Employers Holdings, Inc.
Form 10-K
March 01, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

R ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2012

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____ to ____

Commission file number: 001-33245

EMPLOYERS HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

Nevada	04-3850065
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

10375 Professional Circle, Reno, Nevada 89521
(Address of principal executive offices and zip code)
(888) 682-6671
(Registrant's telephone number, including area code)

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

Title of each class	Name of each exchange on which registered
Common Stock, $0.01 par value per share	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 o No R

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

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 R No o

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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes R No o

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

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):

Large accelerated filer R　Accelerated filer o　Non-accelerated filer o　Smaller reporting company o

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2012 was $558,293,802.

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

Class	February 21, 2013
Common Stock, $0.01 par value per share	30,775,229 shares outstanding

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Definitive Proxy Statement relating to the 2013 Annual Meeting of Stockholders are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III of this report.

EXPLANATORY NOTE

We are revising our consolidated financial statements for the fiscal years ended December 31, 2011 and 2010, and our selected financial data for the fiscal years ended December 31, 2011, 2010, 2009, and 2008 in this Annual Report on Form 10-K for the fiscal year ended December 31, 2012. These revisions are the result of the need to correct the manner in which we account for the contingent profit commission to which we are entitled under the Loss Portfolio Transfer Agreement (LPT Agreement). We assessed the impact of these revisions and concluded that they were not material to any of our financial statements for the each of the three quarters within the nine months ended September 30, 2012, or fiscal years ended December 31, 2011, 2010, 2009, or 2008. As a result, we have not filed amendments to any of our previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q. We have revised these historical financial results in this Annual Report on Form 10-K. Although the effect of these revisions was not material to those previously issued financial statements, the cumulative effect of reflecting these revisions in the current year would have been material for the fiscal year ended December 31, 2012. Since these revisions are treated as corrections to our prior period financial results, the revisions are considered to be a restatement under U.S. generally accepted accounting principles (GAAP). Accordingly, the revised financial information included in this Annual Report on Form 10-K has been identified as "restated."

In 1999, the Nevada State Industrial Insurance System (the Fund) entered into a retroactive 100% quota share reinsurance agreement through a loss portfolio transfer transaction with third party reinsurers. On January 1, 2000, one of our insurance subsidiaries, Employers Insurance Company of Nevada, assumed all of the assets, liabilities and operations of the Fund, including the Fund's rights and obligations associated with the LPT Agreement. The LPT Agreement was a non-recurring transaction which does not affect our ongoing operations. In the quarter ended December 31, 2012, we concluded that a modification was necessary in order to properly apply reinsurance accounting principles to the contingent profit commission under the LPT Agreement. This modification resulted in a change in the manner in which we record the estimate of contingent commission receivable–LPT Agreement, which impacts the amortization of the deferred reinsurance gain–LPT Agreement and is reflected in losses and loss adjustment expense (LAE) incurred in our consolidated statements of income and comprehensive income. The effect of the revisions to the previously issued consolidated statements of income and comprehensive income for the years ended December 31, 2011 and 2010 was to increase the commission expense and decrease the losses and LAE, with the net effect of increasing net income and earnings per share. Additionally, total stockholders' equity at December 31, 2011 decreased and there was an increase to the contingent commission receivable–LPT Agreement and the deferred reinsurance gain–LPT Agreement on the consolidated balance sheets as of December 31, 2011. Note 2 to the consolidated financial statements included in this Annual Report on Form 10-K contains tabular disclosures that set forth certain restated financial information.

For more information regarding the impact on our financial results, please refer to Part II, Item 6, "Selected Financial Data," and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," and to our Consolidated Financial Statements included in Part II, Item 8, including Note 2, "Revision of Previously Issued Consolidated Financial Statements," and Note 21, "Selected Quarterly Financial Data (Unaudited)."

