

Employers Holdings, Inc.  
Form 10-Q  
November 07, 2008

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**FORM 10-Q**

**☐ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2008**

**OR**

**○ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period ended \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 001-33245**

**EMPLOYERS HOLDINGS, INC.**

(Exact name of registrant as specified in its charter)

**Nevada**

(State or other jurisdiction of incorporation or organization)

**04-3850065**

(I.R.S. Employer Identification No.)

**10375 Professional Circle, Reno, Nevada 89521**

(Address of principal executive offices and zip code)

**(888) 682-6671**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Class  
Common Stock, \$0.01 par value per share

November 5, 2008  
48,830,140 shares outstanding

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**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****Employers Holdings, Inc. and Subsidiaries****Consolidated Balance Sheet**

(in thousands, except share data)

|  | <b>As of<br/>September<br/>30,<br/>2008</b><br>(unaudited) | <b>As of<br/>December<br/>31,<br/>2007</b> |
|--|--|--|
| <b>Assets</b>  |  |  |
| Available for sale:  |  |  |
| Fixed maturity investments at fair value (amortized cost \$1,530,282 at September 30, 2008 and \$1,594,159 at December 31, 2007) | \$ 1,500,206   | \$ 1,618,903                               |
| Equity securities at fair value (cost \$54,552 at September 30, 2008 and \$60,551 at December 31, 2007)                          | 79,452   | 107,377                                    |
| Short-term investments at fair value (amortized cost \$70,884 at September 30, 2008)   | 70,386   |  |
| Total investments  | <u>1,650,044</u>   | <u>1,726,280</u>                           |
| Cash and cash equivalents  | 311,793  | 149,703                                    |
| Accrued investment income  | 18,853   | 19,345                                     |
| Premiums receivable, less bad debt allowance of \$5,320 at September 30, 2008 and \$6,037 at December 31, 2007                   | 24,612   | 36,402                                     |
| Reinsurance recoverable for:   |  |  |
| Paid losses  | 10,766   | 10,218                                     |
| Unpaid losses, less allowance of \$1,308 at each period  | 1,024,871  | 1,051,333                                  |
| Funds held by or deposited with reinsureds   | 90,067   | 95,884                                     |
| Deferred policy acquisition costs  | 14,611   | 14,901                                     |
| Deferred income taxes, net   | 80,482   | 59,730                                     |
| Property and equipment, net  | 19,199   | 14,133                                     |
| Other assets   | 19,843   | 13,299                                     |
| Total assets   | <u>\$ 3,265,141</u>  | <u>\$ 3,191,228</u>                        |
| <b>Liabilities and stockholders equity</b>   |  |  |
| Claims and policy liabilities:   |  |  |
| Unpaid losses and loss adjustment expenses   | \$ 2,212,400   | \$ 2,269,710                               |
| Unearned premiums  | 59,061   | 63,924                                     |
| Policyholders dividends accrued  | 149  | 386  |
| Total claims and policy liabilities  | <u>2,271,610</u>   | <u>2,334,020</u>                           |

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|   |           |           |
|---|-----------|-----------|
| Commissions and premium taxes payable     | 5,381     | 7,493     |
| Federal income taxes payable              | 2,140     | 13,884    |
| Accounts payable and accrued expenses     | 18,490    | 20,682    |
| Deferred reinsurance gain - LPT Agreement | 411,094   | 425,002   |
| Note payable                              | 150,000   |           |
| Other liabilities                         | 11,818    | 10,694    |
|   | <hr/>     | <hr/>     |
| Total liabilities                         | 2,870,533 | 2,811,775 |

*See accompanying unaudited notes to consolidated financial statements.*

**Employers Holdings, Inc. and Subsidiaries****Consolidated Balance Sheets**

(in thousands, except share data)

|   | <b>As of<br/>September 30,<br/>2008</b> | <b>As of<br/>December 31,<br/>2007</b> |
|---|---|--|
| Commitments and contingencies   |   |  |
| Stockholders' equity:   |   |  |
| Common stock, \$0.01 par value; 150,000,000 shares authorized; 53,528,207 and 53,527,907 shares issued and 48,830,140 and 49,616,635 shares outstanding at September 30, 2008, and at December 31, 2007, respectively | 535                                     | 535                                    |
| Preferred stock, \$0.01 par value; 25,000,000 shares authorized; none issued  |   |  |
| Additional paid-in capital  | 305,329                                 | 302,862                                |
| Retained earnings   | 181,584                                 | 104,536                                |
| Accumulated other comprehensive (loss) income, net  | (3,688                                  | ) 46,520                               |
| Treasury stock, at cost (4,698,067 shares at September 30, 2008 and 3,911,272 shares at December 31, 2007)  | (89,152                                 | ) (75,000 )                            |
| Total stockholders' equity  | <u>394,608</u>                          | <u>379,453</u>                         |
| Total liabilities and stockholders' equity  | <u>\$3,265,141</u>                      | <u>\$3,191,228</u>                     |

*See accompanying unaudited notes to consolidated financial statements.*

**Employers Holdings, Inc. and Subsidiaries****Consolidated Statements of Income**

(in thousands, except per share data)

|  | <b>Three Months Ended<br/>September 30,<br/>2008</b> |             | <b>Nine Months Ended<br/>September 30,<br/>2008</b> |             |
|--|--|-------------|---|-------------|
|  | <b>2007</b>  | <b>2007</b> | <b>2007</b>   | <b>2007</b> |
|  | <b>(unaudited)</b>                                   |             |   |             |
| <b>Revenues</b>                              |  |             |   |             |
| Net premiums earned                          | \$73,131   | \$88,527    | \$222,842   | \$262,436   |
| Net investment income                        | 18,474   | 19,246      | 55,915  | 59,386      |
| Realized (losses) gains on investments, net  | (1,504 )   | 146         | (3,211 )  | (322 )      |
| Other income                                 | 295  | 861         | 1,155   | 3,047       |
|  | <hr/>  | <hr/>       | <hr/>   | <hr/>       |
| Total revenues                               | 90,396   | 108,780     | 276,701   | 324,547     |
| <b>Expenses</b>                              |  |             |   |             |
| Losses and loss adjustment expenses          | 25,588   | 40,867      | 80,344  | 111,336     |
| Commission expense                           | 10,121   | 12,411      | 30,465  | 35,797      |
| Underwriting and other operating expense     | 21,907   | 21,726      | 66,614  | 67,778      |
|  | <hr/>  | <hr/>       | <hr/>   | <hr/>       |
| Total expenses                               | 57,616   | 75,004      | 177,423   | 214,911     |
|  | <hr/>  | <hr/>       | <hr/>   | <hr/>       |
| Net income before income taxes               | 32,780   | 33,776      | 99,278  | 109,636     |
| Income tax (benefit) expense                 | (289 )   | 3,896       | 13,349  | 21,117      |
|  | <hr/>  | <hr/>       | <hr/>   | <hr/>       |
| Net income                                   | \$33,069   | \$29,880    | \$85,929  | \$88,519    |
|  | <hr/>  | <hr/>       | <hr/>   | <hr/>       |
| Net income after date of conversion (Note 2) |  |             |   | \$82,048    |
|  |  |             |   | <hr/>       |

**Earnings per common share (Note 12):**

|         | <b>For the Three<br/>Months Ended<br/>September 30,<br/>2008</b> |             | <b>For the Nine<br/>Months Ended<br/>September 30,<br/>2008</b> |             | <b>For the Period<br/>February 5,<br/>2007 through<br/>September 30,<br/>2007</b> |
|---------|--|-------------|---|-------------|---|
|         | <b>2007</b>  | <b>2007</b> | <b>2007</b>   | <b>2007</b> |   |
| Basic   | \$0.67   | \$0.58      | \$1.74  | \$1.55      |   |
|         | <hr/>  | <hr/>       | <hr/>   | <hr/>       |   |
| Diluted | \$0.67   | \$0.58      | \$1.74  | \$1.55      |   |
|         | <hr/>  | <hr/>       | <hr/>   | <hr/>       |   |
|         |  |             |   |             | <b>Pro Forma<br/>for the Nine<br/>Months Ended</b>                                |

|  | <b>September 30,<br/>2007</b> |        |        |        |
|--|-------------------------------|--------|--------|--------|
| Basic                                    | \$ 1.69                       |        |        |        |
| Diluted                                  | \$ 1.69                       |        |        |        |
| Cash dividends declared per common share | \$0.06                        | \$0.06 | \$0.18 | \$0.12 |

*See accompanying unaudited notes to consolidated financial statements.*



**Employers Holdings, Inc. and Subsidiaries****Consolidated Statements of Stockholders Equity**

(in thousands, except share data)

|  | <b>Common Stock<br/>Shares</b> | <b>Common Stock<br/>Amount</b> | <b>Additional<br/>Paid-In<br/>Capital</b> | <b>Retained<br/>Earnings<br/>(unaudited)</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>(Loss) Net</b> | <b>Treasury<br/>Stock,<br/>at Cost</b> | <b>Total<br/>Stockholders<br/>Equity</b> |
|--|--------------------------------|--------------------------------|---|--|---|--|--|
| Balance, January 1,<br>2007  |                                | \$                             | \$  | \$274,602                                    | \$ 29,175   | \$                                     | \$ 303,777                               |
| Conversion<br>transaction (Note 2)                                   | 22,765,407                     | 227                            | (182,143 )                                | (281,073 )                                   |   |  | (462,989 )                               |
| Initial public<br>offering transaction<br>(Note 2)                   | 30,762,500                     | 308                            | 483,285                                   |  |   |  | 483,593                                  |
| Stock-based<br>compensation (Note<br>11)                             |                                |                                | 902                                       |  |   |  | 902                                      |
| Acquisition of<br>treasury stock (Note<br>10)                        |                                |                                |   |  |   | (69,043 )                              | (69,043 )                                |
| Dividends to<br>common<br>stockholders                               |                                |                                |   | (6,299 )                                     |   |  | (6,299 )                                 |
| Comprehensive<br>income:   |                                |                                |   |  |   |  |  |
| Net income before<br>conversion                                      |                                |                                |   | 6,471  |   |  | 6,471                                    |
| Net income after<br>conversion                                       |                                |                                |   | 82,048                                       |   |  | 82,048                                   |
| Net income for the<br>period   |                                |                                |   | 88,519                                       |   |  | 88,519                                   |
| Change in net<br>unrealized gains on<br>investments, net of<br>taxes |                                |                                |   |  | 3,294   |  | 3,294                                    |
| Total<br>comprehensive<br>income                                     |                                |                                |   |  |   |  | 91,813                                   |

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|  |                   |              |                   |                  |                    |                    |                   |
|--|-------------------|--------------|-------------------|------------------|--------------------|--------------------|-------------------|
| Balance, September 30, 2007                                  | <u>53,527,907</u> | <u>\$535</u> | <u>\$ 302,044</u> | <u>\$75,749</u>  | <u>\$ 32,469</u>   | <u>\$(69,043 )</u> | <u>\$ 341,754</u> |
| Balance, January 1, 2008                                     | 53,527,907        | \$535        | \$ 302,862        | \$104,536        | \$ 46,520          | \$(75,000 )        | \$ 379,453        |
| Stock-based compensation (Note 11)                           |                   |              | 2,459             |                  |                    |                    | 2,459             |
| Stock options exercised                                      | 300               |              | 5                 |                  |                    |                    | 5                 |
| Acquisition of treasury stock (Note 10)                      |                   |              |                   |                  |                    | (14,152 )          | (14,152 )         |
| Dividends to common stockholders                             |                   |              | 3                 | (8,881 )         |                    |                    | (8,878 )          |
| Comprehensive income:  |                   |              |                   |                  |                    |                    |                   |
| Net income for the period                                    |                   |              |                   | 85,929           |                    |                    | 85,929            |
| Change in net unrealized losses on investments, net of taxes |                   |              |                   |                  | (50,208 )          |                    | (50,208 )         |
| Total comprehensive income                                   |                   |              |                   |                  |                    |                    | <u>35,721</u>     |
| Balance, September 30, 2008                                  | <u>53,528,207</u> | <u>\$535</u> | <u>\$ 305,329</u> | <u>\$181,584</u> | <u>\$ (3,688 )</u> | <u>\$(89,152 )</u> | <u>\$ 394,608</u> |

See accompanying unaudited notes to the consolidated financial statements.

**Employers Holdings, Inc. and Subsidiaries****Consolidated Statements of Cash Flow**

(in thousands)

|   | <b>Nine Months Ended<br/>September 30,</b> |               |
|---|--|---------------|
|   | <b>2008</b>                                | <b>2007</b>   |
|   | (unaudited)                                |               |
| <b>Operating activities</b>   |  |               |
| Net income  | \$85,929                                   | \$88,519      |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |               |
| Depreciation and amortization   | 5,334                                      | 4,517         |
| Stock-based compensation  | 2,459                                      | 902           |
| Amortization of premium on investments, net                                       | 4,814                                      | 4,848         |
| Allowance for doubtful accounts    premiums receivable                            | (717    )                                  | 780           |
| Deferred income tax expense   | 6,284                                      | 5,160         |
| Realized losses on investments, net   | 3,211                                      | 322           |
| Realized losses on retirement of assets   | 16   |               |
| Change in operating assets and liabilities:                                       |  |               |
| Accrued investment income   | 492  | (310    )     |
| Premiums receivable   | 12,507                                     | 5,753         |
| Reinsurance recoverable on paid and unpaid losses                                 | 25,914                                     | 36,748        |
| Funds held by or deposited with reinsureds  | 5,817                                      | 5,283         |
| Unpaid losses and loss adjustment expenses  | (57,310    )                               | (25,264    )  |
| Unearned premiums   | (4,863    )                                | (2,442    )   |
| Federal income taxes payable  | (11,744    )                               | (14,245    )  |
| Accounts payable, accrued expenses and other liabilities                          | (1,967    )                                | (11,400    )  |
| Deferred reinsurance gain    LPT Agreement  | (13,908    )                               | (13,694    )  |
| Other   | (7,073    )                                | (3,041    )   |
|   | <hr/>                                      | <hr/>         |
| Net cash provided by operating activities   | 55,195                                     | 82,436        |
| <b>Investing activities</b>   |  |               |
| Purchase of fixed maturities  | (208,730    )                              | (214,197    ) |
| Purchase of equity securities   | (558    )                                  | (1,021    )   |
| Proceeds from sale of fixed maturities  | 149,487                                    | 156,471       |
| Proceeds from sale of equity securities   | 4,010                                      | 2,744         |
| Proceeds from maturities and redemptions of investments                           | 41,462                                     | 40,650        |
| Capitalized acquisition costs   | (1,260    )                                |               |
| Capital expenditures and other, net   | (4,116    )                                | (3,993    )   |
|   | <hr/>                                      | <hr/>         |
| Net cash used in investing activities   | (19,705    )                               | (19,346    )  |
| <b>Financing activities</b>   |  |               |
| Issuance of common stock, net   |  | 486,670       |
| Cash paid to eligible policyholders under plan of conversion                      |  | (462,989    ) |
| Proceeds from exercise of stock options   | 5  |               |
| Acquisition of treasury stock   | (14,152    )                               | (67,288    )  |
| Dividends paid to stockholders  | (8,878    )                                | (6,299    )   |

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|  |           |           |
|--|-----------|-----------|
| Debt issuance costs                                      | (375 )    |           |
| Proceeds from note payable                               | 150,000   |           |
|  | <hr/>     | <hr/>     |
| Net cash provided by (used in) financing activities      | 126,600   | (49,906 ) |
|  | <hr/>     | <hr/>     |
| Net increase in cash and cash equivalents                | 162,090   | 13,184    |
| Cash and cash equivalents at the beginning of the period | 149,703   | 79,984    |
|  | <hr/>     | <hr/>     |
| Cash and cash equivalents at the end of the period       | \$311,793 | \$93,168  |
|  | <hr/>     | <hr/>     |
| <b>Schedule of non-cash transactions</b>                 |           |           |
| Stock issued in exchange for membership interest         | \$        | \$281,073 |
|  | <hr/>     | <hr/>     |

*See accompanying unaudited notes to consolidated financial statements.*

## **Employers Holdings, Inc. and Subsidiaries**

### **Notes to Consolidated Financial Statements**

**(Unaudited)**

#### **1. Basis of Presentation and Summary of Significant Accounting Policies**

##### **Basis of Presentation**

Employers Holdings, Inc. (EHI) is a holding company and successor to EIG Mutual Holding Company (EIG), which was incorporated in Nevada in 2005. EHI conducts substantially all its business through its two wholly-owned insurance subsidiaries, Employers Insurance Company of Nevada (EICN) and Employers Compensation Insurance Company (ECIC), which are domiciled in Nevada and California, respectively. Unless otherwise indicated, all references to the Company refer to EHI, together with its subsidiaries.

