Hawley, RLI Indemnity Company (RIC), RLI US, and Safefleet, based upon the accounting principles set forth in the NAIC Accounting Practices and Procedures Manual. The intercompany services agreement allows a portion of the expenses incurred by the Company for the benefit of these affiliates to be allocated on a pro rata basis relative to the affiliate companies' gross earned premium to the total of gross earned premiums of the Company, and any other affiliate managed by the Company. This agreement further allows the expenses incurred by Safefleet for the benefit of the Company to be charged back to the Company on a cost reimbursement basis. The Company allocated net expenses of $43.5 million and $43.3 million to the aforementioned related parties during 2007 and 2006, respectively, as a result of services performed.

(b) The Company received $55 million in cash dividends from its wholly owned subsidiary, Mt. Hawley, in 2007. The Company received no dividends from any of its subsidiaries during 2006.

(c) During 2007, the Company paid RLI Corp. dividends of $149.7 million, of which $85 million were extraordinary dividends. A need existed to move additional capital to RLI Corp.; therefore, permission for the extraordinary dividends was sought and obtained from the Division. During the same period in 2006, the Company paid dividends to its parent of $59.5 million consisting of the dividend of shares of $35.2 million for 100% of the carrying value of the Company's investment in Maui Jim and $13.4 million for 100% of the carrying value of the Company's investment in Taylor,



(Continued)

Bean and Whitaker Mortgage Corp., as approved by the Division, as well as a cash dividend of $10.9 million.

(d) At December 31, 2007, the Company owns 100% of the common stock of its subsidiaries, Mt. Hawley, Safefleet, RLI Ltd, UIGA, and RLI US, having statement values of $454,153,779, $162,878, $1,117,426, $995,467, and $284,403, respectively. The Company nonadmitted its investment in Safefleet, UIGA, RLI Ltd, and RLI US, since GAAP audits are not conducted individually for these subsidiaries.

(e) Based on the Company's 100% ownership of Mt. Hawley, the statement value of Mt. Hawley's assets and liabilities as of December 31, 2007 were $1,040.4 million and $586.3 million, respectively. Net income of Mt. Hawley was $104.6 million for the year ended December 31, 2007.

(g) At December 31, 2007, the Company reported $144,304 as net amounts due from affiliates. At December 31, 2006, the Company reported $1,024,009, as net amounts due to affiliates. Any intercompany balance resulting from services performed or costs allocated in accordance with the terms of the intercompany services agreement are settled within 30 calendar days following the end of the calendar quarter in which the intercompany balance was created.

(h) On or about April 1, 2004, the Company entered into an intercompany guarantee with RLI Ltd. The Company has guaranteed the performance of RLI Ltd with respect to a punitive damages wrap policy over an excess policy with the Company. The policy has been renewed with an effective date of April 1, 2007. The guarantee is in the amount of $20 million.

**(4) Borrowed Funds**

The Company had $28.0 million and $0 of outstanding liability for borrowed money at December 31, 2007 and 2006, respectively. Interest paid on outstanding debt for 2007 and 2006 totaled $909,100 and $249,859, respectively.

**(5) Capital and Surplus**

Dividend payments from the Company to its parent are restricted by state insurance laws as to the amount that may be paid without prior approval from the regulatory authorities of Illinois. The maximum dividend distribution in a rolling 12-month period is limited by Illinois laws to the greater of 10% of policyholder surplus as of December 31 of the preceding year or net income of the Company for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend that can be paid by the Company in a rolling 12-month period ending in 2008 without prior approval is $126,205,653, which represents the Company's 2007 net income.

State insurance laws also restrict dividend payments to the Company from Mt. Hawley. The maximum dividends that can be paid to the Company by Mt. Hawley for a 12-month rolling period during 2008 without prior approval are $104.6 million, which represents Mt. Hawley's 2007 net income.

Unassigned surplus includes $65,337,585 in net unrealized gains on unaffiliated investments and has been reduced by $13,988,506 and $12,063,276 relating to nonadmitted assets as of December 31, 2007 and 2006, respectively. Additionally, surplus has been reduced by $903,200 and $3,847,000 for the provision for reinsurance as of December 31, 2007 and 2006, respectively.



(Continued)

## (6) Reinsurance

In the normal course of business, the Company assumes and cedes property and liability insurance exposures with other insurance companies, pools, and associations through various treaties and in certain instances by negotiation of individual risks. Generally, policies are reinsured with other insurance companies to limit the Company's risk on any individual loss to $8,000,000.

The following are summaries of the impact of the Company's reinsurance program on the statutory financial statements:

| | 2007 | | |
|---|---|---|---|
| | Direct | Assumed | Ceded |
| Premiums written | $ 326,497,440 | 10,106,815 | 83,324,614 |
| Premiums earned | 331,539,939 | 11,238,463 | 98,335,235 |
| Losses and loss adjustment expenses incurred | 83,812,475 | 10,407,126 | 4,253,635 |
| Unearned premiums | 170,754,060 | 3,631,900 | 35,336,746 |
| Unpaid losses and loss adjustment expenses | 536,093,750 | 49,096,130 | 244,093,289 |

| | 2006 | | |
|---|---|---|---|
| | Direct | Assumed | Ceded |
| Premiums written | $ 331,709,060 | 10,302,481 | 112,587,186 |
| Premiums earned | 339,074,390 | 10,276,226 | 121,379,644 |
| Losses and loss adjustment expenses incurred | 175,074,425 | 10,326,024 | 80,654,344 |
| Unearned premiums | 175,796,559 | 4,763,548 | 50,347,367 |
| Unpaid losses and loss adjustment expenses | 613,353,594 | 43,153,140 | 297,489,125 |

At December 31, 2007, net balances recoverable from reinsurers (comprising unearned premiums and losses and loss adjustment expenses paid and unpaid, including incurred but not reported amounts) having unsecured portions exceeding 3% of the Company's total capital and surplus were as follows:

| Name of reinsurer | Amount |
|---|---|
| *General Rein Corp* | $ 36,141,000 |
| Munich Re America | 40,130,000 |
| TOA Reinsurance | 23,034,000 |

The losses, loss adjustment expenses, and unearned premiums for business ceded to other insurers are recoverable and realizable to the extent that the assuming reinsurers fulfill their commitments. The Company has initiated arbitration or otherwise instituted legal actions where appropriate on certain outstanding recoverable balances.



(Continued)

As of January 1, 2007 and 2006, our property underwriting was supported by $500 million and $450 million, respectively, in traditional catastrophe reinsurance protection, subject to certain retentions by the Company. The limit decreased to $450 million at July 1, 2007. At January 1, 2008, the Company restructured its reinsurance program decreasing its traditional catastrophe reinsurance protection to $400 million, subject to certain retentions by the Company. The limit decreases to $375 million at July 1, 2008. The Company recorded a charge to income in 2007 of $8,554,039 for reinsurance balances deemed uncollectible. This charge is reflected in losses and loss adjustment expenses incurred. The most significant component was a write-off of $2,746,475 for balances due from Munich Re America.

The total return commission, which would have been due reinsurers if all reinsurance was canceled with the return of unearned premium would be $7,501,192 and $11,335,136 as of December 31, 2007 and 2006, respectively. The amount of return commission, predicated on loss experience as a result of existing contracts, was $281,248 and $366,950 as of December 31, 2007 and 2006, respectively.

The Company participates in a quota share reinsurance agreement with RIC. The agreement is applied after all other external reinsurance cessions. Under the terms of the agreement, RIC cedes and RLI assumes 90% of the net premium and liabilities for policies effective January 1, 2003, and subsequent. The agreement, which was effective January 1, 2003, has been accepted and placed on file by the Division. This agreement was amended in 2004 to include the assumption of 100% of RIC's existing net loss reserves and any future development on these reserves. The Division approved the loss portfolio transfer on June 29, 2004.

The following is a summary of the balances assumed under this agreement as of and for the years ended December 31, 2007 and 2006 (in thousands):

| | | 2007 | 2006 |
|---|---|---|---|
| Premium written | $ | 5,060 | 5,383 |
| Unearned premiums | | 1,933 | 2,387 |
| Premium earned | | 5,514 | 4,295 |
| Loss and loss adjustment expenses incurred | | 2,413 | 1,618 |
| Reserve for loss and loss adjustment expenses | | 3,153 | 2,552 |



(Continued)

## (7) Unpaid Losses and Loss Adjustment Expenses

The following table is a reconciliation of the Company's liability for unpaid losses and loss adjustment expenses (LAE) for the years ended December 31, 2007 and 2006. Since reserves are based on estimates, the ultimate net cost may vary from the original estimate. As adjustments to these estimates become necessary, they are reflected in current operations. As part of the reserving process, historical data is reviewed and consideration is given to the anticipated impact of various factors such as legal developments and economic conditions, including the effects of inflation. Changes in reserves from the prior years' estimates are calculated based on experience as of the end of each succeeding year (loss and LAE development).

| | 2007 | 2006 |
|---|---|---|
| | (In thousands) | |
| Net unpaid losses and LAE at beginning of year, net of reinsurance recoverable of $297,489 and $351,099 as of January 1 | $ 359,018 | 351,665 |
| Incurred losses and LAE related to: | | |
| Current accident year losses | 120,672 | 112,890 |
| Prior accident years losses | (30,706) | (8,144) |
| Total incurred | 89,966 | 104,746 |
| Paid loss and LAE payments related to: | | |
| Current accident year losses | (22,073) | (17,624) |
| Prior accident years losses | (85,814) | (79,769) |
| Total paid | (107,887) | (97,393) |
| Net unpaid losses and LAE at end of year, net of reinsurance recoverable of $244,093 and $297,489 as of December 31 | $ 341,097 | 359,018 |

### Reserve Development

During 2007, the Company undertook an assessment of recent reserving trends and reserve risk factors. This included a detailed ground-up analysis of the actuarial estimation risks associated with each of its products plus discussions with external consultants and an assessment of industry information. This review confirmed a favorable trend in recent years resulting from moderating loss trends, improvements in policy terms and conditions and a favorable underlying exposure mix that occurred during the hard market period of 2001 through 2004, which the Company began to recognize in 2006. Further, based on this review, refinements were made to company reserving methodologies to include a more detailed consideration of the impact of risk factors on total recorded reserves. This, along with increased internal dialogue, improved reserving diagnostics, and greater transparency of the actuarial process, has provided better and faster feedback to management and resulted in greater overall confidence in the actuarial estimates. As a consequence, management believes that the needed level of carried reserves above the actuarial point estimate has diminished. Over half of the favorable prior years' loss development in 2007 was the result of this detailed assessment and resulting changes in booked reserves.



(Continued)

The biggest share of the overall favorable development comes from accident years 2004 and 2005. By line of business, it is principally attributable to Commercial Auto Liability and Surety with smaller contributions coming from the Auto Physical Damage, Fire, Allied Lines and Inland Marine. These decreases offset small increases for the Assumed Reinsurance, Other Liability, Products Liability and Ocean Marine lines of business. Other than as described in the previous paragraph, the most significant driver of changes was updated expected development patterns that were adjusted to take into account the most recent observations.

During 2006, the Company continued to experience favorable loss development and reduced its estimates for loss reserves for prior years. The Company reviewed the expected loss ratios used in several of its reserving methods and made adjustments so they more closely reflected the apparent level of losses. This drove 35% – 40% of the favorable development with the remainder coming from continued favorable emergence and the common practice of, as accident years get older, giving less weight to the results of methods that rely on expected loss ratios. Overall favorable development was $8.1 million and it came primarily from the Other Liability, Auto, and Surety lines. There was some adverse development on property caused by our construction product that is in run-off. There was also some adverse development on ceded reserves, which was driven by both the adoption of a survival ratio reserving methodology and the assumptions used in this survival ratio reserving methodology.

The Company utilized estimates of salvage and subrogation for the surety book of business of $13,935,257 on a gross basis and $9,549,921 on a ceded basis in 2007. These amounts were $11,933,969 on a gross basis and $5,926,790 on a ceded basis in 2006.

**Environmental Exposure**

The Company has exposure to asbestos, and environmental claims through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. The majority of the exposure is in the excess layers of the Company's commercial umbrella and assumed reinsurance books of business.

Although a large majority of the Company's asbestos and environmental exposure is limited to losses occurring before the mid-1980s, management cannot determine the Company's ultimate liability with any high degree of certainty. The Company estimates the full impact of these exposures by establishing case basis reserves on all known losses. Reserves for related IBNR are recorded based upon actuarial projections of ultimate expected losses.

This ultimate liability is difficult to assess due to slow reporting of losses and evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, the Company participates primarily in the excess layers, making it difficult to assess the ultimate impact.



(Continued)

The Company's asbestos-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2007 and 2006 were as follows:

| | | 2007 | 2006 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 4,194,400 | 2,314,494 |
| Incurred losses and LAE | | 8,031,905 | 1,907,197 |
| Calendar year payments for losses and LAE | | (26,491) | (27,291) |
| Ending reserves | $ | 12,199,814 | 4,194,400 |
| Assumed: | | | |
| Beginning reserves | $ | 9,868,328 | 7,725,537 |
| Incurred losses and LAE | | 10,397,137 | 3,656,632 |
| Calendar year payments for losses and LAE | | (76,317) | (1,513,841) |
| Ending reserves | $ | 20,189,148 | 9,868,328 |
| Ceded: | | | |
| Beginning reserves | $ | 3,139,928 | 4,782,552 |
| Incurred losses and LAE | | 7,537,584 | (1,180,695) |
| Calendar year payments for losses and LAE | | (22,889) | (461,929) |
| Ending reserves | $ | 10,654,623 | 3,139,928 |
| Net: | | | |
| Beginning reserves | $ | 10,922,800 | 5,257,479 |
| Incurred losses and LAE | | 10,891,458 | 6,744,524 |
| Calendar year payments for losses and LAE | | (79,919) | (1,079,203) |
| Ending reserves | $ | 21,734,339 | 10,922,800 |

The Company holds both IBNR and case loss reserves related to asbestos exposure. During 2007, the Company experienced some unusual reported loss activity. Two specific developments caused large case reserve adjustments totaling $5 million. The Company reinsured an insurance company in the early 1980's that went into liquidation in 1986 and reported a number of claims in 2007, the largest of which involved asbestos. In response to this, the Company posted total net case reserves of $2.8 million. Also, a $2.2 million reserve adjustment was made on a 1983 asbestos related claim due to the coverage layers below our excess policy being exhausted. In addition, the Company made a minor adjustment to its emergence pattern assumptions that caused an increase in IBNR reserves. Of the total reserves, the Company held IBNR reserves in the amount of $15,472,325 on a gross basis and $9,594,431 on a net basis at December 31, 2007. At December 31, 2006, it held $5,845,315 on a gross basis and $5,440,804 on a net basis.

The Company held $1,719,147 on a gross basis and $1,066,048 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2007. At December 31, 2006, it held $570,513 on a gross basis and $533,644 on a net basis.



(Continued)

The Company's environmental-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2007 and 2006 were as follows:

| | | 2007 | 2006 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 4,891,168 | 13,786,812 |
| Incurred losses and LAE | | 1,257,851 | (4,765,638) |
| Calendar year payments for losses and LAE | | (448,593) | (4,130,006) |
| Ending reserves | $ | 5,700,426 | 4,891,168 |
| Assumed: | | | |
| Beginning reserves | $ | 2,861,566 | 1,913,950 |
| Incurred losses and LAE | | (532,486) | 969,574 |
| Calendar year payments for losses and LAE | | (988,981) | (21,958) |
| Ending reserves | $ | 1,340,099 | 2,861,566 |
| Ceded: | | | |
| Beginning reserves | $ | 2,619,522 | 9,941,636 |
| Incurred losses and LAE | | 1,046,504 | (5,246,009) |
| Calendar year payments for losses and LAE | | (624,096) | (2,076,105) |
| Ending reserves | $ | 3,041,930 | 2,619,522 |
| Net: | | | |
| Beginning reserves | $ | 5,133,212 | 5,759,126 |
| Incurred losses and LAE | | (321,139) | 1,449,945 |
| Calendar year payments for losses and LAE | | (813,478) | (2,075,859) |
| Ending reserves | $ | 3,998,595 | 5,133,212 |

The Company holds both IBNR and case loss reserves related to environmental exposure. Net incurred losses for 2007 were negative as there was favorable development on several direct and assumed claims for which the reinsurance recoveries had previously been written off due to commutations and insolvencies of the reinsurers. IBNR reserves were flat versus 2006, but would have been lower were it not for a change that was made to the expected emergence pattern. Of the total reserves, the Company held IBNR reserves in the amount of $3,465,796 on a gross basis and $1,755,209 on a net basis at December 31, 2007. At December 31, 2006, it held $3,660,106 on a gross basis and $2,821,917 on a net basis.

The Company held $611,611 on a gross basis and $309,743 on a net basis for future allocated loss adjustment expenses related to environmental exposure (including coverage dispute costs) at December 31, 2007. At December 31, 2006, it held $519,306 on a gross basis and $313,457 on a net basis.



(Continued)

## (8) Investment in Mt. Hawley

Condensed financial information for Mt. Hawley on a statutory basis is summarized below:

| | 2007 | 2006 |
|---|---|---|
| Balance sheet at December 31: | | |
| Assets | $ 1,040,417,221 | 1,024,693,618 |
| Liabilities | (586,263,442) | (608,268,983) |
| Total capital and surplus | $ 454,153,779 | 416,424,635 |
| Results of operations for the year ended December 31: | | |
| Premium earned | $ 299,422,237 | 301,848,521 |
| Losses and underwriting expenses | 195,026,856 | 247,428,656 |
| Underwriting gains | 104,395,381 | 54,419,865 |
| Investment income, including realized gains and losses net of tax | 44,909,509 | 37,783,651 |
| Other income | 196,223 | 321,365 |
| Income before federal income taxes | 149,501,113 | 92,524,881 |
| Federal income tax expense | 44,897,403 | 33,437,389 |
| Net income | $ 104,603,710 | 59,087,492 |

## (9) Federal Income Taxes

A reconciliation of federal income tax expense, computed by applying the statutory federal income tax rate of 35% in 2007 and 2006 to income before federal income taxes, which includes net realized capital gains, to the income tax expense shown in the accompanying statutory financial statements is as follows:

| | 2007 | 2006 |
|---|---|---|
| Computed "expected" tax expense | $ 55,234,212 | 33,249,047 |
| Tax-exempt interest | (2,547,578) | (2,730,869) |
| Dividends received deduction | (20,520,325) | (1,190,173) |
| Discounting of liability for losses and loss adjustment expenses | (1,594,517) | (79,195) |
| Change in unearned premiums | 659,844 | (101,737) |
| Intercompany transactions | (385,559) | (5,970,544) |
| Tax on net realized capital gains | (8,745,164) | (13,629,952) |
| Other | 760,307 | (718,777) |
| Federal income tax expense | $ 22,861,220 | 8,827,800 |

Income taxes incurred in current and prior years that will be available for recoupment in the event of future net losses are $33,869,855 for 2007 and $24,196,700 for 2006.



(Continued)

The net deferred tax asset and the change from the prior year comprise the following components:

| | December 31 2007 | December 31 2006 | Change |
|---|---|---|---|
| Total gross deferred tax assets | $ 34,579,819 | 31,855,839 | 2,723,980 |
| Total deferred tax liabilities | (42,515,585) | (51,701,924) | 9,186,339 |
| Net deferred tax liabilities | $ (7,935,766) | (19,846,085) | 11,910,319 |
| Tax effect of unrealized gains (losses) | | | (9,867,215) |
| Change in deferred income tax | | | $ 2,043,104 |

There are no temporary differences for which deferred tax liabilities are not recognized.

Deferred income tax assets and liabilities consist of the following major components:

| | December 31 2007 | December 31 2006 |
|---|---|---|
| Deferred tax assets: | | |
| Loss reserves | $ 12,791,832 | 14,386,349 |
| Unearned premium reserve | 9,774,736 | 9,114,892 |
| Agents balances and other nonadmitted assets | 3,999,916 | 3,813,854 |
| Accrued expenses | 5,281,798 | 3,656,612 |
| Depreciable assets | 151,791 | — |
| Deferred compensation | 2,240,870 | 249,154 |
| Defined benefit pension asset | — | 128,499 |
| Other | 338,876 | 506,479 |
| Total deferred tax assets | 34,579,819 | 31,855,839 |
| Nonadmitted deferred tax assets | — | — |
| Admitted deferred tax assets | 34,579,819 | 31,855,839 |
| Deferred tax liabilities: | | |
| Unrealized gains | 35,232,845 | 45,100,060 |
| Intercompany transactions | 6,356,103 | 5,970,544 |
| Investments | 196,851 | 207,553 |
| Investment income | 131,122 | 184,747 |
| Goodwill amortization | — | 46,640 |
| Other | 598,664 | 192,380 |
| Total deferred tax liabilities | 42,515,585 | 51,701,924 |
| Net deferred tax liabilities | $ (7,935,766) | (19,846,085) |



(Continued)

The Company's income tax incurred and change in deferred income tax differs from the amount obtained by applying the federal statutory rate of 35% to income before income taxes as follows:

| | | 2007 | 2006 |
|---|---|---|---|
| Income before taxes, which includes net realized capital gains | $ | 157,812,037 | 94,997,277 |
| Income tax expense at 35% statutory rate | | 55,234,212 | 33,249,047 |
| Increase (decrease) in tax resulting from: | | | |
| Dividends received deduction | | (20,520,325) | (1,190,173) |
| Nondeductible expenses | | 155,270 | 125,661 |
| Tax-exempt income | | (2,547,578) | (2,730,869) |
| Tax settlement | | (2,356,538) | — |
| Other | | (401,761) | (1,603,562) |
| Total statutory income taxes | $ | 29,563,280 | 27,850,104 |
| Current income taxes incurred | $ | 22,861,220 | 8,827,800 |
| Change in deferred income tax (without tax on unrealized gains and losses) | | (2,043,104) | 5,392,352 |
| Tax on net realized capital gains | | 8,745,164 | 13,629,952 |
| Total statutory income taxes | $ | 29,563,280 | 27,850,104 |

## (10) Employee Benefits

During 2003 through 2006, the Company gradually froze and terminated its defined benefit pension plan. The plan termination was finalized in 2006. All plan distributions were made in late 2006. In 2006, the Company, along with its affiliates and ultimate parent, paid $14.4 million in benefits and had no remaining benefit obligation at December 31, 2006. The pension expense incurred was $2.6 million in 2006. No expenses were incurred in 2007.

The Company, along with its affiliates and ultimate parent, participates in an Employee Stock Ownership Plan (ESOP) and a 401(k) plan, which covers substantially all employees. The Company provides a base contribution to the 401(k) plan of 3% of eligible compensation and allows voluntary contributions by employees. Additionally, annual discretionary profit sharing contributions may be made to both plans, subject to the achievement of certain overall financial goals. The total amount of expense for these plans for 2007 and 2006 was $9,761,233 and $7,983,865, respectively. The Company allocates a portion of this expense to its subsidiaries per the terms of the intercompany services agreement. The Company's total expenditures for employee benefits, including ESOP and 401(k) contributions but excluding the cost of incentive plans discussed below, were $10,966,325 and $11,342,103 for 2007 and 2006, respectively.

The Company, along with its affiliate and ultimate parent, also has bonus and incentive plans covering executives, management, and associates. These plans are subject to the achievement of certain overall financial targets, and to a lesser extent, management incentive plans are affected by other performance measures. The total amount of expense for these plans for 2007 and 2006 was $15,791,311 and $15,079,864, respectively. The Company allocates a portion of this expense to its subsidiaries per the terms of the intercompany services agreement.



(Continued)

In August 2002, the Company, along with its affiliates and ultimate parent, began offering certain eligible employees postemployment medical coverage. Under the Company's plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under the Company's health plan. Employees who elect continuation of coverage pay the full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. The Company expects a relatively small number of employees will become eligible for this benefit. The COBRA rate established for participating employees covers the cost of providing this coverage. The Company does not provide compensated absences.

**(11) Commitments and Contingent Liabilities**

The Company has an accrual for assessments at December 31, 2007 of $1.5 million. It is not possible at this time to determine the periods over which the assessments are expected to be paid.

The following is a description of a complex set of litigation wherein the Company is both a plaintiff and a defendant. While it is impossible to ascertain the ultimate outcome of this matter at this time, the Company believes, based upon facts known to date, that its position is meritorious. The Company's opinion is that the final resolution of these matters will not have a material adverse effect on its financial statements taken as a whole.

The Company is the plaintiff in an action captioned RLI Insurance Co. v. Commercial Money Center, et al., which was filed in U.S. District Court, Southern District of California (San Diego) on February 1, 2002. Other defendants in that action are Commercial Servicing Corporation (CSC), Sterling Wayne Pirtle, Anita Pirtle, Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, and Sky Bank. The Company filed a similar complaint against the Bank of Waukegan in San Diego, California Superior Court. Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, Sky Bank, and Bank of Waukegan are referred to as the Investor Banks. The litigation arises out of the equipment and vehicle leasing program of Commercial Money Center (CMC). CMC originated leases, procured bonds pertaining to the performance of obligations of each lessee under each lease, and then formed "pools" of such leases that it marketed to banks and other institutional investors. The Company sued for rescission and/or exoneration of the bonds the Company issued to CMC and sale and servicing agreements the Company entered into with CMC and the Investor Banks, which had invested in CMC's equipment leasing program. The Company contends that it was fraudulently induced to issue the bonds and enter into the agreements by CMC, who misrepresented and concealed the true nature of its program and the underlying leases originated by CMC (for which bonds were procured). The Company also sued for declaratory relief to determine its rights and obligations, if any, under the instruments. Each Investor Bank disputes the Company's claims for relief. CMC is currently in Chapter 7 bankruptcy proceedings.

Between the dates of April 4 and April 18, 2002, each Investor Bank subsequently filed a complaint against the Company in various state courts, which the Company removed to U.S. District Courts. Each Investor Bank sued the Company on certain bonds the Company issued to CMC as well as a sale and servicing agreement between the Investor Banks, CMC, and the Company. Each Investor Bank sued for breach of contract, bad faith, and other extra-contractual theories. The Company has answered and denies each Investor Bank's entitlement to relief. The Investor Banks claim entitlement to aggregate payment of approximately $53 million under either the surety bonds or the sale and servicing agreements, plus unknown extra-contractual damages, attorney's fees, and interest. On October 25, 2002, the judicial panel


(Continued)

for multidistrict litigation (MDL panel) transferred 23 actions pending in five federal districts involving numerous investor banks, five insurance companies, and CMC to the Federal District Court for the Northern District of Ohio for consolidated pretrial proceedings, assigning the litigation to The Honorable Kathleen O'Malley.

