

KINGSWAY FINANCIAL SERVICES INC

Form 10-K

March 30, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

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☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2011

OR

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

Commission File Number 001-15204

Kingsway Financial Services Inc.

(Exact name of registrant as specified in its charter)

Ontario, Canada

(State or other jurisdiction of  
incorporation or organization)

45 St. Clair Avenue West, Suite 400

Toronto, Ontario

(Address of principal executive  
offices)

Not Applicable

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

M4V 1K9

(Zip Code)

1-416-848-1171

(Registrant's telephone number, including area code)

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

Title of Each Class

Common Stock, no par value

Name of Each Exchange on Which Registered

New York Stock Exchange

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated

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filer    ☐ Smaller reporting company    ☒ x

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

As of June 30, 2011, the aggregate market value of the registrant's voting common stock held by non-affiliates of the registrant was \$39,911,994 based upon the closing sale price of the common stock as reported by the New York Stock Exchange. Solely for purposes of this calculation, all executive officers and directors of the registrant are considered affiliates.

The number of shares of the Registrant's Common Stock outstanding as of March 30, 2012 was 52,595,828.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Form 10-K is incorporated by reference to certain sections of the Proxy Statement for the 2012 Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission no later than 120 days after the end of our fiscal year ended December 31, 2011.

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#### Caution Regarding Forward-Looking Statements

This 2011 Annual Report on Form 10-K (the "2011 Annual Report"), including the accompanying consolidated financial statements of Kingsway Financial Services Inc. ("Kingsway") and its subsidiaries (individually and collectively referred to herein as the "Company") and the notes thereto appearing in Item 8 herein (the "Consolidated Financial Statements"), Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in Item 7 herein (the "MD&A"), and the other Exhibits and Financial Statement Schedules filed as a part hereof or incorporated by reference herein may contain or incorporate by reference information that includes or is based on forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934.

Forward-looking statements relate to future events or future performance and reflect Kingsway management's current beliefs, based on information currently available. The words "anticipate," "expect," "believe," "may," "should," "estimate," "project," "outlook," "forecast" or similar words are used to identify such forward looking information, but these words are not the exclusive means of identifying forward-looking statements. Specifically, statements about (i) the Company's ability to preserve and use its net operating losses; (ii) the Company's expected liquidity; and (iii) the potential impact of volatile investment markets and other economic conditions on the Company's investment portfolio and underwriting results, among others, are forward-looking, and the Company may also make forward-looking statements about, among other things:

- its results of operations and financial condition (including, among other things, premium volume, premium rates, net and operating income, investment income and performance, return on equity, and expected current returns and combined ratios);

- changes in facts and circumstances affecting assumptions used in determining the provision for unpaid loss and loss adjustment expenses;

- the number and severity of insurance claims (including those associated with catastrophe losses) and their impact on the adequacy of the provision for unpaid loss and loss adjustment expenses;

- the impact of emerging claims issues as well as other insurance and non-insurance litigation;

- orders, interpretations or other actions by regulators that impact the reporting, adjustment and payment of claims;

- changes in industry trends and significant industry developments;

- uncertainties related to regulatory approval of insurance rates, policy forms, license applications and similar matters; and

- strategic initiatives.

For a discussion of some of the factors that could cause actual results to differ, see Item 1A, "Risk Factors" and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations-Critical Accounting Estimates and Assumptions" in this 2011 Annual Report.

Except as expressly required by applicable securities laws, the Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, that might arise subsequent to the date of this 2011 Annual Report.

## Part I

### Item 1. BUSINESS

Kingsway Financial Services Inc. was incorporated under the Business Corporations Act (Ontario) on September 19, 1989. In this report, the terms "Kingsway," the "Company," "we," "us" or "our" mean Kingsway Financial Services Inc. and all entities included in our consolidated financial statements.

The Company's registered office is located at 45 St. Clair Avenue West, Suite 400, Toronto, Ontario, Canada M4V 1K9. The common shares of Kingsway are listed on the Toronto Stock Exchange and the New York Stock Exchange under the trading symbol "KFS."