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal, recurring adjustments) necessary for a fair presentation of the Company's financial position and results of operations for the periods presented have been included. The results of operations for an interim period are not necessarily indicative of the results for an entire year. These financial statements have been prepared consistent with the accounting policies described in the Company's 2007 Annual Report on Form 10-K (Annual Report) for the year ended December 31, 2007, and should be read together with the Annual Report.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 131, *Disclosures About Segments of an Enterprise and Related Information*, the Company considers an operating segment to be any component of its business whose operating results are regularly reviewed by the Company's chief operating decision makers to make decisions about resources to be allocated to the segment and assess its performance based on discrete financial information. Currently, the Company has one operating segment: workers' compensation insurance and related services.

##### **Estimates and Assumptions**

The preparation of the consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. As a result, actual results could differ from these estimates. The most significant areas that require management judgment are the estimate of unpaid losses and loss adjustment expenses (LAE), evaluation of reinsurance recoverables, recognition of premium revenue, deferred policy acquisition costs, deferred income taxes and the valuation of investments.

##### **New Accounting Standards**

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 141 (Revised 2007), *Business Combinations* (SFAS No. 141(R)). SFAS No. 141(R) significantly changes the accounting for business combinations and requires the acquiring entity in the transaction to recognize the acquired assets and assumed liabilities at the acquisition-date fair value with limited exceptions. SFAS No. 141(R) is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, which, for the Company, would include business combinations that are completed after January 1, 2009. Early adoption is prohibited. The adoption of SFAS No. 141(R) will have an impact on the consolidated financial statements for any business combinations completed after

January 1, 2009.

In March 2008, the FASB issued SFAS No. 161 *Disclosures About Derivative Instruments and Hedging Activities an Amendment of FASB No. 133* (SFAS No. 161). SFAS No. 161 expands the disclosure requirements in SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities* about an entity's derivative instruments and hedging activities. SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk related contingent features in derivative agreements. SFAS No. 161 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2008, which, for the Company, would be January 1, 2009. The Company is currently assessing the impact SFAS No. 161 will have on the consolidated financial statements.

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## 2. Conversion and Initial Public Offering

Effective February 5, 2007, under the terms of the plan of conversion, EIG converted from a mutual insurance holding company to a stock company (the Conversion). All membership interests in EIG were extinguished on that date and eligible members of EIG received, in aggregate, 22,765,407 shares of EHI's common stock and \$463.0 million of cash.

In addition, effective February 5, 2007, EHI completed its Initial Public Offering (IPO) in which it issued 30,762,500 shares of its common stock at a price of \$17.00 per share. The cash proceeds of the IPO, after underwriting discounts and commission of \$34.0 million and offering and conversion costs of \$16.3 million, were \$472.7 million, of which \$9.7 million was retained by EHI and was used for working capital, payment of dividends on common stock, repurchase of shares of common stock and other general corporate purposes.

Upon completion of EHI's IPO, the capitalized issuance costs related to the IPO of \$5.4 million were netted against the IPO proceeds in additional paid-in capital in the accompanying consolidated balance sheets. The costs related to the Conversion were \$10.9 million. Conversion expenses consisted primarily of printing and mailing costs and the aggregate cost of engaging independent accounting, actuarial, financial, investment banking, legal and other consultants. These costs had no tax benefit and were expensed as incurred.

## 3. Income Taxes

During the three months ended September 30, 2008, the Company reversed the remaining \$10.6 million of liabilities for previously unrecognized tax benefits (including \$2.3 million of related accrued interest of which \$0.4 million was recognized in the nine months ended September 30, 2008), as a result of certain statutory periods expiring. The reversal decreased the Company's effective tax rate by 26.3 and 8.7 percentage points for the three and nine months ended September 30, 2008, respectively. Tax years 2005 through 2007 are subject to examination by the federal taxing authority. There are no income tax examinations currently in progress.

## 4. Fair Value of Financial Instruments

On January 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements* (SFAS No. 157), which provides a common definition of fair value and establishes a framework to make the measurement of fair value more consistent and comparable. The Company's adoption of SFAS No. 157 did not have a material impact on its consolidated financial statements or results of operations.

Additionally, on January 1, 2008, the Company adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (SFAS No. 159). SFAS No. 159 permits an entity to choose to measure many financial instruments and certain items at fair value. The Company's adoption of SFAS No. 159 did not have a material impact on its consolidated financial statements or results of operations.

The following table presents the items on the accompanying consolidated balance sheet that are stated at fair value and the fair value measurements used as of September 30, 2008. The interest rate swap, a level 2 measurement (Note 8), has been omitted from the table because it had no fair value at September 30, 2008.

|   | <b>Fixed<br/>Maturities</b> | <b>Equity<br/>Securities</b> | <b>Short-Term<br/>Investments</b> |
|---|-----------------------------|------------------------------|-----------------------------------|
|   | (in thousands)              |                              |                                   |
| Level 1: Quoted prices in active markets for identical assets | \$                          | \$79,452                     | \$                                |
| Level 2: Significant other observable inputs                  | 1,492,856                   |                              | 70,386                            |

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|                              |                    |                   |                   |
|------------------------------|--------------------|-------------------|-------------------|
| Level 3: Unobservable inputs | <u>7,350</u>       | <u>          </u> | <u>          </u> |
| Balance, September 30, 2008  | <u>\$1,500,206</u> | <u>\$79,452</u>   | <u>\$70,386</u>   |

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The following table provides a reconciliation of the beginning and ending balances, for the above items, that are measured using Level 3: Unobservable inputs for the nine months ended September 30, 2008:

|   |   |
|---|---|
|   | <b>Fixed<br/>Maturities</b><br>(in thousands) |
| Balance, January 1, 2008                      | \$7,384                                       |
| Unrealized losses in other comprehensive loss | (34 )   |
|   | <hr/>   |
| Balance, September 30, 2008                   | \$7,350                                       |
|   | <hr/>   |

**Other-Than-Temporary Impairment**

The Company reviews its investment portfolio quarterly for securities that may have incurred an other-than-temporary impairment (OTTI). For any investment security deemed to have an OTTI, the investment's cost or amortized cost is written down to its fair value and the amount written down is recorded in earnings as a realized loss on investments.

Net realized (losses) gains on investments for the three and nine months ended September 30, 2008 include write-downs of \$3.8 million and \$5.5 million on 34 and 47 securities, respectively, for which the Company determined the declines in fair value were other-than-temporary due to the amount and length of time that fair values were below cost. Based on the Company's review of the other securities, the Company has the intent and ability to hold the securities until fair value recovers above cost or to maturity.

**5. Liability for Unpaid Losses and Loss Adjustment Expenses**

The following table represents a reconciliation of changes in the liability for unpaid losses and LAE for the nine months ended:

|   | <b>September 30,<br/>2008</b> | <b>2007</b> |
|---|-------------------------------|-------------|
|   | ( in thousands)               |             |
| Unpaid losses and LAE, gross of reinsurance, at beginning of period                   | \$2,269,710                   | \$2,307,755 |
| Less reinsurance recoverables, excluding bad debt allowance, on unpaid losses and LAE | 1,052,641                     | 1,098,103   |
|   | <hr/>                         | <hr/>       |
| Net unpaid losses and LAE at beginning of period                                      | 1,217,069                     | 1,209,652   |
| Losses and LAE, net of reinsurance, incurred in:                                      |                               |             |
| Current period  | 147,569                       | 168,481     |
| Prior periods   | (53,317 )                     | (43,451 )   |
|   | <hr/>                         | <hr/>       |
| Total net losses and LAE incurred during the period                                   | 94,252                        | 125,030     |
|   | <hr/>                         | <hr/>       |
| Deduct payments for losses and LAE, net of reinsurance, related to:                   |                               |             |
| Current period  | 25,860                        | 26,702      |
| Prior periods   | 99,240                        | 87,239      |
|   | <hr/>                         | <hr/>       |
| Total net payments for losses and LAE during the period                               | 125,100                       | 113,941     |

|   |             |             |
|---|-------------|-------------|
| Ending unpaid losses and LAE, net of reinsurance                                | 1,186,221   | 1,220,741   |
| Reinsurance recoverable, excluding bad debt allowance, on unpaid losses and LAE | 1,026,179   | 1,061,750   |
| Unpaid losses and LAE, gross of reinsurance, at end of period                   | \$2,212,400 | \$2,282,491 |

The above table excludes the impact of the amortization of the deferred reinsurance gain LPT Agreement (Deferred Gain) (Note 6). The Company amortized \$13.9 million and \$13.7 million of the Deferred Gain for the nine months ended September 30, 2008 and 2007, respectively, which are reflected in losses and LAE incurred in the consolidated statements of income. For the nine months ended September 30, 2008 and 2007, no reductions were made to the ceded reserves on the Deferred Gain.

The reduction in the liability for unpaid losses and LAE attributable to insured events of prior periods was \$53.3 million and \$43.4 million for the nine months ended September 30, 2008 and 2007, respectively. The major sources of this favorable development are actual paid losses being less than expected and the impact of new information on selected

claim payments and emergence patterns used in the projection of future loss payments in the Company's California and Nevada business as more information becomes known.

## **6. LPT Agreement**

The Company is a party to a 100% quota share retroactive reinsurance agreement (LPT Agreement) under which \$1.5 billion in liabilities for losses and LAE related to claims incurred prior to July 1, 1995 were reinsured for consideration of \$775.0 million. The LPT Agreement provides coverage up to \$2.0 billion. The Deferred Gain is recorded as a liability in the accompanying consolidated balance sheets and is being amortized using the recovery method, whereby the amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries. The Company amortized \$4.5 million and \$13.9 million of the Deferred Gain for the three and nine months ended September 30, 2008, respectively, and \$4.6 million and \$13.7 million of the Deferred Gain for the three and nine months ended September 30, 2007, respectively. The adjustments to the Deferred Gain are recorded in losses and LAE in the accompanying consolidated statements of income. The remaining Deferred Gain was \$411.1 million and \$425.0 million as of September 30, 2008 and December 31, 2007, respectively, and is included in the accompanying consolidated balance sheets as deferred reinsurance gain LPT Agreement.

## **7. Note Payable**

Effective September 30, 2008, EHI and Wells Fargo Bank, National Association (Wells Fargo) entered into a Second Amended and Restated Secured Revolving Credit Facility (Amended Credit Facility). The Amended Credit Facility provides the Company with: (a) \$150.0 million line of credit through December 31, 2009; (b) \$100.0 million line of credit from January 1, 2010 through December 31, 2010; and (c) \$50.0 million line of credit from January 1, 2011 through March 26, 2011. Amounts outstanding bear interest at a rate equal to, at the Company's option: (a) a fluctuating rate of 1.25% above Wells Fargo's prime rate or (b) a fixed rate that is 1.25% above the LIBOR rate then in effect. The Company previously paid a non-refundable commitment fee of \$375.0 thousand, which is being amortized over 12 months. In addition, the Company is required to pay a quarterly commitment fee equal to a per annum rate of 0.10% on any portion of the Amended Credit Facility that is unused. The Amended Credit Facility contains customary non-financial covenants and requires EHI to maintain \$7.5 million of cash and cash equivalents.

On September 30, 2008, EHI borrowed \$150.0 million through the Amended Credit Facility with an interest rate of 5.25%. The proceeds borrowed under the Amended Credit Facility will be used to finance the acquisition of AmCOMP Incorporated (Note 13) and for general working capital purposes. The Amended Credit Facility is secured by fixed maturity securities which had a fair value of \$186.7 million at September 30, 2008.

## **8. Derivative**

### **Interest Rate Swap**

On September 30, 2008, the Company, in connection with the borrowings through the Amended Credit Facility (Note 7), executed an interest rate swap with Wells Fargo with a notional amount of \$100.0 million. Execution of the interest rate swap established a fixed interest rate of 4.84%, on the notional amount, through September 30, 2010. The Company uses this interest rate swap to mitigate the risks associated with unexpected cash outflows resulting from shifts in variable interest rates. As of September 30, 2008, the same date the derivative was established, the interest rate swap had no fair value.



**9. Accumulated Other Comprehensive (Loss) Income**

Accumulated other comprehensive (loss) income is comprised of unrealized (depreciation) appreciation on investments classified as available-for-sale. The following table summarizes the components of accumulated other comprehensive (loss) income:

|  | <b>September 30,</b> |                   |
|--|----------------------|-------------------|
|  | <b>2008</b>          | <b>2007</b>       |
|  | (in thousands)       |                   |
| Net unrealized (loss) gain on investment, before taxes                         | \$(5,674 )           | \$49,953          |
| Deferred tax benefit (expense)   | 1,986                | (17,484 )         |
|  | <u>          </u>    | <u>          </u> |
| Total accumulated other comprehensive (loss) income, net of taxes net of taxes | <u>\$(3,688 )</u>    | <u>\$32,469</u>   |

The following table summarizes changes in the components of total comprehensive income for the stated periods:

|   | <b>Three Months Ended</b> |                   | <b>Nine Months Ended</b> |                   |
|---|---------------------------|-------------------|--------------------------|-------------------|
|   | <b>September 30,</b>      | <b>2007</b>       | <b>September 30,</b>     | <b>2007</b>       |
|   | <b>2008</b>               | <b>2007</b>       | <b>2008</b>              | <b>2007</b>       |
|   | ( in thousands)           |                   |                          |                   |
| Unrealized (losses) gains arising during the period, before taxes     | \$(43,805 )               | \$29,059          | \$(80,455 )              | \$4,746           |
| Less: income tax (benefit) expense                                    | (15,331 )                 | 10,131            | (28,159 )                | 1,661             |
|   | <u>          </u>         | <u>          </u> | <u>          </u>        | <u>          </u> |
| Unrealized (losses) gains arising during the period, net of taxes     | (28,474 )                 | 18,928            | (52,296 )                | 3,085             |
| Less reclassification adjustment:                                     |                           |                   |                          |                   |
| (Losses) gains realized in net income                                 | (1,504 )                  | 146               | (3,211 )                 | (322 )            |
| Income tax (benefit) expense  | (526 )                    | 51                | (1,123 )                 | (113 )            |
|   | <u>          </u>         | <u>          </u> | <u>          </u>        | <u>          </u> |
| Reclassification adjustment for (losses) gains realized in net income | (978 )                    | 95                | (2,088 )                 | (209 )            |
|   | <u>          </u>         | <u>          </u> | <u>          </u>        | <u>          </u> |
| Other comprehensive (loss) gain                                       | (27,496 )                 | 18,833            | (50,208 )                | 3,294             |
| Net income  | 33,069                    | 29,880            | 85,929                   | 88,519            |
|   | <u>          </u>         | <u>          </u> | <u>          </u>        | <u>          </u> |
| Total comprehensive income  | <u>\$5,573</u>            | <u>\$48,713</u>   | <u>\$35,721</u>          | <u>\$91,813</u>   |

**10. Stockholders Equity****Stock Repurchase Program**

On February 21, 2008, the EHI Board of Directors authorized a stock repurchase program (the 2008 Program). The 2008 Program authorizes the Company to repurchase up to \$100.0 million of the Company's common stock through June 30, 2009. As of September 30, 2008, the Company repurchased 786,795 shares at a cost of \$14.2 million. EHI

may repurchase shares from time to time at prevailing market prices in open market or private transactions. The repurchases may be commenced or suspended from time to time without prior notice.

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**11. Stock-Based Compensation**

The Company accounts for stock-based compensation according to the provisions of SFAS No. 123(R), *Share-Based Payment*. Net stock-based compensation expense recognized in the accompanying consolidated statements of income is as follows:

|                                      | <b>Three Months Ended<br/>September 30,<br/>2008</b> |             | <b>Nine Months Ended<br/>September 30,<br/>2008</b> |             |
|--------------------------------------|--|-------------|---|-------------|
|                                      | <b>2007</b>  | <b>2007</b> | <b>2007</b>   | <b>2007</b> |
|                                      | (in thousands)                                       |             |   |             |
| Stock-based compensation related to: |  |             |   |             |
| Nonqualified stock options           | \$375  | \$351       | \$878   | \$557       |
| Restricted stock units               | 301  | 80          | 601   | 80          |
| Performance shares                   | 296  | 265         | 980   | 265         |
|                                      | 972  | 696         | 2,459   | 902         |
| Less: related tax benefit            | 333  | 244         | 851   | 316         |
|                                      | \$639  | \$452       | \$1,608   | \$586       |

**Nonqualified Stock Options**

On May 29, 2008, the Company awarded 475,167 options to the officers of the Company. These options have a service vesting period of four years and vest 25% on May 29, 2009, and the subsequent three anniversaries of such date. The options are subject to accelerated vesting in certain limited circumstances, such as death or disability of the holder, or in connection with a change of control of the Company. The options expire seven years from the date of grant. The per share exercise price of these options is equal to the fair value of the stock on the grant date, or \$19.21.