The following tables present the summary impacts of the restatement adjustments on our previously reported consolidated retained earnings at December 31, 2009 and consolidated net income and earnings per share for the years ended December 31, 2011 and 2010 (in thousands, except per share data):

Retained earnings at December 31, 2009 (previously reported)	$266,491
LPT Contingent Commission Adjustment	(13,183)
Retained earnings at December 31, 2009 (as restated)	$253,308

	December 31,	
	2011	2010
Net income (previously reported)	$48,313	$62,799
Adjustment	310	670
Net income (as restated)	$48,623	$63,469

Earnings per common share:

Basic (previously reported)	$1.30	$1.52
Adjustment	—	0.01
Basic (as restated)	$1.30	$1.53
Diluted (previously reported)	$1.29	$1.51
Adjustment	0.01	0.02
Diluted (as restated)	$1.30	$1.53

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FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements if accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those discussed. You should not place undue reliance on these statements, which speak only as of the date of this report. 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 including words such as “expect,” “intend,” “plan,” “believe,” “estimate,” “may,” “anticipate,” “will” or similar statements of a future or forward-looking nature identify forward-looking statements. 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. All forward-looking statements address matters that involve 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 set forth in Item 1A, “Risk Factors” and the other documents that we have filed with the Securities and Exchange Commission.

NOTE REGARDING RELIANCE ON STATEMENTS IN OUR CONTRACTS

The agreements included or incorporated by reference as exhibits to this Annual Report on Form 10-K may contain representations and warranties by each of the parties to the applicable agreement. These representations and warranties were made solely for the benefit of the other parties to the applicable agreement and:

- were not intended to be treated as categorical statements of fact, but rather as a way of allocating the risk to one of the parties if those statements prove to be inaccurate;
- may have been qualified in such agreement by disclosures that were made to the other party in connection with the negotiation of the applicable agreement;
- may apply contract standards of “materiality” that are different from “materiality” under the applicable securities laws; and
- were made only as of the date of the applicable agreement or such other date or dates as may be specified in the agreement.

Notwithstanding the inclusion of the foregoing cautionary statements, we acknowledge that we are responsible for considering whether additional specific disclosures of material information regarding material contractual provisions are required to make the statements in this report not misleading.

PART I

Item 1. Business

General

Employers Holdings, Inc. (EHI) is a holding company incorporated in Nevada in 2005. Unless otherwise indicated, all references to “we,” “us,” “our,” the “Company” or similar terms refer to EHI together with its subsidiaries. We had 667 full-time employees at December 31, 2012 and our principal executive offices are located at 10375 Professional Circle in Reno, Nevada.

Our insurance subsidiaries have each been assigned an A.M. Best Company (A.M. Best) rating of “A-” (Excellent), with a “negative” financial outlook.

Our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, amendments to those reports, and Proxy Statement for our Annual Meeting of Stockholders are available free of charge on our website at www.employers.com as soon as reasonably practicable after they are electronically filed with or furnished to the Securities and Exchange Commission (SEC). Our website also provides access to reports filed by our Directors, executive officers and certain significant stockholders pursuant to Section 16 of the Securities Exchange Act of 1934. In addition, our Corporate Governance Guidelines, Code of Business Conduct and Ethics, Code of Ethics for Senior Financial Officers, and charters for the standing committees of our Board of Directors are available on our website. Copies of these documents may also be obtained free of charge by written request to Investor Relations, 10375 Professional Circle, Reno, Nevada 89521-4802. The SEC also maintains a website at www.sec.gov that contains the information that we file electronically with the SEC.

Description of Business

We are a specialty provider of workers' compensation insurance focused on select small businesses in low to medium hazard industries. We employ a disciplined, conservative underwriting approach designed to individually select specific types of businesses, predominantly those in the lowest four of the seven workers' compensation insurance industry defined hazard groups, that we believe will have fewer and less costly claims relative to other businesses in the same hazard groups. Workers' compensation is provided for under a statutory system wherein most employers are required to provide coverage for their employees' medical, disability, vocational rehabilitation, and/or death benefit costs for work-related injuries or illnesses. We operate as a single reportable segment and conduct operations in 31 states and the District of Columbia, with a concentration in California, where over one-half of our business is generated. We had total assets of $3.5 billion at December 31, 2012 and 2011. The following table highlights key results of our operations for the last three years.

For the Years Ended	Net Premiums Written	Total Revenue	Net Income	Statutory Combined Ratio[1]	
	(in thousands, except ratios)				
December 31, 2012	$569,676	$579,182	$106,891	85.8	%
December 31, 2011 (As Restated)	410,038	464,154	48,623	112.1	
December 31, 2010 (As Restated)	313,098	415,604	63,469	109.8	

(1) Our combined ratio on a statutory basis is a measure of underwriting profitability. Elsewhere in this report, unless otherwise stated, the term “combined ratio” refers to a calculation based on U.S. generally accepted accounting principles (GAAP).