In the third quarter of 2005, the Company reached a confidential settlement agreement with Lakeland Bank (Lakeland). This settlement ends our litigation with Lakeland, but does not resolve our pending litigation with the four other investor banks. The settlement with Lakeland relates to surety bonds representing approximately 17% of the amount to which the five investor banks had claimed entitlement. The settlement did not have a material adverse effect on the Company's financial statements taken as a whole. In addition, in August 2005, the Federal District Court denied outright the investor banks' motion for judgment on the pleadings as to the Company and subsequently ordered all remaining cases to mandatory mediation. Mediations held in January 2006 between the Company and each of the four remaining investor banks did not resolve the claims of those investor banks. In September 2006, the Court issued a case management order governing expert witness discovery and future motion practice. In the second quarter of 2007, the Company reached a confidential settlement agreement with Sky Bank. In the third quarter of 2007, the Company reached a confidential settlement agreement with Ameriana Bank. These settlements ended the Company's litigation with Sky Bank and Ameriana Bank but did not resolve the Company's pending litigation with the remaining two investor banks by year-end 2007 (Bank of Waukegan and Atlantic Coast Federal, whose combined initial bond penal sum claims total approximately $9.3 million). The settlements with Sky Bank and Ameriana Bank related to surety bonds, which represented approximately 66% of the amount to which the five investor banks had claimed entitlement. In total, the Company's settlement with the three investor banks noted above related to surety bonds representing approximately 83% of the amount to which the five investor banks had claimed entitlement.

On March 13, 2008, the Company reached a settlement with Bank of Waukegan. The settlement ends the Company's litigation with Bank of Waukegan but does not resolve its pending litigation with Atlantic Coast Federal Bank. The settlement with Bank of Waukegan relates to surety bonds representing approximately 12% of the amount to which the investor banks had claimed entitlement. The settlement did not have a material adverse impact on the Company's financial statements taken as a whole. While the Company cannot predict the ultimate outcome of the pending litigation between the Company and the one remaining investor bank at this time, the Company continues to believe it has meritorious defenses with respect to Atlantic Coast Federal Bank's claims against it and will continue to vigorously assert those defenses in the pending litigation.



(Continued)

The Company's financial statements contain an appropriate accrual for costs related to this matter, included in unpaid losses and settlement expenses, as well as an accrual to cover rescission of the collected premiums related to this program. In the opinion of management, final resolution of this matter will not have a material adverse effect on the Company's financial condition, results of operations, or cash flows. However, litigation is subject to inherent uncertainties, and if there were an outcome unfavorable to the Company, there exists the possibility of a material adverse impact on the Company's financial condition, results of operations, or cash flows in the period in which the outcome occurs.

The Company is also party to numerous claims and losses that arise in the normal course of the Company's business. Many of these claims or losses involve claims under policies that the Company underwrites as an insurer. The Company believes that the resolution of these claims and losses will not have a material adverse effect on the Company's financial condition, results of operations, or cash flows.

## (12) Leases

The Company leases regional office facilities and computers under operating leases. These leases expire in various years through 2014. Minimum future rental payments under noncancelable leases are as follows:

| | | |
|---|---|---|
| 2008 | $ | 3,379,154 |
| 2009 | | 3,425,667 |
| 2010 | | 3,059,179 |
| 2011 | | 2,486,835 |
| 2012 and thereafter | | 2,921,503 |
| Total minimum future rental payments | $ | 15,272,338 |

The Company shares rental expense with its affiliate, Mt. Hawley, through an intercompany cost sharing agreement. The Company's portion of rental expense for 2007 and 2006 was $1,028,287 and $1,363,061, respectively.



(Continued)

## (13) Reconciliation to the Annual Statement

No reconciling adjustments were necessary for 2007 between the audit report and the annual statement as previously filed with the Illinois Department of Financial and Professional Regulation – Division of Insurance (Division). Subsequent to the filing of the 2005 annual statement, the Company made adjustments for differences between the annual statement as filed with the Division and other regulatory authorities and the audited statutory financial statements. These adjustments were the result of a Type I subsequent event with respect to an income tax settlement from an exam conducted by the Internal Revenue Service for which the Company entered into a closing agreement in May 2006. This adjustment was included in the 2006 annual statement but not in the audited financial statements, thereby causing a reconciling difference for 2006. The following is a summary of the adjustment and the impact on the 2006 financial statements:

| | | 2006 |
|---|---|---|
| Net income per annual statement | $ | 75,710,500 |
| Adjustment for tax settlement | | (3,170,975) |
| Net income as reported herein | $ | 72,539,525 |
| Total liabilities per annual statement | $ | 619,404,680 |
| Adjustment for tax settlement | | — |
| Total liabilities as reported herein | $ | 619,404,680 |
| Unassigned surplus per annual statement | $ | 494,453,956 |
| Adjustment for tax settlement | | — |
| Unassigned surplus as reported herein | $ | 494,453,956 |
| Total capital and surplus per annual statement | $ | 746,905,415 |
| Adjustment for tax settlement | | — |
| Total capital and surplus as reported herein | $ | 746,905,415 |

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risk Interrogatories

December 31, 2007

1) Total admitted assets: $ 1,351,885,102

2) 10 largest exposures to a single issuer/borrower/investment:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Company | $ 454,153,779 | 33.6% |
| Morgan Stanley Capital I | 9,171,799 | 0.7 |
| Deere & Company | 8,120,824 | 0.6 |
| AT&T Inc | 6,888,570 | 0.5 |
| Textron Inc | 6,670,841 | 0.5 |
| Hewlett-Packard Co | 6,551,119 | 0.5 |
| Bear Stearns Commercial Mortgage | 6,514,538 | 0.5 |
| Bank of America Corp | 6,468,182 | 0.5 |
| Maryland State | 6,083,349 | 0.4 |
| Portland Oregon Swr Sys Rev | 5,944,226 | 0.4 |

3) Total admitted assets held in bonds by NAIC rating:

| Bonds | Amount | Percentage |
|---|---|---|
| NAIC-1 | $ 562,215,168 | 41.6% |
| NAIC-2 | 26,410,575 | 2.0 |
| NAIC-3 | — | — |
| NAIC-4 | — | — |
| NAIC-5 | — | — |
| NAIC-6 | — | — |

| Preferred Stocks | Amount | Percentage |
|---|---|---|
| P/RP-1 | $ 17,752,800 | 1.3% |
| P/RP-2 | — | — |
| P/RP-3 | — | — |
| P/RP-4 | — | — |
| P/RP-5 | — | — |
| P/RP-6 | — | — |

4) Assets held in foreign investments:

| | Amount | Percentage |
|---|---|---|
| Total admitted assets held in foreign investments | $ 17,378,096 | 1.3% |
| Foreign currency denominated investments | — | — |
| Insurance liabilities denominated in that same foreign currency | — | — |

5) Assets held in foreign investments represent less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatories 5 – 10.

11) Assets held in Canadian investments and unhedged Canadian currency exposure is less than 2.5% of the reporting entity's total admitted assets, therefore, detail not required.

12) There were no admitted assets held in investments with contractual sales restrictions.

13) Admitted assets held in the largest 10 equity interests:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Company | $ 454,153,779 | 33.6% |
| AT&T Inc | 6,888,570 | 0.5 |
| Deere & Company | 5,866,560 | 0.4 |
| Textron Inc | 5,276,200 | 0.4 |
| Exxon Mobil Corporation | 5,059,260 | 0.4 |
| Hewlett-Packard Co | 5,048,000 | 0.4 |
| Bank of America Corp | 4,951,200 | 0.4 |
| JP Morgan Chase & Co | 4,712,891 | 0.3 |
| Sempra Energy | 4,640,072 | 0.3 |
| Dominion Resources Inc | 4,479,280 | 0.3 |

14) There were no assets held in nonaffiliated, privately placed equities, exceeding 2.5% of the Company's total admitted assets.



(Continued)

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risk Interrogatories

December 31, 2007

15) There were no admitted assets held in general partnership interests that exceeded 2.5% of the Company's total admitted assets.

16) There were no mortgage loans reported on the Company's Annual Statement Schedule B; therefore, detail not required for interrogatories 16 and 17.

18) Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in the Annual Statement Schedule A, were less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatory 18.

19) There were no admitted assets held in investments held in mezzanine real estate loans.

20) Total admitted assets subject to the following types of agreements:

| Agreement type | At year-end | | At end of each quarter | | |
|---|---|---|---|---|---|
| | Amount | Percentage | 1st Qtr | 2nd Qtr | 3rd Qtr |
| Securities lending | $ 16,109,733 | 1.2% | $ 28,381,386 | 37,557,866 | 25,854,870 |
| Repurchase | — | — | — | — | — |
| Reverse repurchase | 28,375,333 | 2.1 | — | 27,514,239 | 53,624,020 |
| Dollar repurchase | — | — | — | — | — |
| Dollar reverse repurchase | — | — | — | — | — |

21) The Company owns no warrants not attached to other financial instruments, options, caps, and floors.

22) The Company has no exposure to collars, swaps, or forwards.

23) The Company has no exposure for future contracts.

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2007

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Bonds: | | | | |
| U.S. Treasury securities | $ 6,379,243 | 0.49% | $ 6,379,243 | 0.49% |
| U.S. government agency and corporate obligations: | | | | |
| Issued by U.S. government agencies | 4,711,598 | 0.36 | 4,711,598 | 0.36 |
| Issued by U.S. government-sponsored agencies | 100,968,804 | 7.80 | 100,968,804 | 7.82 |
| Foreign government: | — | — | — | — |
| Securities issued by states, territories, and political subdivisions in the U.S.: | | | | |
| State, territory, and possession and general obligations | 30,223,014 | 2.34 | 30,223,014 | 2.34 |
| Political subdivisions of states, territories, and possessions' political subdivisions' general obligations | 56,294,245 | 4.35 | 56,294,245 | 4.36 |
| Revenue and assessment obligations | 106,315,422 | 8.22 | 106,315,422 | 8.24 |
| Industrial development and similar obligations | — | — | — | — |
| Mortgage-backed securities: | | | | |
| Pass-through securities: | | | | |
| Guaranteed by GNMA | 4,918,133 | 0.38 | 4,918,133 | 0.38 |
| Issued by FNMA and FHLMC | 75,915,541 | 5.87 | 75,915,541 | 5.88 |
| All other | 91,670 | 0.01 | 91,670 | 0.01 |
| CMOs and REMICs: | | | | |
| Issued by FNMA, FHLMC, GNMA, or VA | 16,779,186 | 1.30 | 16,779,186 | 1.30 |
| Issued by non-U.S. government issuers and collateralized by mortgage-backed securities issued or guaranteed by above agencies | — | — | — | — |
| All other | 29,447,974 | 2.28 | 29,447,974 | 2.28 |
| Other debt and other fixed-income securities: | | | | |
| Unaffiliated domestic securities | 112,137,614 | 8.67 | 112,137,614 | 8.69 |
| Unaffiliated foreign securities | 10,643,886 | 0.82 | 10,643,886 | 0.82 |
| Affiliated securities | — | — | — | — |
| Equity interests: | | | | |
| Investments in mutual funds | — | — | — | — |
| Preferred stocks: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | 17,752,800 | 1.37 | 17,752,800 | 1.38 |
| Publicly traded equity securities: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | 227,218,784 | 17.56 | 227,218,784 | 17.60 |
| Tangible personal property under lease: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | — | — | — | — |
| Other equity securities: | | | | |
| Affiliated | 456,713,953 | 35.30 | 454,153,779 | 35.18 |
| Unaffiliated | — | — | — | — |
| Mortgage loans: | | | | |
| Construction and land development | — | — | — | — |
| Agricultural | — | — | — | — |
| Single family residential properties | — | — | — | — |
| Multifamily residential properties | — | — | — | — |
| Commercial loans | — | — | — | — |
| Mezzanine real estate loans | — | — | — | — |



(Continued)

Schedule 2

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2007

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Real estate investments: | | | | |
| Property occupied by company | $ 6,477,214 | 0.50% | $ 6,174,137 | 0.48% |
| Property held for production of income | — | — | — | — |
| Property held for sale | — | — | — | — |
| Policy loans | — | — | — | — |
| Receivable for securities | 1,710,930 | 0.13 | 1,710,930 | 0.13 |
| Cash and short-term investments | 29,143,595 | 2.25 | 29,143,595 | 2.26 |
| Write-in invested assets | — | — | — | — |
| Total invested assets | $ 1,293,843,606 | 100.00% | $ 1,290,980,355 | 100.00% |

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year ended December 31, 2007

7.1 Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit, or any similar provisions)? Yes [ ] No [X]

7.2 If yes, indicate the number of reinsurance contracts containing such provisions. N/A [X]

7.3 If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)? Yes [ ] No [ ] N/A [X]

8.1 Has this reporting entity reinsured any risk with any other entity and agreed to release such entity from liability, in whole or in part, from any loss that may occur on this risk, or portion thereof, reinsured? Yes [ ] No [X]

8.2 If yes, give full information. N/A [X]

9.1 Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 3% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of prior year-end surplus as regards policyholders: (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

(a) A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;

(b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

(c) Aggregate stop loss reinsurance coverage;

(d) An unconditional or unilateral right by either party to commute the reinsurance contract except for such provisions, which are only triggered by a decline in the credit status of the other party;

(e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

(f) Payment schedule, accumulating retentions from multiple years, or any features inherently designed to delay timing of the reimbursement to the ceding entity Yes [ ] No [X]



(Continued)

## RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year ended December 31, 2007

9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member where:

(a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

(b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates — Yes [ ] No [X]

9.3 If yes to 9.1 or 9.2, please provide the following information in the Reinsurance Summary Supplemental Filing for general interrogatory 9:

(a) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

(b) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 9.1 or 9.2; and

(c) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved. — N/A [X]

9.4 Except for transactions meeting the requirements of paragraph 30 of SSAP No. 62, *Property and Casualty Reinsurance*, has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

(a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principals (SAP) and as a deposit under generally accepted accounting principals (GAAP); or

(b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP? — Yes [ ] No [X]

9.5 If yes to 9.4, explain in the Reinsurance Summary Supplemental Filing for general interrogatory 9 (section D) why the contract(s) is treated differently for GAAP and SAP. — N/A [X]

9.6 The reporting entity is exempt from the Reinsurance Attestation Supplement under one or more of the following criteria:

(a) The entity does not utilize reinsurance; or, — Yes [ ] No [X]

(b) The entitiy only engages in a 100% quota share contract with an affiliate or lead company has filed an attestation supplement; or — Yes [ ] No [X]

(c) The entity has no external cessions and only participates in an intercompany pool and the affiliated lead company has filed an attestation supplement. — Yes [ ] No [X]

See accompanying independent auditors' report.

KPMG

# RLI INSURANCE COMPANY

Statutory Financial Statements and Schedules

December 31, 2008 and 2007

(With Independent Auditors' Report Thereon)

KPMG LLP
303 East Wacker Drive
Chicago, IL 60601-5212

# Independent Auditors' Report

The Board of Directors
RLI Insurance Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and capital and surplus of RLI Insurance Company (the Company) as of December 31, 2008 and 2007, and the related statutory statements of income and changes in capital and surplus, and cash flow for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 1 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance, which practices differ from U.S. generally accepted accounting principles. The effects on the statutory financial statements of the variances between the statutory basis of accounting and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of the Company as of December 31, 2008 and 2007, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus of the Company as of December 31, 2008 and 2007, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

KPMG

Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included on the schedule of supplemental investment risk interrogatories, the summary investment schedule, and the supplemental schedule of reinsurance interrogatories is presented for purposes of additional analysis and is not a required part of the basic statutory financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic statutory financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole.

KPMG LLP

May 26, 2009

## RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2008 and 2007

| Admitted Assets | 2008 | 2007 |
|---|---|---|
| Bonds | $ 473,418,131 | 554,826,330 |
| Common stocks | 165,667,930 | 227,218,784 |
| Preferred stocks | 812,800 | 17,752,800 |
| Investment in affiliates | 470,109,432 | 454,153,779 |
| Real estate occupied by the Company, at cost, less accumulated depreciation of $8,993,553 and $8,383,949 in 2008 and 2007, respectively | 8,781,991 | 6,174,137 |
| Cash and short-term investments | 56,690,060 | 29,143,595 |
| Receivable for securities | 16,925,208 | 1,710,930 |
| Total cash and invested assets | 1,192,405,552 | 1,290,980,355 |
| Uncollected premiums and agents' balances | 45,787,561 | 33,873,966 |
| Funds held by or deposited with reinsured companies | 4,000 | 4,000 |
| Current federal and foreign income tax recoverable | — | 1,385,987 |
| Reinsurance recoverable on paid losses and loss adjustment expenses | 6,367,879 | 14,984,528 |
| Federal income taxes including deferred tax asset of $18,363,143 and $0 in 2008 and 2007, respectively | 18,363,143 | — |
| Electronic data processing equipment, at cost less accumulated straight-line depreciation of $24,579,066 and $23,252,910 in 2008 and 2007, respectively | 617,907 | 638,781 |
| Investment income due and accrued | 6,120,428 | 7,336,257 |
| Receivable from affiliates | 4,863,045 | 144,304 |
| Other assets | 4,544,152 | 2,536,924 |
| Total admitted assets | $ 1,279,073,667 | 1,351,885,102 |



(Continued)

## RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2008 and 2007

| Liabilities and Capital and Surplus | 2008 | 2007 |
|---|---|---|
| Unpaid losses and loss adjustment expenses | $ 350,305,788 | 341,096,591 |
| Reinsurance payable on paid losses | 783,841 | 544,184 |
| Accrued expenses | 32,299,661 | 38,452,163 |
| Borrowed money including accrued interest | — | 28,022,985 |
| Unearned premiums | 148,165,761 | 139,049,214 |
| Advance premiums | 3,785,888 | 3,954,125 |
| Ceded reinsurance premiums payable | 15,421,779 | 8,941,408 |
| Funds held under reinsurance agreements | 608,919 | 537,795 |
| Amounts withheld | 32,095,258 | 13,934,729 |
| Provision for reinsurance | 838,000 | 903,200 |
| Federal income taxes including deferred tax liability of $0 and $7,935,766 in 2008 and 2007, respectively | 208,160 | 7,935,766 |
| Commissions payable, contingent commissions, and other similar charges | 13,798,927 | 15,122,083 |
| Other liabilities | 2,720,516 | 1,386,534 |
| Total liabilities | 601,032,498 | 599,880,777 |
| Capital and surplus: | | |
| Capital stock, $125 par value. Authorized 1,000,000 shares; issued and outstanding 80,003 shares | 10,000,375 | 10,000,375 |
| Paid-in contributed capital | 242,451,084 | 242,451,084 |
| Unassigned surplus | 425,589,710 | 499,552,866 |
| Total capital and surplus | 678,041,169 | 752,004,325 |
| Total liabilities and capital and surplus | $ 1,279,073,667 | 1,351,885,102 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Income and Changes in Capital and Surplus

Years ended December 31, 2008 and 2007

| | 2008 | 2007 |
|---|---|---|
| Premiums earned | $ 265,297,702 | 244,443,167 |
| Losses and underwriting expenses incurred: | | |
| Losses and loss adjustment expenses | 117,746,812 | 89,965,966 |
| Other underwriting expenses | 119,317,595 | 111,352,486 |
| Total losses and underwriting expenses incurred | 237,064,407 | 201,318,452 |
| Net underwriting gain | 28,233,295 | 43,124,715 |
| Net investment income | 32,249,833 | 89,508,960 |
| Net realized capital gains (losses), less tax of $(6,965,037) and $8,745,164 for 2008 and 2007, respectively | (12,935,070) | 16,241,019 |
| Total investment income | 19,314,763 | 105,749,979 |
| Other income | 87,738 | 192,179 |
| Income before federal income taxes, net of tax on realized gain (losses) | 47,635,796 | 149,066,873 |
| Federal income tax expense | 20,921,262 | 22,861,220 |
| Net income | 26,714,534 | 126,205,653 |
| Capital and surplus at beginning of year | 752,004,325 | 746,905,415 |
| Change in unrealized gains (losses) of investments (net of tax) | (31,890,770) | 25,554,010 |
| Change in net deferred income tax | 773,149 | 2,043,104 |
| Change in nonadmitted assets | 374,731 | (1,925,230) |
| Change in provision for reinsurance | 65,200 | 2,943,800 |
| Dividends to stockholder | (70,000,000) | (149,722,427) |
| Capital and surplus at end of year | $ 678,041,169 | 752,004,325 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Cash Flow

Years ended December 31, 2008 and 2007

| | 2008 | 2007 |
|---|---|---|
| Operating activities: | | |
| Premiums collected, net of reinsurance | $ 268,474,341 | 247,878,190 |
| Investment income, net of investment expense | 35,923,529 | 92,788,159 |
| Other income | 87,738 | 192,179 |
| Benefits and loss related payments | (69,686,990) | (63,779,649) |
| Commissions and other expenses paid | (156,787,572) | (132,562,010) |
| Federal income taxes paid | (12,362,072) | (37,057,820) |
| Net cash flow from operations | 65,648,974 | 107,459,049 |
| Investing activities: | | |
| Cash provided from investments sold, matured, or repaid: | | |
| Bonds | 193,503,739 | 135,050,789 |
| Stocks | 50,549,222 | 58,411,121 |
| Other invested assets | — | 9,500,000 |
| Miscellaneous proceeds | 163,268 | 100,974 |
| Cost of investments acquired: | | |
| Bonds | (118,915,131) | (122,104,264) |
| Stocks | (60,600,754) | (62,135,532) |
| Real estate | (3,184,190) | (609,563) |
| Miscellaneous cash applications | (15,214,278) | (2,793,753) |
| Net cash flow from investing activities | 46,301,876 | 15,419,772 |
| Financing activities and miscellaneous sources: | | |
| Borrowed funds received (repaid) | (28,022,985) | 28,022,985 |
| Dividends to stockholder | (70,000,000) | (149,722,427) |
| Other cash provided | 13,618,600 | 1,031,123 |
| Net cash flow from financing activities and miscellaneous sources | (84,404,385) | (120,668,319) |
| Net change in cash and short-term investments | 27,546,465 | 2,210,502 |
| Cash and short-term investments at beginning of year | 29,143,595 | 26,933,093 |
| Cash and short-term investments at end of year | $ 56,690,060 | 29,143,595 |

See accompanying notes to statutory financial statements.

## (1) Background and Significant Accounting Policies

### *(a) Organization*

RLI Insurance Company (the Company or RLI) is a wholly owned subsidiary of RLI Corp. The Company is primarily engaged in writing selected property and casualty insurance, including commercial fire, homeowners, general and product liability, directors and officers, commercial and personal umbrella, marine, and commercial auto. The Company also writes small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical, and refining industries. In addition, the Company offers fidelity and crime coverage for commercial insureds and select financial institutions.

### *(b) Basis of Presentation*

The accompanying statutory financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation – Division of Insurance (Division). The National Association of Insurance Commissioners' *Accounting Practices and Procedures* (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the Division. The Division has adopted all of the prescribed accounting practices as stated in the NAIC SAP and the Company has no permitted accounting practices. Statutory accounting practices differ in certain respects from U.S. generally accepted accounting principles (GAAP). The most significant differences include:

(1) Acquisition costs related to premiums written are expensed as incurred, rather than deferred to the extent recoverable and charged to operations ratably over the period covered by the related insurance policies as prescribed by GAAP.

(2) Investments in bonds are not classified as to the Company's intention to trade, hold to maturity, or make available for sale. Investments in bonds are generally carried at amortized cost rather than fair value. Accordingly, unrealized changes in fair value attributable to bonds are not reflected in the statutory statements of income and changes in capital and surplus.

(3) Certain assets are designated as nonadmitted assets and are charged to surplus, as opposed to being carried at amounts recoverable for GAAP purposes.

(4) The realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles (SSAP) No. 10, Income Taxes. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in tax expense under GAAP, whereas under statutory accounting principles, these changes directly impact surplus. For contingent tax liabilities, GAAP also uses a "more likely than not" threshold for measurement purposes whereas SSAP uses a measurement threshold in accordance with SSAP No. 5, Liabilities, Contingencies and Impairments of Assets.

(5) A liability is established, which is not required under GAAP, by a direct charge to unassigned surplus for unsecured reinsurance recoverables from unauthorized reinsurers and certain past


(Continued)

due amounts from authorized reinsurers, rather than just providing for the estimated amounts deemed uncollectible.

(6) The liability for unpaid losses and loss adjustment expenses is reported net of reinsurance recoverables, and unearned premiums are reported net of prepaid reinsurance premiums, rather than presenting these amounts gross of the effects of reinsurance ceded for GAAP.

(7) Wholly owned insurance subsidiaries are reflected at net statutory book value with changes reflected directly in capital and surplus, as opposed to consolidation of assets and liabilities and income on the financial statements for GAAP.

(8) The statutory statement of cash flow differs in certain respects from the presentation required by Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows,* including the presentation of the changes in cash and short-term investments instead of cash and cash equivalents. Short-term investments include securities with original maturities of one year or less at the time of acquisition.

(9) Comprehensive income, which is required under GAAP, is not determined for statutory reporting purposes.

Under GAAP, for the years ended December 31, 2008 and 2007, the Company had net income of $30,036,968 and $131,970,678, respectively. The Company's GAAP shareholder's equity amounted to $820,933,544 and $889,998,337 at December 31, 2008 and 2007, respectively.

Significant statutory accounting policies are as follows:

*(c) Investments*

Bonds are generally carried at amortized cost with the discount or premium on bonds amortized using the scientific method. Bonds with a NAIC designation of 3-6 are carried at the lower of amortized cost or fair value. Interest income consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on bonds acquired and the addition of discount accrual. Short-term investments are valued at cost, which approximates fair value, and are considered cash equivalents in the statutory financial statements. Realized investment gains and losses are determined at the trade date on the basis of the specific-identification method. Real estate is valued at cost less accumulated depreciation, which is computed on a straight-line basis over the estimated useful lives of the properties.

Loan-backed securities are carried at either amortized cost or the lower of amortized cost or fair value dependent upon NAIC designations. All of the Company's loan-backed securities were purchased subsequent to January 1, 1994. Loan-backed securities are amortized using currently estimated cash flows, including new prepayment assumptions, under the retrospective methodology. Prepayment assumptions for single-Class and multiclass mortgage-backed securities were obtained from external sources and through management estimates. The Company uses an external pricing service to determine the fair value of its loan-backed/asset-backed securities.