Changes in outstanding stock options for the nine months ended September 30, 2008 were as follows:

|   | <b>Number<br/>of<br/>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life</b><br>(in years) |
|---|----------------------------------|--|--|
| Options outstanding at January 1, 2008    | 584,850                          | \$ 18.29   | 6.4  |
| Granted                                   | 475,167                          | 19.21  | 6.7  |
| Exercised                                 | (300 )                           | 17.00  |  |
| Expired                                   | (4,755 )                         | 17.86  |  |
| Forfeited                                 | (30,152 )                        | 18.40  |  |
|   | 1,024,810                        | 18.71  | 6.1  |
| Options outstanding at September 30, 2008 |                                  |  |  |
| Exercisable at September 30, 2008         | 158,877                          | 18.18  | 5.5  |

**Restricted Stock Units**

On May 29, 2008, 23,760 restricted stock units (RSUs), awarded to the non-employee members of the Board of Directors during 2007, vested in connection with the annual stockholders meeting. The vested RSUs will be settled in common stock six months following the awardee's termination of service from the Board of Directors. Prior to settlement, dividend equivalents are paid with respect to these vested RSUs and are credited as additional vested RSUs. On September 4, 2008, in connection with the Company's dividend to its stockholders, an aggregate of 72 RSUs were credited to vested RSU holders.



Additionally, on May 29, 2008, the Company awarded the non-employee members of the Board of Directors, in aggregate, 24,984 RSUs. These RSUs vest on May 29, 2009, except for accelerated vesting in the case of death or disability of the director or in connection with a change of control. Vested RSUs will be settled in common stock within 30 days after the vesting date or can be deferred until six months following the awardee's termination of service from the Board of Directors, at the awardee's election. In the event of a deferral election, dividend equivalents are paid with respect to vested RSUs and are credited as additional vested RSUs. The aggregate fair value of the RSUs on the date of grant was \$479.9 thousand.

On May 29, 2008, the Company awarded 152,564 RSUs to the officers of the Company. The RSUs have a service vesting period of four years and vest 25% on May 29, 2009, and the subsequent three anniversaries of such date. The RSUs are subject to accelerated vesting in certain limited circumstances, such as: death or disability of the holder, or in connection with a change of control of the Company. The aggregate fair value of the RSUs on the date of grant was \$2.9 million.

Changes in outstanding RSUs for the nine months ended September 30, 2008 were as follows:

|   | <b>Number of<br/>RSUs</b> | <b>Weighted<br/>Average<br/>Grant<br/>Date<br/>Fair Value</b> |
|---|---------------------------|---|
| RSUs outstanding at January 1, 2008             | 23,760                    | \$ 16.83  |
| Granted   | 177,692                   | 19.21   |
| Forfeited                                       | (1,667 )                  | 19.21   |
|   | <u>199,785</u>            | 18.93   |
| RSUs outstanding at September 30, 2008          | <u>199,785</u>            | 18.93   |
| Vested but unsettled RSUs at September 30, 2008 | <u>23,904</u>             | 16.84   |

## 12. Earnings Per Share

SFAS No. 128, *Earnings per Share*, provides for the calculation of Basic and Diluted earnings per share. Basic earnings per share includes no dilution and is computed by dividing income applicable to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution of securities that could share in the earnings of equity. Diluted earnings per common share includes common shares assumed issued under the treasury stock method, which reflects the potential dilution that would have occurred had shares been repurchased from the proceeds of potentially dilutive shares.

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The following table presents the net income and the weighted average common shares outstanding used in the earnings per common share calculations for the periods presented:

|   | <b>Three Months Ended<br/>September 30,<br/>2008</b> |            | <b>Nine Months<br/>Ended<br/>September<br/>30,<br/>2008</b> | <b>February 5,<br/>2007<br/>through<br/>September<br/>30,<br/>2007</b> | <b>Pro Forma<br/>Nine Months<br/>Ended<br/>September<br/>30,<br/>2007</b> |
|---|--|------------|---|--|---|
| (in thousands, except share and per share data)               |  |            |   |  |   |
| Net income available to common stockholders basic and diluted | \$33,069   | \$29,880   | \$85,929  | \$82,048   | \$88,519  |
| Weighted average number of common shares outstanding basic    | 49,005,235   | 51,720,231 | 49,339,966  | 52,818,747   | 52,457,369  |
| Effect of dilutive securities:                                |  |            |   |  |   |
| Performance share awards                                      | 66,246   | 4,465      | 48,454  | 1,726  | 1,505   |
| Unvested restricted stock units                               | 3,433  | 2,320      | 1,174   | 897  | 782   |
| Dilutive potential common shares                              | 69,679   | 6,785      | 49,628  | 2,623  | 2,287   |
| Weighted average number of common shares outstanding diluted  | 49,074,914   | 51,727,016 | 49,389,594  | 52,821,370   | 52,459,656  |
| <b>Earnings per common share:</b>                             |  |            |   |  |   |
| Basic   | \$0.67   | \$0.58     | \$1.74  | \$1.55   | \$1.69  |
| Diluted   | \$0.67   | \$0.58     | \$1.74  | \$1.55   | \$1.69  |

For the three months ended September 30, 2008 and 2007, and nine months ended September 30, 2008, earnings per common share basic was calculated using net income for the period and the weighted average common shares outstanding, including contingently issuable shares for which all necessary conditions for issuance have been met. Earnings per common share diluted is based on the basic weighted average common shares outstanding increased by the number of additional common shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of common shares that could have been repurchased from the proceeds of the potentially dilutive shares. The Company's outstanding options have been excluded in computing the diluted earnings per share for the three months ended September 30, 2008 and 2007 and nine months ended September 30, 2008, because their inclusion would be anti-dilutive.

The earnings per common share basic for the period February 5, 2007 through September 30, 2007 was calculated using only the net income available to common stockholders for the period after the IPO, as shown on the consolidated statements of income, and the basic weighted average common shares outstanding during the same period. Earnings per common share diluted is based on the basic weighted average common shares outstanding increased by the number of additional common shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of common shares that could have been repurchased from the proceeds of the potentially dilutive shares. The Company's outstanding options have been excluded in computing the diluted earnings per share for the period February 5, 2007 through September 30, 2007 because their inclusion would

be anti-dilutive.

The pro forma earnings per common share for the nine months ended September 30, 2007, presented on the accompanying consolidated statements of income is intended to depict relative earnings per common share for the period, irrespective of the impact of the Conversion because neither EHI, nor its predecessor, EIG, had, prior to the Conversion, any outstanding common shares. The pro forma earnings per common share basic for the nine months ended September 30, 2007 was calculated using the weighted average common shares of 50,000,002 for the period prior to the Conversion and 52,818,747 for the period after the Conversion through September 30, 2007. Pro forma earnings per common share diluted for the nine months ended September 30, 2007, is based on the pro forma weighted average common shares outstanding basic adjusted by the number of additional common shares that would have been outstanding had potentially dilutive common shares been issued and reduced by the number of common shares that could have been repurchased from the proceeds of the potentially dilutive shares. The Company's outstanding options have

been excluded in computing the pro forma diluted earnings per share for the nine months ended September 30, 2007 because their inclusion would be anti-dilutive.

### 13. Subsequent Events

#### Acquisition of AmCOMP Incorporated

On October 31, 2008, EHI acquired 100% of the outstanding common stock of AmCOMP Incorporated (AmCOMP) for \$188.4 million (the Acquisition). The Company believes the Acquisition will provide significant opportunity to accelerate the execution of its strategic goals and achieve its vision of being the leader in the property and casualty insurance industry specializing in workers' compensation. The accompanying unaudited consolidated statements of income for the three and nine months ended September 30, 2008 do not include the results of AmCOMP.

Pursuant to the terms of Amendment No. 2 to the Agreement and Plan of Merger, as executed on August 29, 2008, the Company paid a cash amount of \$12.15 per share in exchange for the 15,295,462 outstanding shares of AmCOMP common stock. The 844,650 AmCOMP stock options that were outstanding immediately prior to the effective time of the Acquisition were vested by virtue of the Acquisition and exchanged for the right to receive cash consideration equal to the net amount of the excess, if any, of \$12.15 per share over the exercise price per share of the option.

The total estimated purchase price of the Acquisition was as follows:

|   | <b>Amount</b><br>(in<br>thousands) |
|---|------------------------------------|
| Cash for outstanding shares   | \$ 185,840                         |
| Cash for stock options  | 2,529                              |
|   | <hr/>                              |
| Total cash used to acquire the outstanding equity interests of AmCOMP | 188,369                            |
| Estimated acquisition related costs                                   | 4,964                              |
|   | <hr/>                              |
| Total estimated purchase price  | <u>\$ 193,333</u>                  |

The Company will allocate the total purchase price to tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values. The excess of the purchase price over the aggregate fair values will be recorded as goodwill, which is not deductible for federal income tax purposes. The Company is in the process of determining the fair value of the assets acquired and liabilities assumed. The results of AmCOMP for the period October 31, 2008 through December 31, 2008 will be included in the Company's 2008 Annual Report on Form 10-K, along with an allocation of the purchase price.

#### Stockholder Dividend

On November 6, 2008, the Board of Directors declared a \$0.06 dividend per share, payable December 4, 2008, to stockholders of record on November 20, 2008.



## Item 2. Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations

You should read the following discussion and analysis in conjunction with our consolidated financial statements and the related notes thereto included in Item 1 of Part I. Unless otherwise indicated, all references to we, us, our, the Company or similar terms refer to Employers Holdings, Inc. (EHI), together with its subsidiaries. The information contained in this quarterly report is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this quarterly report and in our other reports filed with the Securities and Exchange Commission (SEC), including our 2007 Annual Report on Form 10-K for the year ended December 31, 2007 (Annual Report).

The discussion under the heading Risk Factors in our Annual Report, as updated by the discussion in Part II, Item 1A of this quarterly report and similar discussions in our other SEC filings, describe some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks in addition to the other information in this report and in our other filings with the SEC before deciding to purchase, hold, or sell our common stock.

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and 21E of the Securities Exchange Act of 1934. You should not place undue reliance on these statements. These forward-looking statements include those related to our expected financial position, business, financing plans, litigation, future premiums, revenues, earnings, pricing, investments, business relationships, expected losses, loss reserves, acquisitions, competition, and rate increases with respect to our business and the insurance industry in general. Statements that include the words expect, intend, plan, believe, project, estimate, may, should, potential, forecast, anticipate, will and similar statements of a future or forward-looking nature identify forward-looking statements.

All forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause our actual results to differ materially from those indicated in these statements. We believe that these factors include, but are not limited to, the following:

- impact of the extraordinary conditions in the financial markets;
- adequacy and accuracy of our pricing methodologies;
- our dependence on concentrated geographic areas and on the workers' compensation industry;
- developments in the frequency or severity of claims and loss activity that our underwriting, reserving or investment practices do not anticipate based on historical experience or industry data;
- changes in rating agency policies or practices;
- negative developments in the workers' compensation insurance industry;
- increased competition on the basis of coverage availability, claims management, safety services, payment terms, premium rates, policy terms, types of insurance offered, overall financial strength, financial ratings and reputation;
- changes in the availability, cost or quality of reinsurance and failure of our reinsurers to pay claims timely or at all;
- changes in regulations or laws applicable to us, our policyholders or the agencies that sell our insurance;
- changes in legal theories of liability under our insurance policies;
- changes in general economic conditions, including interest rates, inflation and other factors;
- effects of acts of war, terrorism, or natural or man-made catastrophes;
- non-receipt of expected payments;
- performance of the financial markets and their effects on investment income and the fair values of investments;
- possible failure of our information technology or communication systems;
- adverse state and federal judicial decisions;
- litigation and government proceedings;

possible loss of the services of any of our executive officers or other key personnel;

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cyclical nature of the insurance industry;  
investigations into issues and practices in the insurance industry;  
changes in demand for our products;  
the possibility that the operations acquired from AmCOMP Incorporated (AmCOMP) will not be integrated successfully or cost effectively; and  
possible disruption from the AmCOMP transaction making it more difficult to maintain relationships with customers, employees, agents and producers.

The foregoing factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included in this report.

These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical or anticipated results, depending on a number of factors. These risks and uncertainties include, but are not limited to, those listed under the heading Risk Factors in our Annual Report, as updated by the discussion in Part II, Item 1A of this quarterly report. All subsequent written and oral forward-looking statements attributable to us or individuals acting on our behalf are expressly qualified in their entirety by these cautionary statements. We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. Before making an investment decision, you should carefully consider all of the factors identified in this report that could cause actual results to differ.

## Overview

EHI is a Nevada holding company and is the successor to EIG Mutual Holding Company (EIG), which was incorporated in Nevada in 2005. EHI's principal executive offices are located at 10375 Professional Circle, Reno, Nevada.

On October 31, 2008, we completed our acquisition of AmCOMP Incorporated (the Acquisition). We believe this acquisition will provide significant opportunity to accelerate the execution of our strategic goals and achieve our vision of being the leader in the property casualty insurance industry specializing in workers' compensation.

We are a specialty provider of workers' compensation insurance focused on select small businesses engaged in low to medium hazard industries. Workers' compensation is a statutory system under which an employer is required to provide coverage for its employees' medical, disability, vocational rehabilitation and death benefit costs for work-related injuries or illnesses. Our business, which has historically targeted small businesses located primarily in several western states, with a concentration in California and Nevada, now also includes a concentration in Florida with the acquisition of AmCOMP. We continue to distribute our products almost exclusively through independent agents and brokers and our strategic distribution partners.

On August 29, 2008, we entered into Amendment No. 2 to the Agreement and Plan of Merger (Amended Merger Agreement), as previously amended April 28, 2008, with AmCOMP. Under the Amended Merger Agreement, which was approved by the Boards of Directors of both companies, approximately 15.3 million outstanding common shares received consideration of \$12.15 in cash for each share of AmCOMP common stock. The Florida Office of Insurance Regulation (FOIR) approved the Acquisition pursuant to the terms of the Amended Merger Agreement on August 29, 2008.

On October 29, 2008, the stockholders of AmCOMP approved the Acquisition, and on October 31, 2008, we acquired 100% of the outstanding common stock of AmCOMP for \$188.4 million pursuant to the terms of the Amended Merger Agreement. We used \$188.4 million in available cash, including funds available through the Second Amended and Restated Secured Revolving Credit Facility (Amended Credit Facility) entered into with Wells Fargo Bank, National Association (Wells Fargo). We will allocate the total purchase price to tangible and identifiable intangible



assets acquired and liabilities assumed based on their estimated fair values. The excess of the purchase price over the aggregate fair values will be recorded as goodwill, which is not deductible for federal income tax purposes. We are in the process of determining the fair value of the assets acquired and the liabilities assumed. The results of AmCOMP for the period October 31, 2008 through December 31, 2008 will be included in our 2008 Annual Report on Form 10-K, along with an allocation of the purchase price.

The acquired insurance subsidiaries, AmCOMP Preferred Insurance Company and AmCOMP Assurance Corporation, are mono-line workers compensation insurance companies focused on small to mid-sized businesses,

primarily in Southeastern and Midwestern states. Domiciled in Florida, the insurance subsidiaries are licensed in a combined 29 states and the District of Columbia and currently write business in 21 states with Florida representing approximately 29% of the \$220.6 million in direct premiums written in 2007.

As a result of the Acquisition, we expanded from two to four insurance subsidiaries:

|  | State of Domicile |
|--|-------------------|
| Employers Insurance Company of Nevada (EICN)             | Nevada            |
| Employers Compensation Insurance Company (ECIC)          | California        |
| AmCOMP Preferred Insurance Company (EPIC) <sup>(1)</sup> | Florida           |
| AmCOMP Assurance Corporation (EAC) <sup>(1)</sup>        | Florida           |

(1) On November 3, 2008 we filed an application to change the names of AmCOMP Preferred Insurance Company and AmCOMP Assurance Corporation to Employers Preferred Insurance Company (EPIC) and Employers Assurance Company (EAC), respectively.

We also acquired the following non-insurance subsidiaries:

Pinnacle Administrative Company  
 Pinnacle Benefits, Inc.  
 AmSERV, Inc.

We now operate in a single reportable segment with 17 territorial offices serving 29 states.

**Revenues**

We derive our revenues primarily from the following:

*Net Premiums Earned.* Our net premiums earned have historically been generated primarily in California and Nevada. In California, we have reduced our premium rates by 62.5% from September 2003 through September 30, 2008, including a decline of 38.5% since January 1, 2006 based on our internal actuarial analysis of current and anticipated loss cost trends. This compared with the recommendation of the California Commissioner of Insurance (California Commissioner) of a 45.0% rate decline since January 1, 2006. In November 2007, the California Commissioner recommended that there be no overall change in pure premium rates for policies written on or after January 1, 2008. This was the first recommendation of no rate decrease by the California Commissioner since the adoption of the benefit reforms of 2003 and 2004. On May 9, 2008, the California Commissioner announced that stability in the workers compensation insurance marketplace had eliminated the need for an interim pure premium rate advisory.