The statutory combined ratio for the year ended December 31, 2012 includes the impact of a $100.0 million favorable adjustment to the ceded reserves under the Loss Portfolio Transfer Agreement. See Note 3 in the Notes to our Consolidated Financial Statements.

Our statutory combined ratio for the five years ended December 31, 2011 was 99.5%, compared to the industry composite statutory combined ratio of 115.2% for the same five-year period (calculated by A.M. Best for individual companies that have more than 50% of their business in workers' compensation).

Our insurance subsidiaries are domiciled in the following states:

State of Domicile

Employers Insurance Company of Nevada (EICN)	Nevada
Employers Compensation Insurance Company (ECIC)	California
Employers Preferred Insurance Company (EPIC)	Florida
Employers Assurance Company (EAC)	Florida

Products and Services

Workers' compensation provides insurance coverage for the statutorily prescribed benefits that employers are required to provide to their employees who may be injured or suffer illness in the course of employment. The level of benefits varies by state, the nature and severity of the injury or disease, and the wages of the injured worker. Each state has a statutory, regulatory, and adjudicatory system that sets the amount of wage replacement to be paid, determines the level of medical care required to be provided, establishes the degree of permanent impairment, and specifies the options in selecting healthcare providers. These state laws generally require two types of benefits for injured employees: (a) medical benefits, including expenses related to the diagnosis and treatment of an injury, disease, or both, as well as any required rehabilitation, and (b) indemnity payments, which consist of temporary wage replacement, permanent disability payments, and death benefits to surviving family members.

Disciplined Underwriting

Our strategy is to focus on disciplined underwriting and continue to pursue profitable growth opportunities across market cycles. We carefully monitor market trends to assess new business opportunities that we expect will meet our pricing and risk standards. We price our policies based on the specific risks associated with each potential insured rather than solely on the industry class in which a potential insured is classified. Our disciplined underwriting approach is a critical element of our culture and we believe that it has allowed us to offer competitive prices, diversify our risks, and out-perform the industry.

The following table compares our statutory loss and loss adjustment expense (LAE) ratio, a measure which relates inversely to our underwriting profitability, to the statutory industry composite loss and LAE ratio reported by A.M. Best (calculated for U.S. insurance companies having more than 50% of their premiums generated by workers' compensation insurance products).

	Statutory Loss and LAE Ratio			
Year	EHI[(1)]		A.M. Best	
2007	46.4	%	77.7	%
2008	51.4		78.6	
2009	57.5		86.1	
2010	66.2		87.4	
2011	77.6		89.6	
2012	57.4		N/A[(2)]	

(1) Our statutory loss and LAE ratio includes changes to reserves for losses and LAE established for prior periods.
(2) As of the date of this report, statutory industry composite loss and LAE ratio data was not available for 2012.

We execute our underwriting processes through automated systems and experienced underwriters with specific knowledge of local markets. We have developed automated underwriting templates for specific classes of business that produce faster quotes when certain underwriting criteria are met. Our underwriting guidelines consider many factors, such as type of business, nature of operations, and risk exposures, and are designed to minimize or prevent underwriting of certain undesirable classes of business.

Loss Control

Our loss control professionals provide consultation to policyholders to assist them in preventing losses and containing costs once claims occur. They also assist our underwriting personnel in evaluating potential and current policyholders and are an important part of our underwriting discipline.

Premium Audit

We conduct premium audits on substantially all of our policyholders annually upon the policy expiration. Premium audits allow us to comply with applicable state and reporting bureau requirements and to verify that policyholders have accurately reported their payroll and employee job classifications. We also selectively perform interim audits on certain classes of business or if unusual claims are filed or concerns are raised regarding projected annual payrolls, which could result in substantial variances at final audit.

Claims and Medical Case Management

The role of our claims department is to actively and efficiently investigate, evaluate, and pay claims, and to aid injured workers in returning to work in accordance with applicable laws and regulations. We have implemented rigorous claims guidelines and control procedures in our claims units and have claims operations throughout the markets we serve. We also provide medical case management services for those claims that we determine will benefit from such involvement.