Kingsway is a holding company and is engaged, through its subsidiaries, in the property and casualty insurance business and conducts its business through the following two reportable segments: Insurance Underwriting and Insurance Services. Insurance Underwriting and Insurance Services conduct their business and distribute their products in the United States. The subsidiaries in the Insurance Underwriting segment issue insurance policies and retain the risk of operating profit or loss related to the ultimate loss and loss adjustment expenses incurred on the underlying policies. The subsidiaries in the Insurance Services segment market generally the same type of insurance products; however, they do not retain the risk of operating profit or loss related to the ultimate loss and loss adjustment expenses incurred on the underlying policies. The risk of operating profit or loss in the case of Insurance Services is borne by the insurance companies which partner with Insurance Services in their marketing efforts. Because of this key difference between our two segments, certain of the business descriptions below, particularly "Underwriting," "Unpaid Loss and Loss Adjustment Expenses," "Investments," "Reinsurance," and "Regulatory Environment," are principally or exclusively related to Insurance Underwriting. The "Debt" description below is unrelated to either segment.

Financial information about Kingsway's reportable business segments for the years ended December 31, 2011 and 2010 is contained in the following sections of this 2011 Annual Report: (i) Note 22, "Segmented Information" to the Consolidated Financial Statements; and (ii) "Results of Continuing Operations" section of MD&A.

#### Insurance Underwriting Segment

The Company's property and casualty insurance business operations are conducted primarily through the following subsidiaries: Mendota Insurance Company ("Mendota"), Mendakota Insurance Company, Universal Casualty Company ("UCC"), Kingsway Amigo Insurance Company ("Amigo"), Kingsway Reinsurance Corporation and Kingsway Reinsurance (Bermuda) Ltd. (collectively, "Insurance Underwriting"). Insurance Underwriting provides non-standard automobile and other types of property and casualty insurance to individuals and commercial automobile insurance to businesses and actively conducts business in 17 states. In 2011, the following states accounted for 85.9% of the Company's gross premiums written: Florida (46.5%), Illinois (11.6%), Texas (8.7%), California (7.2%), Nevada (6.4%) and Colorado (5.5%).

Insurance Underwriting principally offers personal automobile insurance to drivers who do not meet the criteria for coverage by standard automobile insurers. For the year ended December 31, 2011, non-standard automobile insurance accounted for 86.4% of the Company's gross premiums written.

#### Insurance Services Segment

Insurance Services includes the following subsidiaries of the Company: Assigned Risk Solutions Ltd. ("ARS"), Northeast Alliance Insurance Agency, LLC ("NEA") and KAI Advantage Auto, Inc. ("Advantage Auto"), (collectively, "Insurance Services").

In 2011, ARS and NEA were organized to run as one business under the ARS name. ARS is a licensed property and casualty agent, full service managing general agent and third-party administrator focused primarily on the assigned risk market. ARS is licensed to administer business in 22 states but generates its revenues primarily by operating in the states of New York and New Jersey.

Advantage Auto is a licensed property and casualty agent. Advantage Auto is licensed as an agency in Illinois and Indiana and produces business in both states.

#### CHANGE OF REPORTING STATUS

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Effective July 1, 2011, the Company ceased to be a "foreign private issuer," as defined in Rule 3b-4 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and became subject to the rules and regulations under the Exchange Act applicable to domestic issuers. As a result, the Company is required to prepare and file this Annual Report on Form 10-K for the fiscal year ended December 31, 2011. Our Annual Reports were previously filed on Form 40-F.

The accompanying information in the 2011 Annual Report has been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The Company previously presented its consolidated financial statements for the year ended December 31, 2010 in accordance with Canadian Generally Accepted Accounting Principles ("Canadian GAAP"). The comparative figures in respect of 2010 were restated to reflect the adoption of U.S. GAAP.

#### REPORTING CURRENCY

The Company prepares its financial statements in U.S. dollars in order to provide more meaningful information to their users. Figures contained in this report have been translated into U.S. dollars using the current rate method, pursuant to which the consolidated statements of operations and cash flows have been translated using average monthly rates of exchange; all assets and liabilities have been translated using the relevant year-end rate of exchange; and shareholders' equity has been translated using the rates of exchange in effect as of the dates of various capital transactions. Foreign exchange differences arising from the translations as described above are included in shareholders' equity under the caption accumulated other comprehensive income.

All of the dollar amounts in this 2011 Annual Report are expressed in U.S. dollars, except where otherwise indicated. References to "dollars" or "\$" are to U.S. dollars, and any references to "C\$" are to Canadian dollars.