Unaffiliated common stocks are carried at values assigned by the NAIC, which approximates fair value. Stocks of affiliates in which the Company has an interest of 20% or more are carried based upon the affiliate's audited statutory surplus. Dividends on stocks are credited to income on the ex-dividend date. Realized investment gains and losses are determined at the trade date on the basis of the specific-identification method. Unrealized gains or losses are charged or credited directly to unassigned surplus, net of provision for deferred income taxes.

Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2) that have characteristics of debt securities are carried at cost or amortized cost. Highest-quality or high-quality perpetual preferred stocks (NAIC designations 1 and 2) that have characteristics of equity securities are carried using unit prices as reported in the NAIC *Valuations of Securities Manual*. Dividends on preferred stock, other than mandatorily redeemable preferred stock, are recorded as investment income on the ex-dividend date. Dividends on mandatorily redeemable preferred stock are accrued to the redemption price, even if not declared, using the interest method over the period ending on the redemption date. The Company did not have any preferred stock investments with NAIC ratings 3-6 as of December 31, 2008.

The Company reviews the values of their investments in bonds and common stocks on a quarterly basis for other-than-temporary impairment losses. Investments that have a fair value that is less than cost or amortized cost are evaluated for other-than-temporary impairment. The Company's methodology of assessing other-than-temporary impairments is based on security-specific facts and circumstances as of the date of the reporting period. Management considers the length of time and the extent to which the fair value has been less than cost, the financial condition and short-term prospects of the issuer including any specific events that may influence the operations of the issuer, and whether or not the Company intended to sell bonds with interest-related impairments in evaluating other-than-temporary impairment. If this review suggests that a decline in fair value is other than temporary, the carrying value in the investment is reduced to its fair value through an adjustment to earnings.

***(d) Investment in Affiliates and Related Parties***

The Company owns 100% of the common stock of Mt. Hawley Insurance Company (Mt. Hawley), Safe Fleet Insurance Services, Inc. (Safe Fleet), RLI Insurance Ltd (RLI Ltd), Underwriters Indemnity General Agency (UIGA), and RLI Underwriting Services, Inc. (RLI US). Mt. Hawley is engaged in writing excess and surplus lines of insurance. The Company's investment in Mt. Hawley is carried at cost plus equity in statutory net income and surplus adjustments since the date of formation, less dividends received. Changes in the carrying value of the Company's investment in Mt. Hawley are reflected directly in unassigned surplus. Mt. Hawley maintains at December 31, 2008 an investment of 2,022,086 shares in its ultimate parent, RLI Corp. The estimated fair value of this common stock at December 31, 2008, after reduction of Mt. Hawley's reciprocal ownership, was $31,285,747.

Safe Fleet, RLI Ltd, UIGA, and RLI US are valued based on their underlying audited GAAP equity adjusted to a statutory basis of accounting under the provisions of SSAP No. 97, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88,* which supersedes SSAP No. 88, *Investments in Subsidiary, Controlled and Affiliated Entities,* and was adopted as of

December 31, 2007. Per SSAP No. 97, the Company has nonadmitted its investment in Safe Fleet, RLI Ltd, UIGA, and RLI US since GAAP audits are not conducted individually for these subsidiaries.

*(e) Revenue Recognition*

Premiums, net of reinsurance, are earned and recognized as revenue ratably in relation to the risk covered over the period of the underlying policies. Unearned premiums, which are reflected net of reinsurance, represent the pro rata portion of premiums written, which are applicable to the unexpired terms of the policies in force.

*(f) Acquisition Costs*

The costs of acquiring insurance premiums (principally commissions and premium taxes) are charged to current operations as incurred.

*(g) Liability for Unpaid Losses and Loss Adjustment Expenses*

The estimated liability for unpaid losses and loss adjustment expenses includes a provision for reported and unpaid losses as well as estimates of losses incurred but not reported, net of amounts covered by reinsurance. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social, and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. As these amounts are determined based upon estimates, the ultimate liability may be more or less than such estimates. Based on the current assumptions used in estimating reserves, management believes that the Company's overall reserve levels at December 31, 2008 make a reasonable provision to meet its future obligations.

*(h) Federal Income Taxes*

The Company files a consolidated federal income tax return with its parent and affiliates. The provision for federal income taxes is based on current taxable income. The method of allocation between the companies is subject to written agreement and approved by the board of directors. Allocation is based on the ratio of that portion of the separate company taxable income each member bears to the total taxable income of the group. Intercompany tax balances are settled within 30 days of filing the consolidated income tax return.

Current year federal income tax expense is based on financial reporting income or loss adjusted for certain permanent and timing differences. The timing differences are the result of dissimilar financial reporting and tax basis accounting methods. A net deferred tax asset, representing the tax effect of timing differences between financial reporting and the tax basis of assets and liabilities, is only reported as an admitted asset to the extent that it will be realized within one year, subject to certain limitations, or to the extent that it offsets deferred tax liabilities. The change in net deferred tax asset or liability is reflected directly in unassigned surplus.

The Company records liabilities for potential tax contingencies only when it is probable the position will not be sustainable upon audit by taxing authorities. These liabilities are reevaluated routinely and are adjusted appropriately based upon changes in facts or law. Penalties and interest, in the event they are incurred, are included in tax expense. The amount of uncertain tax items is not significant as of December 31, 2008 and 2007, respectively.

***(i) Provision for Reinsurance***

A statutory reinsurance liability must be established for unsecured amounts ceded to unauthorized reinsurers and certain amounts of past due recoverables from authorized reinsurers. This amount is recorded through a direct charge to unassigned surplus.

***(j) Nonadmitted Assets***

Certain assets (principally direct premiums 90 days past due, office furniture and equipment, EDP equipment, real estate, and certain investments in affiliates) are designated as nonadmitted assets and charged to unassigned surplus.

***(k) Allowance for Uncollectible Reinsurance***

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

***(l) Depreciation and Amortization***

Currently all depreciation and amortization is calculated using the straight-line method. The useful lives are as follows: 3 years for computers and external operating software and 5 to 40 years for tenant improvements and real estate. Depreciation and amortization expense for the Company totaled $2,611,528 and $2,848,157 for 2008 and 2007, respectively.

***(m) Risks and Uncertainties***

Certain risks and uncertainties are inherent to the Company's day-to-day operations and to the process of preparing its statutory financial statements. The more significant of those risks and uncertainties, as well as the Company's methods for attempting to mitigate, quantify, and minimize such risks and uncertainties, are presented below and throughout the notes to the statutory financial statements.

**Catastrophe Exposures**

The Company's insurance coverages include exposure to catastrophic events. The Company's major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Its second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes the Company insures in Hawaii. The Company monitors these exposures by quantifying its exposed policy limits in each region and by using computer-assisted modeling techniques. Additionally, the Company further limits its risk to such catastrophes through the purchase of reinsurance.

**Environmental Exposures**

The Company is subject to environmental claims and exposures through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, management has attempted to mitigate or control the extent of this exposure through the following methods: 1) the Company's policies include pollution exclusions that have been continually updated to further strengthen the exclusion and 2) the Company's policies primarily cover moderate hazard risks. The Company includes historical environmental loss experience with the remaining loss experience in the applicable line of business to project ultimate incurred losses and loss adjustment expenses and related incurred but not reported loss and loss adjustment expense reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, the Company has used this experience to record loss and loss adjustment expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 8.

**Reinsurance**

Reinsurance does not discharge the Company from its primary liability to policyholders, and to the extent that a reinsurer is unable to meet its obligations, the Company would be liable. The Company continuously monitors the financial condition of prospective and existing reinsurers. As a result, the Company currently purchases reinsurance from a number of financially strong reinsurers. The Company provides an allowance for reinsurance balances deemed uncollectible, as discussed previously.

**Investments**

The Company's investment portfolio is subject to market, credit, and interest rate risks. The equity portfolio will fluctuate with movements in the overall stock market. While the equity portfolio has been constructed to have lower downside risk than the market, the portfolio is sensitive to movements in the market. The bond portfolio is affected by interest rate changes and credit spreads. The Company attempts to mitigate its interest rate and credit risks by constructing a well-diversified portfolio with high-quality securities.

The prolonged downturn of the global financial markets and economy resulted in significant declines and lack of liquidity in the financial markets. While the Company maintains a high quality portfolio, it was not immune to the negative swings in the markets. The deterioration was not limited in its

scope, as most segments of the financial markets were impacted. Continued downturns in the financial markets could have a negative effect on the Company's portfolio. However, the Company attempts to manage this risk through asset allocation and security selection.

**Liquidity Risk**

Liquidity is essential to the Company's business and a key component of its concept of asset-liability matching. The Company's liquidity may be impaired by an inability to collect premium receivable or reinsurance recoverable balances timely, an inability to sell assets or redeem its investments, an inability to access funds from its insurance subsidiaries, unforeseen outflows of cash or large claim payments, or an inability to access debt or equity capital markets. This situation may arise due to circumstances that the Company may be unable to control, such as a general market disruption or an operational problem that affects third parties or the Company, or even by the perception among market participants that the Company, or other market participants, are experiencing greater liquidity risk. To date, the ongoing liquidity crisis and the loss of confidence in financial institutions has not increased the Company's cost of funding and has not limited its access to some of its traditional sources of liquidity. The Company's credit ratings are important to its liquidity. A reduction in the Company's credit ratings could adversely affect its liquidity and competitive position, increase its borrowing costs, or limit its access to the capital markets.

**Use of Estimates**

The preparation of statutory financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ from those estimates. The most significant of these amounts is the liability for unpaid losses and loss adjustment expenses. Management continually updates its estimates as additional data becomes available and adjusts the statutory financial statements as deemed necessary. Other estimates such as the recoverability of reinsurance balances are constantly monitored, evaluated, and adjusted. Although recorded estimates are supported by actuarial computations and other data, the estimates are ultimately based on management's expectations of future events. It is reasonably possible that expectations associated with these accounts can change in the near term (i.e., one year) and that the effect of these changes could be material to the statutory financial statements.

**External Factors**

The Company is regulated by the State of Illinois, in which it is domiciled, as well as states in which it does business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments, and regulate rates insurers may charge for various products. The Company is also subject to insolvency and guarantee fund assessments for policyholder losses covered by insolvent insurers. The Company generally accrues an assessment during the period in which it becomes probable that a liability has been incurred from an insolvency and the amount of the related assessment can be reasonably estimated.

The NAIC has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory capital and surplus to the risks inherent in its overall operations. The

RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written, and unearned premium) risk. The NAIC calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency, if any. The Company continuously monitors its internal capital requirements and the NAIC's RBC developments. The Company has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that the Company's capital levels are sufficient to support the level of risk inherent in its operations.

***(n) Fair Value Disclosures***

Equity securities, which include common stocks and preferred stocks, are valued using NAIC fair value prices, if available. If a NAIC fair value is not available, fair value is estimated using quoted market prices of the security or similar securities. Equity securities are carried at NAIC fair value, whereas bonds are generally carried at amortized cost based upon NAIC designations. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, and accounts payable, the carrying value of each is a reasonable estimate of fair value. Fair values of bonds and equities are disclosed in notes 2 and 3.

***(o) Significant Events***

During 2008, the Company paid ordinary cash dividends to its parent, RLI Corp., of $70,000,000. During the same period in 2007, the Company paid dividends to its parent of $149,722,427. The 2007 amount included $85,000,000 of extraordinary dividends. A need existed to move additional capital to RLI Corp.; therefore, permission for the extraordinary dividends was sought and obtained from the Division.

***(p) Recent Accounting Pronouncements***

During 2008, the NAIC adopted SSAP No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment.* SSAP No. 99 clarifies when an other-than-temporary impairment has occurred and requires that subsequent to the recognition of the impairment loss, the security be accounted as if it had been purchased on the measurement date of the other-than-temporary impairment. SSAP No. 99 is effective for reporting periods beginning on January 1, 2009 and thereafter, with early adoption permitted. The adoption of SSAP No. 99 is not expected to have a material impact on the Company's financial statements.

In November 2008, the NAIC's Statutory Accounting Principles Working Group adopted SSAP No. 98, *Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, An Amendment to SSAP No. 43-Loan-Backed and Structured Securities (SSAP No. 98).* SSAP No. 98, which amends SSAP No. 43, *Loan-Backed and Structured Securities*, requires insurers to write down the cost basis of a loan-backed or structured security to fair value for any decline in fair value below the amortized cost that is determined to be other-than-temporary. SSAP No. 98 is effective September 30, 2009. The Company estimates that the initial application of SSAP No. 98 will not have a material impact on the Company's financial statements.

## (2) Fair Value Measurement

Certain financial instruments are periodically measured at fair value on a nonrecurring basis, such as when impaired, or for certain bonds when carried at the lower of cost or fair value.

The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties (exit price), that is other than in a forced or liquidation sale. The fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, that is, other than a forced or liquidation sale.

Fair values are based on quoted market prices when available. In instances where there is little or no market activity for the same or similar instruments, the Company estimates fair value using observable information that management believes market participants would use to determine a current transaction price. This process involves some level of management estimation and judgment, which becomes significant with increasingly complex instruments.

The Company's financial assets and liabilities carried at fair value have been classified, for disclosure purposes, based on a hierarchy defined by Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*. The hierarchy gives the highest ranking to fair values determined using unadjusted quoted prices in active markets for identical assets and liabilities (Level 1) and the lowest ranking to fair values determined using methodologies and models with unobservable inputs (Level 3). An asset's or liability's classification is based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

*Level 1* – Quoted price (unadjusted) in active markets for identical assets.

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

*Level 3* – Inputs to the valuation methodology are unobservable for the asset or liability.

**Financial assets and liabilities measured at fair value on a recurring basis**

Certain financial assets are measured at fair value on a recurring basis, such as unaffiliated common and certain preferred stock, which are carried at values assigned by the NAIC, that approximate fair value. Redeemable preferred stock with a NAIC 1-2 designation is carried at cost. The following table summarizes assets measured at fair value on a recurring basis as of December 31, 2008:

| | Fair value at December 31, 2008 | | |
|---|---|---|---|
| | Level 1 | Level 2 | Level 3 |
| Description: | | | |
| Equities | $ 165,667,934 | — | — |



(Continued)

**Assets measured at fair value on a nonrecurring basis**

Certain financial assets are measured at fair value on a nonrecurring basis. Generally, bonds are carried at amortized cost. Bonds with a NAIC designation of 3-6, however, are carried at the lower of amortized cost or fair value. In addition, investments that are impaired during the reporting period are recorded at fair value on the balance sheet at December 31, 2008. The following table summarizes assets measured at fair value on a nonrecurring basis as of December 31, 2008:

| | Fair value at December 31, 2008 | | |
|---|---|---|---|
| | Level 1 | Level 2 | Level 3 |
| Description: | | | |
| Bonds | $ — | 5,046,536 | — |

## (3) Investments

The Company's bond portfolio consists of investments in treasury, government-sponsored agency, corporate, municipal, mortgage-backed, and asset-backed securities. All bonds in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities and the Company believes it is probable that it will receive all contractual or estimated cash flows based on its analysis of previously disclosed factors.

The statement value and estimated fair value of bonds at December 31, 2008 and 2007, respectively, are reflected below. Estimated fair values are based on pricing information obtained from the NAIC's Securities Valuation Office (SVO). For any securities not priced by the NAIC, fair values are based on quoted market prices, where available. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services.

| | 2008 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 4,059,982 | 231,703 | — | 4,291,685 |
| Government agencies and government-backed securities | 86,229,456 | 1,765,179 | (11,978) | 87,982,657 |
| States, political subdivisions, and special revenue securities | 154,174,575 | 3,821,184 | (1,132,321) | 156,863,438 |
| Corporate and other securities | 128,117,147 | 1,077,808 | (8,277,395) | 120,917,560 |
| Mortgage-backed securities and collateralized mortgage obligations (CMOs) | 100,836,971 | 2,001,534 | (2,799,854) | 100,038,651 |
| Totals | $ 473,418,131 | 8,897,408 | (12,221,548) | 470,093,991 |



(Continued)

| | 2007 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 6,379,243 | 159,357 | (46) | 6,538,554 |
| Government agencies and government-backed securities | 105,680,402 | 1,767,129 | — | 107,447,531 |
| States, political subdivisions, and special revenue securities | 192,832,681 | 3,207,033 | (137,114) | 195,902,600 |
| Corporate and other securities | 122,781,500 | 1,307,855 | (1,657,614) | 122,431,741 |
| Mortgage-backed securities and collateralized mortgage obligations (CMOs) | 127,152,504 | 1,181,911 | (745,450) | 127,588,965 |
| Totals | $ 554,826,330 | 7,623,285 | (2,540,224) | 559,909,391 |

The unrealized losses in the Company's mortgage-backed and Collateralized Mortgage Obligations (CMOs) portfolio are primarily related to commercial mortgage-backed securities. These securities were negatively affected in the second half of the year by the overall decline in the real estate market and the lack of liquidity in the credit markets. The securities remain AAA rated and the Company believes it is probable that it will receive all contractual or estimated cash flows in the form of principal and interest. The Company does not intend to sell these securities and would expect to hold these investments until recovery in value, which may be maturity, and thus does not consider these investments to be other-than-temporarily impaired at December 31, 2008.

The unrealized losses in the corporate bond portfolio were caused by a general rise in interest rate spreads in 2008. The interest rate spread widening was primarily caused by the financial crisis and slowing economy. The corporate bond portfolio has an overall rating of A and the Company believes it is probable that it will receive all contractual payments in the form of principal and interest. In addition, the Company does not intend to sell these investments and would expect to hold these investments until a recovery in value, which may be maturity. The Company does not consider these investments to be other-than-temporarily impaired at December 31, 2008.

The Company's stock portfolio consists of common stock, REITs, preferred stocks, exchange-traded funds (ETFs) and a high-yield municipal bond fund. The majority of net unrealized losses are contained within the three ETFs in the portfolio. The Company began diversifying its equity portfolio towards the end of 2007 with ETFs. The ETFs track various indices and have returns for 2008 consistent with the equity benchmark indices they follow. Given the short amount of time the Company has owned these securities, the ETFs' position relative to the benchmarks they track, and forecasted recovery periods, the Company does not consider the ETFs to be other-than-temporarily impaired at December 31, 2008.

As of December 31, 2008 and 2007, the Company held 31 and 20 common and preferred stocks that were in unrealized loss positions, respectively. The total unrealized loss on these securities was $17.8 million. In considering both the significance and duration of the unrealized loss positions, the Company has no equity securities in an unrealized loss position of greater than 20% for more than four months. As of


(Continued)

December 31, 2008 of 2007, 160 and 137 bonds, respectively, had an unrealized loss. These bonds represent a total fair value of $133.7 million and $130.2 million, respectively, and a total unrealized loss of $12.2 million and $2.5 million, respectively. None of these bonds have been in an unrealized loss position of more than 20% for more than six consecutive months. The fixed income unrealized losses can be primarily attributed to spreads widening in the corporate, municipal, and mortgage-backed security markets. The Company does not intend to sell these securities, and would expect to hold them to maturity. In addition, the Company continually monitors the credit quality of its fixed income investments to assess if it is probable that it will receive its contractual or estimated cash flows in the form of principal and interest. The Company considers price declines of securities in its other-than-temporary impairment analysis where such price declines provide evidence of declining credit quality, and distinguishes between price changes caused by credit deterioration, as opposed to rising interest rates.

Factors that are considered in the evaluation of credit quality include:

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

The Company concluded that the securities in an unrealized loss position are not other-than-temporarily impaired.

During 2008, the Company recognized impairment losses of $34.1 million. This total includes $28.4 million related to equity securities and $5.7 million related to fixed income securities. The majority of the Company's other-than-temporary impairment is related to securities in the financial sector and a high-yield municipal bond mutual fund. The impaired securities were negatively impacted by the overall financial crisis and lack of liquidity in the credit markets. There were no losses associated with the other-than-temporary impairment of securities in 2007.



(Continued)

The following tables illustrate the total value of securities, other than affiliated Company investments, that were in an unrealized loss position as of December 31, 2008 and 2007, respectively.

| | 2008 | | |
|---|---|---|---|
| | Less than 12 months | Greater than 12 months | Total |
| | | (In thousands) | |
| U.S. government: | | | |
| Fair value | $ — | — | — |
| Cost or amortized cost | — | — | — |
| Unrealized loss | $ — | — | — |
| U.S. agency: | | | |
| Fair value | $ 888 | — | 888 |
| Cost or amortized cost | 900 | — | 900 |
| Unrealized loss | $ (12) | — | (12) |
| Mortgage-backed: | | | |
| Fair value | $ 12,470 | 6,864 | 19,334 |
| Cost or amortized cost | 13,987 | 8,147 | 22,134 |
| Unrealized loss | $ (1,517) | (1,283) | (2,800) |
| Corporate: | | | |
| Fair value | $ 63,512 | 11,701 | 75,213 |
| Cost or amortized cost | 68,916 | 14,574 | 83,490 |
| Unrealized loss | $ (5,404) | (2,873) | (8,277) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 34,321 | 3,932 | 38,253 |
| Cost or amortized cost | 35,159 | 4,227 | 39,386 |
| Unrealized loss | $ (838) | (295) | (1,133) |
| Subtotal, debt securities: | | | |
| Fair value | $ 111,191 | 22,497 | 133,688 |
| Cost or amortized cost | 118,962 | 26,948 | 145,910 |
| Unrealized loss | $ (7,771) | (4,451) | (12,222) |
| Common stock: | | | |
| Fair value | $ 48,889 | 11,706 | 60,595 |
| Cost or amortized cost | 62,538 | 15,823 | 78,361 |
| Unrealized loss | $ (13,649) | (4,117) | (17,766) |
| Preferred stock: | | | |
| Fair value | $ — | — | — |
| Cost or amortized cost | — | — | — |
| Unrealized loss | $ — | — | — |
| Subtotal, equity securities: | | | |
| Fair value | $ 48,889 | 11,706 | 60,595 |
| Cost or amortized cost | 62,538 | 15,823 | 78,361 |
| Unrealized loss | $ (13,649) | (4,117) | (17,766) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 160,080 | 34,203 | 194,283 |
| Cost or amortized cost | 181,500 | 42,771 | 224,271 |
| Unrealized loss | $ (21,420) | (8,568) | (29,988) |



(Continued)

| | 2007 | | |
|---|---|---|---|
| | Less than 12 months | Greater than 12 months | Total |
| | (In thousands) | | |
| U.S. government: | | | |
| Fair value | $ 204 | — | 204 |
| Cost or amortized cost | 204 | — | 204 |
| Unrealized loss | $ — | — | — |
| U.S. agency: | | | |
| Fair value | $ — | — | — |
| Cost or amortized cost | — | — | — |
| Unrealized loss | $ — | — | — |
| Mortgage-backed: | | | |
| Fair value | $ 3,243 | 37,206 | 40,449 |
| Cost or amortized cost | 3,286 | 37,908 | 41,194 |
| Unrealized loss | $ (43) | (702) | (745) |
| Corporate: | | | |
| Fair value | $ 24,085 | 35,021 | 59,106 |
| Cost or amortized cost | 24,779 | 35,985 | 60,764 |
| Unrealized loss | $ (694) | (964) | (1,658) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 15,560 | 14,862 | 30,422 |
| Cost or amortized cost | 15,665 | 14,894 | 30,559 |
| Unrealized loss | $ (105) | (32) | (137) |
| Subtotal, debt securities: | | | |
| Fair value | $ 43,092 | 87,089 | 130,181 |
| Cost or amortized cost | 43,934 | 88,787 | 132,721 |
| Unrealized loss | $ (842) | (1,698) | (2,540) |
| Common stock: | | | |
| Fair value | $ 19,273 | — | 19,273 |
| Cost or amortized cost | 23,014 | — | 23,014 |
| Unrealized loss | $ (3,741) | — | (3,741) |
| Preferred stock: | | | |
| Fair value | $ 5,183 | — | 5,183 |
| Cost or amortized cost | 6,453 | — | 6,453 |
| Unrealized loss | $ (1,270) | — | (1,270) |
| Subtotal, equity securities: | | | |
| Fair value | $ 24,456 | — | 24,456 |
| Cost or amortized cost | 29,467 | — | 29,467 |
| Unrealized loss | $ (5,011) | — | (5,011) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 67,548 | 87,089 | 154,637 |
| Cost or amortized cost | 73,401 | 88,787 | 162,188 |
| Unrealized loss | $ (5,853) | (1,698) | (7,551) |



(Continued)

The statement value and estimated fair value of bonds at December 31, 2008 by contractual maturity are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties and because most mortgage-backed and asset-backed securities provide for periodic payments throughout their lives. Such securities have been classified in the table below based upon contractual maturities.

| | Statement value | Estimated fair value |
|---|---|---|
| Due in one year or less | $ 15,114,602 | 15,226,998 |
| Due after one year through five years | 112,232,474 | 113,663,890 |
| Due after five years through ten years | 153,483,465 | 150,767,538 |
| Due after ten years | 192,587,590 | 190,435,565 |
| | $ 473,418,131 | 470,093,991 |

Proceeds from sales of bonds during 2008 and 2007 were $76,853,137 and $57,972,521, respectively. Proceeds from maturities/calls of bonds during 2008 and 2007 were $116,650,602 and $77,078,268, respectively. Proceeds from sales of equity securities during 2008 and 2007 were $50,549,222 and $58,411,121, respectively.

The components of realized gains and losses on investments are as follows:

| | 2008 | 2007 |
|---|---|---|
| | (In thousands) | |
| Bonds: | | |
| Gains | $ 2,263,329 | 318,288 |
| Losses | (1,025,423) | (942,345) |
| OTTI | (5,689,658) | — |
| Realized losses on bonds | (4,451,752) | (624,057) |
| Stocks: | | |
| Gains | 13,104,587 | 26,946,786 |
| Losses | (157,847) | (1,336,546) |
| OTTI | (28,395,095) | — |
| Realized gains (losses) on stocks | (15,448,355) | 25,610,240 |
| Less: | | |
| Income taxes | (6,965,037) | 8,745,164 |
| | (6,965,037) | 8,745,164 |
| Net realized gains (losses) on investments | $ (12,935,070) | 16,241,019 |



(Continued)

The cost of common and preferred stocks of nonaffiliates owned at December 31, 2008 and 2007 was $139,703,128 and $145,263,218, respectively. Gross unrealized gains and losses on such investments are as follows:

| | 2008 | 2007 |
|---|---|---|
| Unrealized gains | $ 44,543,235 | 104,718,962 |
| Unrealized losses | (17,765,630) | (5,010,596) |
| Net unrealized gains | $ 26,777,605 | 99,708,366 |

The unrealized gains on investments in affiliates are as follows:

| | 2008 | 2007 |
|---|---|---|
| Carrying value of investments in affiliates, gross of nonadmitted assets | $ 472,747,764 | 456,713,953 |
| Cost of investments in affiliates | 145,688,624 | 145,688,624 |
| Unrealized gains | $ 327,059,140 | 311,025,329 |

The carrying value of investments in affiliates for 2008 and 2007 as reported in the statutory statements of admitted assets, liabilities, and capital and surplus is net of $2,638,336 and $2,560,174, respectively, of nonadmitted assets.