Our claims department also provides claims management services for those claims incurred by the Nevada State Industrial Insurance System (the Fund) and assumed by EICN and subject to a 100% retroactive reinsurance agreement (the LPT Agreement) with dates of injury prior to July 1, 1995. Additional information regarding the LPT Agreement is set forth under "–Reinsurance–LPT Agreement." We receive a management fee from the third party reinsurers equal to 7% of the loss payments on these claims.

We utilize medical provider networks affiliated with Anthem Blue Cross of California (Anthem) and Coventry Health Care, Inc. and make every appropriate effort to direct injured workers into these networks for medical treatments. In addition to our medical networks, we work closely with local vendors, including attorneys, medical professionals, and investigators, to bring local expertise to our reported claims. We pay special attention to reducing costs and have established discounting arrangements with the aforementioned service providers. We use preferred provider organizations, bill review services, and utilization management to closely monitor medical costs.

We actively pursue fraud and subrogation recoveries to mitigate claims costs. Subrogation rights are based upon state and federal laws, as well as the insurance policies we issue. Our fraud and subrogation efforts are handled through dedicated units.

Information Technology

Core Operating Systems

We have an efficient, cost-effective and scalable infrastructure that complements our geographic reach and business model and have developed a highly automated underwriting system. This technology allows for the electronic submission, review, and quoting of insurance applications that applies our underwriting standards and guidelines. This policy administration system reduces transaction costs and provides for more efficient and timely processing of applications for small policies that meet our underwriting standards. We believe this approach saves our independent agents and brokers considerable time in processing customer applications and maintains our competitiveness in our target markets. We will continue to invest in technology and systems across our business to maximize efficiency, customer self-service, and create increased capacity that will allow us to lower our expense ratios while growing premiums.

Business Continuity/Disaster Recovery

We maintain business continuity and disaster recovery plans for our critical business functions, including the restoration of information technology infrastructure and applications. We have two data centers that act as production facilities and as disaster recovery sites for each other. In addition, we utilize an off-site data storage facility for critical customer and systems data.

Customers and Workers' Compensation Premiums

The workers' compensation insurance industry classifies risks into seven hazard groups, as defined by the National Council on Compensation Insurance (NCCI), based on severity of claims, with businesses in the first or lowest group having the lowest claims costs.

We target select small businesses engaged in low to medium hazard industries. Our historical loss experience has been more favorable for lower industry defined hazard groups than for higher hazard groups. Further, we believe it is generally less costly to service and manage the risks associated with these lower hazard groups. Our underwriters use their local market expertise and disciplined underwriting to select specific types of businesses and risks within the classes of business we underwrite that allow us to generate loss ratios that are consistently better than the industry average.

The following table sets forth our in-force premiums by hazard group and as a percentage of our total in-force premiums as of December 31:

Hazard Group	2012	Percentage of 2012 Total		2011	Percentage of 2011 Total		2010	Percentage of 2010 Total	
	(in thousands, except percentages)								
A	$120,863	22.5	%	$70,398	17.9	%	$45,537	14.2	%
B	136,849	25.5		95,783	24.3		74,435	23.2	
C	182,416	33.9		145,282	36.9		120,656	37.6	
D	77,148	14.4		58,534	14.9		47,906	14.9	
E	15,850	2.9		19,094	4.8		24,592	7.7	
F	4,128	0.8		4,682	1.2		7,531	2.3	
G	88	<0.1		148	<0.1		480	0.1	
Total	$537,342	100.0	%	$393,921	100.0	%	$321,137	100.0	%

Our in-force premiums for our top ten types of insureds and as a percentage of our total in-force premiums as of December 31, 2012 were as follows:

Employer Classifications	In-force Premiums	Percentage of Total	
	(in thousands, except percentages)		
Restaurants	$117,109	21.8	%
Dentists, Optometrists, and Physicians	36,142	6.7	
Automobile Service or Repair Shops	34,444	6.4	
Hotels, Motels, and Clubs	28,661	5.3	
Wholesale Stores	27,503	5.1	
Gasoline Stations	19,783	3.7	
Real Estate Management	16,002	3.0	
Schools – Colleges and Religious Organizations	15,038	2.8	
Groceries and Provisions	13,090	2.4	
Apparel Manufacturing	11,993	2.2	
Total	$319,765	59.4	%

We currently write business in 31 states and the District of Columbia. Our business is concentrated in California, which makes the results of our operations more dependent on the trends that are unique to that state and that may differ from national trends. State legislation, local competition, economic and employment trends, and workers' compensation medical costs trends can be material to our financial results.