#### ACQUISITIONS, DISCONTINUED OPERATIONS AND DISPOSITIONS

##### Acquisitions

On January 4, 2010, the Company and its subsidiary, Kingsway America Inc. ("KAI"), acquired certain assets of Itasca Financial, LLC ("Itasca"), a property and casualty insurance industry advisory firm owned and controlled by Mr. Larry G. Swets, Jr., a former director and the current Chief Executive Officer and President of the Company. The consideration for the assets purchased was equal to \$1.5 million cash and one million restricted common shares of the Company, payable in three annual installments. The purchase price of the Itasca assets was subject to adjustment at the end of the installment period. In 2011, purchase price adjustments were finalized, resulting in total goodwill of \$2.8 million related to the purchase. This goodwill was not associated with the Company's two reportable segments. The Company tested the Itasca goodwill for recoverability at December 31, 2011 and determined that the carrying value of the Itasca goodwill exceeded its fair value. Further information is contained in Note 10, "Goodwill and Intangible Assets" to the Consolidated Financial Statements.

Effective June 30, 2010, the Company acquired 100% of JBA Associates, Inc. ("JBA") for approximately \$16.3 million. JBA is a managing general agency based in New Jersey that specializes in assigned risk automobile insurance. The acquisition allows the Company to benefit from its institutional knowledge of non-standard automobile and assigned risk business and expand in the agency market. Subsequent to the acquisition, JBA was renamed Assigned Risk Solutions Ltd.

Kingsway Linked Return of Capital Trust ("KLROC Trust") is an investment trust established under the laws of the Province of Ontario and is governed by a Declaration of Trust dated May 12, 2005, amended July 14, 2005. KLROC Trust was created to provide holders with exposure to a promissory note issued by KAI.

KLROC Trust commenced operations on July 14, 2005 and raised C\$78.0 million through the issuance of 3,120,000 preferred units ("LROC preferred units") at C\$25 per LROC preferred unit. Beginning in 2009, KFS Capital LLC ("KFS Capital"), an affiliate of the Company, began purchasing LROC preferred units. The LROC preferred units purchased at that time were accounted for as available-for-sale investments. As of June 30, 2010, the Company held 833,715 LROC preferred units representing 26.7% of the issued and outstanding LROC preferred units; therefore, the Company was not obligated to consolidate KLROC Trust. In July 2010, the Company purchased an additional 1,500,000 LROC preferred units and now beneficially owns and controls 74.8% of the issued and outstanding LROC preferred units. The Company has determined that the consolidated financial statements of KLROC Trust should be consolidated with the financial statements of the Company beginning July 23, 2010. As a result of consolidating KLROC Trust, the Company recorded a gain of \$17.8 million in the third quarter of 2010 related to the LROC preferred units held by KFS Capital. The gain arose from the difference between the carrying value of the debt held by KLROC Trust and the fair value of the LROC preferred units held by KFS Capital.

Further information about Kingsway's acquisitions is contained in Note 4, "Acquisitions" to the Consolidated Financial Statements.





#### Discontinued Operations

During 2010, the Company disposed of Jevco Insurance Company ("Jevco"), American Country Insurance Company ("American Country"), and American Service Insurance Company, Inc. ("American Service").

Each of the operations above is considered to be discontinued operations and is recorded as such in the consolidated statements of operations. In this 2011 Annual Report, unless otherwise disclosed, only continuing operating activities of Kingsway are included. Further information about Kingsway's discontinued operations is contained in Note 5, "Discontinued Operations and Dispositions" to the Consolidated Financial Statements.

#### Disposition

On March 30, 2011, KAI sold all of the issued and outstanding shares of its wholly owned subsidiary Hamilton Risk Management Company ("Hamilton") and its subsidiaries, including Amigo, to HRM Acquisition Corp., a wholly owned subsidiary of Acadia Acquisition Partners, L.P. ("Acadia"), in exchange for a \$10.0 million senior promissory note due March 30, 2014, a \$5.0 million junior promissory note due March 30, 2016 and a Class B partnership interest in Acadia, representing a 40% economic interest.

A third-party and members of the Hamilton management team hold Class A partnership interests in Acadia representing a 60% economic interest. KAI acts as the general partner of Acadia. As general partner, KAI has control of the policies and financial affairs of Hamilton; therefore, Kingsway will continue to consolidate the financial statements of Hamilton. During the second quarter of 2011, HRM Acquisition Corp. merged into Hamilton. As a result of this transaction, as of December 31, 2011, Hamilton has notes payable balances of \$2.2 million maturing in March 2014 with the third-party and \$0.2 million maturing in June 2015 with members of the Hamilton management team. The notes bear interest at 2% annually.