The Company does not engage in subprime residential mortgage lending. The Company evaluates many characteristics when classifying collateral as subprime, including credit quality of the borrower as defined by Fair Isaac Credit Organization (FICO) scores, as well as other factors, such as loan-to-value ratios and type of real estate. Relating to investments, the Company's exposure to subprime lending is limited to investments within the bond investment portfolio which contains securities collateralized by mortgages that have characteristics of subprime lending such as home equity mortgages. These investments are in the form of asset-backed securities collateralized by subprime mortgages and collateralized mortgage obligations backed by alternative documentation mortgages. The total carrying value of these investments is approximately $1.4 million, with a fair value of $1.3 million and comprises less than 1% of the Company's total fixed maturity portfolio. The average credit rating of all of these securities was AAA as of December 31, 2008 and reflects the Company's practice of minimizing exposure to low quality (subprime type) credit risk. In addition, all of the securities containing subprime collateral were originated before 2005.

From an insurance standpoint, the Company has exposure to subprime market issues through the Company's other liability (directors and officers) coverage. The Company's exposure to subprime, however, is minimal. The Company has a limited number of claims and expects net exposure to subprime to be less than $5 million. The surety segment is another area that the Company can have direct exposure to subprime. The Company writes few mortgage broker bonds, and believes this exposure to be minimal. In addition, the Company does not have significant exposure from a surety standpoint to the home building industry.



(Continued)

The Company is party to a securities lending program whereby fixed-income securities are loaned to third parties, primarily major brokerage firms. At December 31, 2008 and 2007, fixed maturities with a fair value of $10.4 million and $16.3 million were loaned, respectively. Agreements with custodian banks facilitating such lending generally require 102% of the value of the loaned securities to be separately maintained as collateral for each loan. The collateral received pursuant to the securities lending transactions is restricted as governed by the lending agreements. To further minimize the credit risks related to this lending program, the Company monitors the financial condition of other parties to these agreements.

Investments with a statement value of $4,809,789 and $32,827,545, as of December 31, 2008 and 2007, respectively, were on deposit with governmental authorities or banks to comply with insurance laws or were pledged as collateral for borrowing arrangements.

The composition of net investment income is as follows:

| | 2008 | 2007 |
|---|---|---|
| Bonds | $ 26,495,479 | 28,915,188 |
| Stocks | 7,572,849 | 7,074,062 |
| Dividends from affiliate | — | 55,000,000 |
| Real estate | 1,124,760 | 1,105,800 |
| Cash on deposit and short-term investments | 651,163 | 1,155,745 |
| Other | 81,450 | 584,897 |
| | 35,925,701 | 93,835,692 |
| Less investment expenses | 3,675,868 | 4,326,732 |
| Net investment income | $ 32,249,833 | 89,508,960 |

## (4) Related-Party Transactions

As described below and elsewhere in the notes to the statutory financial statements, the Company has engaged in transactions with its parent, affiliates, and subsidiaries during the normal course of business:

(a) The Company allocates certain expenses to RLI Corp. and affiliated companies, Mt. Hawley, RLI Indemnity Company (RIC), RLI US, and Safe Fleet. The intercompany services agreement allows a portion of the expenses incurred by the Company for the benefit of these affiliates to be allocated on a pro rata basis relative to the affiliate companies' gross earned premium to the total of gross earned premiums of the Company, and any other affiliate managed by the Company. This agreement further allows the expenses incurred by Safe Fleet for the benefit of the Company to be charged back to the Company on a cost reimbursement basis. The Company allocated net expenses of $35.8 million and $43.5 million to the aforementioned related parties during 2008 and 2007, respectively, as a result of services performed.

(b) The Company received no cash dividends from its wholly owned subsidiary, Mt. Hawley, in 2008. The Company received $55 million in cash dividends from Mt. Hawley during 2007.



(Continued)

(c) During 2008, the Company paid RLI Corp. ordinary dividends of $70 million. During 2007, the Company paid RLI Corp. dividends of $149.7 million, of which $85 million were extraordinary dividends. A need existed to move additional capital to RLI Corp.; therefore, permission for the extraordinary dividends was sought and obtained from the Division.

(d) At December 31, 2008, the Company owns 100% of the common stock of its subsidiaries, Mt. Hawley, Safe Fleet, RLI Ltd, UIGA, and RLI US, having statement values of $470,109,432, $(22,134), $1,096,490, $998,707, and $565,269, respectively. The Company nonadmitted its investment in Safe Fleet, UIGA, RLI Ltd, and RLI US, since GAAP audits are not conducted individually for these subsidiaries.

(e) Based on the Company's 100% ownership of Mt. Hawley, the statement value of Mt. Hawley's assets and liabilities as of December 31, 2008 were $1,052.3 million and $582.2 million, respectively. Net income of Mt. Hawley was $46.2 million for the year ended December 31, 2008. The statement value of Mt. Hawley's assets and liabilities as of December 31, 2007 was $1,040.4 million and $586.3 million, respectively. Net income of Mt. Hawley was $104.6 million for the year ended December 31, 2007.

(f) At December 31, 2008 and 2007, the Company reported $4,863,045 and $144,304 as net amounts due from affiliates, respectively. Any intercompany balance resulting from services performed or costs allocated in accordance with the terms of the intercompany services agreement are settled within 30 calendar days following the end of the calendar quarter in which the intercompany balance was created.

(g) On or about April 1, 2004, the Company entered into an intercompany guarantee with RLI Ltd. The Company has guaranteed the performance of RLI Ltd. with respect to a punitive damages wrap policy over an excess policy with the Company. The policy has been renewed with an effective date of April 1, 2008. The guarantee is in the amount of $20 million.

## (5) Borrowed Funds

The Company had no outstanding liability for borrowed money at December 31, 2008. At December 31, 2007, the Company had $28.0 million of outstanding liability. Interest paid on outstanding debt for 2008 and 2007 totaled $705,602 and $909,100, respectively.

## (6) Capital and Surplus

Dividend payments from the Company to its parent are restricted by state insurance laws as to the amount that may be paid without prior approval from the regulatory authorities of Illinois. The maximum dividend distribution in a rolling 12-month period is limited by Illinois laws to the greater of 10% of policyholder surplus as of December 31 of the preceding year or net income of the Company for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend that can be paid by the Company in a rolling 12-month period ending in 2009 without prior approval is $67,804,117, which represents 10% of the Company's 2008 policyholder surplus.

State insurance laws also restrict dividend payments to the Company from Mt. Hawley. The maximum dividends that can be paid to the Company by Mt. Hawley for a 12-month rolling period during 2009



(Continued)

without prior approval are $47.0 million, which represents 10% of Mt. Hawley's 2008 policyholder surplus.

Unassigned surplus includes $17,413,003 in net unrealized gains on unaffiliated investments. Unassigned surplus has been reduced by $13,613,775 and $13,988,506 relating to nonadmitted assets as of December 31, 2008 and 2007, respectively. Additionally, surplus has been reduced by $838,000 and $903,200 for the provision for reinsurance as of December 31, 2008 and 2007, respectively.

## (7) Reinsurance

In the normal course of business, the Company assumes and cedes property and liability insurance exposures with other insurance companies, pools, and associations through various treaties and in certain instances by negotiation of individual risks. Generally, policies are reinsured with other insurance companies to limit the Company's risk on any individual loss to $7,500,000.

The following are summaries of the impact of the Company's reinsurance program on the statutory financial statements:

| | 2008 | | |
|---|---|---|---|
| | Direct | Assumed | Ceded |
| Premiums written | $ 342,964,649 | 11,943,993 | 80,494,393 |
| Premiums earned | 332,784,176 | 9,530,947 | 77,017,421 |
| Losses and loss adjustment expenses incurred | 130,992,311 | 10,559,178 | 23,804,677 |
| Unearned premiums | 180,934,531 | 6,044,947 | 38,813,717 |
| Unpaid losses and loss adjustment expenses | 535,521,769 | 47,194,518 | 232,410,499 |

| | 2007 | | |
|---|---|---|---|
| | Direct | Assumed | Ceded |
| Premiums written | $ 326,497,440 | 10,106,815 | 83,324,614 |
| Premiums earned | 331,539,939 | 11,238,463 | 98,335,235 |
| Losses and loss adjustment expenses incurred | 83,812,475 | 10,407,126 | 4,253,635 |
| Unearned premiums | 170,754,060 | 3,631,900 | 35,336,746 |
| Unpaid losses and loss adjustment expenses | 536,093,750 | 49,096,130 | 244,093,289 |



(Continued)

At December 31, 2008, net balances recoverable from reinsurers (comprising unearned premiums and losses and loss adjustment expenses paid and unpaid, including incurred but not reported amounts) having unsecured portions exceeding 3% of the Company's total capital and surplus were as follows:

| Name of reinsurer | Amount |
|---|---|
| Axis Reinsurance Corp | $ 21,833,000 |
| Berkley Insurance Co. | 22,478,000 |
| General Rein Corp | 29,750,000 |
| Munich Re America | 29,910,000 |

The losses, loss adjustment expenses, and unearned premiums for business ceded to other insurers are recoverable and realizable to the extent that the assuming reinsurers fulfill their commitments. The Company has initiated arbitration or otherwise instituted legal actions where appropriate on certain outstanding recoverable balances.

As of January 1, 2008 and 2007, the Company's property underwriting was supported by $375 million and $500 million, respectively, in traditional catastrophe reinsurance protection, subject to certain retentions by the Company. The limit decreased to $350 million at July 1, 2008. At January 1, 2009, the Company restructured its reinsurance program decreasing its traditional catastrophe reinsurance protection to $350 million, subject to certain retentions by the Company. The Company recorded a charge to income in 2008 of $1,758,798 for reinsurance balances deemed uncollectible. This charge is reflected in losses and loss adjustment expenses incurred. The most significant component was a write-off of $1,327,742 for balances due from Toa-Re.

The total return commission, which would have been due reinsurers if all reinsurance was canceled with the return of unearned premium would be $8,572,511 and $7,501,192 as of December 31, 2008 and 2007, respectively. The amount of return commission, predicated on loss experience as a result of existing contracts, was $2,213 and $281,248 as of December 31, 2008 and 2007, respectively.

The Company participates in a quota share reinsurance agreement with RIC. The agreement is applied after all other external reinsurance cessions. Under the terms of the agreement, RIC cedes and RLI assumes 90% of the net premium and liabilities for policies effective January 1, 2003, and subsequent. The agreement, which was effective January 1, 2003, has been accepted and placed on file by the Division. This agreement was amended in 2004 to include the assumption of 100% of RIC's existing net loss reserves and any future development on these reserves. The Division approved the loss portfolio transfer on June 29, 2004.



(Continued)

The following is a summary of the balances assumed under this agreement as of and for the years ended December 31, 2008 and 2007 (in thousands):

| | | 2008 | 2007 |
|---|---|---|---|
| Premium written | $ | 4,001 | 5,060 |
| Unearned premiums | | 1,621 | 1,933 |
| Premium earned | | 4,313 | 5,514 |
| Loss and loss adjustment expenses incurred | | 1,766 | 2,413 |
| Reserve for loss and loss adjustment expenses | | 2,883 | 3,153 |

## (8) Unpaid Losses and Loss Adjustment Expenses

The following table is a reconciliation of the Company's liability for unpaid losses and loss adjustment expenses (LAE) for the years ended December 31, 2008 and 2007. Since reserves are based on estimates, the ultimate net cost may vary from the original estimate. As adjustments to these estimates become necessary, they are reflected in current operations. As part of the reserving process, historical data is reviewed and consideration is given to the anticipated impact of various factors such as legal developments and economic conditions, including the effects of inflation. Changes in reserves from the prior years' estimates are calculated based on experience as of the end of each succeeding year (loss and loss adjustment expense development).

| | | 2008 | 2007 |
|---|---|---|---|
| | | (In thousands) | |
| Net unpaid losses and loss adjustment expenses at beginning of year, net of reinsurance recoverable of $244,093 and $297,489 as of January 1 | $ | 341,097 | 359,018 |
| Incurred losses and loss adjustment expenses related to: | | | |
| Current accident year losses | | 134,097 | 120,672 |
| Prior accident years losses | | (16,350) | (30,706) |
| Total incurred | | 117,747 | 89,966 |
| Paid loss and loss adjustment expense payments related to: | | | |
| Current accident year losses | | (25,923) | (22,073) |
| Prior accident years losses | | (82,615) | (85,814) |
| Total paid | | (108,538) | (107,887) |
| Net unpaid losses and loss adjustment expenses at end of year, net of reinsurance recoverable of $232,411 and $244,093 as of December 31 | $ | 350,306 | 341,097 |

### Reserve Development

The deviations from the Company's initial reserve estimates appeared as changes in its ultimate loss estimates occurred as it updated those estimates through its reserve analysis process. The recognition of the changes in initial reserve estimates occurred over time as claims were reported, initial case reserves were


(Continued)

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

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

2008: During 2008, the Company experienced favorable development overall on prior accident years' reserves totaling $16.4 million. Other liability, property lines, and surety were the primary contributors to the favorable development, totaling $8.5 million, $6.5 million, and $5.8 million, respectively. Favorable reserve development was partially offset by adverse development on assumed reinsurance and marine, which amounted to $3.4 million and $3.0 million, respectively. The five most recent accident years contributed the most to the favorable development. In retrospect, the expected loss ratios initially used to set booked reserves for these accident years have proven to be conservative, which has resulted in loss emergence significantly lower than expected.

The favorable development on other liability lines comes primarily from personal umbrella and directors and officers liability coverages. Favorable development on property is primarily due to builder's risk construction coverages. This line of business has been in run-off for three years and recent experience has been much better than expected, with a significant reduction in both frequency and severity of claims. Only a handful of contracts remain open and the Company has observed little new activity from this product line. The favorable development on surety is primarily from contract and commercial coverages from the 2007 accident year. Very little observed loss severity in the commercial surety coverage resulted in favorable emergence. In addition, continued improvement in the Company's contract surety loss ratio resulting from past re-underwriting of the business led to favorable loss reserve development. The adverse development from assumed reinsurance business comes from accident years prior to 1990 and was caused mostly by increases in reported losses on asbestos and environmental claims. Marine protection and indemnity coverage is the cause of the adverse marine development. For this coverage, loss ratio estimates and expected development patterns appear, so far, to have not been adequate.

2007: The Company periodically reviews its loss reserve estimates and underlying actuarial reserving methodologies in order to assess its accuracy and suitability, and to benchmark its reserving practices against industry best practices. A detailed assessment of recent trends and reserve risk factors was undertaken in 2007. As part of the Company's review, it performed a more detailed, ground-up analysis of the actuarial estimation risks associated with each of its products and segments, including an assessment of industry information. The Company's analyses also revealed that its quarterly actuarial reserve estimates over recent historical periods had shown a downward trend as a result of a moderating loss trend environment, improvements in policy terms and conditions and a favorable underlying exposure mix that occurred during the hard market period from 2001 through 2004. Based on this review, the Company made certain refinements to its reserving methodologies to include a more detailed consideration of the impact of risk factors on total recorded reserves through increased internal dialogue among the claim, underwriting,

risk management, and actuarial departments, greater transparency of the actuarial process and results, and improved reserving diagnostics. Overall, these enhancements and improved information provide better and faster feedback to management regarding loss development resulting in greater overall confidence in the actuarial estimates. This and the increased stability in the Company's business in the last few years diminished the needed level of carried reserves above the actuarial point estimate. The Company believes that these reserve methodology enhancements improved the overall accuracy of its best estimate of loss and LAE reserves. Much of the favorable prior years' loss development was the result of this detailed assessment and resulting changes in its booked reserves.

Overall development on prior accident years was favorable by $30.7 million. The three most recent prior accident years were the biggest contributors to this result. By line of business, the biggest contributors to the favorable development were the commercial auto liability, surety, and special property lines with favorable development of $16.8 million, $11.7 million, and $7.0 million respectively. Partially offsetting the favorable development, the Company did experience adverse development on old accident years in the other liability and assumed reinsurance lines. This development was attributable to strengthening of IBNR reserves on asbestos and environmental exposures from accident years prior to 1990.

**Environmental Exposure**

The Company has exposure to asbestos and environmental claims through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. The majority of the exposure is in the excess layers of the Company's commercial umbrella and assumed reinsurance books of business.

Although a large majority of the Company's asbestos and environmental exposure is limited to losses occurring before the mid-1980s, management cannot determine the Company's ultimate liability with any high degree of certainty. The Company estimates the full impact of these exposures by establishing case basis reserves on all known losses. Reserves for related IBNR are recorded based upon actuarial projections of ultimate expected losses.

This ultimate liability is difficult to assess due to slow reporting of losses and evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, the Company participates primarily in the excess layers, making it difficult to assess the ultimate impact.



(Continued)

The Company's asbestos-related loss and loss adjustment expense (LAE) reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2008 and 2007 were as follows:

| | 2008 | 2007 |
|---|---|---|
| Direct: | | |
| Beginning reserves | $ 12,199,814 | 4,194,400 |
| Incurred losses and LAE | 1,657,269 | 8,031,905 |
| Calendar year payments for losses and LAE | (28,059) | (26,491) |
| Ending reserves | $ 13,829,024 | 12,199,814 |
| Assumed: | | |
| Beginning reserves | $ 20,189,148 | 9,868,328 |
| Incurred losses and LAE | 2,141,153 | 10,397,137 |
| Calendar year payments for losses and LAE | (3,593,243) | (76,317) |
| Ending reserves | $ 18,737,058 | 20,189,148 |
| Ceded: | | |
| Beginning reserves | $ 10,654,623 | 3,139,928 |
| Incurred losses and LAE | (292,764) | 7,537,584 |
| Calendar year payments for losses and LAE | (957,409) | (22,889) |
| Ending reserves | $ 9,404,450 | 10,654,623 |
| Net: | | |
| Beginning reserves | $ 21,734,339 | 10,922,800 |
| Incurred losses and LAE | 4,091,186 | 10,891,458 |
| Calendar year payments for losses and LAE | (2,663,893) | (79,919) |
| Ending reserves | $ 23,161,632 | 21,734,339 |

The Company holds both IBNR and case loss reserves related to asbestos exposure. For asbestos, direct and assumed case incurred losses increased by about $3.3 million and net case incurred losses increased by about $2.6 million. Two related assumed claims from accident years 1981 and 1982 were responsible for $2.7 million in gross emergence and $2.1 million net. These claims were also responsible for most of the payment activity. Of the total reserves, the Company held IBNR reserves in the amount of $15,472,325 and $15,942,274 on a gross basis and $10,946,865 and $9,594,431 on a net basis at December 31, 2008 and 2007, respectively.

The Company held $1,771,365 on a gross basis and $1,216,319 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2008. The Company held $1,719,147 on a gross basis and $1,066,048 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2007.



(Continued)

The Company's environmental-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2008 and 2007 were as follows:

| | | 2008 | 2007 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 5,700,426 | 4,891,168 |
| Incurred losses and LAE | | 2,583,285 | 1,257,851 |
| Calendar year payments for losses and LAE | | (333,249) | (448,593) |
| Ending reserves | $ | 7,950,462 | 5,700,426 |
| Assumed: | | | |
| Beginning reserves | $ | 1,340,099 | 2,861,566 |
| Incurred losses and LAE | | 331,174 | (532,486) |
| Calendar year payments for losses and LAE | | (43,385) | (988,981) |
| Ending reserves | $ | 1,627,888 | 1,340,099 |
| Ceded: | | | |
| Beginning reserves | $ | 3,041,930 | 2,619,522 |
| Incurred losses and LAE | | 1,690,618 | 1,046,504 |
| Calendar year payments for losses and LAE | | (242,471) | (624,096) |
| Ending reserves | $ | 4,490,077 | 3,041,930 |
| Net: | | | |
| Beginning reserves | $ | 3,998,595 | 5,133,212 |
| Incurred losses and LAE | | 1,223,841 | (321,139) |
| Calendar year payments for losses and LAE | | (134,163) | (813,478) |
| Ending reserves | $ | 5,088,273 | 3,998,595 |

The Company holds both IBNR and case loss reserves related to environmental exposure. The most significant environmental claims were two commercial umbrella claims from accident years 1978 and 1981 and an ocean marine claim from accident year 2007. These claims contributed $967,000 in direct emergence and $770,000 net. In light of these developments, the Company also decided to strengthen its IBNR position. Of the total reserves, the Company held IBNR reserves in the amount of $4,944,090 and $3,465,796 on a gross basis and $2,314,418 and $1,755,209 on a net basis at December 31, 2008 and 2007, respectively.

The Company held $872,486 and $611,611 on a gross basis and $408,427 and $309,743 on a net basis for future allocated loss adjustment expenses related to environmental exposure (including coverage dispute costs) at December 31, 2008 and 2007, respectively.



(Continued)

## (9) Investment in Mt. Hawley

Condensed financial information for Mt. Hawley on a statutory basis is summarized below:

| | 2008 | 2007 |
|---|---|---|
| Balance sheet at December 31: | | |
| Assets | $ 1,052,280,349 | 1,040,417,221 |
| Liabilities | (582,170,917) | (586,263,442) |
| Total capital and surplus | $ 470,109,432 | 454,153,779 |
| Results of operations for the year ended December 31: | | |
| Premium earned | $ 263,005,386 | 299,422,237 |
| Losses and underwriting expenses | 209,825,619 | 195,026,856 |
| Underwriting income | 53,179,767 | 104,395,381 |
| Investment income, including realized gains and losses net of tax | 27,937,178 | 44,909,509 |
| Other income | 179,368 | 196,223 |
| Income before federal income taxes | 81,296,313 | 149,501,113 |
| Federal income tax expense | 35,116,809 | 44,897,403 |
| Net income | $ 46,179,504 | 104,603,710 |

## (10) Federal Income Taxes

A reconciliation of federal income tax expense, computed by applying the statutory federal income tax rate of 35% in 2008 and 2007 to income before federal income taxes, which includes net realized capital gains, to the income tax expense shown in the accompanying statutory financial statements is as follows:

| | 2008 | 2007 |
|---|---|---|
| Computed "expected" tax expense | $ 14,234,766 | 55,234,212 |
| Tax-exempt interest | (2,168,849) | (2,547,578) |
| Dividends received deduction | (1,206,701) | (20,520,325) |
| Discounting of liability for losses and loss adjustment expenses | (825,850) | (1,594,517) |
| Change in unearned premiums | 638,159 | 659,844 |
| Intercompany transactions | — | (385,559) |
| Tax on net realized capital (gains) losses | 6,965,037 | (8,745,164) |
| Other | 3,284,700 | 760,307 |
| Federal income tax expense | $ 20,921,262 | 22,861,220 |

Income taxes incurred in current and prior years that will be available for recoupment in the event of future net losses are $14,639,671 for 2008 and $33,869,855 for 2007.



(Continued)

The net deferred tax asset and the change from the prior year comprise the following components:

| | December 31 2008 | 2007 | Change |
|---|---|---|---|
| Total gross deferred tax assets | $ 35,444,057 | 34,579,819 | 864,238 |
| Total deferred tax liabilities | (17,080,914) | (42,515,585) | 25,434,671 |
| Net deferred tax liabilities | $ 18,363,143 | (7,935,766) | 26,298,909 |
| Tax effect of unrealized gains (losses) | | | (25,525,760) |
| Change in deferred income tax | | | $ 773,149 |

There are no temporary differences for which deferred tax liabilities are not recognized.

Deferred income tax assets and liabilities consist of the following major components:

| | December 31 2008 | 2007 |
|---|---|---|
| Deferred tax assets: | | |
| Loss reserves | $ 11,965,982 | 12,791,832 |
| Unearned premium reserve | 10,412,895 | 9,774,736 |
| Agents balances and other nonadmitted assets | 3,841,404 | 3,999,916 |
| Accrued expenses | 262,500 | 5,281,798 |
| Depreciable assets | — | 151,791 |
| Deferred compensation | 5,427,637 | 2,240,870 |
| Impairments on investments | 3,368,361 | — |
| Other | 165,278 | 338,876 |
| Total deferred tax assets | 35,444,057 | 34,579,819 |
| Nonadmitted deferred tax assets | — | — |
| Admitted deferred tax assets | 35,444,057 | 34,579,819 |
| Deferred tax liabilities: | | |
| Unrealized gains | 9,707,079 | 35,232,845 |
| Intercompany transactions | 6,356,103 | 6,356,103 |
| Investments | 115,192 | 196,851 |
| Investment income | 152,637 | 131,122 |
| Depreciable assets | 124,716 | — |
| Other | 625,187 | 598,664 |
| Total deferred tax liabilities | 17,080,914 | 42,515,585 |
| Net deferred tax assets (liabilities) | $ 18,363,143 | (7,935,766) |



(Continued)

The Company's income tax incurred and change in deferred income tax differs from the amount obtained by applying the federal statutory rate of 35% to income before income taxes as follows:

| | | 2008 | 2007 |
|---|---|---|---|
| Income before taxes, which includes net realized capital gains (losses) | $ | 40,670,759 | 157,812,037 |
| Income tax expense at 35% statutory rate | | 14,234,766 | 55,234,212 |
| Increase (decrease) in tax resulting from: | | | |
| Dividends received deduction | | (1,206,701) | (20,520,325) |
| Nondeductible expenses | | 141,474 | 155,270 |
| Tax-exempt income | | (2,168,849) | (2,547,578) |
| Tax settlement | | 1,334,745 | (2,356,538) |
| Other | | 847,641 | (401,761) |
| Total statutory income taxes | $ | 13,183,076 | 29,563,280 |
| Current income taxes incurred | $ | 20,921,262 | 22,861,220 |
| Change in deferred income tax (without tax on unrealized gains and losses) | | (773,149) | (2,043,104) |
| Tax on net realized capital gains (losses) | | (6,965,037) | 8,745,164 |
| Total statutory income taxes | $ | 13,183,076 | 29,563,280 |

## (11) Employee Benefits

During 2003 through 2006, the Company, along with its affiliates and ultimate parent, gradually froze and terminated its defined benefit pension plan. The plan termination was finalized in 2006. All plan distributions were made in late 2006. In 2006, the Company, along with its affiliates and ultimate parent, paid $14.4 million in benefits and had no remaining benefit obligation at December 31, 2006. The pension expense incurred was $2.6 million in 2006. No expenses were incurred in 2008 or 2007.