As of December 31, 2012, our policyholders had average annual in-force premiums of $6,732. We are not dependent on any single policyholder and the loss of any single policyholder would not have a material adverse effect on our business.

Our total in-force premiums and number of policies in-force by state were as follows as of December 31:

State	2012 In-force Premiums	2012 Policies In-force	2011 In-force Premiums	2011 Policies In-force	2010 In-force Premiums	2010 Policies In-force
	(dollars in thousands)					
California	$317,890	46,829	$221,910	36,867	$172,621	29,244
Illinois	30,555	3,302	24,744	2,433	18,617	932
Georgia	22,985	3,150	16,393	2,050	10,772	757
Florida	17,676	2,918	15,226	2,399	15,071	1,963
Nevada	15,522	3,876	14,639	3,718	16,940	3,596
Other	132,714	19,739	101,009	13,226	87,116	8,069
Total	$537,342	79,814	$393,921	60,693	$321,137	44,561

The following trends affected our workers' compensation business from 2010 through 2012:

- In-force premiums increased 67.3%, primarily due to an increasing number of policies in-force and higher premium rates; and
- Total policies in-force increased 79.1%, reflecting our efforts to continue to grow our business profitably across market cycles.

We cannot be certain how these trends will ultimately impact our consolidated financial position and results of operations.

Our premiums are generally a function of the applicable premium rate, the amount of the insured's payroll, and if applicable, a factor reflecting the insured's historical loss experience (experience modification factor). Premium rates vary by state according to the nature of the employees' duties and the business of the employer. The premium is computed by applying the applicable premium rate to each class of the insured's payroll after it has been appropriately classified. Total policy premium is determined after applying an experience modification factor and a further adjustment, known as a schedule rating adjustment, which may be made in certain circumstances, to increase or decrease the policy premium. Schedule rating adjustments are made based on individual risk characteristics of the insured and subject to maximum amounts as established in our premium rate filings.

Our premium rates are based upon actuarial analyses for each state in which we do business, except in “administered pricing” states, primarily Florida and Wisconsin, where premium rates are set by state insurance regulators.

In September 2012, the California legislature passed Senate Bill No. 863 (SB 863), which was subsequently signed into law. SB 863 includes a number of reforms to California's workers' compensation system, including increases to permanent disability benefits offset by reforms designed to reduce costs in the system. According to the Workers' Compensation Insurance Rating Bureau, the cost savings are expected to be achieved through a number of measures, including: the creation of a new dispute resolution process outside of the Workers' Compensation Appeals Board for medical treatments and billing issues; new controls on liens; and calls for new fee schedules for physicians, interpreters, ambulatory surgery centers, and home health care.

Any cost savings associated with SB 863 will be dependent on the implementation of the provisions of the bill and are not included in our current rate filings. We will evaluate SB 863's mandated regulations as they are adopted and will adjust our rate filings as indicated. We can offer no assurance that SB 863 will result in any cost savings for us or when any cost savings might occur.

In California, where we generated 59% of our in-force premiums, we set our premium rates based upon actuarial analyses of current and anticipated loss trends with a goal of maintaining underwriting profitability. Due to increasing loss costs, primarily medical cost inflation, we increased our filed premium rates in California by a cumulative 41.3% since February 1, 2009.

The following table sets forth the percentage increases to our filed California rates effective for new and renewal policies incepting on or after the dates shown.

Effective Date	Premium Rate Change Filed in California	
February 1, 2009	10.0	%
August 15, 2009	10.5	
March 15, 2010	3.0	
March 15, 2011	2.5	
September 15, 2011	3.9	
June 15, 2012	6.0	

Losses and LAE Reserves and Loss Development

We are directly liable for losses and LAE under the terms of the insurance policies our insurance subsidiaries write. Significant periods of time can elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of that loss. Loss reserves are reflected on our consolidated balance sheets under the line item caption “Unpaid losses and loss adjustment expenses.” Estimating reserves is a complex process that involves a considerable degree of judgment by management and is inherently uncertain. Loss reserve estimates represent a significant risk to our business and we attempt to mitigate by frequently and routinely reviewing loss cost trends.