On September 12, 2008, the California Workers Compensation Insurance Rating Bureau (WCIRB) submitted an amended filing with the California Department of Insurance (CDOI) recommending a 16.0% increase in pure premium rates effective January 1, 2009. The filing was based on insurer loss and loss adjustment expense experience valued as of March 31, 2008. According to the WCIRB, the recommended increase was primarily due to medical cost inflation and increasing loss adjustment expenses. On October 24, 2008, the California Commissioner issued a decision on the amended filing approving a 5.0% average increase in pure premium rates on new and renewal policies dated January 1, 2009. Decisions of the California Commissioner are advisory only and insurance companies may choose whether or not to adopt the loss costs. The California Commissioner has adopted the term Workers Compensation Claims Cost Benchmark to describe the overall change in pure premium rates.

The recommendation of the WCIRB does not reflect the cost impact of the proposed changes to the Permanent Disability Rating Schedule (PDRS). If the proposed changes are adopted, the WCIRB has indicated that it will amend

its recommendation to increase pure premium rates by an additional 3.7%. The WCIRB has also indicated that it will recommend that pure premium rates applicable to the unexpired portion of the 2008 policies be increased by 3.7% for the PDRS change.

Based on our most recent analysis of California loss trends, medical cost inflation and the competitive market, we have filed new rates based upon our actuarial analysis for new or renewal policies incepting on or after February 1, 2009. If the PDRS change is adopted, we will re-evaluate the adequacy of our rate level and may decide to amend our filing.

On December 19, 2007, the Nevada Commissioner of Insurance (Nevada Commissioner) announced that the National Council on Compensation Insurance (NCCI) submitted a filing for an average voluntary loss cost decrease of

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10.5% for new and renewal policies incepting on or after March 1, 2008. On February 6, 2008, the Nevada Commissioner approved the filing. The Nevada Commissioner cited decreasing claim frequency as the primary driver of the decrease, which more than offset increasing indemnity and medical costs per claim and cost of living benefit adjustments. In our last filed Nevada rate change, we adopted the approved loss costs effective for new and renewal policies incepting on or after March 1, 2008 with a revised loss cost modifier, the combination of which we expected would produce an average overall decrease of 5.0% on our rate level.

The following table sets forth our direct premiums written by state and as a percentage of total direct premiums written for the periods presented:

| State                              | Three Months Ended September 30, |                          |                 | Nine Months Ended September 30, |                  |                          | Percentage of 2007 |                |  |
|------------------------------------|----------------------------------|--------------------------|-----------------|---------------------------------|------------------|--------------------------|--------------------|----------------|--|
|                                    | 2008                             | Percentage of 2008 Total | 2007            | Percentage of 2007 Total        | 2008             | Percentage of 2008 Total | 2007               | Total          |  |
| (in thousands, except percentages) |                                  |                          |                 |                                 |                  |                          |                    |                |  |
| California                         | \$56,011                         | 74.9 %                   | \$63,526        | 71.9 %                          | \$169,496        | 74.1 %                   | \$189,018          | 70.5 %         |  |
| Nevada                             | 8,822                            | 11.8                     | 14,214          | 16.1                            | 30,187           | 13.2                     | 51,504             | 19.2           |  |
| Colorado                           | 2,428                            | 3.2                      | 3,322           | 3.8                             | 7,851            | 3.4                      | 9,433              | 3.5            |  |
| Utah                               | 1,314                            | 1.8                      | 2,145           | 2.4                             | 4,814            | 2.1                      | 6,163              | 2.3            |  |
| Idaho                              | 1,529                            | 2.1                      | 1,674           | 1.9                             | 4,700            | 2.0                      | 5,028              | 1.9            |  |
| Montana                            | 1,569                            | 2.1                      | 1,784           | 2.0                             | 3,614            | 1.6                      | 3,464              | 1.3            |  |
| Arizona                            | 1,221                            | 1.6                      | 770             | 0.9                             | 3,180            | 1.4                      | 1,823              | 0.7            |  |
| Illinois                           | 1,040                            | 1.4                      | 412             | 0.4                             | 2,634            | 1.2                      | 677                | 0.2            |  |
| Other                              | 821                              | 1.1                      | 486             | 0.6                             | 2,404            | 1.0                      | 1,083              | 0.4            |  |
| <b>Total</b>                       | <b>\$74,755</b>                  | <b>100.0 %</b>           | <b>\$88,333</b> | <b>100.0 %</b>                  | <b>\$228,880</b> | <b>100.0 %</b>           | <b>\$268,193</b>   | <b>100.0 %</b> |  |

The decline in our overall premium revenue in California and Nevada is reflective of the impact of rate reductions and increased price competition. Challenging economic conditions, evidenced by slowing or declining employment and payroll, have also affected premium revenue in certain states in which we operate other than California. The decline was partially offset by the growth in premium volume in our seven smallest states, which resulted in a nine month period over period increase of nearly 70% in direct premiums written in those seven states. We continue to operate in an increasingly competitive market. California and Nevada accounted for 87.3% of our direct premiums written for the nine months ended September 30, 2008 compared to 89.7% of our direct premiums written for the nine months ended September 30, 2007.

For the nine months ended September 30, 2008, we wrote 74.1% and 13.2% of our direct premiums written in California and Nevada, respectively. Prior to the acquisition of AmCOMP we were writing business in ten other states (Arizona, Colorado, Florida, Idaho, Illinois, Montana, Oregon, Pennsylvania, Texas and Utah) and were licensed to write business in five additional states (Georgia, Maryland, Massachusetts, New Mexico and New York). We entered into a new strategic relationship and began writing business through the Small Business Payroll Services Group of Wells Fargo Bank, National Association in August, 2008.

The number of policies in force, at the specified dates, was as follows:

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| <b>States</b> | <b>September 30, 2008</b> | <b>December 31, 2007</b> | <b>September 30, 2007</b> |
|---------------|---------------------------|--------------------------|---------------------------|
| California    | 27,615                    | 24,986                   | 24,441                    |
| Nevada        | 5,468                     | 6,147                    | 6,241                     |
| Other         | 3,019                     | 2,566                    | 2,345                     |
|               | <hr/>                     | <hr/>                    | <hr/>                     |
| Total         | 36,102                    | 33,699                   | 33,027                    |
|               | <hr/>                     | <hr/>                    | <hr/>                     |

During the nine months ended September 30, 2008, we realized an increase of 2,403 policies, or 7.1%, over the total number of policies in force at December 31, 2007. For the same nine month period, policies in California increased by 2,629, or 10.5%, and policies in states other than California and Nevada increased by 453, or 17.7%, which was offset by a decline in policies in Nevada of 679, or 11.0%.

During the 12 months ended September 30, 2008, our policies in force increased by 3,075 policies, or 9.3%, over the total number of policies in force at September 30, 2007. For the same 12 month period, policies in California increased by 3,174, or 13.0%, and policies in states other than California and Nevada increased by 674 or 28.7%, which was offset by a decline in policies in Nevada of 773, or 12.4%. We believe the decline in policy count in Nevada is a direct result of economic conditions and competitive pressures. We have not observed a similar impact on policy count in California.

On October 23, 2008, the NCCI made an amended rate filing providing for an overall average premium rate level decrease of 18.6% as ordered by the Florida Commissioner of the Office of Insurance Regulation (Florida Commissioner). In its original filing, the NCCI cited a significant drop in claims frequency and a reduction in the cost of claims as reasons for recommending a decrease. On October 28, 2008, the Florida Commissioner entered an order approving the NCCI's amended filing.

Also on October 23, 2008, the Florida Supreme Court issued a decision that has the effect of removing a measure from the state's workers' compensation insurance laws enacted in 2003, and according to the Florida Commissioner, might significantly erode cost savings. The court, in the case of *Emma Murray v. Mariners Health/ACE USA*, interpreted attorneys' fees provisions in Florida's workers' compensation statutes. The Florida Commissioner has indicated he expects the NCCI to make a new filing in support of the rate impact the NCCI believes will result from this decision. We are in the process of evaluating the impact this decision may have on our Florida book of business.

The financial statements included in this quarterly report on Form 10-Q do not include significant results from operations in Florida. Including the acquired operations of AmCOMP, approximately 10% of our business will be generated in Florida. Florida is an Administered Pricing state and rate changes adopted by the Florida Commissioner will affect the rates that we are able to charge in that state.

Rate changes have been adopted in other states in which we operate. We believe policy count in California and other states will continue to grow. However, that increase may not completely offset the decline in total premiums written. We cannot precisely determine how these trends will ultimately impact our financial position and results of operations.

### ***Expenses***

Our expenses consist of the following:

*Losses and Loss Adjustment Expenses (LAE).* Losses and LAE represent our largest expense item and include claim payments made, estimates for future claim payments and changes in those estimates for current and prior periods and costs associated with investigating, defending, and adjusting claims. The quality of our financial reporting depends in large part on accurately predicting our losses and LAE, which are inherently uncertain as they are estimates of the ultimate cost of individual claims based on actuarial estimation techniques. In states other than Nevada, we have a short operating history and must rely on a combination of industry experience and our specific experience to establish our best estimate of losses and LAE reserves. The interpretation of historical data can be impacted by external forces, principally legislative changes, economic fluctuations and legal trends. In recent years, we experienced lower losses and LAE in California than we anticipated due to factors such as regulatory reform designed to reduce loss costs in that market. As we continue to gain experience in the California market, we rely more on our own loss experience and place less reliance on industry experience.

*Commission Expense.* Commission expense includes direct commissions to our agents and brokers for the premiums that they produce for us. Also included in commission expense are incentive payments, other direct marketing costs and fees. Commission expense is net of contingent commission income related to the retroactive 100% quota share reinsurance agreement (LPT Agreement). Also, commissions paid to our agents and brokers are deferred and amortized to commission expense in our consolidated statements of income as the premiums generating these

commissions are earned. We pay commissions that we believe are competitive with other workers' compensation insurers.

*Underwriting and Other Operating Expense.* Underwriting and other operating expense includes the costs to acquire and maintain an insurance policy (excluding commissions) consisting of premium taxes and certain other general expenses that vary with, and are primarily related to, producing new or renewal business. These acquisition costs are deferred and amortized to underwriting and other operating expense in the consolidated statements of income as the related premiums are earned. Other underwriting expenses consist of policyholder dividends and general administrative expenses such as salaries and benefits, rent, office supplies, depreciation and all other operating expenses not otherwise classified separately, and fees and assessments of boards, bureaus and statistical agencies for policy service and administration items such as manuals, rating plans and experience data. Our underwriting and other operating expense is

a reflection of our operating efficiency in producing, underwriting and administering our business. Over recent periods, our underwriting and other operating expense has remained relatively flat in the face of increasing policy volume. We continue to pursue technological improvements that will, over time, reduce transaction costs and support future profitable growth.



**Results of Operations****Three Months Ended September 30, 2008 and 2007**

The following table summarizes our consolidated financial results for the three months ended September 30, 2008 and 2007:

|  | <b>2008</b>     | <b>2007</b>     | <b>Increase<br/>(Decrease)<br/>2008 over<br/>2007</b> | <b>Percentage<br/>Increase<br/>(Decrease)<br/>2008 over<br/>2007</b> |
|--|-----------------|-----------------|---|--|
| (in thousands, except for percentages)                   |                 |                 |   |  |
| <b>Selected Financial Data:</b>                          |                 |                 |   |  |
| Gross premiums written                                   | \$75,092        | \$90,265        | \$(15,173 )   | (16.8 )%   |
| Net premiums written                                     | 72,311          | 87,319          | (15,008 )   | (17.2 )  |
| Net premiums earned                                      | \$73,131        | \$88,527        | \$(15,396 )   | (17.4 )%   |
| Net investment income                                    | 18,474          | 19,246          | (772 )  | (4.0 )   |
| Realized (losses) gains on investments, net              | (1,504 )        | 146             | (1,650 )  | n/a  |
| Other income   | 295             | 861             | (566 )  | (65.7 )  |
| <b>Total revenues</b>                                    | <b>90,396</b>   | <b>108,780</b>  | <b>(18,384 )</b>                                      | <b>(16.9 )</b>   |
| Losses and LAE   | 25,588          | 40,867          | (15,279 )   | (37.4 )  |
| Commission expense                                       | 10,121          | 12,411          | (2,290 )  | (18.5 )  |
| Underwriting and other operating expense                 | 21,907          | 21,726          | 181   | 0.8  |
| Income tax (benefit) expense                             | (289 )          | 3,896           | (4,185 )  | n/a  |
| <b>Total expenses</b>                                    | <b>57,327</b>   | <b>78,900</b>   | <b>(21,573 )</b>                                      | <b>(27.3 )</b>   |
| <b>Net income</b>  | <b>\$33,069</b> | <b>\$29,880</b> | <b>\$3,189</b>  | <b>10.7 %</b>  |
| <b>Selected Operating Data:</b>                          |                 |                 |   |  |
| Combined ratio <sup>(1)</sup>                            | 78.8            | % 84.7          | % (5.9 )%   | n/a  |
| Net income before impact of LPT Agreement <sup>(2)</sup> | \$28,520        | \$25,323        | \$3,197   | 12.6 %   |

(1) The combined ratio is calculated by dividing the sum of losses and LAE, commission expense and underwriting and other operating expense by net premiums earned.

(2) We define net income before impact of LPT Agreement as net income less: (a) amortization of deferred reinsurance gain LPT Agreement and (b) adjustments to LPT Agreement ceded reserves. Deferred reinsurance gain LPT Agreement reflects the unamortized gain from our LPT Agreement. Under GAAP, this gain is deferred and is being amortized using the recovery method, whereby the amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries, and the amortization is reflected in losses and LAE. We periodically reevaluate the remaining direct reserves subject to the LPT Agreement. Our reevaluation results in corresponding adjustments, if needed, to reserves, ceded reserves, reinsurance recoverables and the deferred reinsurance gain, with the net effect being an increase or decrease, as the case may be, to net income. Net income before impact of LPT Agreement is not a measurement of financial performance under GAAP and should not be considered in isolation or as an alternative to net income before income taxes and net income or any other measure of performance derived in accordance with GAAP.

We present net income before impact of LPT Agreement because we believe that it is an important supplemental measure of operating performance to be used by analysts, investors and other interested parties in evaluating us. The LPT Agreement was a non-recurring transaction which does not result in ongoing cash benefits, and, consequently, we believe this presentation is useful in providing a meaningful understanding of our operating performance. In addition, we believe this non-GAAP measure, as we have defined it, is helpful to our management in identifying trends in our performance because the excluded item has limited significance in our current and ongoing operations.

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The table below shows the reconciliation of net income to net income before impact of LPT Agreement for the three months ended:

|   | <b>September 30,</b> |                 |
|---|----------------------|-----------------|
|   | <b>2008</b>          | <b>2007</b>     |
|   | (in thousands)       |                 |
| Net income  | \$33,069             | \$29,880        |
| Less impact of LPT Agreement:                             |                      |                 |
| Amortization of deferred reinsurance gain LPT Agreement   | 4,549                | 4,557           |
| Adjustment to LPT Agreement ceded reserves <sup>(a)</sup> |                      |                 |
|   | <hr/>                | <hr/>           |
| Net income before impact of LPT Agreement                 | <b>\$28,520</b>      | <b>\$25,323</b> |
|   | <hr/>                | <hr/>           |

(a) Any adjustment to the estimated direct reserves ceded under the LPT Agreement is reflected in losses and LAE for the period during which the adjustment is determined, with a corresponding increase or decrease in net income in the period. There is a corresponding change to the reinsurance recoverables on unpaid losses as well as the deferred reinsurance gain. A cumulative adjustment to the amortization of the deferred gain is also then recognized in earnings so that the deferred reinsurance gain reflects the balance that would have existed had the revised reserves been recognized at the inception of the LPT Agreement. See Note 6 in the notes to our consolidated financial statements which are included elsewhere in this report.

*Gross Premiums Written.* Gross premiums written decreased \$15.2 million, or 16.8%, to \$75.1 million for the three months ended September 30, 2008, from \$90.3 million for the three months ended September 30, 2007. The decrease in gross premiums written was primarily due to the overall reduction in our average policy size as a result of the impacts of rate reductions, the effects of increased competition and changes in economic and business conditions. Compared to the third quarter of 2007, the average rate level of premiums written during the third quarter of 2008 was 7.8% lower in California due to rate decreases in January 2007 of 9.9% and September 2007 of 4.5%. The average overall in force policy premium at September 30, 2008 decreased to \$8,006, or 22.2%, from \$10,296 at September 30, 2007. Total policy count, however, has increased 9.3% from September 30, 2007, mainly in California, lessening the impact of the change in policy size. The policy count increase was primarily attributable to sales and marketing efforts in our California market. The number of in force policies in California increased 13.0%, or 3,174 from September 30, 2007.