The Company, along with its affiliates and ultimate parent, maintains an Employee Stock Ownership Plan (ESOP), 401(k), and bonus and incentive plans covering executives, managers, and associates. At the board's discretion, funding of these plans is primarily dependent upon reaching predetermined levels of operating return on equity and Market Value Potential (MVP). MVP is a compensation model that measures comprehensive earnings against a minimum required return on the Company's capital. Bonuses are earned as the Company generates earnings in excess of this required return. While some management incentive plans may be affected somewhat by other performance factors, the larger influence is corporate performance. The Company's 401(k) plan allows voluntary contributions by employees and permits ESOP diversification transfers for employees meeting certain age or service requirements. The Company provides a basic 401(k) contribution of 3% of eligible compensation. Participants are 100% vested in both voluntary and basic contributions. Additionally, an annual discretionary profit-sharing contribution may be made to the ESOP and 401(k), subject to the achievement of certain overall financial goals. For plan years prior to 2007, profit-sharing contributions were subject to a five-year cliff vest. For plan year 2007 and later, contributions vest after three years of service. The Company's ESOP and 401(k) cover all employees meeting eligibility requirements. ESOP and 401(k) profit-sharing contributions are determined annually by


(Continued)

the board of directors and are expensed in the year earned. The total amount of expense for these plans for 2008 and 2007 was $8,750,639 and $9,761,233, respectively. The Company allocates a portion of this expense to its subsidiaries per the terms of the intercompany services agreement. The Company's total expenditures for employee benefits, including ESOP and 401(k) contributions but excluding the cost of incentive plans discussed below, were $9,152,104 and $10,966,325 for 2008 and 2007, respectively.

Annual bonuses are awarded to executives, managers, and associates through the Company's incentive plans, provided certain financial and operational goals are met. The total amount of expense for these incentive plans for 2008 and 2007 was $4,641,039 and $15,791,311, respectively. The Company allocates a portion of this expense to its subsidiaries per the terms of the intercompany services agreement.

In 2002, the Company, along with its affiliates and ultimate parent, began offering certain eligible employees postemployment medical coverage. Under the Company's plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under the Company's health plan. Employees who elect continuation of coverage pay the full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. The Company expects a relatively small number of employees will become eligible for this benefit. The COBRA rate established for participating employees covers the cost of providing this coverage. The Company does not provide compensated absences.

## (12) Commitments and Contingent Liabilities

The Company has an accrual for assessments at December 31, 2008 of $2.7 million. It is not possible at this time to determine the periods over which the assessments are expected to be paid.

The following is a description of a complex set of litigation wherein the Company is both a plaintiff and a defendant. While it is impossible to ascertain the ultimate outcome of this matter at this time, the Company believes, based upon facts known to date, that its position is meritorious. The Company's opinion is that the final resolution of these matters will not have a material adverse effect on its financial statements taken as a whole.

The Company was the plaintiff and a defendant in an action captioned RLI Insurance Co. v. Commercial Money Center (CMC), which was filed in U.S. District Court, Southern District of California (San Diego) on February 1, 2002. Other defendants in that action are Commercial Servicing Corporation, Sterling Wayne Pirtle, Anita Pirtle, Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank and Sky Bank. The Company filed a similar complaint against the Bank of Waukegan in San Diego, California Superior Court. Americana Bank & Trust, Atlantic Coast Federal Bank, Lakeland Bank, Sky Bank and Bank of Waukegan are referred to here as the "investor banks." The litigation arises out of the equipment and vehicle leasing program of CMC. CMC originated leases, procured bonds pertaining to the performance of obligations of each lessee under each lease, and then formed "pools" of such leases that it marketed to banks and other institutional investors. The Company sued for rescission and/or exoneration of the bonds the Company issued to CMC and sale and servicing agreements the Company entered into with CMC and the investor banks, which had invested in CMC's equipment leasing program. The Company contends it was fraudulently induced to issue the bonds and enter into the agreements by CMC, who misrepresented and concealed the true nature of its program and the underlying leases originated by CMC (for which bonds were procured). The Company also sued for declaratory relief to determine its rights and


(Continued)

obligations, if any, under the instruments. Each investor bank disputes the Company's claims for relief. CMC is currently in Chapter 7 bankruptcy proceedings.

Between the dates of April 4 and April 18, 2002, each investor bank subsequently filed a complaint against the Company in various state courts, which the Company removed to U.S. District Courts. Each investor bank sued the Company on certain bonds it issued to CMC as well as a sale and servicing agreement between the investor bank, CMC, and us. Each investor bank sued for breach of contract, bad faith and other extra-contractual theories. The Company has answered and denied each investor bank's claim to entitlement to relief. The investor banks claimed entitlement to aggregate payment of approximately $53 million under either the surety bonds or the sale and servicing agreements, plus unknown extra-contractual damages, attorney's fees, and interest. On October 25, 2002, the judicial panel for multi-district litigation (MDL Panel) transferred 23 actions pending in five federal districts involving numerous investor banks, five insurance companies, and CMC to the Federal District Court for the Northern District of Ohio for consolidated pretrial proceedings, assigning the litigation to the Honorable Kathleen O'Malley.

In the third quarter of 2005, the Company reached a confidential settlement agreement with Lakeland Bank. This settlement ended the Company's litigation with Lakeland, but did not resolve its pending litigation with the four other investor banks. The settlement with Lakeland related to surety bonds representing approximately 17% of the amount to which the five investor banks had claimed entitlement. The settlement did not have a material adverse effect on the Company's financial statements taken as a whole. In addition, in August 2005, the Federal District Court denied outright the investor banks' motion for judgment on the pleadings and subsequently ordered all remaining cases to mandatory mediation. Mediations held in January 2006 between the Company and each of the four remaining investor banks did not resolve the claims of those investor banks. In September 2006, the Court issued a case management order governing expert witness discovery and future motion practice. In the second quarter of 2007, the Company reached a confidential settlement agreement with Sky Bank. In the third quarter of 2007, the Company reached a confidential settlement agreement with Ameriana Bank. These settlements ended the Company's litigation with Sky Bank and Ameriana Bank but did not resolve its pending litigation with the remaining two investor banks (Bank of Waukegan and Atlantic Coast Federal, whose initial bond penal sum claims total approximately $9.3 million). The settlements with Sky Bank and Ameriana Bank related to surety bonds representing approximately 66% of the amount to which the five investor banks had claimed entitlement. In the first quarter of 2008, the Company reached a confidential settlement agreement with the Bank of Waukegan. In the fourth quarter of 2008, the Company reached a confidential settlement agreement with Atlantic Coast Federal Bank. The settlements with Bank of Waukegan and Atlantic Coast Federal related to surety bonds representing approximately 17% of the amount to which the five investor banks had claimed entitlement. With these latter two settlements, the Company has now reached settlements with each of the five investor banks that had claimed entitlement under the surety bonds issued by RLI.



(Continued)

The Company is also party to numerous claims and losses that arise in the normal course of its business. Many of these claims or losses involve claims under policies that the Company underwrites as an insurer. The Company believes that the resolution of these claims and losses will not have a material adverse effect on its financial statements. The Company is also involved in various other legal proceedings and litigation unrelated to its insurance business that arises in the ordinary course of business operations. The Company believes that any liabilities that may arise as a result of these legal matters will not have a material adverse effect on its financial condition or operating results.

**(13) Leases**

The Company leases regional office facilities and computers under operating leases. These leases expire in various years through 2014. Minimum future rental payments under noncancelable leases are as follows:

| | | |
|---|---|---|
| 2009 | $ | 3,676,228 |
| 2010 | | 3,256,515 |
| 2011 | | 2,644,388 |
| 2012 | | 2,335,729 |
| 2013 and thereafter | | 1,035,065 |
| Total minimum future rental payments | $ | 12,947,925 |

The Company shares rental expense with its affiliate, Mt. Hawley, through an intercompany cost sharing agreement. The Company's portion of rental expense for 2008 and 2007 was $921,985 and $1,028,287, respectively.

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risk Interrogatories

December 31, 2008

1) Total admitted assets: $ 1,279,073,667

2) 10 largest exposures to a single issuer/borrower/investment:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Company | $ 470,109,432 | 36.8% |
| iShares DJ Select Dividend | 11,705,715 | 0.9 |
| iShares S&P 500 Index Fund | 10,324,239 | 0.8 |
| Bear Stearns Comm Mtg Sec | 6,510,627 | 0.5 |
| Louisiana State | 5,003,382 | 0.4 |
| AT&T Inc | 4,723,875 | 0.4 |
| Deere & Company | 4,632,873 | 0.4 |
| Wells Fargo Co | 4,241,231 | 0.3 |
| Goldman Sachs Group Inv | 4,219,840 | 0.3 |
| Alabama St Pub Sch & College | 4,187,733 | 0.3 |

3) Total admitted assets held in bonds by NAIC rating:

| Bonds | Amount | Percentage |
|---|---|---|
| NAIC-1 | $ 502,500,714 | 39.3% |
| NAIC-2 | 31,296,718 | 2.4 |
| NAIC-3 | 1,480,000 | 0.1 |
| NAIC-4 | — | — |
| NAIC-5 | — | — |
| NAIC-6 | 5,700 | — |

| Preferred Stocks | Amount | Percentage |
|---|---|---|
| P/RP-1 | $ 812,800 | 0.1% |
| P/RP-2 | — | — |
| P/RP-3 | — | — |
| P/RP-4 | — | — |
| P/RP-5 | — | — |
| P/RP-6 | — | — |

4) Assets held in foreign investments:

| | Amount | Percentage |
|---|---|---|
| Total admitted assets held in foreign investments | $ 17,504,001 | 1.4% |
| Foreign currency denominated investments | — | — |
| Insurance liabilities denominated in that same foreign currency | — | — |

5) Assets held in foreign investments represent less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatories 5 – 10.

11) Assets held in Canadian investments and unhedged Canadian currency exposure is less than 2.5% of the reporting entity's total admitted assets, therefore, detail not required.

12) There were no admitted assets held in investments with contractual sales restrictions.

13) Admitted assets held in the largest 10 equity interests:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Company | $ 470,109,432 | 36.8% |
| iShares DJ Select Dividend Fund | 11,705,715 | 0.9 |
| iShares S&P 500 Index Fund | 10,324,239 | 0.8 |
| AT&T Inc | 4,723,875 | 0.4 |
| Exxon Mobil Corporation | 4,164,731 | 0.3 |
| JP Morgan Chase & Co | 3,404,294 | 0.3 |
| Utilities Select Sector Spdr | 3,400,865 | 0.3 |
| Dominion Resources Inc | 3,383,296 | 0.3 |
| Piedmont Natural Gas | 3,167,000 | 0.2 |
| Chevron Corporation | 3,154,821 | 0.2 |

14) There were no assets held in nonaffiliated, privately placed equities, exceeding 2.5% of the Company's total admitted assets.



(Continued)

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risk Interrogatories

December 31, 2008

15) There were no admitted assets held in general partnership interests that exceeded 2.5% of the Company's total admitted assets.

16) There were no mortgage loans reported on the Company's Annual Statement Schedule B; therefore, detail not required for interrogatories 16 and 17.

18) Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in the Annual Statement Schedule A, were less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatory 18.

19) There were no admitted assets held in investments held in mezzanine real estate loans.

20) Total admitted assets subject to the following types of agreements:

| Agreement type | At year-end | | At end of each quarter | | |
|---|---|---|---|---|---|
| | Amount | Percentage | 1st Qtr | 2nd Qtr | 3rd Qtr |
| Securities lending | $ 10,602,669 | 0.8% | $ 18,355,369 | 10,425,800 | 8,871,950 |
| Repurchase | — | — | — | — | — |
| Reverse repurchase | — | — | 28,147,750 | 25,868,750 | — |
| Dollar repurchase | — | — | — | — | — |
| Dollar reverse repurchase | — | — | — | — | — |

21) The Company owns no warrants not attached to other financial instruments, options, caps, and floors.

22) The Company has no exposure to collars, swaps, or forwards.

23) The Company has no exposure for future contracts.

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2008

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Bonds: | | | | |
| U.S. Treasury securities | $ 4,059,982 | 0.34% | $ 4,059,982 | 0.34% |
| U.S. government agency and corporate obligations: | | | | |
| Issued by U.S. government agencies | 1,927,191 | 0.16 | 1,927,191 | 0.16 |
| Issued by U.S. government-sponsored agencies | 84,302,265 | 7.05 | 84,302,265 | 7.07 |
| Foreign government: | | | | |
| Securities issued by states, territories, and political subdivisions in the U.S.: | | | | |
| State, territory, and possession and general obligations | 19,696,425 | 1.65 | 19,696,425 | 1.65 |
| Political subdivisions of states, territories, and possessions' political subdivisions' general obligations | 53,397,113 | 4.47 | 53,397,113 | 4.48 |
| Revenue and assessment obligations | 81,081,037 | 6.78 | 81,081,037 | 6.80 |
| Industrial development and similar obligations | — | — | — | — |
| Mortgage-backed securities: | | | | |
| Pass-through securities: | | | | |
| Guaranteed by GNMA | 6,375,705 | 0.53 | 6,375,705 | 0.53 |
| Issued by FNMA and FHLMC | 55,979,627 | 4.68 | 55,979,627 | 4.69 |
| All other | — | — | — | — |
| CMOs and REMICs: | | | | |
| Issued by FNMA, FHLMC, GNMA, or VA | 16,466,443 | 1.38 | 16,466,443 | 1.38 |
| Issued by non-U.S. government issuers and collateralized by mortgage-backed securities issued or guaranteed by above agencies | — | — | — | — |
| All other | 22,015,196 | 1.84 | 22,015,196 | 1.85 |
| Other debt and other fixed-income securities: | | | | |
| Unaffiliated domestic securities | 112,804,318 | 9.44 | 112,804,318 | 9.46 |
| Unaffiliated foreign securities | 15,312,829 | 1.28 | 15,312,829 | 1.28 |
| Affiliated securities | — | — | — | — |
| Equity interests: | | | | |
| Investments in mutual funds | — | — | — | — |
| Preferred stocks: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | 812,800 | 0.07 | 812,800 | 0.07 |
| Publicly traded equity securities: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | 165,667,930 | 13.86 | 165,667,930 | 13.89 |
| Tangible personal property under lease: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | — | — | — | — |
| Other equity securities: | | | | |
| Affiliated | 472,747,764 | 39.55 | 470,109,432 | 39.43 |
| Unaffiliated | — | — | — | — |
| Mortgage loans: | | | | |
| Construction and land development | — | — | — | — |
| Agricultural | — | — | — | — |
| Single family residential properties | — | — | — | — |
| Multifamily residential properties | — | — | — | — |
| Commercial loans | — | — | — | — |
| Mezzanine real estate loans | — | — | — | — |



(Continued)

Schedule 2

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2008

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Real estate investments: | | | | |
| Property occupied by company | $ 9,051,804 | 0.76% | $ 8,781,991 | 0.74% |
| Property held for production of income | — | — | — | — |
| Property held for sale | — | — | — | — |
| Policy loans | — | — | — | — |
| Receivable for securities | 16,925,208 | 1.42 | 16,925,208 | 1.42 |
| Cash and short-term investments | 56,690,060 | 4.74 | 56,690,060 | 4.75 |
| Write-in invested assets | — | — | — | — |
| Total invested assets | $ 1,195,313,697 | 100.00% | $ 1,192,405,552 | 100.00% |

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year ended December 31, 2008

| | | |
|---|---|---|
| 7.1 | Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit, or any similar provisions)? | Yes [ ] No [X] |
| 7.2 | If yes, indicate the number of reinsurance contracts containing such provisions. | N/A [X] |
| 7.3 | If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)? | Yes [ ] No [ ] N/A [X] |
| 8.1 | Has this reporting entity reinsured any risk with any other entity and agreed to release such entity from liability, in whole or in part, from any loss that may occur on this risk, or portion thereof, reinsured? | Yes [ ] No [X] |
| 8.2 | If yes, give full information. | N/A [X] |
| 9.1 | Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 3% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of prior year-end surplus as regards policyholders: (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results: | |
| | (a) A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term; | |
| | (b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer; | |
| | (c) Aggregate stop loss reinsurance coverage; | |
| | (d) An unconditional or unilateral right by either party to commute the reinsurance contract except for such provisions, which are only triggered by a decline in the credit status of the other party; | |
| | (e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or | |
| | (f) Payment schedule, accumulating retentions from multiple years, or any features inherently designed to delay timing of the reimbursement to the ceding entity | Yes [ ] No [X] |



(Continued)

## RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year ended December 31, 2008

9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member where:

(a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

(b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates — Yes [ ] No [X]

9.3 If yes to 9.1 or 9.2, please provide the following information in the Reinsurance Summary Supplemental Filing for general interrogatory 9:

(a) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

(b) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 9.1 or 9.2; and

(c) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved. — N/A [X]

9.4 Except for transactions meeting the requirements of paragraph 30 of SSAP No. 62, *Property and Casualty Reinsurance*, has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

(a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principals (SAP) and as a deposit under generally accepted accounting principals (GAAP); or

(b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP? — Yes [ ] No [X]

9.5 If yes to 9.4, explain in the Reinsurance Summary Supplemental Filing for general interrogatory 9 (section D) why the contract(s) is treated differently for GAAP and SAP. — N/A [X]

9.6 The reporting entity is exempt from the Reinsurance Attestation Supplement under one or more of the following criteria:

(a) The entity does not utilize reinsurance; or, — Yes [ ] No [X]

(b) The entity only engages in a 100% quota share contract with an affiliate or lead company has filed an attestation supplement; or — Yes [ ] No [X]

(c) The entity has no external cessions and only participates in an intercompany pool and the affiliated lead company has filed an attestation supplement. — Yes [ ] No [X]

See accompanying independent auditors' report.

KPMG

# RLI INSURANCE COMPANY

Statutory Financial Statements and Schedules

December 31, 2009 and 2008

(With Independent Auditors' Report Thereon)

KPMG LLP
303 East Wacker Drive
Chicago, IL 60601-5212

# Independent Auditors' Report

The Audit Committee of the Board of Directors of RLI Corp.
The Board of Directors of RLI Insurance Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and capital and surplus of RLI Insurance Company (the Company) as of December 31, 2009 and 2008, and the related statutory statements of income and changes in capital and surplus, and cash flow for the years then ended. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in note 1 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Illinois Department of Insurance, which practices differ from U.S. generally accepted accounting principles. The effects on the financial statements of the variances between the statutory basis of accounting and U.S. generally accepted accounting principles also are described in note 1.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of the Company as of December 31, 2009 and 2008, or the results of its operations or its cash flows for the years then ended.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus of the Company as of December 31, 2009 and 2008, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in note 1.

KPMG LLP is a Delaware limited liability partnership, the U.S. member firm of KPMG International Cooperative ("KPMG International"), a Swiss entity.

KPMG

Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included on the schedule of supplemental investment risk interrogatories, the summary investment schedule, and the supplemental schedule of reinsurance interrogatories is presented for purposes of additional analysis and is not a required part of the basic statutory financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic statutory financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole.

KPMG LLP

May 25, 2010

## RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2009 and 2008

| Admitted Assets | 2009 | 2008 |
|---|---|---|
| Bonds | $ 555,772,021 | 473,418,131 |
| Common stocks | 176,733,568 | 165,667,930 |
| Preferred stocks | — | 812,800 |
| Investment in affiliates | 565,555,042 | 470,109,432 |
| Real estate occupied by the Company, at cost, less accumulated depreciation of $9,634,512 and $8,993,553 in 2009 and 2008, respectively | 8,270,110 | 8,781,991 |
| Cash and short-term investments | 54,727,963 | 56,690,060 |
| Other invested assets | 1,000,000 | — |
| Receivable for securities | — | 16,925,208 |
| Total cash and invested assets | 1,362,058,704 | 1,192,405,552 |
| Uncollected premiums and agents' balances | 45,043,314 | 45,787,561 |
| Funds held by or deposited with reinsured companies | 4,000 | 4,000 |
| Reinsurance recoverable on paid losses and loss adjustment expenses | 4,862,173 | 6,367,879 |
| Deferred tax asset | 6,055,029 | 18,363,143 |
| Electronic data processing equipment, at cost less accumulated straight-line depreciation of $16,647,991 and $24,579,066 in 2009 and 2008, respectively | 373,439 | 617,907 |
| Investment income due and accrued | 6,497,019 | 6,120,428 |
| Receivable from affiliates | — | 4,863,045 |
| Other assets | 1,917,353 | 4,544,152 |
| Total admitted assets | $ 1,426,811,031 | 1,279,073,667 |



(Continued)

## RLI INSURANCE COMPANY

Statutory Statements of Admitted Assets, Liabilities, and Capital and Surplus

December 31, 2009 and 2008

| Liabilities and Capital and Surplus | 2009 | 2008 |
|---|---|---|
| Unpaid losses and loss adjustment expenses | $ 373,115,827 | 350,305,788 |
| Reinsurance payable on paid losses | 235,370 | 783,841 |
| Accrued expenses | 30,312,702 | 32,299,661 |
| Unearned premiums | 153,088,592 | 148,165,761 |
| Advance premiums | 3,922,921 | 3,785,888 |
| Ceded reinsurance premiums payable | 9,831,655 | 15,421,779 |
| Funds held under reinsurance agreements | 779,814 | 608,919 |
| Amounts withheld | 47,344,613 | 32,095,258 |
| Provision for reinsurance | 883,400 | 838,000 |
| Current federal and foreign income tax recoverable | 3,512,672 | 208,160 |
| Commissions payable, contingent commissions, and other similar charges | 13,285,962 | 13,798,927 |
| Payable to parent | 5,763,640 | — |
| Other liabilities | 573,015 | 2,720,516 |
| Total liabilities | 642,650,183 | 601,032,498 |
| Capital and surplus: | | |
| Capital stock, $125 par value. Authorized 1,000,000 shares; issued and outstanding 80,003 shares | 10,000,375 | 10,000,375 |
| Paid-in contributed capital | 242,451,084 | 242,451,084 |
| Unassigned surplus | 531,709,389 | 425,589,710 |
| Total capital and surplus | 784,160,848 | 678,041,169 |
| Total liabilities and capital and surplus | $ 1,426,811,031 | 1,279,073,667 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Income and Changes in Capital and Surplus

Years ended December 31, 2009 and 2008

| | 2009 | 2008 |
|---|---|---|
| Premiums earned | $ 277,947,449 | 265,297,702 |
| Losses and underwriting expenses incurred: | | |
| Losses and loss adjustment expenses | 128,992,281 | 117,746,812 |
| Other underwriting expenses | 127,609,674 | 119,317,595 |
| Total losses and underwriting expenses incurred | 256,601,955 | 237,064,407 |
| Net underwriting gain | 21,345,494 | 28,233,295 |
| Net investment income | 28,221,741 | 32,249,833 |
| Net realized capital losses, less tax benefit of $3,597,036 and $6,965,037 for 2009 and 2008, respectively | (6,680,209) | (12,935,070) |
| Total investment income | 21,541,532 | 19,314,763 |
| Other income | (417,744) | 87,738 |
| Income before federal income taxes, net of tax on realized losses | 42,469,282 | 47,635,796 |
| Federal income tax expense | 13,521,562 | 20,921,262 |
| Net income | 28,947,720 | 26,714,534 |
| Capital and surplus at beginning of year | 678,041,169 | 752,004,325 |
| Change in unrealized gains (losses) of investments (net of tax) | 116,714,745 | (31,890,770) |
| Change in net deferred income tax | (1,031,936) | 773,149 |
| Change in nonadmitted assets | 1,534,550 | 374,731 |
| Change in provision for reinsurance | (45,400) | 65,200 |
| Dividends to stockholder | (40,000,000) | (70,000,000) |
| Capital and surplus at end of year | $ 784,160,848 | 678,041,169 |

See accompanying notes to statutory financial statements.

## RLI INSURANCE COMPANY

Statutory Statements of Cash Flow

Years ended December 31, 2009 and 2008

| | 2009 | 2008 |
|---|---|---|
| Operating activities: | | |
| Premiums collected, net of reinsurance | $ 277,895,447 | 268,474,341 |
| Investment income, net of investment expense | 30,301,591 | 35,923,529 |
| Other income (expense) | (417,744) | 87,738 |
| Benefits and loss related payments | (80,125,160) | (69,686,990) |
| Commissions and other expenses paid | (155,209,445) | (156,787,572) |
| Federal income taxes paid | (6,620,014) | (12,362,072) |
| Net cash flow from operations | 65,824,675 | 65,648,974 |
| Investing activities: | | |
| Cash provided from investments sold, matured, or repaid: | | |
| Bonds | 249,465,211 | 193,503,739 |
| Stocks | 81,716,272 | 50,549,222 |
| Miscellaneous proceeds | 16,925,208 | 163,268 |
| Cost of investments acquired: | | |
| Bonds | (330,378,015) | (118,915,131) |
| Stocks | (72,720,255) | (60,600,754) |
| Real estate | (86,794) | (3,184,190) |
| Miscellaneous cash applications | (45,424) | (15,214,278) |
| Net cash flow from investing activities | (55,123,797) | 46,301,876 |
| Financing activities and miscellaneous sources: | | |
| Borrowed funds received (repaid) | — | (28,022,985) |
| Dividends to stockholder | (40,000,000) | (70,000,000) |
| Other cash provided | 27,337,025 | 13,618,600 |
| Net cash flow from financing activities and miscellaneous sources | (12,662,975) | (84,404,385) |
| Net change in cash and short-term investments | (1,962,097) | 27,546,465 |
| Cash and short-term investments at beginning of year | 56,690,060 | 29,143,595 |
| Cash and short-term investments at end of year | $ 54,727,963 | 56,690,060 |

See accompanying notes to statutory financial statements.