#### INSURANCE PRODUCTS

Each of Insurance Underwriting and Insurance Services markets automobile insurance products which provide coverage in three major areas: liability, accident benefits and physical damage. Liability insurance provides coverage for claims against our insureds legally responsible for automobile accidents which have injured third-parties or caused property damage to third-parties. Accident benefit policies or personal injury protection policies provide coverage for loss of income, medical and rehabilitation expenses for insured persons who are injured in an automobile accident, regardless of fault. Physical damage policies cover damages to an insured automobile arising from a collision with another object or from other risks such as fire or theft.

#### Non-Standard Automobile

Non-standard automobile insurance is principally provided to individuals who do not qualify for standard automobile insurance coverage because of their payment history, driving record, place of residence, age, vehicle type or other factors. Such drivers typically represent higher than normal risks and pay higher insurance rates for comparable coverage.

Non-standard automobile insurance loss experience is generally driven by higher frequency and lower severity than the standard automobile market. The higher frequency, however, is mitigated to some extent by higher premium rates, the tendency of high-risk individuals to own low-value automobiles, and generally lower limits of insurance coverage as insureds tend to purchase coverage at the minimum prescribed limits. In the United States, non-standard automobile insurance policies generally have lower limits of insurance commensurate with the minimum coverage requirement under the statute of the state in which we write the business. These limits of liability are typically not greater than \$50,000 per occurrence.

The insuring of non-standard drivers is often transitory. When their driving records improve, insureds may qualify to obtain insurance in the standard market at lower premium rates. We often cancel policies for non-payment of premium and, following a period of lapse in coverage, insureds frequently return to purchase a new policy at a later date. As a result, our non-standard automobile insurance policies experience a retention rate that is lower than that experienced for standard market risks. This creates an on-going requirement to replace non-renewing policyholders with new policyholders and to react promptly to issue cancellation notices for non-payment of premiums to mitigate potential bad debt write-offs. Most of our insureds pay their premiums on a monthly installment basis and we typically limit our risk of non-payment of premiums by requiring a deposit for future insurance premiums and the prepayment of subsequent installments.

In the United States, automobile insurers are generally required to participate in various involuntary residual market pools and assigned risk plans that provide automobile insurance coverage to individuals or other entities that are unable to purchase such coverage in the voluntary market. Participation in these pools in most jurisdictions is in proportion to voluntary writings of selected lines of business in those jurisdictions.

Tables 1 and Table 2 below set forth our gross premiums written by line of business and geographic region, respectively, for Insurance Underwriting for the periods indicated. For the year ended December 31, 2011, gross premiums written for non-standard automobile insurance decreased 38.6% to \$119.6 million as compared to \$194.7 million in 2010. Non-standard automobile insurance accounted for 86.4% and 92.0% of our gross premiums written for the years ended December 31, 2011 and 2010, respectively. The significant decrease in gross premiums written is due to the various steps taken to discontinue unprofitable lines and exit the managing general agent distribution channel, primarily at UCC. Also contributing to the reduction in non-standard automobile premium volumes is the continuing poor economic conditions in much of the United States. The non-standard automobile insurance market tends to contract during periods of high unemployment as was experienced in the United States throughout 2011.

TABLE 1 Gross premiums written by line of business

For the years ended December 31 (in millions of dollars, except for percentages)

	2011		2010		
Private passenger auto liability	87.5	63.2	% 140.8	66.5	%
Auto physical damage	32.1	23.2	% 53.9	25.5	%
Total non-standard automobile	119.6	86.4	% 194.7	92.0	%
Commercial auto liability	10.7	7.7	% 8.7	4.1	%
Allied lines	8.1	5.9	% 8.2	3.9	%
Total gross premiums written	138.4	100.0	% 211.6	100.0	%

TABLE 2 Gross premiums written by state

For the years ended December 31 (in millions of dollars, except for percentages)

	2011		2010		
Florida	64.4	46.5	% 95.1	44.9	%
Illinois	16.1	11.6	% 18.5	8.7	%
Texas	12.1	8.7	% 13.1	6.2	%
California	9.9	7.2	% 25.3	12.0	%
Nevada	8.8	6.4	% 11.7	5.5	%
Colorado	7.6	5.5	% 13.2	6.2	%
Other	19.5	14.1	% 34.7	16.5	%
Total gross premiums written	138.4	100.0	% 211.6	100.0	%

#### Commercial Automobile

Commercial automobile policies provide coverage for low-limit, light-weight, individual unit or small fleet commercial vehicles. For the year ended December 31, 2011, gross premiums written for commercial automobile insurance increased by 23.0% to \$10.7 million compared to \$8.7 million in 2010. This increase is related in part to a modest increase in gross premiums written at Amigo. This increase also reflects negative gross premiums written at UCC in 2010 resulting from cancellation activity due to its termination of managing general agency agreements.