*Net Premiums Written.* Net premiums written decreased \$15.0 million, or 17.2%, to \$72.3 million for the three months ended September 30, 2008, from \$87.3 million for the three months ended September 30, 2007. The decrease was primarily attributable to a \$15.2 million decrease in gross premiums written. Ceded premiums were \$2.8 million and \$2.9 million, or 3.7% and 3.3%, of gross premiums written for the three months ended September 30, 2008 and September 30, 2007, respectively.

*Net Premiums Earned.* Net premiums earned decreased \$15.4 million, or 17.4%, to \$73.1 million for the three months ended September 30, 2008, from \$88.5 million for the three months ended September 30, 2007. The decrease in net premiums earned was primarily the result of the decrease in net premiums written.

*Net Investment Income.* Net investment income decreased \$0.7 million, or 4.0%, to \$18.5 million for the three months ended September 30, 2008, from \$19.2 million for the three months ended September 30, 2007. The decrease in investment income was primarily attributable to a decrease in investment yield which was partially offset by income earned on increased invested assets. The average pre-tax book yield on invested assets decreased approximately \$1.5 million, or 33 basis points, to 3.98% at September 30, 2008, as compared to 4.31% at September 30, 2007, due to an

increase in short-term investments and cash and cash equivalents.

*Realized (Losses) Gains on Investments.* Realized losses on investments for the three months ended September 30, 2008, totaled \$1.5 million as compared to realized gains of \$0.1 million for the three months ended September 30, 2007. The increase was the result of other-than-temporary impairments on equity and fixed maturity securities of \$3.8 million for the three months ended September 30, 2008. The other-than-temporary impairments were primarily due to the decline in the fair value of equity securities and one fixed maturity security. These losses were partially offset by net gains of \$2.3 million realized on the sale of equity securities.

*Losses and LAE.* Losses and LAE decreased \$15.3 million, or 37.4%, to \$25.6 million for the three months ended September 30, 2008, from \$40.9 million for the three months ended September 30, 2007. The decrease was primarily due to favorable prior accident year loss development of \$25.0 million for the three months ended September 30, 2008, compared with \$7.4 million for the three months ended September 30, 2007. The third quarter 2007 development also included an increase to net losses of \$1.6 million related to a commutation of excess loss reinsurance agreements with GLOBAL Reinsurance Corporation of America. The quarter over quarter change in net premiums earned reduced losses

and LAE by approximately \$9.2 million. These reductions were partially offset by an increase to the current year loss estimate.

During the three months ended September 30, 2008, we adjusted the current accident year loss estimate 4.5 percentage points from 61.7% for the six months ended June 30, 2008 to 66.2% for the nine months ended September 30, 2008.

The table below reflects the losses and LAE reserve adjustments for the three months ended:

|   | <b>September 30,</b> |             |
|---|----------------------|-------------|
|   | <b>2008</b>          | <b>2007</b> |
|   | (in millions)        |             |
| Prior accident year favorable development, net    | \$25.0               | \$7.4       |
| LPT reserve favorable change                      | \$                   | \$          |
| LPT amortization of the deferred reinsurance gain | \$4.5                | \$4.6       |

There was no adjustment in either period to the direct reserves subject to the LPT Agreement. Losses and LAE include amortization of deferred reinsurance gain LPT Agreement of \$4.5 million and \$4.6 million for each of the three month periods ended September 30, 2008 and 2007, respectively. Excluding the impact from the LPT Agreement, losses and LAE would have been \$30.1 million and \$45.5 million, or 41.2% and 51.4%, of net premiums earned for the three months ended September 30, 2008 and 2007, respectively.

*Commission Expense.* Commission expense decreased \$2.3 million, or 18.5%, to \$10.1 million for the three months ended September 30, 2008, from \$12.4 million for the three months ended September 30, 2007. Commission expense was 13.8% and 14.0% of net premiums earned for the three months ended September 30, 2008 and 2007, respectively. The reduction in commission expense was due to a decrease in net premiums earned and agency incentive commissions.

*Underwriting and Other Operating Expense.* Underwriting and other operating expense increased \$0.2 million, or 0.8%, to \$21.9 million for the three months ended September 30, 2008, from \$21.7 million for the three months ended September 30, 2007. There were no significant changes to underwriting and other operating expense quarter over quarter.

*Income Taxes.* Income taxes decreased \$4.2 million, resulting in a net tax benefit of \$0.3 million for the three months ended September 30, 2008, which compares to \$3.9 million in expense for the three months ended September 30, 2007. The decrease in income taxes was primarily due to a change of \$4.8 million in the final reversal of the liability for previously unrecognized tax benefits. The effective tax rate for the three months ended September 30, 2008, was a tax benefit rate of 0.9% compared to a tax rate of 11.5% for the same period in 2007. The decrease of 12.4 percentage points in the effective tax rate was primarily due to the reversal of the liability, including interest.

*Net Income.* Net income increased \$3.2 million, or 10.7%, to \$33.1 million for the three months ended September 30, 2008, from \$29.9 million for the three months ended September 30, 2007. The increase in net income was primarily due to favorable prior accident year loss development of \$25.0 million for the three months ended September 30, 2008, compared with \$7.4 million for the three months ended September 30, 2007 and the reversal of the tax liability. This was partially offset by lower net premiums earned and related expenses.

Net income includes amortization of deferred reinsurance gain LPT Agreement of \$4.5 million and \$4.6 million for the three month periods ended September 30, 2008 and 2007, respectively. Excluding the LPT Agreement amortization, net income would have been \$28.5 million and \$25.3 million for the three months ended September 30, 2008 and

2007, respectively.

*Combined Ratio.* The combined ratio improved 5.9 percentage points, to 78.8%, for the three months ended September 30, 2008, from 84.7% for the three months ended September 30, 2007. As a percentage of net premiums earned, reductions in losses and LAE related to prior year favorable loss adjustments more than offset increases in the underwriting and other operating expense ratio.

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**Results of Operations****Nine Months Ended September 30, 2008 and 2007**

The following table summarizes our consolidated financial results for the nine months ended September 30, 2008 and 2007:

|  | <b>2008</b>      | <b>2007</b>      | <b>Increase<br/>(Decrease)<br/>2008 over<br/>2007</b> | <b>Percentage<br/>Increase<br/>(Decrease)<br/>2008 over<br/>2007</b> |
|--|------------------|------------------|---|--|
| (in thousands, except for percentages)                   |                  |                  |   |  |
| <b>Selected Financial Data:</b>                          |                  |                  |   |  |
| Gross premiums written                                   | \$ 229,918       | \$ 271,312       | \$(41,394 )   | (15.3 )%   |
| Net premiums written                                     | 221,804          | 262,032          | (40,228 )   | (15.4 )  |
| Net premiums earned                                      | \$ 222,842       | \$ 262,436       | \$(39,594 )   | (15.1 )%   |
| Net investment income                                    | 55,915           | 59,386           | (3,471 )  | (5.8 )   |
| Realized losses on investments, net                      | (3,211 )         | (322 )           | (2,889 )  | n/a  |
| Other income   | 1,155            | 3,047            | (1,892 )  | (62.1 )  |
| <b>Total revenues</b>                                    | <b>276,701</b>   | <b>324,547</b>   | <b>(47,846 )</b>                                      | <b>(14.7 )</b>   |
| Losses and LAE   | 80,344           | 111,336          | (30,992 )   | (27.8 )  |
| Commission expense                                       | 30,465           | 35,797           | (5,332 )  | (14.9 )  |
| Underwriting and other operating expense                 | 66,614           | 67,778           | (1,164 )  | (1.7 )   |
| Income tax expense                                       | 13,349           | 21,117           | (7,768 )  | (36.8 )  |
| <b>Total expenses</b>                                    | <b>190,772</b>   | <b>236,028</b>   | <b>(45,256 )</b>                                      | <b>(19.2 )</b>   |
| <b>Net income</b>  | <b>\$ 85,929</b> | <b>\$ 88,519</b> | <b>\$(2,590 )</b>                                     | <b>(2.9 )%</b>   |
| <b>Selected Operating Data:</b>                          |                  |                  |   |  |
| Combined ratio <sup>(1)</sup>                            | 79.6             | % 81.9           | % (2.3 )%   | n/a  |
| Net income before impact of LPT Agreement <sup>(2)</sup> | \$ 72,021        | \$ 74,825        | \$(2,804 )  | (3.7 )%  |

(1) The combined ratio is calculated by dividing the sum of losses and LAE, commission expense and underwriting and other operating expense by net premiums earned.

(2) We define net income before impact of LPT Agreement as net income less: (a) amortization of deferred reinsurance gain LPT Agreement and (b) adjustments to LPT Agreement ceded reserves. Deferred reinsurance gain LPT Agreement reflects the unamortized gain from our LPT Agreement. Under GAAP, this gain is deferred and is being amortized using the recovery method, whereby the amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries, and the amortization is reflected in losses and LAE. We periodically reevaluate the remaining direct reserves subject to the LPT Agreement. Our reevaluation results in corresponding adjustments, if needed, to reserves, ceded reserves, reinsurance recoverables and the deferred reinsurance gain, with the net effect being an increase or decrease, as the case may be, to net income. Net income before impact of LPT Agreement is not a measurement of financial performance under GAAP and should not be considered in isolation or as an alternative to net income before income taxes and net income or any other measure of performance derived in accordance with GAAP.

We present net income before impact of LPT Agreement because we believe that it is an important supplemental measure of operating performance to be used by analysts, investors and other interested parties in evaluating us. The LPT Agreement was a non-recurring transaction which does not result in ongoing cash benefits, and, consequently, we believe this presentation is useful in providing a meaningful understanding of our operating performance. In addition, we believe this non-GAAP measure, as we have defined it, is helpful to our management in identifying trends in our performance because the excluded item has limited significance in our current and ongoing operations.



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The table below shows the reconciliation of net income to net income before impact of LPT Agreement for the nine months ended:

|   | <b>September 30,<br/>2008</b> | <b>2007</b> |
|---|-------------------------------|-------------|
|   | (in thousands)                |             |
| Net income  | \$85,929                      | \$88,519    |
| Less impact of LPT Agreement:                             |                               |             |
| Amortization of deferred reinsurance gain LPT Agreement   | 13,908                        | 13,694      |
| Adjustment to LPT Agreement ceded reserves <sup>(a)</sup> |                               |             |
|   | <hr/>                         | <hr/>       |
| Net income before impact of LPT Agreement                 | \$72,021                      | \$74,825    |
|   | <hr/>                         | <hr/>       |

(a) Any adjustment to the estimated direct reserves ceded under the LPT Agreement is reflected in losses and LAE for the period during which the adjustment is determined, with a corresponding increase or decrease in net income in the period. There is a corresponding change to the reinsurance recoverables on unpaid losses as well as the deferred reinsurance gain. A cumulative adjustment to the amortization of the deferred gain is also then recognized in earnings so that the deferred reinsurance gain reflects the balance that would have existed had the revised reserves been recognized at the inception of the LPT Agreement. See Note 6 in the notes to our consolidated financial statements which are included elsewhere in this report.

*Gross Premiums Written.* Gross premiums written decreased \$41.4 million, or 15.3%, to \$229.9 million for the nine months ended September 30, 2008, from \$271.3 million for the nine months ended September 30, 2007. The decrease in gross premiums written was primarily due to the overall reduction in our average policy size as a result of the impacts of rate reductions, the effects of increased competition and changes in economic and business conditions. Compared to the first nine months of 2007, the average rate level of premiums written during the first nine months of 2008 was 11.9% lower in California due to rate decreases in April 2006 of 10.5%, July 2006 of 12.7%, January 2007 of 9.9% and September 2007 of 4.5%. The average overall in force policy premium at September 30, 2008 decreased to \$8,006, or 22.2%, from \$10,296 at September 30, 2007. The policy count, however, has increased 9.3% from September 30, 2007, mainly in California, lessening the impact of the change in policy size. The policy count increase was primarily attributable to sales and marketing efforts in our California market. The number of in force policies in California increased 13.0%, or 3,174 from September 30, 2007.

*Net Premiums Written.* Net premiums written decreased \$40.2 million, or 15.4%, to \$221.8 million for the nine months ended September 30, 2008, from \$262.0 million for the nine months ended September 30, 2007. The decrease was primarily attributable to a \$41.4 million decrease in gross premiums written. Ceded premiums were \$8.1 million and \$9.3 million, or 3.5% and 3.4%, of gross premiums written for the nine months ended September 30, 2008 and 2007, respectively.

*Net Premiums Earned.* Net premiums earned decreased \$39.6 million, or 15.1%, to \$222.8 million for the nine months ended September 30, 2008, from \$262.4 million for the nine months ended September 30, 2007. The decrease in net premiums earned was primarily the result of the decrease in net premiums written.

*Net Investment Income.* Net investment income decreased \$3.5 million, or 5.8%, to \$55.9 million for the nine months ended September 30, 2008, from \$59.4 million for the nine months ended September 30, 2007. The decrease was primarily attributable to one-time interest income from the net proceeds of our IPO, a decrease in investment yield as well as a slight decrease in the underlying invested assets. The net proceeds from the IPO generated \$1.8 million of interest income prior to distribution to eligible members in 2007. The average pre-tax book yield on invested assets

decreased approximately \$1.5 million, or approximately 10 basis points, to 4.04% at September 30, 2008, from 4.14% at September 30, 2007, due to an increase in short-term investments and cash and cash equivalents.

*Realized Losses on Investments.* Realized losses on investments for the nine months ended September 30, 2008, totaled \$3.2 million compared to \$0.3 million for the nine months ended September 30, 2007. The increase was the result of other-than-temporary impairments on equity and fixed maturity securities of \$5.5 million for the nine months ended September 30, 2008. The other-than-temporary impairments were primarily due to the decline in the fair value of equity securities and one fixed maturity security. These losses were partially offset by net gains of \$2.3 million realized on the sale of equity securities.

*Losses and LAE.* Losses and LAE decreased \$31.0 million, or 27.8%, to \$80.3 million for the nine months ended September 30, 2008, from \$111.3 million for the nine months ended September 30, 2007. The decrease was primarily due to the period over period change in net premiums earned which reduced losses and LAE by approximately \$25.4 million. Additionally, favorable prior accident year loss development was \$53.3 million for the nine months ended

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September 30, 2008, compared with \$43.4 million for the nine months ended September 30, 2007. The offsetting increase of \$4.3 million was primarily related to an increase in the current year loss estimate.

Our current year loss estimate was 66.2% for the nine months ended September 30, 2008, as compared with 64.2% for the nine months ended September 30, 2007.

The table below reflects the losses and LAE reserve adjustments for the nine months ended:

|   | <b>September 30,<br/>2008</b> | <b>2007</b> |
|---|-------------------------------|-------------|
|   | (in millions)                 |             |
| Prior accident year favorable development, net    | \$53.3                        | \$43.4      |
| LPT reserve favorable change                      | \$                            | \$          |
| LPT amortization of the deferred reinsurance gain | \$13.9                        | \$13.7      |

There was no adjustment in either period to the direct reserves subject to the LPT Agreement. Losses and LAE include amortization of deferred reinsurance gain LPT Agreement of \$13.9 million and \$13.7 million for the nine months ended September 30, 2008 and 2007, respectively. Excluding the impact from the LPT Agreement, losses and LAE would have been \$94.2 million and \$125.0 million, or 42.3% and 47.6%, of net premiums earned for the nine months ended September 30, 2008 and 2007, respectively.

*Commission Expense.* Commission expense decreased \$5.3 million, or 14.9%, to \$30.5 million for the nine months ended September 30, 2008, from \$35.8 million for the nine months ended September 30, 2007. Commission expense was 13.7% and 13.6% of net premiums earned for the nine months ended September 30, 2008 and 2007, respectively. The decrease in commission expense was primarily due to the decrease in net premiums earned.

*Underwriting and Other Operating Expense.* Underwriting and other operating expense decreased \$1.2 million, or 1.7%, to \$66.6 million for the nine months ended September 30, 2008, from \$67.8 million for the nine months ended September 30, 2007. Premium taxes declined \$2.0 million as a result of lower net premiums earned. There was a reduction of \$2.8 million in one-time consulting and professional fees related to Sarbanes-Oxley Act compliance and the conversion from a mutual insurance holding company to a stock company in 2007. Additionally, there was a \$1.6 million decrease in the allowance for bad debts. These decreases were partially offset by an increase of \$3.8 million in salaries and related benefits. Salary and benefit increases included annual salary increases, higher benefit costs for medical coverage and expenses related to the equity and incentive plans.

*Income Taxes.* Income taxes decreased \$7.8 million, or 36.8%, to \$13.3 million for the nine months ended September 30, 2008, from \$21.1 million for the nine months ended September 30, 2007. The decrease in income taxes was primarily due to a change of \$4.8 million for the final reversal of the liability for previously unrecognized tax benefits including interest. The effective tax rate for the nine months ended September 30, 2008, was 13.4% compared to 19.3% for the same period in 2007. The decrease of 5.9 percentage points in the effective tax rate was primarily due to the reversal of the liability.