## (1) Background and Significant Accounting Policies

### *(a) Organization*

RLI Insurance Company (the Company or RLI) is a wholly owned subsidiary of RLI Corp. The Company is primarily engaged in writing selected property and casualty insurance, including commercial fire, homeowners, general and product liability, directors and officers, commercial and personal umbrella, marine, and commercial auto. The Company also writes small-to-large commercial and small contract surety coverages, as well as those for the energy (plugging and abandonment of oil wells), petrochemical, and refining industries. In addition, the Company offers fidelity and crime coverage for commercial insureds and select financial institutions.

### *(b) Basis of Presentation*

The accompanying statutory financial statements have been prepared in conformity with accounting practices prescribed or permitted by the Illinois Department of Insurance (the Department). The National Association of Insurance Commissioners' *Accounting Practices and Procedures* (NAIC SAP) has been adopted as a component of prescribed or permitted practices by the Department. The Department has adopted all of the prescribed accounting practices as stated in the NAIC SAP and the Company has no permitted accounting practices. Statutory accounting practices differ in certain respects from U.S. generally accepted accounting principles (GAAP). The most significant differences include the following:

(1) Acquisition costs related to premiums written are expensed as incurred, rather than deferred to the extent recoverable and charged to operations ratably over the period covered by the related insurance policies as prescribed by GAAP.

(2) Investments in bonds are not classified as to the Company's intention to trade, hold to maturity, or make available for sale. Investments in bonds are generally carried at amortized cost rather than fair value. Accordingly, unrealized changes in fair value attributable to bonds are not reflected in the statutory statements of income and changes in capital and surplus.

(3) Certain assets are designated as nonadmitted assets and are charged to surplus, as opposed to being carried at amounts recoverable for GAAP purposes.

(4) The realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles (SSAP) No. 10R, *Income Taxes – Revised, A Temporary Replacement of SSAP No. 10*, as adopted in 2009. Under this standard, gross deferred tax assets are reduced by a statutory valuation allowance if it is more likely than not that some portion or all of the gross deferred tax assets will not be realized. Thereafter, a net deferred tax asset, for the tax effect of temporary differences between financial reporting and the tax basis of assets and liabilities, is only reported as an admitted asset to the extent of the sum of federal income taxes paid in prior years that can be recovered through loss carrybacks from temporary differences that reverse during a time frame corresponding with IRS tax loss carryback


(Continued)

provisions, not to exceed three years; gross deferred tax assets expected to be realized within three years, but limited to 15% of adjusted surplus; and the amount of gross deferred tax assets that can be offset against gross deferred tax liabilities. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in tax expense under GAAP, whereas under statutory accounting principles, these changes directly impact surplus. For contingent tax liabilities, GAAP also uses a "more likely than not" threshold for recognition purposes whereas SSAP uses a "probable" threshold in accordance with SSAP No. 5, *Liabilities, Contingencies and Impairments of Assets*.

(5) A liability is established, which is not required under GAAP, by a direct charge to unassigned surplus for unsecured reinsurance recoverables from unauthorized reinsurers and certain past due amounts from authorized reinsurers, rather than just providing for the estimated amounts deemed uncollectible.

(6) The liability for unpaid losses and loss adjustment expenses (LAE) is reported net of reinsurance recoverables, and unearned premiums are reported net of prepaid reinsurance premiums, rather than presenting these amounts gross of the effects of reinsurance ceded for GAAP.

(7) Wholly owned insurance subsidiaries are reflected at net statutory book value with changes reflected directly in capital and surplus, as opposed to consolidation of assets and liabilities and income on the financial statements for GAAP.

(8) The statutory statement of cash flow differs in certain respects from the presentation required by GAAP, including the presentation of the changes in cash and short-term investments instead of cash and cash equivalents. Short-term investments include securities with original maturities of one year or less at the time of acquisition.

(9) The statutory financial statements are prepared in a form using language and groupings substantially the same as the annual statements filed with the NAIC and state regulatory authorities, which differ from the presentation and disclosures of financial statements presented under GAAP.

(10) Comprehensive income, which is required under GAAP, is not determined for statutory reporting purposes.

Under GAAP, for the years ended December 31, 2009 and 2008, the Company had net income of $29,971,636 and $30,036,968, respectively. The Company's GAAP shareholder's equity amounted to $943,371,730 and $820,933,544 at December 31, 2009 and 2008, respectively.

Significant statutory accounting policies are as follows:

***(c) Investments***

Bonds are generally carried at amortized cost with the discount or premium on bonds amortized using the scientific method. Bonds with a NAIC designation of 3-6 are carried at the lower of amortized cost or fair value. Interest income consists of interest collected during the period, the

change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on bonds acquired and the addition of discount accrual. Short-term investments are valued at cost, which approximates fair value, and are considered cash equivalents in the statutory financial statements. Realized investment gains and losses are determined at the trade date on the basis of the specific-identification method. Real estate is valued at cost less accumulated depreciation, which is computed on a straight-line basis over the estimated useful lives of the properties.

Loan-backed securities are carried at either amortized cost or the lower of amortized cost or fair value dependent upon NAIC designations. All of the Company's loan-backed securities were purchased subsequent to January 1, 1994. Loan-backed securities are amortized using currently estimated cash flows, including new prepayment assumptions, under the retrospective methodology. For loan-backed and structured securities that have been other-than-temporarily impaired, the prospective adjustment method is used subsequent to loss recognition. Prepayment assumptions for single-class and multiclass mortgage-backed securities were obtained from external sources and through management estimates. The Company uses an external pricing service to determine the fair value of its loan-backed/asset-backed securities.

Unaffiliated common stocks are carried at values assigned by the NAIC, which approximate fair value. Stocks of affiliates in which the Company has an interest of 20% or more are carried based upon the affiliate's audited statutory surplus. Dividends on stocks are credited to income on the ex-dividend date. Realized investment gains and losses are determined at the trade date on the basis of the specific-identification method. Unrealized gains or losses are charged or credited directly to unassigned surplus, net of the provision for deferred income taxes.

Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2) that have characteristics of debt securities are carried at cost or amortized cost. Highest-quality or high-quality perpetual preferred stocks (NAIC designations 1 and 2) that have characteristics of equity securities are carried using unit prices as reported in the NAIC *Valuations of Securities Manual*. Dividends on preferred stock, other than mandatorily redeemable preferred stock, are recorded as investment income on the ex-dividend date. Dividends on mandatorily redeemable preferred stock are accrued to the redemption price, even if not declared, using the interest method over the period ending on the redemption date. The Company did not have any preferred stock investments with NAIC ratings 3-6 as of December 31, 2008, nor did the Company hold any preferred stock investments as of December 31, 2009.

The Company reviews the values of their investments in bonds and common stocks on a quarterly basis for other-than-temporary impairment losses. Investments that have a fair value that is less than cost or amortized cost are evaluated for other-than-temporary impairment. The Company's methodology of assessing other-than-temporary impairments is based on security-specific facts and circumstances as of the date of the reporting period. Management considers the length of time and the extent to which the fair value has been less than cost, the financial condition and short-term prospects of the issuer including any specific events that may influence the operations of the issuer, and whether or not the Company intended to sell bonds with interest-related impairments in evaluating other-than-temporary impairment. Pursuant to the adoption of SSAP No. 43R, *Loan-Backed and Structured Securities*, effective July 1, 2009, loan-backed and structured securities, for

which the Company does not have the intent to sell or for which it is not more likely than not that the Company will be required to sell prior to recovery of amortized cost and which are ultimately deemed to be other-than-temporarily impaired, are written down to net discounted cash flows with a corresponding realized loss recognized in the statements of income. For loan-backed and structured securities that may be other-than-temporarily impaired, the Company's historical practice has generally been to sell these securities to maximize the associated tax benefit. Given this intent to sell, other-than-temporary losses on such securities are recorded to fair value. If any other security is deemed to be other-than-temporarily impaired, it is written down to fair value with a corresponding realized loss recognized in the statements of income.

Prior to July 1, 2009, for loan-backed and structured securities, the Company recorded impairments to fair value under the provisions of the exposed and now superseded SSAP No. 98, *Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments*.

***(d) Investment in Affiliates and Related Parties***

The Company owns 100% of the common stock of Mt. Hawley Insurance Company (Mt. Hawley), Safe Fleet Insurance Services, Inc. (Safe Fleet), RLI Insurance Ltd. (RLI Ltd), Underwriters Indemnity General Agency (UIGA), and RLI Underwriting Services, Inc. (RLI US). Mt. Hawley is engaged in writing excess and surplus lines of insurance. The Company's investment in Mt. Hawley is carried at cost plus equity in statutory net income and surplus adjustments since the date of formation, less dividends received. Changes in the carrying value of the Company's investment in Mt. Hawley are reflected directly in unassigned surplus. Mt. Hawley maintains at December 31, 2009 an investment of 2,022,086 shares in its ultimate parent, RLI Corp. The estimated fair value of this common stock at December 31, 2009, after reduction of Mt. Hawley's reciprocal ownership, was $26,038,618.

Safe Fleet, RLI Ltd, UIGA, and RLI US are valued based on their underlying audited GAAP equity adjusted to a statutory basis of accounting under the provisions of SSAP No. 97, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 88.* Per SSAP No. 97, the Company has nonadmitted its investment in Safe Fleet, RLI Ltd, UIGA, and RLI US since GAAP audits are not conducted individually for these subsidiaries.

***(e) Revenue Recognition***

Premiums, net of reinsurance, are earned and recognized as revenue ratably in relation to the risk covered over the period of the underlying policies. Unearned premiums, which are reflected net of reinsurance, represent the pro rata portion of premiums written, which are applicable to the unexpired terms of the policies in force.

***(f) Acquisition Costs***

The costs of acquiring insurance premiums (principally commissions and premium taxes) are charged to current operations as incurred.

*(g) Liability for Unpaid Losses and Loss Adjustment Expenses*

The estimated liability for unpaid losses and loss adjustment expenses includes a provision for reported and unpaid losses as well as estimates of losses incurred but not reported, net of amounts covered by reinsurance. The estimates are based on certain actuarial and other assumptions related to the ultimate cost to settle such claims. Such assumptions are subject to occasional changes due to evolving economic, social, and political conditions. All estimates are periodically reviewed and, as experience develops and new information becomes known, the reserves are adjusted as necessary. Such adjustments are reflected in the results of operations in the period in which they are determined. As these amounts are determined based upon estimates, the ultimate liability may be more or less than such estimates. Based on the current assumptions used in estimating reserves, management believes that the Company's overall reserve levels at December 31, 2009 make a reasonable provision to meet its future obligations.

*(h) Federal Income Taxes*

The Company files a consolidated federal income tax return with RLI Corp. and affiliates. The provision for federal income taxes is based on current taxable income. The method of allocation between the companies is subject to written agreement and approved by the board of directors. Allocation is based on the ratio of that portion of the separate company taxable income each member bears to the total taxable income of the group. Intercompany tax balances are settled within 30 days of filing the consolidated income tax return.

Current year federal income tax expense is based on financial reporting income or loss adjusted for certain permanent and timing differences. The timing differences are the result of dissimilar financial reporting and tax basis accounting methods. A net deferred tax asset, net of any requisite valuation allowance, representing the tax effect of timing differences between financial reporting and the tax basis of assets and liabilities is only reported as an admitted asset to the extent that it will be realized subject to the provisions of SSAP 10R, which was adopted during 2009. The change in net deferred tax asset or liability is reflected directly in unassigned surplus.

The Company records liabilities for potential tax contingencies only when it is probable the position will not be sustainable upon audit by taxing authorities. These liabilities are reevaluated routinely and are adjusted appropriately based upon changes in facts or law. Penalties and interest, in the event they are incurred, are included in tax expense. The amount of uncertain tax items is not significant as of December 31, 2009 and 2008, respectively.

*(i) Provision for Reinsurance*

A statutory reinsurance liability must be established for unsecured amounts ceded to unauthorized reinsurers and certain amounts of past due recoverables from authorized reinsurers. This amount is recorded through a direct charge to unassigned surplus.

*(j) Nonadmitted Assets*

Certain assets (principally direct premiums 90 days past due, office furniture and equipment, EDP equipment, real estate, and certain investments in affiliates) are designated as nonadmitted assets and charged to unassigned surplus.



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*(k) Allowance for Uncollectible Reinsurance*

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

*(l) Depreciation and Amortization*

Currently all depreciation and amortization is calculated using the straight-line method. The useful lives are as follows: 3 years for computers and external operating software and 5 to 40 years for tenant improvements and real estate. Depreciation and amortization expense for the Company totaled $2,363,766 and $2,611,528 for 2009 and 2008, respectively.

*(m) Risks and Uncertainties*

Certain risks and uncertainties are inherent to the Company's day-to-day operations and to the process of preparing its statutory financial statements. The more significant of those risks and uncertainties, as well as the Company's methods for attempting to mitigate, quantify, and minimize such risks and uncertainties, are presented below and throughout the notes to the statutory financial statements.

**Catastrophe Exposures**

The Company's insurance coverages include exposure to catastrophic events. The Company's major catastrophe exposure is to losses caused by earthquakes, primarily on the West Coast. Its second largest catastrophe exposure is to losses caused by hurricanes to commercial properties throughout the Gulf and East Coasts, as well as to homes the Company insures in Hawaii. The Company monitors these exposures by quantifying its exposed policy limits in each region and by using computer-assisted modeling techniques. Additionally, the Company further limits its risk to such catastrophes through the purchase of reinsurance.

**Environmental Exposures**

The Company is subject to environmental claims and exposures through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. Although exposure to environmental claims exists in these lines of business, management has attempted to mitigate or control the extent of this exposure through the following methods: 1) the Company's policies include pollution exclusions that have been continually updated to further strengthen the exclusion and 2) the Company's policies primarily cover moderate hazard risks. The Company includes historical environmental loss experience with the remaining loss experience in the applicable line of business

to project ultimate incurred losses and loss adjustment expenses and related incurred but not reported loss and LAE reserves.

Although historical experience on environmental claims may not accurately reflect future environmental exposures, the Company has used this experience to record loss and loss adjustment expense reserves in the exposed lines of business. See further discussion of environmental exposures in note 8.

**Reinsurance**

Reinsurance does not discharge the Company from its primary liability to policyholders, and to the extent that a reinsurer is unable to meet its obligations, the Company would be liable. The Company continuously monitors the financial condition of prospective and existing reinsurers. As a result, the Company currently purchases reinsurance from a number of financially strong reinsurers. The Company provides an allowance for reinsurance balances deemed uncollectible, as discussed previously.

**Investments**

The Company's investment portfolio is subject to market, credit, and interest rate risks. The equity portfolio will fluctuate with movements in the overall stock market. While the equity portfolio has been constructed to have lower downside risk than the market, the portfolio is sensitive to movements in the market. The bond portfolio is affected by interest rate changes and credit spreads. The Company attempts to mitigate its interest rate and credit risks by constructing a well-diversified portfolio with high-quality securities.

The prolonged downturn of the global financial markets and economy resulted in significant declines and lack of liquidity in the financial markets. While the Company maintains a high quality portfolio, it was not immune to the negative swings in the markets. The deterioration was not limited in its scope, as most segments of the financial markets were impacted. Continued downturns in the financial markets could have a negative effect on the Company's portfolio. However, the Company attempts to manage this risk through asset allocation and security selection.

**Liquidity Risk**

Liquidity is essential to the Company's business and a key component of its concept of asset-liability matching. The Company's liquidity may be impaired by an inability to collect premium receivable or reinsurance recoverable balances timely, an inability to sell assets or redeem its investments, an inability to access funds from its insurance subsidiaries, unforeseen outflows of cash or large claim payments, or an inability to access debt or equity capital markets. This situation may arise due to circumstances that the Company may be unable to control, such as a general market disruption or an operational problem that affects third parties or the Company, or even by the perception among market participants that the Company, or other market participants, is experiencing greater liquidity risk. To date, disruptions in the financial markets have not increased the Company's cost of funding and have not limited its access to some of its traditional sources of liquidity. The Company's credit ratings are important to its liquidity. A reduction in the Company's credit ratings could adversely



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affect its liquidity and competitive position, increase its borrowing costs, or limit its access to the capital markets.

**Use of Estimates**

The preparation of statutory financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses for the reporting period. Actual results could differ from those estimates. The most significant of these amounts is the liability for unpaid losses and loss adjustment expenses. Management continually updates its estimates as additional data becomes available and adjusts the statutory financial statements as deemed necessary. Other estimates such as the recoverability of reinsurance balances are constantly monitored, evaluated, and adjusted. Although recorded estimates are supported by actuarial computations and other data, the estimates are ultimately based on management's expectations of future events. It is reasonably possible that expectations associated with these accounts can change in the near term (i.e., one year) and that the effect of these changes could be material to the statutory financial statements.

**External Factors**

The Company is regulated by the Illinois Department of Insurance, as well as states in which it does business. Such regulations, among other things, limit the amount of dividends, impose restrictions on the amount and types of investments, and regulate rates insurers may charge for various products. The Company is also subject to insolvency and guarantee fund assessments for policyholder losses covered by insolvent insurers. The Company generally accrues an assessment during the period in which it becomes probable that a liability has been incurred from an insolvency and the amount of the related assessment can be reasonably estimated.

The NAIC has developed Property-Casualty Risk-Based Capital (RBC) standards that relate an insurer's reported statutory capital and surplus to the risks inherent in its overall operations. The RBC formula uses the statutory annual statement to calculate the minimum indicated capital level to support asset (investment and credit) risk and underwriting (loss reserves, premiums written, and unearned premium) risk. If applicable, the NAIC calls for various levels of regulatory action based on the magnitude of an indicated RBC capital deficiency. The Company continuously monitors its internal capital requirements and the NAIC's RBC developments. The Company has determined that its capital levels are in excess of the minimum capital requirements for all RBC action levels. Management believes that the Company's capital levels are sufficient to support the level of risk inherent in its operations.

***(n) Fair Value Disclosures***

Equity securities, which include common stocks and preferred stocks, are valued using NAIC fair value prices, if available. If a NAIC fair value is not available, fair value is estimated using quoted market prices of the security or similar securities. Equity securities are carried at NAIC fair value, whereas bonds are generally carried at amortized cost based upon NAIC designations. Due to the relatively short-term nature of cash, short-term investments, accounts receivable, and accounts

payable, the carrying value of each is a reasonable estimate of fair value. The Company's approach to determining the fair values of bonds and equities is disclosed in notes 2 and 3.

*(o) Significant Events*

During 2009 and 2008, the Company paid ordinary cash dividends to its parent, RLI Corp., of $40,000,000 and $70,000,000, respectively.

*(p) Recent Accounting Pronouncements*

During 2009, the NAIC adopted SSAP No. 43R, *Loan-Backed and Structured Securities*. SSAP No. 43R supersedes SSAP No. 98, *Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments*, and paragraph 13 of SSAP No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*. If the fair value of an asset-backed or structured debt security is less than its amortized cost basis at the reporting date, an entity shall assess whether the impairment is other-than-temporary. When an entity intends to sell an impaired loan-backed or structured security or more likely than not will be required to sell an impaired loan-backed or structured security before recovery of its amortized cost basis, an other-than-temporary impairment is recognized in earnings as the difference between the amortized cost basis and fair value. If an entity does not intend to sell the security and it is not more likely than not that it would be required to sell the security before recovery of its amortized cost basis and the security is deemed other-than-temporarily impaired, a credit loss is recorded in earnings based upon the discounted cash flows expected to be collected.

SSAP No. 43R also required a cumulative effect adjustment to the opening balance of unassigned surplus in the period of adoption for other-than-temporary-impairments on structured debt securities recognized in prior periods, which are still held as investments at July 1, 2009. The accounting guidance is effective for interim and annual reporting periods ending September 30, 2009. There was no cumulative effect adjustment necessary as of July 1, 2009 related to the Company's adoption of this standard, given the Company's intent to dispose of any other-than-temporarily impaired loan-backed or structured security.

In 2009, the Company adopted SSAP No. 99, *Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*. This statement adopts the guidance in paragraph 16 of Financial Accounting Standards Board Staff Position FAS 115-1/124-1 with modification to be consistent with statutory language in the respective statutory accounting statements. Paragraph 16 describes the accounting for debt securities subsequent to other-than-temporary impairment. There was no impact to the financial statements upon adoption of this standard by the Company.

In 2009, the NAIC adopted temporary changes to SSAP No. 10, *Income Taxes*, and issued SSAP No. 10R, *Income Taxes – Revised, A Temporary Replacement of SSAP No. 10*. The changes are effective for the years ended December 31, 2010 and 2009, and for interim reporting periods in 2010. Under this new guidance, the Company considers a statutory valuation allowance against deferred tax assets that may or may not be realized. There are also new elective admissibility considerations, including the increase in the loss carryback allowance from one year to a limit not to exceed three years and a capital and surplus limitation increasing from 10% to 15%. The Company met certain RBC requirements and elected to pursue the additional admissibility considerations offered by the


(Continued)

standard. However, there was no change in the admissibility of deferred tax assets as there were no non-admitted deferred tax assets as of December 31, 2009 or 2008.

*(q) Prospective Accounting Pronouncements*

During 2010, the NAIC adopted SSAP No. 100, *Fair Value Measurements* (SSAP No. 100). SSAP No. 100 provides guidance on defining fair value, establishing a framework for measurement of fair value, and expanding fair value disclosures. This new SSAP applies fair value when required by other statutory accounting pronouncements that require or permit fair value measurements, but does not require any new items to be measured at fair value. SSAP No. 100 establishes a fair value hierarchy to increase consistency and comparability in fair value measurements and related disclosures. SSAP No. 100 is effective for years ending December 31, 2010 and subsequent. The Company does not expect the adoption of this guidance to have a material impact on the Company's financial statements.

**(2) Fair Value Measurement**

Certain financial instruments are periodically measured at fair value on a nonrecurring basis, such as when impaired, or for certain bonds when carried at the lower of cost or fair value.

The fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties (exit price), that is other than in a forced or liquidation sale. The fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, that is, other than a forced or liquidation sale.

Fair values are based on quoted market prices when available. In instances where there is little or no market activity for the same or similar instruments, the Company estimates fair value using observable information that management believes market participants would use to determine a current transaction price. This process involves some level of management estimation and judgment, which becomes significant with increasingly complex instruments.

The Company's financial assets and liabilities carried at fair value have been classified, for disclosure purposes, based on a hierarchy which gives the highest ranking to fair values determined using unadjusted quoted prices in active markets for identical assets and liabilities (Level 1) and the lowest ranking to fair values determined using methodologies and models with unobservable inputs (Level 3). An asset's or liability's classification is based on the lowest level input that is significant to its measurement. For example, a Level 3 fair value measurement may include inputs that are both observable (Levels 1 and 2) and unobservable (Level 3). The levels of the fair value hierarchy are as follows:

*Level 1* – Quoted price (unadjusted) in active markets for identical assets.

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

*Level 3* – Inputs to the valuation methodology are unobservable for the asset or liability.



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**Financial assets and liabilities measured at fair value on a recurring basis**

Certain financial assets are measured at fair value on a recurring basis, such as unaffiliated common stock, which is carried at values assigned by the NAIC that approximate fair value. The following table summarizes assets measured at fair value on a recurring basis as of December 31, 2009 and 2008, respectively:

| Description | Fair value at December 31 Level 1 | Level 2 | Level 3 |
|---|---|---|---|
| 2009: | | | |
| Equities | $ 176,733,568 | — | — |
| 2008: | | | |
| Equities | 165,667,930 | — | — |

**Assets measured at fair value on a nonrecurring basis**

Certain financial assets are measured at fair value on a nonrecurring basis. Generally, bonds are carried at amortized cost. Bonds with a NAIC designation of 3-6, however, are carried at the lower of amortized cost or fair value. In addition, investments that are other-than-temporarily impaired during the reporting period are recorded at fair value on the statutory financial statements. The following table summarizes bonds measured at fair value on a nonrecurring basis as of December 31, 2009 and 2008, respectively:

| Description | Fair value at December 31 Level 1 | Level 2 | Level 3 |
|---|---|---|---|
| 2009: | $ — | 1,967,500 | — |
| Corporate and other securities | | | |
| 2008: | — | 5,046,536 | — |
| Corporate and other securities | | | |

## (3) Investments

The Company's bond portfolio consists of investments in U.S. treasury, government-sponsored agency, corporate, municipal, mortgage-backed, and asset-backed securities. All bonds in the investment portfolio continue to pay the expected coupon payments under the contractual terms of the securities and the Company believes it is probable that it will receive all contractual or estimated cash flows based on its analysis of previously disclosed factors.

The statement value and estimated fair value of bonds at December 31, 2009 and 2008, respectively, are reflected below. The fair values for bonds are based on quoted market prices, where available. For bonds not actively traded, fair values are estimated using values obtained from independent pricing services.



(Continued)

| | 2009 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 158,016 | — | (10,716) | 147,300 |
| Government agencies and government-backed securities | 142,630,443 | 1,016,045 | (1,697,206) | 141,949,282 |
| States, political subdivisions, and special revenue securities | 126,643,450 | 4,204,814 | (227,710) | 130,620,554 |
| Corporate and other securities | 181,244,538 | 7,331,512 | (668,077) | 187,907,973 |
| Mortgage-backed securities and collateralized mortgage obligations (CMOs) | 105,095,574 | 3,432,669 | (134,176) | 108,394,067 |
| Totals | $ 555,772,021 | 15,985,040 | (2,737,885) | 569,019,176 |

| | 2008 | | | |
|---|---|---|---|---|
| | Statement value | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| United States Treasury securities | $ 4,059,982 | 231,703 | — | 4,291,685 |
| Government agencies and government-backed securities | 86,229,456 | 1,765,179 | (11,978) | 87,982,657 |
| States, political subdivisions, and special revenue securities | 154,174,575 | 3,821,184 | (1,132,321) | 156,863,438 |
| Corporate and other securities | 128,117,147 | 1,077,808 | (8,277,395) | 120,917,560 |
| Mortgage-backed securities and collateralized mortgage obligations (CMOs) | 100,836,971 | 2,001,534 | (2,799,854) | 100,038,651 |
| Totals | $ 473,418,131 | 8,897,408 | (12,221,548) | 470,093,991 |

The unrealized losses in the government agencies portfolio were caused by a general rise in Treasury bond yields during 2009. The rise in yields was caused as investors left the relative safety of U.S. Treasuries as the credit crisis abated. The government agency portfolio has an overall rating of AAA and the Company believes it is probable that it will receive all contractual payments in the form of principal and interest. In addition, the Company does not intend to sell these investments and would expect to hold these investments until a recovery in value, which may be until maturity. The Company does not consider these investments to be other-than-temporarily impaired at December 31, 2009 and 2008.