#### Allied Lines

Allied lines premium relates to Amigo's participation in the National Flood Insurance Program. The program is a cooperative undertaking of the insurance industry and the Federal Emergency Management Agency which allows participating property and casualty insurance companies to write and service the Standard Flood Insurance Policy in their own names. Under the program, Amigo receives an expense allowance for policies written and claims processed while the federal government retains responsibility for underwriting all losses. For the year ended December 31, 2011, gross premiums written from allied lines decreased by 1.2% to \$8.1 million compared to \$8.2 million in 2010.

## MARKETING AND DISTRIBUTION

Our strategy focuses on developing and maintaining strong relationships with our independent agents. Insurance Underwriting's products and services are marketed through approximately 4,700 independent agencies. Insurance Services markets their products to over 5,000 independent agencies. We maintain an "open market" approach which enables these agents to place business with us without the obligation of minimum production commitments, providing us with a broad, flexible and scalable distribution network. We continually strive to provide excellent service in the markets in which we operate, communicating through a variety of channels as we look for opportunities to increase efficiency and reduce operating costs with our agents. Our independent agents have the ability to bind insurance policies on our behalf, subject to our insurance guidelines. Our proprietary point-of-sale systems, however, prevent any agent from binding an unacceptable risk. We do not, though, delegate authority to settle or adjust claims, establish underwriting guidelines, develop rates or enter into other transactions or commitments through our independent agents.

Texas business is originated through an affiliated managing general agent and written through an unaffiliated Texas county mutual insurance company. This business is then 100% assumed through a quota-share arrangement by one of our insurance subsidiaries. This represents a common way of originating non-standard automobile business in the state of Texas due to the greater rating and underwriting flexibility accorded Texas county mutual insurance companies under Texas statutes.

No material part of the business of the Company is dependent upon a single customer or group of customers, the loss of any one of which would have a material adverse effect on the Company, and no one customer or group of affiliated customers accounts for 10% or more of the Company's consolidated revenues.

## PRICING AND PRODUCT MANAGEMENT

Responsibility for pricing and product management rests with the Company's individual operating subsidiaries in each of Insurance Underwriting and Insurance Services. Typically, teams comprised of internal pricing actuaries, product managers and business development managers work together by territory to develop policy forms and language, rating structures, regulatory filings and new product ideas. Data solutions and claims groups track loss performance on a monthly basis so as to alert the operating subsidiaries to the potential need to adjust forms or rates.

## COMPETITION

Insurance Underwriting operates in a highly competitive environment. Our core non-standard automobile offerings are policies at the minimum prescribed limits in each state produced entirely through our independent agents. We compete with large national insurance companies and smaller regional insurance companies which produce through independent agents. We also compete with insurance companies which sell policies directly to their customers.

Large national insurance companies and direct underwriters typically operate in standard lines of personal automobile and property insurance in addition to non-standard lines and typically bring with them increased name recognition obtained through extensive media advertising, loyalty of the customer base to the insurer rather than to an independent agency and, potentially, reduced policy acquisition costs and increased customer retention.

From time to time, the non-standard automobile market attracts competition from new entrants. In many cases, these entrants are looking for growth and, as a result, price their insurance below the rates that we believe provide an acceptable return for the related risk. We firmly believe that it is not in our best interest to compete solely on price; consequently, we are willing to experience a loss of market share during periods of intense price competition or "soft" market conditions. In 2010 and 2011, the Company carried out a detailed review of its premium adequacy in the territories in which it operates and has taken steps to terminate business where premium adequacy is unlikely to be achieved within an acceptable period of time.

In order to stay competitive while striving to generate an economic rate of return, we compete on a number of factors such as distribution strength and breadth, premium adequacy, agency relationships, ease of doing business and market reputation. Ultimately, we believe that our ability to compete successfully in our industry is based, among other things, on our ability to:

- identify markets that are most likely to produce an underwriting profit;
- operate with a disciplined underwriting approach;
- practice prudent claims management;

• establish an appropriate provision for unpaid loss and loss adjustment expenses;  
• strive for cost containment and the economics of shared support functions where deemed appropriate; and  
• provide our independent agents and brokers with competitive commissions, an ease of doing business and additional value-added products and services for them and their customers.

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The Company does not compete on the basis of ratings. In October, 2011 the Company had the A.M. Best ratings for all of its insurance subsidiaries withdrawn. As a result, the Comp