*Net Income.* Net income decreased \$2.6 million, or 2.9%, to \$85.9 million for the nine months ended September 30, 2008, from \$88.5 million for the nine months ended September 30, 2007. The decrease in net income was primarily due to reductions in net premiums earned and investment income, partially offset by reduced losses and LAE and income taxes as a result of the reversal of the tax liability.

Net income includes amortization of deferred reinsurance gain LPT Agreement of \$13.9 million and \$13.7 million for the nine months ended September 30, 2008 and 2007, respectively. Excluding the LPT Agreement amortization, net

income would have been \$72.0 million and \$74.8 million for the nine months ended September 30, 2008 and 2007, respectively.

*Combined Ratio.* The combined ratio improved by 2.3 percentage points for the nine months ended September 30, 2008, to 79.6% compared to 81.9% for the nine months ended September 30, 2007. As a percentage of net premiums earned, reductions in losses and LAE related to prior year favorable loss adjustments more than offset increases in the underwriting and other operating expense ratio.

## Liquidity and Capital Resources

*Parent Company.* We are a holding company and substantially all of our operations have historically been conducted through our insurance subsidiaries, EICN and ECIC. On October 31, 2008, we completed the acquisition of AmCOMP and, as a result, added two new insurance subsidiaries: EPIC and EAC. Dividends to EHI from our insurance subsidiaries are contingent upon our subsidiaries' earnings and subject to business considerations and regulatory requirements. The primary uses of cash are to pay stockholder dividends, repurchase common stock, and support general operating expenses.

EICN received approval from the Nevada Commissioner on December 18, 2007, for a \$200.0 million extraordinary dividend from EICN special surplus to be paid in 2008. On May 15, 2008, EICN requested and received approval from the Nevada Commissioner to increase the \$200.0 million extraordinary dividend to \$275.0 million subject to maintaining the risk-based capital (RBC) total adjusted capital of EICN above a specified level on the date of payment after giving effect to such payment. On August 18, 2008, EICN requested and received approval from the Nevada Commissioner to increase the extraordinary dividend from \$275.0 million to a total of \$355.0 million subject to the same terms and conditions. The additional extraordinary dividend provides capital management flexibility. As of September 30, 2008, \$297.0 million in extraordinary dividend had been paid to EHI.

Effective September 30, 2008, EHI and Wells Fargo entered into the Amended Credit Facility. The Amended Credit Facility provides EHI with (a) \$150.0 million line of credit through December 31, 2009; (b) \$100.0 million line of credit from January 1, 2010 through December 31, 2010; and (c) \$50.0 million line of credit from January 1, 2011 through March 26, 2011. Amounts outstanding bear interest at a rate equal to, at our option: (a) a fluctuating rate of 1.25% above Wells Fargo's prime rate or (b) a fixed rate that is 1.25% above the LIBOR rate then in effect. The Amended Credit Facility is secured by fixed maturity securities that had a fair value of \$186.7 million at September 30, 2008. The Amended Credit Facility contains customary non-financial covenants and requires EHI to maintain \$7.5 million of cash and cash equivalents at all times. We are currently in compliance with all applicable covenants.

On September 30, 2008, EHI borrowed \$150.0 million of funds through the line of credit provided by the Amended Credit Facility to facilitate the acquisition of AmCOMP and for general corporate purposes. In connection with the borrowing, EHI and Wells Fargo entered into an interest rate swap agreement providing that \$100.0 million of the amount borrowed will bear interest at approximately 4.9% per annum. The remaining \$50.0 million will bear interest at a fluctuating rate based on LIBOR plus 1.25%. Previously, EHI had no amounts outstanding under the Amended Credit Facility.

On October 31, 2008, EHI assumed control of a Loan and Security Agreement (Loan Agreement) previously entered into by AmCOMP and Regions Bank on May 23, 2008. The Loan Agreement provides for term loans of up to \$30.0 million in aggregate principal amount to be made by Regions Bank to AmCOMP at any time until May 23, 2010. The scheduled maturity date of any borrowings under the Loan Agreement is May 23, 2017. Proceeds under the Loan Agreement may be used for strategic and general corporate purposes. Amounts outstanding under the Loan Agreement bear interest at a fluctuating rate based on LIBOR plus 1.60%. The obligations under the Loan Agreement are secured by a pledge of the stock of EPIC and by a pledge of certain surplus notes issued by each of EPIC and EAC. The Loan Agreement contains financial covenants relating to the insurance subsidiaries' ratio of net written premiums to policyholders' surplus and combined ratio as well as customary representations, warranties and affirmative and negative covenants. Our obligations under the Loan Agreement are guaranteed by our non-insurance subsidiaries, AmSERV, Inc., Pinnacle Benefits, Inc. and Pinnacle Administrative Company. We have no amounts borrowed under the Loan Agreement and are currently in compliance with all applicable covenants.

Historically, we have met our cash requirements and financed our growth principally from underwriting operations, asset maturities, and investment income. The recent acquisition of AmCOMP was funded through a combination of available cash and funds provided by the Amended Credit Facility.

On February 21, 2008, EHI's Board of Directors authorized a stock repurchase program (the 2008 Program). The 2008 Program authorizes us to repurchase up to \$100 million of our common stock through June 30, 2009. We expect the shares to be repurchased from time to time at prevailing market prices in open market or private transactions, in accordance with applicable laws and regulations, and subject to market conditions and other factors. The repurchases may be commenced or suspended from time to time without prior notice. There can be no assurance that we will continue to undertake any repurchase of our common stock pursuant to the 2008 Program. Through September 30, 2008, we have repurchased 786,795 shares of common stock, at the average price paid including commissions of \$17.99 per share, for a total of approximately \$14.2 million.

On November 6, 2008, the Board of Directors declared a \$0.06 dividend per share, payable December 4, 2008, to stockholders of record on November 20, 2008.

*Operating Subsidiaries.* The primary sources of cash for our insurance operating subsidiaries, are funds generated from underwriting operations, asset maturities and income received from investments. We use trend and variance analyses to project future cash needs at both the consolidated and subsidiary levels. Cash provided from these sources has historically been used primarily for claims and loss adjustment expense payments and operating expenses. In the future, we also expect to have sufficient cash from these sources for the payment of dividends to parent holding companies to the extent permitted by law.

Our net cash flows are generally invested in marketable securities. We closely monitor the duration of our investments and investment purchases, and sales are executed with the objective of having adequate funds available for the payment of claims at the subsidiary level and for the subsidiaries to pay dividends to EHI. Because our investment strategy focuses on asset and liability durations, and not on cash flows, asset sales may be required to satisfy obligations or rebalance asset portfolios. At September 30, 2008, 95.2% of our investment portfolio consisted of fixed maturity and short-term investments, and 4.8% consisted of equity securities.

The ongoing availability of cash to pay claims is dependent upon our disciplined underwriting and pricing standards and the purchase of reinsurance to protect us against severe losses and catastrophic events. On July 1, 2008, we entered into a new reinsurance treaty program (Reinsurance Program) that is effective through July 1, 2009. The Reinsurance Program consists of three contracts, one excess of loss treaty agreement and two catastrophic loss treaty agreements. The Reinsurance Program provides coverage up to \$200.0 million per loss occurrence, subject to certain exclusions. Our loss retention for the treaty year beginning July 1, 2008, is \$5.0 million. The coverage is subject to an aggregate loss in the first layer (\$5.0 million in excess of our \$5.0 million retention) of \$20.0 million and is limited to \$10.0 million for any loss to a single individual involving the second through fifth layers of our Reinsurance Program. In our catastrophe excess of loss contracts we have one mandatory reinstatement for each contract and layer. Effective November 1, 2008, our newly acquired insurance subsidiaries are included in our Reinsurance Program. We continue to believe, with the acquisition of AmCOMP, that our Reinsurance Program meets our needs and that we are sufficiently capitalized for the above described retention.

As of September 30, 2008, on a consolidated basis, we had cash, short-term investments and fixed maturity securities that will mature over the next 24 months, of approximately \$615.9 million. We used approximately \$188.4 million of available cash to fund the acquisition of AmCOMP. We believe that our liquidity needs over the next 24 months, including the integration of AmCOMP, the payment of future stockholder dividends, stock repurchases and other capital expenditures will be met from the above sources.

### ***Cash Flows***

We monitor cash flows at both the consolidated and subsidiary levels and project future cash needs using trend and variance analyses.

The table below shows our net cash flows for the nine months ended:

|   | <b>September 30,</b> |             |
|---|----------------------|-------------|
|   | <b>2008</b>          | <b>2007</b> |
|   | (in thousands)       |             |
| <b>Cash and cash equivalents provided by (used in):</b> |                      |             |
| Operating activities                                    | \$55,195             | \$82,436    |
| Investing activities                                    | (19,705 )            | (19,346 )   |

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|                                       |                  |                  |
|---------------------------------------|------------------|------------------|
| Financing activities                  | <u>126,600</u>   | <u>(49,906 )</u> |
| Increase in cash and cash equivalents | <u>\$162,090</u> | <u>\$13,184</u>  |

Net cash provided by operating activities was \$55.2 million for the nine months ended September 30, 2008, as compared to \$82.4 million for the same period in 2007. The \$27.2 million decrease in net cash flow from operations for the nine months ended September 30, 2008, compared to the same period in 2007, was due to: (a) a decrease of \$35.2 million in net premiums received; (b) an increase of \$11.6 million in losses and LAE paid; and (c) offsetting decreases of \$9.4 million in underwriting and other operating expenses paid and \$11.4 million in income taxes paid. The decrease in



underwriting and other operating expenses paid was related to one-time incurred expenses paid for consulting and professional fees for the conversion from a mutual insurance holding company to a stock company in 2007. In 2007, income tax payments included amounts related to a prior year realized gain of \$42.9 million that resulted from the sale of \$169.2 million of equity securities in the fourth quarter 2006.

Net cash used by investing activities was \$19.7 million for the nine months ended September 30, 2008, as compared to \$19.3 million for the same period in 2007. Cash used by investing activities remained relatively unchanged as proceeds from sales and maturities of securities were reinvested.

Net cash provided by financing activities was \$126.6 million for the nine months ended September 30, 2008, as compared to net cash used of \$49.9 million for the same period in 2007. In 2008, the cash was primarily provided by proceeds from our Amended Credit Facility in the amount of \$150.0 million. In 2007, the cash used by financing activities was primarily related to the 2007 stock repurchase program that was partially offset by cash provided by our conversion from a mutual insurance holding company to a stock company.

### ***Investments***

We employ an investment strategy that emphasizes asset quality and the matching of maturities of fixed maturity securities against anticipated claim payments and expenditures, other liabilities and capital needs. Our investment portfolio is structured so that investments mature periodically over time in reasonable relation to current expectations of future claim payments. Currently, we make claim payments from positive cash flow from operations and use excess cash to invest in operations, invest in marketable securities, return capital to our stockholders and fund our growth strategy.

At September 30, 2008, our investment portfolio, which is classified as available-for-sale, was made up almost entirely of investment grade fixed maturity securities whose fair values may fluctuate due to interest rate changes. We strive to limit interest rate risk by managing the duration of our fixed maturity securities. As of September 30, 2008, our fixed maturity securities (excluding cash and cash equivalents) had a duration of 5.44. The duration reflects additional short-term investments held for the acquisition of AmCOMP. To minimize interest rate risk, our portfolio is weighted toward short-term and intermediate-term bonds; however, our investment strategy balances consideration of duration, yield and credit risk. Our current investment guidelines require that the minimum weighted average quality of our fixed maturity securities portfolio shall be AA. As of September 30, 2008, our fixed maturity securities portfolio had an average quality of AA+, with approximately 86.5% of the carrying value of our investment portfolio rated AA or better. Our investment portfolio is comprised of less than 0.02% of subprime mortgage debt securities or derivative securities relating thereto. Agency backed mortgage pass-throughs totaled \$167.5 million, or 10.2%, of the total portfolio.

We carry our portfolio of equity securities on our balance sheet at fair value. In order to minimize our exposure to equity price risk and the resulting increases and decreases to our assets, we invest primarily in equity securities of mid-to-large capitalization issuers and seek to diversify our equity holdings across several industry sectors.

Our overall investment philosophy is to maximize total investment returns within the constraints of prudent portfolio risk. We employ Conning Asset Management (Conning) to act as our independent investment advisor. Conning follows our written investment guidelines based upon strategies approved by the EHI Board of Directors. In addition to the construction and management of the portfolio, we utilize the investment advisory services of Conning. These services include investment accounting and company modeling using Dynamic Financial Analysis (DFA). The DFA tool is utilized in developing a tailored set of portfolio targets and objectives that are used in constructing an optimal portfolio.



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The following table shows the fair values of various categories of invested assets, the percentage of the total fair value of our invested assets represented by each category and the tax equivalent yield based on the fair value of each category of invested assets as of September 30, 2008:

| Category                              | Fair<br>Value                      | Percentage<br>of<br>Total | Yield |   |
|---------------------------------------|------------------------------------|---------------------------|-------|---|
|                                       | (in thousands, except percentages) |                           |       |   |
| U.S. Treasury securities              | \$ 149,506                         | 9.1                       | % 4.4 | % |
| U.S. Agency securities                | 150,922                            | 9.2                       | 4.6   |   |
| Tax-exempt municipal securities       | 850,076                            | 51.5                      | 5.8   |   |
| Corporate securities                  | 187,912                            | 11.4                      | 5.0   |   |
| Mortgage-backed securities            | 172,916                            | 10.5                      | 5.5   |   |
| Commercial mortgage-backed securities | 40,453                             | 2.4                       | 5.1   |   |
| Asset-backed securities               | 18,807                             | 1.1                       | 4.9   |   |
| Equities securities                   | 79,452                             | 4.8                       |       |   |
|                                       | <hr/>                              | <hr/>                     |       |   |
| Total                                 | \$ 1,650,044                       | 100.0                     | %     |   |
|                                       | <hr/>                              | <hr/>                     |       |   |

Weighted average yield 5.33

We regularly monitor our portfolio to preserve principal values whenever possible. All securities in an unrealized loss position are reviewed to determine whether the impairment is other-than-temporary. Factors considered in determining whether a decline is considered to be other-than-temporary include the length of time and the extent to which fair value has been below cost, the financial condition and near-term prospects of the issuer, and our ability and intent to hold the security until its expected recovery or maturity. For the nine months ended September 30, 2008, we recognized an impairment of \$5.5 million in the fair values of fixed maturity and equity securities in our investment portfolio. The impairment was recognized as a result of the severity and duration of the decline in market value of these securities. We believe that we have appropriately identified other-than-temporary declines in the fair values of our remaining unrealized losses at September 30, 2008. We have the ability and intent to hold fixed maturity and equity securities with unrealized losses for a sufficient amount of time to allow them to recover their value or reach maturity.

The cost or amortized cost, gross unrealized gains, gross unrealized losses and estimated fair value of our investments at September 30, 2008, were as follows:

|                                   | Cost or<br>Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|-----------------------------------|------------------------------|------------------------------|-------------------------------|----------------------------|
|                                   | (in thousands)               |                              |                               |                            |
| U.S. government                   | \$255,207                    | \$10,615                     | \$(12 )                       | \$265,810                  |
| All other governments             | 629                          | 10                           |                               | 639                        |
| States and political subdivisions | 540,200                      | 2,330                        | (17,256 )                     | 525,274                    |
| Special revenue                   | 345,869                      | 1,780                        | (17,330 )                     | 330,319                    |
| Public utilities                  | 18,255                       | 96                           | (408 )                        | 17,943                     |
| Industrial and miscellaneous      | 135,347                      | 654                          | (7,957 )                      | 128,044                    |
| Mortgage-backed securities        | 234,775                      | 1,508                        | (4,106 )                      | 232,177                    |

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|   |             |          |             |             |
|---|-------------|----------|-------------|-------------|
| Total fixed maturity investments                | 1,530,282   | 16,993   | (47,069 )   | 1,500,206   |
| Short-term investments                          | 70,884      |          | (498 )      | 70,386      |
| Total fixed maturity and short-term investments | 1,601,166   | 16,993   | (47,567 )   | 1,570,592   |
| Equity securities                               | 54,552      | 26,969   | (2,069 )    | 79,452      |
| Total investments                               | \$1,655,718 | \$43,962 | \$(49,636 ) | \$1,650,044 |

Financial market conditions during the third quarter caused a reduction in the market value of the fixed maturity securities portion of our portfolio from a position of unrealized gains of \$3.1 million at June 30, 2008, to a position of unrealized losses of approximately \$30.1 million at September 30, 2008. We maintained the portfolio approximately .60 basis points short of our target duration during the quarter to mitigate unrealized losses. If interest rates decline, we may consider an increase in the duration of our fixed maturity securities portfolio. We intend, and have the ability, to hold these fixed maturity securities until their expected recovery or maturity.