The unrealized losses in the Company's mortgage-backed and collateralized mortgage obligations (CMOs) portfolio have dramatically decreased year over year as the credit crisis has subsided and housing markets have stabilized. The securities remain AAA rated by one or more rating agency and the Company believes it is probable that it will receive all contractual or estimated cash flows in the form of principal and interest. The Company does not intend to sell these securities and would expect to hold these investments


(Continued)

until recovery in value, which may be maturity, and thus does not consider these investments to be other-than-temporarily impaired at December 31, 2009.

The following tables illustrate the total value of securities, other than affiliated Company investments, that were in an unrealized loss position as of December 31, 2009 and 2008, respectively:

| | 2009 | | |
|---|---|---|---|
| | Less than 12 months | 12 months or Greater | Total |
| | | (In thousands) | |
| U.S. government: | | | |
| Fair value | $ 147 | — | 147 |
| Cost or amortized cost | 158 | — | 158 |
| Unrealized loss | $ (11) | — | (11) |
| U.S. agency: | | | |
| Fair value | $ 95,242 | — | 95,242 |
| Cost or amortized cost | 96,939 | — | 96,939 |
| Unrealized loss | $ (1,697) | — | (1,697) |
| Mortgage-backed: | | | |
| Fair value | $ 1,948 | — | 1,948 |
| Cost or amortized cost | 1,984 | — | 1,984 |
| Unrealized loss | $ (36) | — | (36) |
| ABS/CMO* | | | |
| Fair value | $ 2,624 | 1,628 | 4,252 |
| Cost or amortized cost | 2,685 | 1,665 | 4,350 |
| Unrealized loss | $ (61) | (37) | (98) |
| Corporate: | | | |
| Fair value | $ 28,752 | 3,740 | 32,492 |
| Cost or amortized cost | 29,163 | 3,997 | 33,160 |
| Unrealized loss | $ (411) | (257) | (668) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 28,419 | — | 28,419 |
| Cost or amortized cost | 28,647 | — | 28,647 |
| Unrealized loss | $ (228) | — | (228) |
| Subtotal, debt securities: | | | |
| Fair value | $ 157,132 | 5,368 | 162,500 |
| Cost or amortized cost | 159,576 | 5,662 | 165,238 |
| Unrealized loss | $ (2,444) | (294) | (2,738) |
| Common stock: | | | |
| Fair value | $ 11,801 | 2,467 | 14,268 |
| Cost or amortized cost | 12,085 | 2,623 | 14,708 |
| Unrealized loss | $ (284) | (156) | (440) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 168,933 | 7,835 | 176,768 |
| Cost or amortized cost | 171,661 | 8,285 | 179,946 |
| Unrealized loss | $ (2,728) | (450) | (3,178) |

* Asset-backed & collateralized mortgage obligations



(Continued)

| | 2008 | | |
|---|---|---|---|
| | Less than 12 months | 12 months or Greater | Total |
| | | (In thousands) | |
| U.S. agency: | | | |
| Fair value | $ 888 | — | 888 |
| Cost or amortized cost | 900 | — | 900 |
| Unrealized loss | $ (12) | — | (12) |
| Mortgage-backed: | | | |
| Fair value | $ 34 | — | 34 |
| Cost or amortized cost | 34 | — | 34 |
| Unrealized loss | $ — | — | — |
| ABS/CMO* | | | |
| Fair value | $ 4,931 | 14,369 | 19,300 |
| Cost or amortized cost | 5,586 | 16,514 | 22,100 |
| Unrealized loss | $ (655) | (2,145) | (2,800) |
| Corporate: | | | |
| Fair value | $ 63,512 | 11,701 | 75,213 |
| Cost or amortized cost | 68,916 | 14,574 | 83,490 |
| Unrealized loss | $ (5,404) | (2,873) | (8,277) |
| States, political subdivisions, and revenues: | | | |
| Fair value | $ 33,280 | 4,973 | 38,253 |
| Cost or amortized cost | 34,088 | 5,298 | 39,386 |
| Unrealized loss | $ (808) | (325) | (1,133) |
| Subtotal, debt securities: | | | |
| Fair value | $ 102,645 | 31,043 | 133,688 |
| Cost or amortized cost | 109,524 | 36,386 | 145,910 |
| Unrealized loss | $ (6,879) | (5,343) | (12,222) |
| Common stock: | | | |
| Fair value | $ 48,209 | 12,386 | 60,595 |
| Cost or amortized cost | 61,801 | 16,560 | 78,361 |
| Unrealized loss | $ (13,592) | (4,174) | (17,766) |
| Total temporarily impaired securities: | | | |
| Fair value | $ 150,854 | 43,429 | 194,283 |
| Cost or amortized cost | 171,325 | 52,946 | 224,271 |
| Unrealized loss | $ (20,471) | (9,517) | (29,988) |

* Asset-backed & collateralized mortgage obligations

The Company's stock portfolio consists of common stock and exchange-traded funds (ETFs). The majority of net unrealized losses at December 31, 2009 are due to one healthcare and one automotive services stock. None of the equity securities are in an unrealized loss position of more than 8%. The Company has the ability and intent to hold these securities until recovery and therefore does not consider any equity securities to be other-than-temporarily impaired at December 31, 2009.

As of December 31, 2009, the Company held 8 common stocks that were in unrealized loss positions totaling $0.4 million. As of December 31, 2008, the Company held 31 common and preferred stocks that were in unrealized loss positions totaling $17.8 million. None of these securities have been in a loss position of at least 20% for any period of time. Only one security has been in an unrealized loss position



(Continued)

for twelve or more consecutive months. However, this security only had an unrealized loss of 5.9% relative to book value. We believe these securities have the ability to substantively recover in a reasonable time period. Therefore, no equity securities held as of December 31, 2009 are considered other than temporarily impaired. As of December 31, 2009 and 2008, 76 and 160 bonds, respectively, had an unrealized loss. These bonds represent a total fair value of $162.5 million and $133.7 million, respectively, and a total unrealized loss of $2.7 million and $12.2 million, respectively, as of December 31, 2009 and 2008. None of these bonds were in an unrealized loss position of more than 20% for more than six consecutive months. In addition, of the 76 bonds that were in an unrealized loss position as of December 31, 2009, 72 have been in an unrealized loss position for less than 12 months. The fixed income unrealized losses can primarily be attributed to spreads widening in the corporate, municipal, and mortgage-backed security markets. The Company does not intend to sell these securities, and would expect to hold them to maturity. In addition, the Company continually monitors the credit quality of its fixed income investments to assess if it is probable that it will receive its contractual or estimated cash flows in the form of principal and interest. The Company considers price declines of securities in its other-than-temporary impairment analysis where such price declines provide evidence of declining credit quality, and distinguishes between price changes caused by credit deterioration, as opposed to rising interest rates.

Key factors that are considered in the evaluation of credit quality include:

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

The Company concluded that the securities in an unrealized loss position are not other-than-temporarily impaired.

During 2009 and 2008, the Company recognized impairment losses of $26.7 million and $34.1 million, respectively. This total includes $25.0 million and $28.4 million related to equity securities and $1.7 million and $5.7 million, respectively, related to fixed income securities. The majority of the Company's other-than-temporary impairment for 2009 was recorded in the first quarter and is related to Exchange Traded Funds (ETFs) that track the overall equity markets. The impaired securities were negatively impacted by the overall financial crisis as the equity markets hit lows not seen in over a decade. There was one loan-backed and structured security that was deemed other-than-temporarily impaired during 2009, and given the Company's intent to sell, the impairment loss was recorded to fair value.

The statement value and estimated fair value of bonds at December 31, 2009 by contractual maturity are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties and because most mortgage-backed and asset-backed securities provide for periodic payments throughout their lives. Such securities have been classified in the following table based upon contractual maturities.



(Continued)

| | Statement value | Estimated fair value |
|---|---|---|
| Due in one year or less | $ 12,643,023 | 12,840,257 |
| Due after one year through five years | 102,330,812 | 107,642,320 |
| Due after five years through ten years | 218,443,321 | 223,029,034 |
| Due after ten years | 117,259,291 | 117,113,498 |
| Mtge/ABS/CMO* | 105,095,574 | 108,394,067 |
| | $ 555,772,021 | 569,019,176 |

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

Proceeds from sales of bonds during 2009 and 2008 were $99,174,034 and $76,853,137, respectively. Proceeds from maturities/calls of bonds during 2009 and 2008 were $150,291,177 and $116,650,602, respectively. Proceeds from sales of equity securities during 2009 and 2008 were $81,716,272 and $50,549,222, respectively.

The components of realized gains and losses on investments are as follows:

| | 2009 | 2008 |
|---|---|---|
| Bonds: | | |
| Gains | $ 4,815,708 | 2,263,329 |
| Losses | (370,784) | (1,025,423) |
| OTTI | (1,710,729) | (5,689,658) |
| Realized gains (losses) on bonds | 2,734,195 | (4,451,752) |
| Stocks: | | |
| Gains | 12,088,681 | 13,104,587 |
| Losses | (107,844) | (157,847) |
| OTTI | (24,992,277) | (28,395,095) |
| Realized losses on stocks | (13,011,440) | (15,448,355) |
| Less: | | |
| Income tax benefit | (3,597,036) | (6,965,037) |
| | (3,597,036) | (6,965,037) |
| Net realized losses on investments | $ (6,680,209) | (12,935,070) |



(Continued)

The cost of common and preferred stocks of nonaffiliates owned at December 31, 2009 and 2008 was $117,738,306 and $139,703,128, respectively. Gross unrealized gains and losses on such investments are as follows:

| | 2009 | 2008 |
|---|---|---|
| Unrealized gains | $ 59,435,058 | 44,543,232 |
| Unrealized losses | (439,796) | (17,765,630) |
| Net unrealized gains | $ 58,995,262 | 26,777,602 |

The unrealized gains on investments in affiliates are as follows:

| | 2009 | 2008 |
|---|---|---|
| Carrying value of investments in affiliates, gross of nonadmitted assets | $ 568,001,446 | 472,747,764 |
| Cost of investments in affiliates | 145,688,624 | 145,688,624 |
| Unrealized gains | $ 422,312,822 | 327,059,140 |

The carrying value of investments in affiliates for 2009 and 2008 as reported in the statutory statements of admitted assets, liabilities, and capital and surplus is net of $2,446,404 and $2,638,336, respectively, of nonadmitted assets.

In 2009, the Company eliminated its exposure to subprime mortgages. The Company does not own any subprime mortgages, credit card asset-backed securities, or auto loan asset-backed securities as of December 31, 2009.

From an insurance standpoint, the casualty segment has exposure to subprime market issues through the Company's other liability (directors and officers) coverage. The Company's exposure to subprime, however, is minimal. The Company has a limited number of claims and expects future net exposure to subprime to be less than $5.0 million. The surety segment is another area that the Company can have direct exposure to subprime. The Company writes few mortgage broker bonds, and believes this exposure to be minimal. In addition, the Company does not have significant exposure from a surety standpoint to the home building industry.

The Company completely exited its securities lending program as of June 30, 2009. At December 31, 2008, fixed maturities with a fair value of $10.4 million were loaned.

Investments with a statement value of $4,510,766 and $4,809,789, as of December 31, 2009 and 2008, respectively, were on deposit with governmental authorities or banks to comply with insurance laws or were pledged as collateral for borrowing arrangements.



(Continued)

The composition of net investment income is as follows:

| | 2009 | 2008 |
|---|---|---|
| Bonds | $ 23,979,343 | 26,495,479 |
| Stocks | 5,135,537 | 7,572,849 |
| Real estate | 1,372,559 | 1,124,760 |
| Cash on deposit and short-term investments | 274,921 | 651,163 |
| Other | 59,953 | 81,450 |
| | 30,822,313 | 35,925,701 |
| Less investment expenses | 2,600,572 | 3,675,868 |
| Net investment income | $ 28,221,741 | 32,249,833 |

**(4) Related-Party Transactions**

As described below and elsewhere in the notes to the statutory financial statements, the Company has engaged in transactions with its parent, affiliates, and subsidiaries during the normal course of business:

(a) The Company allocates certain expenses to RLI Corp. and affiliated companies, Mt. Hawley, RLI Indemnity Company (RIC), RLI US, and Safe Fleet. The intercompany services agreement allows a portion of the expenses incurred by the Company for the benefit of these affiliates to be allocated on a pro rata basis relative to the affiliate companies' gross earned premium to the total of gross earned premiums of the Company, and any other affiliate managed by the Company. This agreement further allows the expenses incurred by Safe Fleet for the benefit of the Company to be charged back to the Company on a cost reimbursement basis. The Company allocated net expenses of $38.4 million and $35.8 million to the aforementioned related parties during 2009 and 2008, respectively, as a result of services performed.

(b) The Company received no cash dividends from its wholly owned subsidiary, Mt. Hawley, in 2009 and 2008.

(c) During 2009 and 2008, the Company paid RLI Corp. ordinary dividends of $40.0 million and $70 million.

(d) At December 31, 2009 and 2008, the Company owns 100% of the common stock of its subsidiaries, Mt. Hawley, Safe Fleet, RLI Ltd, UIGA, and RLI US, having statement values of $565,555,039, $(205,587), $1,047,542, $998,869, and $605,583, respectively. The Company nonadmitted its investment in Safe Fleet, UIGA, RLI Ltd, and RLI US, since GAAP audits are not conducted individually for these subsidiaries.

(e) Based on the Company's 100% ownership of Mt. Hawley, the statement value of Mt. Hawley's assets and liabilities as of December 31, 2009 were $1,097.6 million and $532.1 million, respectively. Net income of Mt. Hawley was $86.2 million for the year ended December 31, 2009. The statement value of Mt. Hawley's assets and liabilities as of December 31, 2008 were



(Continued)

$1,052.3 million and $582.2 million, respectively. Net income of Mt. Hawley was $46.2 million for the year ended December 31, 2008.

(f) At December 31, 2009 and 2008, the Company reported $5,763,640 as net amounts due to affiliates and $4,863,045 as net amounts due from affiliates, respectively. Any intercompany balance resulting from services performed or costs allocated in accordance with the terms of the intercompany services agreement are settled within 30 calendar days following the end of the calendar quarter in which the intercompany balance was created.

(g) On or about April 1, 2004, the Company entered into an intercompany guarantee with RLI Ltd. The Company has guaranteed the performance of RLI Ltd. with respect to a punitive damages wrap policy over an excess policy with the Company. The policy was not renewed during 2009.

**(5) Borrowed Funds**

The Company had no outstanding liability for borrowed money at December 31, 2009 and 2008. Interest paid on outstanding debt for 2009 and 2008 totaled $0 and $705,602, respectively.

**(6) Capital and Surplus**

Dividend payments from the Company to its parent are restricted by state insurance laws as to the amount that may be paid without prior approval from the regulatory authorities of Illinois. The maximum dividend distribution in a rolling 12-month period is limited by Illinois laws to the greater of 10% of policyholder surplus as of December 31 of the preceding year or net income of the Company for the 12-month period ending December 31 of the preceding year. Therefore, the maximum dividend that can be paid by the Company in a rolling 12-month period ending in 2009 without prior approval is $78,416,085, which represents 10% of the Company's 2009 policyholder surplus.

State insurance laws also restrict dividend payments to the Company from Mt. Hawley. The maximum dividends that can be paid to the Company by Mt. Hawley for a 12-month rolling period during 2009 without prior approval are $86.2 million, which represents Mt. Hawley's 2009 net income.

Unassigned surplus includes $38,874,066 in net unrealized gains on unaffiliated investments. Unassigned surplus has been reduced by $12,079,225 and $13,613,775 relating to nonadmitted assets as of December 31, 2009 and 2008, respectively. Additionally, surplus has been reduced by $883,400 and $838,000 for the provision for reinsurance as of December 31, 2009 and 2008, respectively.

**(7) Reinsurance**

In the normal course of business, the Company assumes and cedes property and liability insurance exposures with other insurance companies, pools, and associations through various treaties and in certain instances by negotiation of individual risks. Generally, policies are reinsured with other insurance companies to limit the Company's risk on any individual loss to $7,500,000.

The following are summaries of the impact of the Company's reinsurance program on the statutory financial statements:

| | 2009 | | | |
|---|---|---|---|---|
| | Direct | Assumed | Ceded | Net |
| Premiums written | $ 355,288,706 | 18,145,491 | 90,563,917 | 282,870,280 |
| Premiums earned | 348,386,897 | 16,073,192 | 86,512,640 | 277,947,449 |
| Losses and loss adjustment expenses incurred | 143,078,968 | 10,997,045 | 25,083,732 | 128,992,281 |
| Unearned premiums | 187,836,340 | 8,117,231 | 42,864,979 | 153,088,592 |
| Unpaid losses and loss adjustment expenses | 537,969,105 | 54,178,977 | 219,032,255 | 373,115,827 |

| | 2008 | | | |
|---|---|---|---|---|
| | Direct | Assumed | Ceded | Net |
| Premiums written | $ 342,964,649 | 11,943,993 | 80,494,393 | 274,414,249 |
| Premiums earned | 332,784,176 | 9,530,947 | 77,017,421 | 265,297,702 |
| Losses and loss adjustment expenses incurred | 130,992,311 | 10,559,178 | 23,804,677 | 117,746,812 |
| Unearned premiums | 180,934,531 | 6,044,947 | 38,813,717 | 148,165,761 |
| Unpaid losses and loss adjustment expenses | 535,521,769 | 47,194,518 | 232,410,499 | 350,305,788 |

At December 31, 2009, net balances recoverable from reinsurers (comprising unearned premiums and losses and loss adjustment expenses paid and unpaid, including incurred but not reported amounts) having unsecured portions exceeding 3% of the Company's total capital and surplus were as follows:

| Name of reinsurer | Amount |
|---|---|
| Axis Reinsurance Corp | $ 23,804,000 |
| Munich Re America | 29,403,000 |

The losses, loss adjustment expenses, and unearned premiums for business ceded to other insurers are recoverable and realizable to the extent that the assuming reinsurers fulfill their commitments. The Company has initiated arbitration or otherwise instituted legal actions where appropriate on certain outstanding recoverable balances.

As of January 1, 2009 and 2008, the Company's property underwriting was supported by $350 million and $375 million, respectively, in traditional catastrophe reinsurance protection, subject to certain retentions by the Company. At January 1, 2010, the Company renewed its traditional catastrophe reinsurance protection at $350 million, subject to certain retentions by the Company. The Company recorded a charge to income in 2009 and 2008 of $1,021,602 and $1,758,798, respectively, for reinsurance balances deemed uncollectible. This charge is reflected in losses and loss adjustment expenses incurred. The most significant component was a write-off of $473,711 for balances due from Cherokee Insurance Company.

The total return commission, which would have been due reinsurers if all reinsurance was canceled with the return of unearned premium would be $9,616,630 and $8,572,511 as of December 31, 2009 and 2008,



(Continued)

respectively. The amount of return commission, predicated on loss experience as a result of existing contracts, was $0 and $2,213 as of December 31, 2009 and 2008, respectively.

The Company participates in a quota share reinsurance agreement with RIC. The agreement is applied after all other external reinsurance sessions. Under the terms of the agreement, RIC cedes and RLI assumes 90% of the net premium and liabilities for policies effective January 1, 2003, and subsequent. The agreement, which was effective January 1, 2003, has been accepted and placed on file by the Department. This agreement was amended in 2004 to include the assumption of 100% of RIC's existing net loss reserves and any future development on these reserves. The Department approved the loss portfolio transfer on June 29, 2004.

The following is a summary of the balances assumed under this agreement as of and for the years ended December 31, 2009 and 2008 (in thousands):

| | 2009 | 2008 |
|---|---|---|
| Premium written | $ 1,832 | 4,001 |
| Unearned premiums | 1,669 | 1,621 |
| Premium earned | 1,784 | 4,313 |
| Loss and loss adjustment expenses incurred | 172 | 1,766 |
| Reserve for loss and loss adjustment expenses | 1,947 | 2,883 |

**(8) Unpaid Losses and Loss Adjustment Expenses**

The following table is a reconciliation of the Company's liability for unpaid losses and LAE for the years ended December 31, 2009 and 2008. Since reserves are based on estimates, the ultimate net cost may vary from the original estimate. As adjustments to these estimates become necessary, they are reflected in current operations. As part of the reserving process, historical data is reviewed and consideration is given to the anticipated impact of various factors such as legal developments and economic conditions, including the effects of inflation. Changes in reserves from the prior years' estimates are calculated based on experience as of the end of each succeeding year (loss and loss adjustment expense development).



(Continued)

| | 2009 | 2008 |
|---|---|---|
| | (In thousands) | |
| Net unpaid losses and loss adjustment expenses at beginning of year, net of reinsurance recoverable of $232,411 and $244,093 as of January 1 | $ 350,306 | 341,097 |
| Incurred losses and loss adjustment expenses related to: | | |
| Current accident year losses | 148,634 | 134,097 |
| Prior accident years losses | (19,642) | (16,350) |
| Total incurred | 128,992 | 117,747 |
| Paid loss and loss adjustment expense payments related to: | | |
| Current accident year losses | (27,388) | (25,923) |
| Prior accident years losses | (78,794) | (82,615) |
| Total paid | (106,182) | (108,538) |
| Net unpaid losses and loss adjustment expenses at end of year, net of reinsurance recoverable of $219,032 and $232,411 as of December 31 | $ 373,116 | 350,306 |

**Reserve Development**

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

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

2009: The majority of the $19.6 million of favorable development in 2009 came from accident years 2006 and 2004 with sizable contributions also coming from accident years 2005 and 2008. By line of business, the most significant favorable development came from our Other Liability, Commercial Auto Liability and Surety lines. In addition to reported losses on prior accident years being generally less than expected, downward adjustments to the expected loss ratios that are used in calculating actuarial reserve estimates also contributed to the favorable development. Partially offsetting the results on these lines, we experienced unfavorable development on our Ocean Marine line driven primarily by the commercial towing exposure, as well as unfavorable development on accident years 2000 and prior due mostly to environmental exposures from runoff casualty business.



(Continued)

2008: During 2008, the Company experienced favorable development overall on prior accident years' reserves totaling $16.4 million. Other liability, property lines, and surety were the primary contributors to the favorable development, totaling $8.5 million, $6.5 million, and $5.8 million, respectively. Favorable reserve development was partially offset by adverse development on assumed reinsurance and marine, which amounted to $3.4 million and $3.0 million, respectively. The five most recent accident years contributed the most to the favorable development. In retrospect, the expected loss ratios initially used to set booked reserves for these accident years have proven to be conservative, which has resulted in loss emergence significantly lower than expected.

The favorable development on other liability lines comes primarily from personal umbrella and directors and officers liability coverages. Favorable development on property is primarily due to builder's risk construction coverages. This line of business has been in run-off for three years and recent experience has been much better than expected, with a significant reduction in both frequency and severity of claims. Only a handful of contracts remain open and the Company has observed little new activity from this product line. The favorable development on surety is primarily from contract and commercial coverages from the 2007 accident year. Very little observed loss severity in the commercial surety coverage resulted in favorable emergence. In addition, continued improvement in the Company's contract surety loss ratio resulting from past re-underwriting of the business led to favorable loss reserve development. The adverse development from assumed reinsurance business comes from accident years prior to 1990 and was caused mostly by increases in reported losses on asbestos and environmental claims. Marine protection and indemnity coverage is the cause of the adverse marine development. For this coverage, loss ratio estimates and expected development patterns appear, so far, to have not been adequate.

**Environmental Exposure**

The Company has exposure to asbestos and environmental claims through its commercial umbrella, general liability, and discontinued assumed reinsurance lines of business. The majority of the exposure is in the excess layers of the Company's commercial umbrella and assumed reinsurance books of business.

Although a large majority of the Company's asbestos and environmental exposure is limited to losses occurring before the mid-1980s, management cannot determine the Company's ultimate liability with any high degree of certainty. The Company estimates the full impact of these exposures by establishing case basis reserves on all known losses. Reserves for related IBNR are recorded based upon actuarial projections of ultimate expected losses.

This ultimate liability is difficult to assess due to slow reporting of losses and evolving legislation on such issues as joint and several liability, retroactive liability, and standards of cleanup. Additionally, the Company participates primarily in the excess layers, making it difficult to assess the ultimate impact.



(Continued)

The Company's asbestos-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2009 and 2008 were as follows:

| | | 2009 | 2008 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 13,829,024 | 12,199,814 |
| Incurred losses and LAE | | (1,807,245) | 1,657,269 |
| Calendar year payments for losses and LAE | | (12,057) | (28,059) |
| Ending reserves | $ | 12,009,722 | 13,829,024 |
| Assumed: | | | |
| Beginning reserves | $ | 18,737,058 | 20,189,148 |
| Incurred losses and LAE | | 1,699,931 | 2,141,153 |
| Calendar year payments for losses and LAE | | (1,305,940) | (3,593,243) |
| Ending reserves | $ | 19,131,049 | 18,737,058 |
| Ceded: | | | |
| Beginning reserves | $ | 9,404,450 | 10,654,623 |
| Incurred losses and LAE | | 2,194,696 | (292,764) |
| Calendar year payments for losses and LAE | | (1,232,860) | (957,409) |
| Ending reserves | $ | 10,366,286 | 9,404,450 |
| Net: | | | |
| Beginning reserves | $ | 23,161,632 | 21,734,339 |
| Incurred losses and LAE | | (2,302,010) | 4,091,186 |
| Calendar year payments for losses and LAE | | (85,137) | (2,663,893) |
| Ending reserves | $ | 20,774,485 | 23,161,632 |

The Company holds both IBNR and case loss reserves related to asbestos exposure. For asbestos, direct and assumed case incurred losses combined changed very little, but net case incurred losses decreased by about $2.3 million. This decrease is primarily due to an increase in ceded IBNR resulting from our IBNR allocation process. Of the total reserves, the Company held IBNR reserves in the amount of $15,486,110 and $15,472,325 on a gross basis and $8,641,770 and $10,946,865 on a net basis at December 31, 2009 and 2008, respectively.

The Company held $1,720,679 on a gross basis and $960,197 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2009. The Company held $1,771,365 on a gross basis and $1,216,319 on a net basis for future allocated loss adjustment expenses related to asbestos exposure (including coverage dispute costs) at December 31, 2008.