The amortized cost and estimated fair value of fixed maturity and short-term investments at September 30, 2008, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | <b>Cost or<br/>Amortized<br/>Cost</b> | <b>Estimated<br/>Fair Value</b> |
|--|---------------------------------------|---------------------------------|
|  | (in thousands)                        |                                 |
| Due in one year or less                | \$141,605                             | \$141,382                       |
| Due after one year through five years  | 366,455                               | 371,078                         |
| Due after five years through ten years | 417,716                               | 411,815                         |
| Due after ten years                    | 440,615                               | 414,140                         |
| Mortgage-backed securities             | 234,775                               | 232,177                         |
|  | <u>\$1,601,166</u>                    | <u>\$1,570,592</u>              |
| Total                                  | <u>\$1,601,166</u>                    | <u>\$1,570,592</u>              |

We are required by various state regulations to keep securities in a depository account. At September 30, 2008 and 2007, securities having a fair value of \$518.3 million and \$507.2 million, respectively, were on deposit. Additionally, certain reinsurance contracts require Company funds to be held in trust for the benefit of the ceding reinsurer to secure the outstanding liabilities assumed by the Company. The fair value of securities held in trust for reinsurance at September 30, 2008 and 2007, was \$5.0 million and \$4.9 million, respectively. The Amended Credit Facility is secured by fixed maturity securities which had a fair value of \$186.7 million at September 30, 2008.

### Contractual Obligations and Commitments

The following table identifies our long-term debt and contractual obligations as of September 30, 2008:

|  | <b>Payment Due By Period</b> |                             |                  |                  | <b>More Than<br/>5 Years</b> |
|--|------------------------------|-----------------------------|------------------|------------------|------------------------------|
|  | <b>Total</b>                 | <b>Less Than<br/>1 Year</b> | <b>1-3 Years</b> | <b>4-5 Years</b> |                              |
|  | (in thousands)               |                             |                  |                  |                              |
| Note payable <sup>(1)</sup>                              | \$166,632                    | \$8,006                     | \$158,626        | \$               | \$                           |
| Operating leases   | 30,156                       | 2,640                       | 13,825           | 5,659            | 8,032                        |
| Purchased liabilities                                    | 2,194                        | 938                         | 1,256            |                  |                              |
| Losses and LAE reserves <sup>(2)</sup><br><sup>(3)</sup> | 2,212,400                    | 165,216                     | 233,367          | 176,364          | 1,637,453                    |
|  | <u>\$2,411,382</u>           | <u>\$176,800</u>            | <u>\$407,074</u> | <u>\$182,023</u> | <u>\$1,645,485</u>           |
| Total contractual obligations                            | <u>\$2,411,382</u>           | <u>\$176,800</u>            | <u>\$407,074</u> | <u>\$182,023</u> | <u>\$1,645,485</u>           |

- (1) Note payable reflects principal and interest payments that are based on the current interest rate detailed in the Amended Credit Facility.

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- (2) The losses and LAE reserves are presented gross of our reinsurance recoverables on unpaid losses, which are as follows for each of the periods presented above:

|  | Recoveries Due By Period |                     |              |              |
|--|--------------------------|---------------------|--------------|--------------|
|  | Total                    | Less Than<br>1 Year | 1-3<br>Years | 4-5<br>Years |

(in thousands)

Reinsurance recoverables

excluding allowance \$(1,026,179) \$(40,938 ) \$(78,167 ) \$(72,756 ) \$(834,318 )

- (3) Estimated losses and LAE reserve payment patterns have been computed based on historical information. As a result, our calculation of losses and LAE reserve payments by period is subject to the same uncertainties associated with determining the level of reserves and to the additional uncertainties arising from the difficulty of predicting when claims (including claims that have not yet been reported to us) will be paid. For a discussion of our reserving process, see *Critical Accounting Policies*. Actual payments of losses and LAE by period will vary, perhaps materially, from the above table to the extent that current estimates of losses and LAE reserves vary from actual ultimate claims amounts as a result of variations between expected and actual payout patterns.

### Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements.

### Critical Accounting Policies

These unaudited interim consolidated financial statements include amounts based on informed estimates and judgments of management for those transactions that are not yet complete. Such estimates and judgments affect the reported amounts in the financial statements. Those estimates and judgments that were most critical to the preparation of the financial statements involved the following: (a) reserves for losses and loss adjustment expenses; (b) reinsurance recoverables; (c) recognition of premium income; (d) deferred policy acquisition costs; (e) deferred income taxes; and (f) valuation of investments. These estimates and judgments require the use of assumptions about matters that are highly uncertain and therefore are subject to change as facts and circumstances develop. If different estimates and judgments had been applied, materially different amounts might have been reported in the financial statements. Our accounting policies are discussed under *Critical Accounting Policies* in the Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report. Additional information regarding our accounting policy for reserves for loss and loss adjustment expenses and reinsurance recoverables follows.

### Reserves for Losses and Loss Adjustment Expenses

We are directly liable for losses and LAE under the terms of insurance policies our insurance subsidiaries underwrite. Significant periods of time can elapse between the occurrence of an insured loss, the reporting of the loss to the insurer and the insurer's payment of that loss. Our loss reserves are reflected in our balance sheets under the line item caption *unpaid losses and loss adjustment expenses*. As of September 30, 2008, our reserves for unpaid losses and LAE, net of reinsurance, were \$1.19 billion.

Accounting for workers' compensation insurance requires us to estimate the liability for the expected ultimate cost of unpaid losses and LAE, referred to as loss reserves, as of a balance sheet date. We seek to provide estimates of loss reserves that equal the difference between the expected ultimate losses and LAE of all claims that have occurred as of a balance sheet date and amounts already paid. Management establishes the loss reserve based on its own analysis of emerging claims experience and environmental conditions in our markets and a review of the results of various actuarial projection methods and their underlying assumptions. Our aggregate carried reserve for unpaid losses and LAE is a point estimate, which is the sum of our reserves for each accident year in which we have exposure. This

aggregate carried reserve, calculated by us, represents our best estimate of our outstanding unpaid losses and LAE.

Although claims for which reserves are established may not be paid for several years or more, we do not discount loss reserves in our financial statements for the time value of money.

The three main components of our reserves for unpaid losses and LAE are case reserves, incurred but not reported or IBNR reserves, and LAE reserves.

Case reserves are estimates of future claim payments based upon periodic case-by-case evaluation and the judgment of our claims adjusting staff, as applied at the individual claim level. Our claims examiners determine these case



reserves for reported claims on a claim-by-claim basis, based on the examiner's judgment and experience and on our case reserving practices. We update and monitor our case reserves frequently to appropriately reflect current information.

IBNR is an actuarial estimate of future claim payments beyond those considered in the case reserve estimates, relating to claims arising from accidents that occurred during a particular time period on or prior to the balance sheet date. Thus, IBNR is the compilation of the estimated ultimate losses for each accident year less amounts that have been paid and case reserves. IBNR reserves, unlike case reserves, do not apply to a specific claim, but rather apply to the entire body of claims arising from a specific time period. IBNR primarily provides for costs due to:

- future claim payments in excess of case reserves on recorded open claims;
- additional claim payments on closed claims; and
- the cost of claims that have not yet been reported to us.

Most of our IBNR reserves relate to estimated future claim payments over and above our case reserves on recorded open claims. For workers' compensation, most claims are reported to the employer and to the insurance company relatively quickly, and relatively small amounts are paid on claims that already have been closed (which we refer to as reopenings). Consequently, late reporting and reopening of claims are a less significant part of IBNR for our insurance subsidiaries.

LAE reserves are our estimate of the diagnostic, legal, administrative and other similar expenses that we will pay in the future to manage claims that have occurred on or before the balance sheet date. LAE reserves are established in the aggregate, rather than on a claim-by-claim basis.

A portion of our losses and LAE obligations are ceded to unaffiliated reinsurers. We establish our losses and LAE reserves both gross and net of ceded reinsurance. The determination of the amount of reinsurance that will be recoverable on our losses and LAE reserves includes both the reinsurance recoverable from our excess of loss reinsurance policies, as well as reinsurance recoverable under the terms of the LPT Agreement. Our reinsurance arrangements also include an intercompany pooling arrangement between EICN and ECIC, whereby each of the insurance subsidiaries cedes some of its premiums, losses, and LAE to the other, but this intercompany pooling arrangement does not affect our consolidated financial statements.

Our reserve for unpaid losses and LAE (gross and net), as well as the above-described main components of such reserves were as follows:

|  | <b>September 30,</b> |             |
|--|----------------------|-------------|
|  | <b>2008</b>          | <b>2007</b> |
|  | (in thousands)       |             |
| Case reserves  | \$725,328            | \$750,931   |
| IBNR   | 1,199,487            | 1,233,809   |
| LAE  | 287,585              | 297,751     |
|  | <hr/>                | <hr/>       |
| Gross unpaid losses and LAE                                    | 2,212,400            | 2,282,491   |
| Less: Reinsurance recoverables on unpaid losses and LAE, gross | 1,026,179            | 1,061,750   |
|  | <hr/>                | <hr/>       |
| Net unpaid losses and LAE                                      | \$1,186,221          | \$1,220,741 |
|  | <hr/>                | <hr/>       |

Actuarial methodologies are used by workers' compensation insurance companies, including us, to analyze and estimate the aggregate amount of unpaid losses and LAE. As mentioned above, management considers the results of

various actuarial projection methods and their underlying assumptions among other factors in establishing the reserves for unpaid losses and LAE.

Judgment is required in the actuarial estimation of unpaid losses and LAE. Judgment includes: the selection of methodologies to project the ultimate cost of claims; the selection of projection parameters based on historical company data, industry data, and other benchmarks; the identification and quantification of potential changes in parameters from historical levels to current and future levels due to changes in future claims development expectations caused by internal or external factors; and the weighting of differing reserve indications that result from alternative methods and assumptions. The adequacy of our ultimate loss reserves, which are based on estimates, is inherently uncertain and represents a significant risk to our business, which we attempt to mitigate through our claims management process and by monitoring and reacting to statistics relating to the cost and duration of claims. However, no assurance can be given as to whether the ultimate liability will be more or less than our loss reserve estimates.

We have retained an independent actuarial consulting firm (consulting actuary) to perform a comprehensive study of our losses and LAE liability on a semi-annual basis. The role of our consulting actuary as an advisor to management is to conduct sufficient analyses to produce a range of reasonable estimates, as well as a point estimate, of our unpaid losses and LAE liability, and to present those results to our actuarial staff and to management.

For purposes of analyzing claim payment and emergence patterns and trends over time, we compile and aggregate our claims data by grouping the claims according to the year or quarter in which the claim occurred ( accident year or accident quarter ), since each such group of claims is at a different stage of progression toward the ultimate resolution and payment of those claims. The claims data is aggregated and compiled separately for different types of claims and/or claimant benefits. For our Nevada business, where a substantial detailed historical database is available from the Nevada State Industrial Insurance System (the Fund), (from which our Nevada insurance subsidiary, EICN, assumed assets, liabilities and operations in 2000), these separate groupings of benefit types include death, permanent total disability, permanent partial disability, temporary disability, medical care and vocational rehabilitation. Third party subrogation recoveries are separately analyzed and projected. For other states such as California, where substantial and detailed history on our book of business is not available, and where industry data is in a generally more aggregated form, the analyses are conducted separately for medical care benefits, and for all disability and death (indemnity) benefits combined.

Both the consulting actuary and the internal actuarial staff select and apply a variety of generally accepted actuarial methods to our data. The methods applied vary somewhat according to the type of claim benefit being analyzed. The primary methods utilized in recent evaluations are: Paid Bornhuetter-Ferguson Method; Reported Bornhuetter-Ferguson Method; Paid Development Method; Reported Development Method; Frequency-Severity Method; and Initial Expected Loss Method. Each of the methods requires the selection and application of parameters and assumptions. The key parameters and assumptions are: the pattern with which our aggregate claims data will be paid or will emerge over time; claims cost inflation rates; and trends in the frequency of claims, both overall and by severity of claim. Of these, we believe the most important are the pattern with which our aggregate claims data will be paid or emerge over time and claims cost inflation rates.

Both management, with internal actuarial staff, and the consulting actuary separately analyze LAE and estimate unpaid LAE. This analysis relies primarily on examining the relationship between the aggregate amount that has been spent on LAE historically, as compared with the dollar volume of claims activity for the corresponding historical calendar periods. Based on these historical relationships, and judgmental estimates of the extent to which claim management resources are focused more intensely on the initial handling of claims than on the ongoing management of claims, the consulting actuary selects a range of future LAE estimates that is a function of the projected future claim payment activity. The portion of unpaid LAE that will be recoverable from reinsurers is estimated based on the contractual reinsurance terms.

Based on the results of the analyses conducted, the stability of the historical data, and the characteristics of the various claims segments analyzed, the consulting actuary selects a range of estimated unpaid losses and LAE and a point estimate of unpaid losses and LAE, for presentation to internal actuarial staff and management. The selected range is intended to represent the range in which it is most likely that the ultimate losses will fall. This range is narrower than the range of indications produced by the individual methods applied because it is not likely, although it is possible, that the high or low result will emerge for every state, benefit type and accident year. The actuarial point estimate of unpaid losses and LAE is based on a judgmental selection for each benefit type from within the range of results indicated by the different actuarial methods.

Management formally establishes loss reserves for financial statement purposes on a quarterly basis. In doing so, we make reference to the most current analyses of our consulting actuary, including a review of the assumptions and the results of the various actuarial methods used by the consulting actuary. Comprehensive studies are conducted June 30 and December 31 by both internal actuarial staff and the consulting actuary. On the alternate quarters, the preceding study results are updated by internal actuarial staff based on quarterly claim reporting and claim payment activity and

other information as indicated below:

recoveries from reinsurance and from other third party sources;  
expenses of managing claims;

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characteristics of the business we have written in the current quarter and prior quarters, including characteristics such as geographical location, type of business, size of accounts, historical claims experience, and pricing levels; and

case reserve component of our loss reserves. The case reserves are updated on an ongoing basis, in the normal course of claims examiners managing individual claims, and this component of our loss reserves at quarter-end is the sum of the case reserve as of quarter-end on each individual open claim.

The consulting actuary, management and internal actuarial staff provide the following analyses:

claim frequency and claim severity trends indicated by the claim activity as well as any emerging claims environment or operational issues that may indicate changing trends and workers compensation industry trends as reported by industry rating bureaus, the media, and other similar sources.

Management determines the IBNR and LAE components of our loss reserves by establishing a point in the range of the consulting actuary's most recent analysis of unpaid losses and LAE with the selection of the point based on management's own view of recent and future claim emergence patterns, payment patterns, and trends information obtained from internal actuarial staff pertaining to:

our view of the markets in which we are operating, including economic, business and political conditions; the characteristics of the business we have written in recent quarters; recent and pending recoveries from reinsurance; our view of trends in the future costs of managing claims; and other similar considerations as we view relevant.

The aggregate carried reserve calculated by management represents our best estimate of our outstanding unpaid losses and LAE. We believe that we should be conservative in our reserving practices due to the long tail nature of workers compensation claims payouts, the susceptibility of those future payments to unpredictable external forces such as medical cost inflation and other economic conditions, and the actual variability of loss reserve adequacy that we have observed in the workers compensation insurance industry.

The following table provides a reconciliation of the beginning and ending loss reserves on a GAAP basis:

|   | <b>For the Nine<br/>Months Ended<br/>September 30,<br/>2008</b> | <b>For the<br/>Year Ended<br/>December 31,<br/>2007</b> |
|---|---|---|
|   | (in thousands)  |   |
| Unpaid losses and LAE, gross of reinsurance, at beginning of period                   | \$2,269,710   | \$2,307,755   |
| Less reinsurance recoverables, excluding bad debt allowance, on unpaid losses and LAE | 1,052,641   | 1,098,103   |
|   | <hr/>   | <hr/>   |
| Net unpaid losses and LAE at beginning of period                                      | 1,217,069   | 1,209,652   |
| Losses and LAE, net of reinsurance, incurred in:                                      |   |   |
| Current period  | 147,569   | 221,347   |
| Prior periods   | (53,317 )   | (60,011 )   |
|   | <hr/>   | <hr/>   |
| Total net losses and LAE incurred during the period                                   | 94,252  | 161,336   |
| Deduct payments for losses and LAE, net of reinsurance, related to:                   |   |   |
| Current period  | 25,860  | 44,790  |
| Prior periods   | 99,240  | 109,129   |
|   | <hr/>   | <hr/>   |

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|   |             |             |
|---|-------------|-------------|
| Total net payments for losses and LAE during the period                         | 125,100     | 153,919     |
| Ending unpaid losses and LAE, net of reinsurance                                | 1,186,221   | 1,217,069   |
| Reinsurance recoverable, excluding bad debt allowance, on unpaid losses and LAE | 1,026,179   | 1,052,641   |
| Unpaid losses and LAE, gross of reinsurance, at end of period                   | \$2,212,400 | \$2,269,710 |

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Estimates of incurred losses and LAE attributable to insured events of prior years decreased due to continued favorable development in such prior accident years (actual losses and LAE paid and current projections of unpaid losses and LAE were less than we originally anticipated). The reduction in the estimated liability for unpaid losses and LAE related to prior years was \$53.3 million for the nine months ended September 30, 2008 and \$60.0 million for the year ended December 31, 2007.

The major sources of favorable development include: (a) actual paid losses have been less than expected and (b) the impact of new information on selected patterns of claims emergence and claim payment used in the projection of future loss payments (particularly in California where we are now able to rely more on our own loss experience and place less reliance on industry experience).

We review our loss reserves each quarter and, as discussed earlier, our consulting actuary assists our review by performing a comprehensive actuarial analysis and projection of unpaid losses and LAE twice each year. We may adjust our reserves based on the results of our reviews and these adjustments could be significant. If we change our estimates, these changes are reflected in our results of operations during the period in which they are made. Our actual claims and LAE experience and emergence in recent years have been more favorable than anticipated in prior evaluations. Our insurance subsidiaries have been operating in a period that includes: (a) changing business conditions; (b) entering into new markets; and (c) operational changes. During periods characterized by such changes, at each evaluation, the actuaries and management must make judgments as to the relative weight to accord to long-term historical and recent company data, external data, evaluations of business environment and other factors in selecting the methods to use in projecting ultimate losses and LAE, the parameters to incorporate in those methods, and the relative weights to accord to the different projection indications. Since the loss reserves are providing for claim payments that will emerge over many years, if management's projections and loss reserves were established in a manner that reacted quickly to each new emerging trend in the data or in the environment, there would be a high likelihood that future adjustments, perhaps significant in magnitude, would be required to correct for trends that turned out not to be persistent. At each balance sheet evaluation, some losses and LAE projection methods have produced indications above the loss reserve selected by us, and some losses and LAE projection methods have produced indications lower than the loss reserve selected by management. At each evaluation, management has given weight to new data, recent indications, and evaluations of environmental conditions and changes that implicitly reflect management's expectation as to the degree to which the future will resemble the most recent information and most recent changes, as compared with long-term claim payment, claim emergence, and claim cost inflation patterns.

As patterns and trends recur consistently over a period of quarters or years, management gives greater implicit weight to these recent patterns and trends in developing our future expectations. In our view, in establishing loss reserves at each historical balance sheet date, we have used prudent judgment in balancing long-term data and recent information.

It is likely that ultimate losses and LAE will differ from the loss reserves recorded in our September 30, 2008 balance sheet. Actual losses and LAE payments could be greater or less than our projections, perhaps significantly. The following paragraphs discuss several potential sources of such deviations, and illustrate their potential magnitudes.

Our reserve estimates reflect expected increases in the costs of contested claims and assume we will not be subject to losses from significant new legal liability theories. While it is not possible to predict the impact of changes in this environment, if expanded legal theories of liability emerge, our IBNR claims may differ substantially from our IBNR reserves. Our reserve estimates assume that there will not be significant future changes in the regulatory and legislative environment. The impact of potential changes in the regulatory or legislative environment is difficult to quantify in the absence of specific, significant new regulation or legislation. In the event of significant new regulation or legislation, we will attempt to quantify its impact on our business.

The range of potential variation of actual ultimate losses and LAE from our current reserve for unpaid losses and LAE is difficult to estimate because of the significant environmental changes in our markets, particularly California, and because our insurance subsidiaries do not have a lengthy operating history in our markets outside Nevada.

Furthermore, the methodologies we currently employ in evaluating our losses and LAE liability do not allow us to quantify the sensitivity of our losses and LAE reserves to reasonably likely changes in the underlying key assumptions. Management will refine its methodologies to provide for such capability in the future.

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### ***Loss Portfolio Transfer (LPT)***

Under the LPT Agreement, \$1.525 billion in liabilities for incurred but unpaid losses and LAE related to claims incurred prior to July 1, 1995 was ceded for consideration of \$775.0 million in cash. The estimated remaining liabilities subject to the LPT Agreement were approximately \$939.9 million and \$971.7 million as of September 30, 2008 and December 31, 2007, respectively. Losses and LAE paid with respect to the LPT Agreement totaled approximately \$437.5 million and \$405.7 million as of September 30, 2008 and December 31, 2007, respectively.

We account for the LPT Agreement in accordance with SFAS No. 113, *Accounting and Reporting for Reinsurance of Short-Term and Long-Duration Contracts*, and as retroactive reinsurance. Upon entry into the LPT Agreement, an initial deferred reinsurance gain was recorded as a liability in our consolidated balance sheet. This gain is being amortized using the recovery method, whereby the amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries, and the amortization is reflected in losses and LAE. In addition, we are entitled to receive a contingent commission under the LPT Agreement. The contingent commission is estimated based on both actual results to date and projections of expected ultimate losses under the LPT Agreement. Increases and decreases in the estimated contingent commission are reflected in our commission expense in the year that the estimate is revised.

### ***New Accounting Standards***

In December 2007, the Financial Accounting Standards Board issued SFAS No. 141 (Revised 2007), *Business Combinations* (SFAS No. 141(R)). SFAS No. 141(R) significantly changes the accounting for business combinations and requires the acquiring entity in the transaction to recognize the acquired assets and assumed liabilities at the acquisition-date fair value with limited exceptions. SFAS No. 141(R) is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, which, for the Company, would include business combinations that are completed after January 1, 2009. Early adoption is prohibited. The adoption of SFAS No. 141(R) will have an impact on the consolidated financial statements for any business combinations completed after January 1, 2009.

In March 2008, the FASB issued SFAS No. 161 *Disclosures About Derivative Instruments and Hedging Activities – an Amendment of FASB No. 133* (SFAS No. 161). SFAS No. 161 expands the disclosure requirements in SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities* about an entity's derivative instruments and hedging activities. SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk related contingent features in derivative agreements. SFAS No. 161 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2008, which, for the Company would be January 1, 2009. The Company is currently assessing the impact SFAS No. 161 will have on the consolidated financial statements.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk is the risk of potential economic loss principally arising from adverse changes in the fair value of financial instruments. The major components of market risk affecting us are credit risk, interest rate risk and equity price risk.

#### **Credit Risk**

##### ***Investments***

Our fixed maturity securities portfolio is exposed to credit risk, which we attempt to manage through issuer and industry diversification. We regularly monitor our overall investment results and review compliance with our investment objectives and guidelines. Our investment guidelines include limitations on the minimum rating of fixed maturity securities in our investment portfolio, as well as restrictions on investments in fixed maturity securities of a single issuer. Our fixed maturity securities were impaired \$1.4 million during the third quarter due to the credit

downgrade of one issuer in the financial services sector.

**Interest Rate Risk**

*Credit Facility*

Our exposure to market risk for changes in interest rates applies to the interest expense of variable rate debt under our Amended Credit Facility. The interest rate we pay increases and decreases with changes to LIBOR. We have, and may continue to utilize, derivative products such as interest rate swaps to manage interest rate risk.

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**Sensitivity Analysis**

Fixed maturity securities include residential mortgage-backed securities, which totaled \$172.9 million, or 10.5%, of the portfolio as of September 30, 2008. Agency backed mortgage pass-throughs totaled \$167.5 million, or 96.9%, of the mortgage-backed securities portion of the portfolio, and 10.2% of the total portfolio. Interest rates have declined recently, increasing the potential for prepayment activity.

The following table summarizes our interest rate risk illustrating the sensitivity of the fair value of fixed maturity securities to selected hypothetical changes in interest rates as of September 30, 2008. The selected scenarios are not predictions of future events, but rather illustrate the effect that such events may have on the fair value of our fixed maturity securities portfolio and stockholders' equity.

| <b>Hypothetical Change in Interest Rates</b> | <b>Estimated<br/>Increase (Decrease)<br/>in Fair Value</b><br>(in thousands, except<br>percentages) |          |
|--|---|----------|
| 300 basis point rise                         | \$(214,896 )  | (13.7 )% |
| 200 basis point rise                         | (149,252 )  | (9.5 )   |
| 100 basis point rise                         | (77,710 )   | (4.9 )   |
| 50 basis point decline                       | 40,204  | 2.6      |
| 100 basis point decline                      | 81,064  | 5.2      |

Financial market conditions during the third quarter caused a reduction in the market value of the fixed maturity securities portion of our portfolio from a position of unrealized gains of \$3.1 million at June 30, 2008, to a position of unrealized losses of approximately \$30.1 million at September 30, 2008. We intend, and have the ability, to hold these fixed maturity securities until their expected recovery or maturity.

**Item 4. Controls and Procedures**

Under the supervision of, and with the participation of our management, including our chief executive officer and chief financial officer, we have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act) as of the end of the period covered by this report. Based on that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report to provide assurance that information we are required to disclose in reports that are filed or submitted under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in the rules and forms specified by the SEC.

There have not been any changes in our internal controls over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

From time to time, the Company is involved in pending and threatened litigation in the normal course of business in which claims for monetary damages are asserted. In the opinion of management, the ultimate liability, if any, arising from such pending or threatened litigation is not expected to have a material effect on our results of operations, liquidity or financial position.

### **Item 1A. Risk Factors**

We have disclosed in our Annual Report the most significant risk factors that can impact year-to-year comparisons and may affect the future performance of the Company's business. On a quarterly basis, we review these disclosures and update the risk factors, as appropriate. As of the date of this report, there have been no material changes to the risk factors described in our Annual Report; however, we have identified the following additional risk factors related to our recent acquisition of AmCOMP.

#### **Risk Related to the Acquisition**

##### ***Our operating results may fluctuate due to the Acquisition.***

Our results, including those acquired from AmCOMP, may be subject to increased volatility as a result of a number of factors, many of which are beyond our control. These factors include:

- deterioration in market conditions in key states, including Florida, Wisconsin and Texas;
- increased business risk from exposure to natural catastrophes in Florida, such as hurricanes;
- premium rate levels mandated by regulators, primarily in Florida and Wisconsin; and
- termination of material contracts including key employee contracts.

##### ***Expected efficiencies may not materialize to the extent anticipated or at all.***

Integrating the operations of AmCOMP successfully or otherwise realizing any of the anticipated benefits of the acquisition, including anticipated cost savings and additional revenue opportunities, involve a number of potential challenges. The failure to meet these integration challenges could have a material adverse affect on our results of operations.

Realizing the benefits of the Acquisition will depend in part on the integration of information technology, operations and personnel. These integration activities are complex and time-consuming, and we may encounter unexpected difficulties or incur unexpected costs, including:

- diversion of management attention from ongoing business concerns to integration matters;
- difficulties in consolidating information technology platforms and administrative infrastructures;
- difficulties in integrating our acquired operations and serving our combined customer base;
- difficulties in combining corporate cultures, maintaining employee morale, retaining distribution channels and retaining key employees; and
- integrating the financial reporting and internal control functions of AmCOMP and maintaining compliance with the requirements of the Exchange Act and the Sarbanes-Oxley Act of 2002.

We may not successfully integrate AmCOMP's operations into ours in a timely manner, or at all, and we may not realize the anticipated benefits and synergies of the Acquisition to the extent, or in the timeframe, anticipated.

***We have outstanding indebtedness, which could impair our financial strength ratings and adversely affect our ability to react to changes in our business and fulfill our debt obligations.***

Our indebtedness could have important consequences, including:

making it more difficult for us to satisfy our obligations;

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limiting our ability to borrow additional amounts to fund working capital, capital expenditures, debt service requirements, the execution of our business strategy, acquisitions and other purposes; requiring us to dedicate a portion of our cash flow from operations to pay principal and interest on our debt, which would reduce the funds available to us for other purposes, including funding future expansion; and

making us more vulnerable to adverse changes in general economic and industry conditions, and limiting our flexibility to plan for, and react quickly to, changing conditions.

***Our ability to service our debt and meet our cash requirements depends on many factors, some of which are beyond our control.***

Our ability to satisfy our obligations, including making principal and interest payments on our outstanding debt, will depend on our future operating performance and general economic, financial and business conditions. If we are unable to generate sufficient cash flow to service our debt, we may be required to:

- refinance all, or a portion, of our debt potentially at adverse rates;
- obtain additional financing;
- sell some of our assets or operations; or
- reduce or delay capital expenditures or merger and acquisition activity.

If we are required to take any of these actions, it could have a material adverse effect on our business, financial condition and results of operations. In addition, we may not be able to execute on any of these actions, or they may not have the desired affects.

***Restrictive covenants in agreements governing our debt may adversely affect our ability to operate our business.***

Restrictive covenants in agreements governing our debt contain various provisions that limit our ability and the ability of our subsidiaries to, among other things:

- incur additional debt;
- pay dividends or distributions, or redeem or repurchase capital stock;
- prepay, redeem or repurchase debt;
- make loans, investments and capital expenditures;
- sell assets and capital stock of our subsidiaries; and
- consolidate or merge with or into, or sell substantially all of our assets to, another entity.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table summarizes the repurchase of our common stock through September 30, 2008:

| <b>Period</b>                          | <b>Total<br/>Number of<br/>Shares<br/>Purchased</b> | <b>Average<br/>Price<br/>Paid<br/>Per<br/>Share <sup>(1)</sup></b> | <b>Total Number<br/>of Shares<br/>Purchased as<br/>Part of Publicly<br/>Announced<br/>Program</b> | <b>Maximum<br/>Number (or<br/>Approximate<br/>Dollar Value)<br/>of Shares that<br/>May Yet be<br/>Purchased<br/>Under the<br/>Program <sup>(2)</sup><br/>(millions)</b> |
|--|---|--|---|---|
| March 17, 2008 - March 31, 2008        | 56,000  | \$ 17.75   | 56,000  | \$99.0  |
| April 1, 2008 - April 30, 2008         | 109,300   | 18.27  | 165,300   | 97.0  |
| May 1, 2008 - May 31, 2008             | 105,000   | 18.85  | 270,300   | 95.0  |
| June 1, 2008 - June 30, 2008           | 105,000   | 19.29  | 375,300   | 93.0  |
| July 1, 2008 - July 31, 2008           | 219,895   | 17.27  | 595,195   | 89.2  |
| August 1, 2008 - August 31, 2008       | 141,500   | 17.38  | 736,695   | 86.7  |
| September 1, 2008 - September 30, 2008 | 50,100  | 17.97  | 786,795   | 85.8  |
| <b>Total 2008 Repurchase</b>           | <b>786,795</b>                                      |  |   |   |

(1) Includes fees and commissions paid on stock repurchases.

(2) On February 21, 2008, the Board of Directors authorized a stock repurchase program of up to \$100.0 million of our common stock through June 30, 2009. The shares may be repurchased from time to time at prevailing market prices in open market or private transactions. The repurchases may be commenced or suspended from time to time without prior notice. There can be no assurance that we will continue to undertake any repurchase of our common stock pursuant to the program.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.





**Item 6. Exhibits****Exhibits:**

| Exhibit No. | Description of Exhibit  | Included<br>Herewith | Incorporated by Reference Herein |         |                  |
|-------------|---|----------------------|----------------------------------|---------|------------------|
|             |   |                      | Form                             | Exhibit | Filing Date      |
| 2.1         | Amendment No. 2 to the Agreement and Plan of Merger, dated August 29, 2008, by and among AmCOMP Incorporated, Employers Holdings, Inc. and Sapphire Acquisition Corp. |                      | 8-K                              | 2.1     | August 29, 2008  |
| 10.1        | Second Amended and Restated Credit Agreement, dated September 30, 2008, between Employers Holdings Inc. and Wells Fargo Bank, National Association                    |                      | 8-K                              | 10.1    | October 22, 2008 |
| 10.2        | Second Amended and Restated Revolving Line of Credit Note, dated September 30, 2008, between Employers Holdings Inc. and Wells Fargo Bank, National Association       |                      | 8-K                              | 10.2    | October 22, 2008 |
| 31.1        | Certification of Douglas D. Dirks Pursuant to Section 302   | X                    |                                  |         |                  |
| 31.2        | Certification of William E. Yocke Pursuant to Section 302   | X                    |                                  |         |                  |
| 32.1        | Certification of Douglas D. Dirks Pursuant to Section 906   | X                    |                                  |         |                  |
| 32.2        | Certification of William E. Yocke Pursuant to Section 906   | X                    |                                  |         |                  |

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

EMPLOYERS HOLDINGS, INC.

Date: November 7, 2008

By: /s/ DOUGLAS D. DIRKS

Name: Douglas D. Dirks  
Title: President and Chief Executive Officer

(Principal Executive Officer)

Date: November 7, 2008

By: /s/ WILLIAM E. YOCKE

Name: William E. Yocke  
Title: Executive Vice President and Chief  
Financial Officer (Principal Financial and  
Accounting Officer)