(Continued)

The Company's environmental-related loss and LAE reserves and incurred losses and LAE (including coverage dispute costs) for the years ended December 31, 2009 and 2008 were as follows:

| | | 2009 | 2008 |
|---|---|---|---|
| Direct: | | | |
| Beginning reserves | $ | 7,950,462 | 5,700,426 |
| Incurred losses and LAE | | 2,463,009 | 2,583,285 |
| Calendar year payments for losses and LAE | | (490,898) | (333,249) |
| Ending reserves | $ | 9,922,573 | 7,950,462 |
| Assumed: | | | |
| Beginning reserves | $ | 1,627,888 | 1,340,099 |
| Incurred losses and LAE | | 202,223 | 331,174 |
| Calendar year payments for losses and LAE | | (50,896) | (43,385) |
| Ending reserves | $ | 1,779,215 | 1,627,888 |
| Ceded: | | | |
| Beginning reserves | $ | 4,490,077 | 3,041,930 |
| Incurred losses and LAE | | 1,752,218 | 1,690,618 |
| Calendar year payments for losses and LAE | | (110,052) | (242,471) |
| Ending reserves | $ | 6,132,243 | 4,490,077 |
| Net: | | | |
| Beginning reserves | $ | 5,088,273 | 3,998,595 |
| Incurred losses and LAE | | 913,014 | 1,223,841 |
| Calendar year payments for losses and LAE | | (431,742) | (134,163) |
| Ending reserves | $ | 5,569,545 | 5,088,273 |

The Company holds both IBNR and case loss reserves related to environmental exposure. Pollution emergence is driven by two separate developments in our direct book of business. The first is activity on a pollution claim from our Marine division. Case incurred losses for this claim in 2009 increased by about $1.7 million direct and $0.4 million net including payments of $0.3 million. Additional development was driven by claim activity from the 1980s associated with a company RLI purchased in 1999. Case incurred pollution losses for this book increased by $0.3 million direct and $0.4 million net. While none of the claims are large, we have assigned more IBNR to this book of business as a whole, resulting in an increase of incurred losses of about $1.0 million direct and $0.8 million net. Of the total reserves, the Company held IBNR reserves in the amount of $5,291,678 and $4,944,090 on a gross basis and $2,294,540 and $2,314,418 on a net basis at December 31, 2009 and 2008, respectively.

The Company held $933,825 and $872,486 on a gross basis and $404,919 and $408,427 on a net basis for future allocated loss adjustment expenses related to environmental exposure (including coverage dispute costs) at December 31, 2009 and 2008, respectively.



(Continued)

## (9) Investment in Mt. Hawley

Condensed financial information for Mt. Hawley on a statutory basis is summarized below:

| | 2009 | 2008 |
|---|---|---|
| Balance sheet at December 31: | | |
| Assets | $ 1,097,605,316 | 1,052,280,349 |
| Liabilities | (532,050,277) | (582,170,917) |
| Total capital and surplus | $ 565,555,039 | 470,109,432 |
| Results of operations for the year ended December 31: | | |
| Premium earned | $ 213,828,935 | 263,005,386 |
| Losses and underwriting expenses | 146,900,887 | 209,825,619 |
| Underwriting income | 66,928,048 | 53,179,767 |
| Investment income, including realized gains and losses net of tax | 38,685,125 | 27,937,178 |
| Other income | 153,589 | 179,368 |
| Income before federal income taxes | 105,766,762 | 81,296,313 |
| Federal income tax expense | 19,531,566 | 35,116,809 |
| Net income | $ 86,235,196 | 46,179,504 |

## (10) Federal Income Taxes

The Company adopted SSAP No. 10R effective December 31, 2009. The December 31, 2009 balances and related disclosures are calculated and presented pursuant to SSAP No. 10R. The December 31, 2008 balances and related disclosures are calculated and presented pursuant to SSAP No. 10 prior to its modifications by SSAP No. 10R.

The net deferred tax asset (DTA) decreased $12.3 million from 2008 to $6.1 million at year-end 2009. This change was mainly attributable to current year increases on unrealized gains in the Company's equity portfolio. The application of SSAP No. 10R, which the Company elected to apply in admitting deferred tax assets, did not have an impact on the Company's admitted assets or surplus for the year ended December 31, 2009.



(Continued)

The net deferred tax assets at December 31, 2009 and the change from prior year are comprised of the following components:

| | 2009 | | | 2008 (Using SSAP10 Calc) | |
|---|---|---|---|---|---|
| | Total | Capital | Ordinary | Total | Change |
| Total of gross deferred tax assets | $ 34,189,292 | 94,491 | 34,094,801 | 35,444,057 | (1,254,765) |
| Valuation allowance adjustment | — | — | — | — | — |
| Adjusted gross deferred tax assets | 34,189,292 | 94,491 | 34,094,801 | 35,444,057 | (1,254,765) |
| Total gross deferred tax liabilities | 28,134,263 | 27,930,688 | 203,575 | 17,080,914 | 11,053,349 |
| Net deferred tax assets (liabilities) | 6,055,029 | (27,836,197) | 33,891,226 | 18,363,143 | (12,308,114) |
| Total deferred tax assets nonadmitted | — | — | — | — | — |
| Net admitted deferred tax assets (liabilities) | $ 6,055,029 | (27,836,197) | 33,891,226 | 18,363,143 | (12,308,114) |
| Net change in total DTAs nonadmitted | $ — | | | | |

The amount of admitted adjusted gross DTAs admitted under each component of SSAP No. 10R is as follows:

| | 2009 | | | 2008 (Using SSAP10 Calc) | |
|---|---|---|---|---|---|
| | Total | Capital | Ordinary | Total | Change |
| Admitted under paragraph 10.a. | $ 15,567,119 | 94,491 | 15,472,628 | 20,467,381 | (4,900,262) |
| Admitted under paragraph 10.b.i. | — | — | — | — | — |
| Admitted under paragraph 10.b.ii. | — | — | — | — | — |
| Admitted under paragraph 10.c. | 18,622,173 | — | 18,622,173 | 14,976,676 | 3,645,497 |
| Admitted under admissibility test | $ 34,189,292 | 94,491 | 34,094,801 | 35,444,057 | (1,254,765) |

The Company's risk-based capital level used for purposes of paragraph 10.d. is based on authorized control level risk-based capital of $49,213,425 and total adjusted capital of $784,160,848.



(Continued)

The amount of admitted DTAs, admitted assets, statutory surplus and total adjusted capital in the risk-based capital calculation and the increased amount of DTAs, admitted assets and surplus as the result of the application of paragraph 10.e. is as follows:

| | 2009 | | | 2008 (Using SSAP 10 Calc) |
|---|---|---|---|---|
| | With election of SSAP10R | Increase due to SSAP10R | Prior to to SSAP10R | Prior to to SSAP10R |
| Total DTAs admitted | $ 6,055,029 | — | 6,055,029 | 18,363,143 |
| Total admitted assets | 1,426,811,031 | — | 1,426,811,031 | 1,279,073,667 |
| Statutory surplus | 784,160,848 | — | 784,160,848 | 678,041,169 |
| Total adjusted capital | 784,160,848 | — | 784,160,848 | — |

The change in deferred income taxes reported in surplus before consideration on nonadmitted assets is comprised of the following components:

| | 2009 | 2008 | Change |
|---|---|---|---|
| Total deferred tax assets | $ 34,189,292 | 35,444,057 | (1,254,765) |
| Valuation allowance adjustment | — | — | — |
| Total adjusted deferred tax assets | 34,189,292 | 35,444,057 | (1,254,765) |
| Total gross deferred tax liabilities | 28,134,263 | 17,080,914 | 11,053,349 |
| Net adjusted deferred tax assets | $ 6,055,029 | 18,363,143 | (12,308,114) |
| Tax effect of unrealized gains (losses) | | | 11,276,178 |
| Change in net deferred income tax | | | $ (1,031,936) |

There are no temporary differences for which deferred tax liabilities are not recognized, except for investments in wholly-owned subsidiaries which are not required to be recognized under SSAP No. 10R.

Current income taxes incurred consists of the following significant components:

| | 2009 | 2008 |
|---|---|---|
| Federal | $ 13,521,562 | 20,921,262 |
| Federal income tax benefit on net capital loss | (3,597,036) | (6,965,037) |
| Federal income tax incurred | $ 9,924,526 | 13,956,225 |



(Continued)

Deferred income tax assets and liabilities consist of the following major components:

| | December 31 | |
|---|---|---|
| | 2009 | 2008 |
| Deferred tax assets: | | |
| Loss reserves | $ 12,295,880 | 11,965,982 |
| Unearned premium reserve | 10,744,558 | 10,412,895 |
| Agents balances and other nonadmitted assets | 3,371,487 | 3,841,404 |
| Accrued expenses | 262,500 | 262,500 |
| Deferred compensation | 7,306,670 | 5,427,637 |
| Impairments on investments | 94,491 | 3,368,361 |
| Other | 113,706 | 165,278 |
| Total deferred tax assets | 34,189,292 | 35,444,057 |
| Nonadmitted deferred tax assets | — | — |
| Admitted deferred tax assets | 34,189,292 | 35,444,057 |
| Deferred tax liabilities: | | |
| Unrealized gains | 20,983,257 | 9,707,079 |
| Intercompany transactions | 6,356,103 | 6,356,103 |
| Investments | 91,178 | 115,192 |
| Investment income | 65,617 | 152,637 |
| Depreciable assets | 36,013 | 124,716 |
| Other | 602,095 | 625,187 |
| Total deferred tax liabilities | 28,134,263 | 17,080,914 |
| Net deferred tax assets | $ 6,055,029 | 18,363,143 |



(Continued)

The Company's income tax incurred and change in deferred income tax differs from the amount obtained by applying the federal statutory rate of 35% to income before income taxes as follows:

| | | 2009 | 2008 |
|---|---|---|---|
| Income before taxes, which includes net realized capital gains (losses) | $ | 38,872,246 | 40,670,759 |
| Income tax expense at 35% statutory rate | | 13,605,286 | 14,234,766 |
| Increase (decrease) in tax resulting from: | | | |
| Dividends received deduction | | (1,008,847) | (1,206,701) |
| Nondeductible expenses | | 130,069 | 141,474 |
| Tax-exempt income | | (1,602,816) | (2,168,849) |
| Tax settlement | | — | 1,334,745 |
| Other | | (167,230) | 847,641 |
| Total statutory income taxes | $ | 10,956,462 | 13,183,076 |
| Current income taxes incurred | $ | 13,521,562 | 20,921,262 |
| Change in deferred income tax (without tax on unrealized gains and losses) | | 1,031,936 | (773,149) |
| Tax on net realized capital losses | | (3,597,036) | (6,965,037) |
| Total statutory income taxes | $ | 10,956,462 | 13,183,076 |

A reconciliation of federal income tax expense, computed by applying the statutory federal income tax rate of 35% in 2009 and 2008 to income before federal income taxes, which includes net realized capital gains, to the income tax expense shown in the accompanying statutory financial statements is as follows:

| | | 2009 | 2008 |
|---|---|---|---|
| Computed "expected" tax expense | $ | 13,605,286 | 14,234,766 |
| Tax-exempt interest | | (1,602,816) | (2,168,849) |
| Dividends received deduction | | (1,008,847) | (1,206,701) |
| Discounting of liability for losses and loss adjustment expenses | | 329,898 | (825,850) |
| Change in unearned premiums | | 331,663 | 638,159 |
| Tax on net realized capital losses | | 3,597,036 | 6,965,037 |
| Other | | (1,730,658) | 3,284,700 |
| Federal income tax expense | $ | 13,521,562 | 20,921,262 |

As of December 31, 2009, the Company had no operating loss carryforwards available to offset future net income subject to federal income tax.

Income taxes incurred in current and prior years that will be available for recoupment in the event of future net losses are $17,703,746 for 2009 and $8,941,946 for 2008.



(Continued)

## (11) Employee Benefits

The Company, along with its affiliates and ultimate parent, maintains an Employee Stock Ownership Plan (ESOP), 401(k), and bonus and incentive plans covering executives, managers, and associates. At the discretion of the Board of Directors, funding of these plans is primarily dependent upon reaching predetermined levels of operating return on equity and Market Value Potential (MVP). MVP is a compensation model that measures comprehensive earnings against a minimum required return on the Company's capital. Bonuses are earned as the Company generates earnings in excess of this required return. While some management incentive plans may be affected somewhat by other performance factors, the larger influence is corporate performance. The Company's 401(k) plan allows voluntary contributions by employees and permits ESOP diversification transfers for employees meeting certain age or service requirements. The Company provides a basic 401(k) contribution of 3% of eligible compensation. Participants are 100% vested in both voluntary and basic contributions. Additionally, an annual discretionary profit-sharing contribution may be made to the ESOP and 401(k), subject to the achievement of certain overall financial goals. For plan years prior to 2007, profit-sharing contributions were subject to a five-year cliff vest. For plan year 2007 and later, contributions vest after three years of service. The Company's ESOP and 401(k) cover all employees meeting eligibility requirements. ESOP and 401(k) profit-sharing contributions are determined annually by the board of directors and are expensed in the year earned. The total amount of expense for these plans for 2009 and 2008 was $8.7 million and $8.8 million, respectively. The Company allocates a portion of this expense to its subsidiaries per the terms of the intercompany services agreement. The Company's total expenditures for employee benefits, including ESOP and 401(k) contributions but excluding the cost of incentive plans discussed below, were $11.2 million and $9.2 million for 2009 and 2008, respectively.

Annual bonuses are awarded to executives, managers, and associates through the Company's incentive plans, provided certain financial and operational goals are met. The total amount of expense for these incentive plans for 2009 and 2008 was $15.5 million and $4.6 million, respectively. The Company allocates a portion of this expense to its subsidiaries per the terms of the intercompany services agreement.

In 2002, the Company, along with its affiliates and ultimate parent, began offering certain eligible employees postemployment medical coverage. Under the Company's plan, employees who retire at age 55 or older with 20 or more years of company service may continue medical coverage under the Company's health plan. Employees who elect continuation of coverage pay the full COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) rate and coverage terminates upon reaching age 65. The Company expects a relatively small number of employees will become eligible for this benefit. The COBRA rate established for participating employees covers the cost of providing this coverage. The Company does not provide compensated absences.

## (12) Commitments and Contingent Liabilities

The Company has an accrual for assessments at December 31, 2009 and 2008 of $3.2 million and $2.7 million, respectively. It is not possible at this time to determine the periods over which the assessments are expected to be paid.



(Continued)

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

## (13) Leases

The Company leases regional office facilities and computers under operating leases. These leases expire in various years through 2014. Minimum future rental payments under noncancelable leases are as follows:

| | | |
|---|---|---|
| 2010 | $ | 2,784,799 |
| 2011 | | 3,146,334 |
| 2012 | | 2,949,496 |
| 2013 | | 1,995,443 |
| 2014 | | 4,823,885 |
| Total minimum future rental payments | $ | 15,699,957 |

The Company shares rental expense with its affiliate, Mt. Hawley, through an intercompany cost sharing agreement. The Company's portion of rental expense for 2009 and 2008 was $0.9 million.

## (14) Subsequent Events

The Company has evaluated subsequent events through May 25, 2010, the date the accompanying financial statements -- statutory basis were available to be issued. During the first quarter of 2010, the IRS began an examination of our consolidated federal income tax returns and capital loss carryback claims. The years under examination are 2005 through 2009.

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risk Interrogatories

December 31, 2009

1) Total admitted assets: $ 1,426,811,031

2) 10 largest exposures to a single issuer/borrower/investment:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Company | $ 565,555,039 | 39.6% |
| iShares Russel 1000 Index | 13,028,375 | 0.9 |
| JP Morgan Chase & Co | 9,211,338 | 0.6 |
| JP Morgan Chase Commercial Mortgage | 7,265,731 | 0.5 |
| Goldman Sachs Group Inc | 6,636,829 | 0.5 |
| General Electric Corp | 6,368,156 | 0.4 |
| Wells Fargo Co | 6,119,023 | 0.4 |
| MSDW Capital I | 5,671,842 | 0.4 |
| Deere & Co | 5,589,174 | 0.4 |
| Maryland State | 5,432,791 | 0.4 |

3) Total admitted assets held in bonds by NAIC rating:

| Bonds | Amount | Percentage |
|---|---|---|
| NAIC-1 | $ 561,561,030 | 39.4% |
| NAIC-2 | 45,608,996 | 3.2 |
| NAIC-3 | 1,967,500 | 0.1 |
| NAIC-4 | | — |
| NAIC-5 | | — |
| NAIC-6 | | — |

| Preferred Stocks | Amount | Percentage |
|---|---|---|
| P/RP-1 | $ | —% |
| P/RP-2 | | — |
| P/RP-3 | | — |
| P/RP-4 | | — |
| P/RP-5 | | — |
| P/RP-6 | | — |

4) Assets held in foreign investments:

| | Amount | Percentage |
|---|---|---|
| Total admitted assets held in foreign investments | $ 30,866,429 | 2.2% |
| Foreign currency denominated investments | | — |
| Insurance liabilities denominated in that same foreign currency | | — |

5) Assets held in foreign investments represent less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatories 5 – 10.

11) Assets held in Canadian investments and unhedged Canadian currency exposure are less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required.

12) There were no admitted assets held in investments with contractual sales restrictions.

13) Admitted assets held in the largest 10 equity interests:

| Issuer | Amount | Percentage |
|---|---|---|
| Mt. Hawley Insurance Company | $ 565,555,039 | 39.6% |
| iShares Russel 1000 Index | 13,028,375 | 0.9 |
| AT&T Inc | 4,645,973 | 0.3 |
| JP Morgan Chase & Co | 4,499,110 | 0.3 |
| Spdr Trust Series 1 | 4,123,280 | 0.3 |
| Utilities Select Sector Spdr | 4,113,252 | 0.3 |
| Dominion Resources Inc | 3,674,048 | 0.3 |
| Exxon Mobil Corporation | 3,557,472 | 0.2 |
| Deere & Co | 3,407,670 | 0.2 |
| Hewlett-Packard Co | 3,348,150 | 0.2 |

14) There were no assets held in nonaffiliated, privately placed equities, exceeding 2.5% of the Company's total admitted assets.



(Continued)

## RLI INSURANCE COMPANY

Schedule of Supplemental Investment Risk Interrogatories

December 31, 2009

15) There were no admitted assets held in general partnership interests that exceeded 2.5% of the Company's total admitted assets.

16) There were no mortgage loans reported on the Company's Annual Statement Schedule B; therefore, detail not required for interrogatories 16 and 17.

18) Assets held in each of the five largest investments in one parcel or group of contiguous parcels of real estate reported in the Annual Statement Schedule A were less than 2.5% of the reporting entity's total admitted assets; therefore, detail not required for interrogatory 18.

19) There were no admitted assets held in investments held in mezzanine real estate loans.

20) Total admitted assets subject to the following types of agreements:

| | At year-end | | At end of each quarter | | |
|---|---|---|---|---|---|
| Agreement type | Amount | Percentage | 1st Qtr | 2nd Qtr | 3rd Qtr |
| Securities lending | $ | —% | $ 3,534,903 | | |
| Repurchase | | — | | | |
| Reverse repurchase | | — | | | |
| Dollar repurchase | | — | | | |
| Dollar reverse repurchase | | — | | | |

21) The Company owns no warrants not attached to other financial instruments, options, caps, and floors.

22) The Company has no exposure to collars, swaps, or forwards.

23) The Company has no exposure for future contracts.

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2009

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Bonds: | | | | |
| U.S. Treasury securities | $ 158,016 | 0.01% | $ 158,016 | 0.01% |
| U.S. government agency and corporate obligations: | | | | |
| Issued by U.S. government agencies | 1,942,650 | 0.14 | 1,942,650 | 0.14 |
| Issued by U.S. government-sponsored agencies | 140,687,793 | 10.31 | 140,687,793 | 10.33 |
| Non-U.S. government | 472,430 | 0.03 | 472,430 | 0.03 |
| Foreign government: | | | | |
| Securities issued by states, territories, and political subdivisions in the U.S.: | | | | |
| State, territory, and possession and general obligations | 19,441,593 | 1.42 | 19,441,593 | 1.43 |
| Political subdivisions of states, territories, and possessions' political subdivisions' general obligations | 47,204,148 | 3.46 | 47,204,148 | 3.47 |
| Revenue and assessment obligations | 59,997,709 | 4.40 | 59,997,709 | 4.40 |
| Industrial development and similar obligations | — | — | — | — |
| Mortgage-backed securities: | | | | |
| Pass-through securities: | | | | |
| Guaranteed by GNMA | 13,345,977 | 0.98 | 13,345,977 | 0.98 |
| Issued by FNMA and FHLMC | 62,826,685 | 4.60 | 62,826,685 | 4.61 |
| All other | — | — | — | — |
| CMOs and REMICs: | | | | |
| Issued by FNMA, FHLMC, GNMA, or VA | 12,523,979 | 0.92 | 12,523,979 | 0.92 |
| Issued by non-U.S. government issuers and collateralized by mortgage-backed securities issued or guaranteed by above agencies | — | — | — | — |
| All other | 16,398,933 | 1.20 | 16,398,933 | 1.20 |
| Other debt and other fixed income securities: | | | | |
| Unaffiliated domestic securities | 149,905,679 | 10.99 | 149,905,679 | 11.01 |
| Unaffiliated foreign securities | 30,866,429 | 2.26 | 30,866,429 | 2.27 |
| Affiliated securities | — | — | — | — |
| Equity interests: | | | | |
| Investments in mutual funds | — | — | — | — |
| Preferred stocks: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | — | — | — | — |
| Publicly traded equity securities: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | 176,733,568 | 12.95 | 176,733,568 | 12.98 |
| Tangible personal property under lease: | | | | |
| Affiliated | — | — | — | — |
| Unaffiliated | — | — | — | — |
| Other equity securities: | | | | |
| Affiliated | 568,001,446 | 41.63 | 565,555,039 | 41.52 |
| Unaffiliated | — | — | — | — |
| Mortgage loans: | | | | |
| Construction and land development | — | — | — | — |
| Agricultural | — | — | — | — |
| Single-family residential properties | — | — | — | — |
| Multifamily residential properties | — | — | — | — |
| Commercial loans | — | — | — | — |
| Mezzanine real estate loans | — | — | — | — |



(Continued)

Schedule 2

## RLI INSURANCE COMPANY

Summary Investment Schedule

December 31, 2009

| Investment categories | Gross investment holdings | | Admitted assets as reported in the annual statement | |
|---|---|---|---|---|
| Real estate investments: | | | | |
| Property occupied by company | $ 8,497,635 | 0.62 | $ 8,270,113 | 0.61 |
| Property held for production of income | — | — | — | — |
| Property held for sale | — | — | — | — |
| Policy loans | — | — | — | — |
| Receivable for securities | | | | |
| Cash and short-term investments | 54,727,963 | 4.01 | 54,727,963 | 4.02 |
| Write-in invested assets | 1,000,000 | 0.07 | 1,000,000 | 0.07 |
| Total invested assets | $ 1,364,732,633 | 100.00% | $ 1,362,058,704 | 100.00% |

See accompanying independent auditors' report.

## RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year ended December 31, 2009

7.1 Has the reporting entity reinsured any risk with any other entity under a quota share reinsurance contract that includes a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g., a deductible, a loss ratio corridor, a loss cap, an aggregate limit, or any similar provisions)? Yes [ ] No [X]

7.2 If yes, indicate the number of reinsurance contracts containing such provisions. N/A [X]

7.3 If yes, does the amount of reinsurance credit taken reflect the reduction in quota share coverage caused by any applicable limiting provision(s)? Yes [ ] No [ ] N/A [X]

8.1 Has this reporting entity reinsured any risk with any other entity and agreed to release such entity from liability, in whole or in part, from any loss that may occur on this risk, or portion thereof, reinsured? Yes [X ] No []

8.2 If yes, give full information.

Reinsurance agreements with Seaton Insurance Company and Gerling, which were in runoff, were commuted during 2009.

9.1 Has the reporting entity ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during the period covered by the statement: (i) it recorded a positive or negative underwriting result greater than 3% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contract(s) contain one or more of the following features or other features that would have similar results:

(a) A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;

(b) A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;

(c) Aggregate stop loss reinsurance coverage;

(d) An unconditional or unilateral right by either party to commute the reinsurance contract except for such provisions, which are only triggered by a decline in the credit status of the other party;

(e) A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or

(f) Payment schedule, accumulating retentions from multiple years, or any features inherently designed to delay timing of the reimbursement to the ceding entity Yes [ ] No [X]



(Continued)

## RLI INSURANCE COMPANY

Supplemental Schedule of Reinsurance Interrogatories

Year ended December 31, 2009

9.2 Has the reporting entity during the period covered by the statement ceded any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member where:

(a) The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statement; or

(b) Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates — Yes [ ] No [X]

9.3 If yes to 9.1 or 9.2, please provide the following information in the Reinsurance Summary Supplemental Filing for general interrogatory 9:

(a) The aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income;

(b) A summary of the reinsurance contract terms and indicate whether it applies to the contracts meeting the criteria in 9.1 or 9.2; and

(c) A brief discussion of management's principal objectives in entering into the reinsurance contract including the economic purpose to be achieved. — N/A [X]

9.4 Except for transactions meeting the requirements of paragraph 30 of SSAP No. 62, *Property and Casualty Reinsurance*, has the reporting entity ceded any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during the period covered by the financial statement, and either:

(a) Accounted for that contract as reinsurance (either prospective or retroactive) under statutory accounting principles (SAP) and as a deposit under generally accepted accounting principles (GAAP); or

(b) Accounted for that contract as reinsurance under GAAP and as a deposit under SAP? — Yes [ ] No [X]

9.5 If yes to 9.4, explain in the Reinsurance Summary Supplemental Filing for general interrogatory 9 (section D) why the contract(s) is treated differently for GAAP and SAP. — N/A [X]

9.6 The reporting entity is exempt from the Reinsurance Attestation Supplement under one or more of the following criteria:

(a) The entity does not utilize reinsurance; or — Yes [ ] No [X]

(b) The entity only engages in a 100% quota share contract with an affiliate or lead company has filed an attestation supplement; or — Yes [ ] No [X]

(c) The entity has no external cessions and only participates in an intercompany pool and the affiliated lead company has filed an attestation supplement. — Yes [ ] No [X]

See accompanying independent auditors' report.

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PEORIA IL 61615

1 LBS PAK 1 OF 1

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WAHINGTON INSURANCE COMMISSIONER
5000 CAPITOL BLVD.
**TUMWATER WA 98501-4426**

**WA 985 0-01**

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5000 CAPITOL BLVD SE
TUMWATER WA 98501-4426
P: BOTTOMS: NORTH
08B-1055
1Z622538019829 6275
KMDSWL8 WATUM10BD FEB 07 08:35:55
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