For a detailed description of our reserves, the judgments, key assumptions and actuarial methodologies that we use to estimate our reserves, and the role of our consulting actuary, see “Item 7 –Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations –Critical Accounting Policies –Reserves for Losses and LAE” and Note 11 in the Notes to our Consolidated Financial Statements.

The following tables show changes in the historical loss reserves, on a gross basis and net of reinsurance, at December 31 for each of the 10 years prior to 2012 for EICN and ECIC, and for each of the years ended December 31, 2008 through December 31, 2011 for EPIC and EAC. This information is presented on a GAAP basis and the paid and reserve data is presented on a calendar year basis.

The top line of each table shows the net and gross reserves for unpaid losses and LAE recorded at each year-end. Such amount represents an estimate of unpaid losses and LAE occurring in that year as well as future payments on claims occurring in prior years. The upper portion of these tables (net and gross cumulative amounts paid, respectively) present the cumulative amounts paid during subsequent years on those losses for which reserves were carried as of each specific year. The lower portions (net and gross reserves re-estimated, respectively) show the re-estimated amounts of the previously recorded reserves based on experience as of the end of each succeeding year. The re-estimated amounts change as more information becomes known about the actual losses for which the initial reserve was carried. An adjustment to the carrying value of unpaid losses for a prior year will also be reflected in the adjustments for each subsequent year. The gross cumulative redundancy (deficiency) line represents the cumulative change in estimates since the initial reserve was established. It is equal to the difference between the initial reserve and the latest re-estimated reserve amount. A redundancy means that the original estimate was higher than the current estimate. A deficiency means that the current estimate is higher than the original estimate.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
	(in thousands)									
Net reserves for losses and LAE										
Originally estimated	$908,326	$962,457	$1,089,814	$1,208,481	$1,209,652	$1,217,069	$1,430,128	$1,373,153	$1,323,686	$1,331,523
Net cumulative amounts paid as of:										
One year later	80,946	91,130	96,661	106,859	109,129	127,912	214,499	206,653	218,569	225,541
Two years later	130,386	150,391	161,252	175,531	186,014	219,496	342,174	361,048	371,065	
Three years later	165,678	193,766	207,868	229,911	249,059	295,646	449,914	472,831		
Four years later	194,400	226,127	247,217	279,405	302,863	354,867	532,107			
Five years later	218,453	255,851	285,388	321,060	345,801	405,556				
Six years later	242,143	288,039	317,489	354,765	384,509					
Seven years later	269,341	315,180	344,968	384,899						
Eight years later	292,791	338,611	369,270							
Nine years later	313,506	359,537								
Ten years later	331,681									
Net reserves re-estimated as of:										
One year later	847,917	924,878	1,011,759	1,101,352	1,149,641	1,151,246	1,378,769	1,359,023	1,324,813	1,333,323
Two years later	805,058	886,711	975,765	1,049,628	1,085,358	1,100,706	1,352,021	1,340,366	1,313,064	
Three years later	779,373	884,426	954,660	1,004,589	1,035,028	1,079,913	1,319,989	1,324,835		
Four years later	788,262	877,151	927,382	970,671	1,010,407	1,046,648	1,303,044			
Five years later	788,481	858,617	900,588	949,446	973,921	1,038,650				
Six years later	776,329	839,430	883,388	917,843	962,798					
Seven years later	763,988	826,608	855,070	907,593						
Eight years later	755,793	804,958	849,217							
	740,182	800,187								

Nine years later										
Ten years later	736,321									
Net cumulative redundancy (deficiency):	172,005	162,270	240,597	300,888	246,854	178,419	127,084	48,318	10,622	(1,800
Gross reserves - December 31	2,212,368	2,193,439	2,284,542	2,349,981	2,307,755	2,269,710	2,506,478	2,425,658	2,279,729	2,272,363
Reinsurance recoverable, gross	1,304,042	1,230,982	1,194,728	1,141,500	1,098,103	1,052,641	1,076,350	1,052,505	956,043	940,840
Net reserves - December 31	908,326	962,457	1,089,814	1,208,481	1,209,652	1,217,069	1,430,128	1,373,153	1,323,686	1,331,523
Gross re-estimated reserves	1,867,074	1,885,825	1,895,418	1,918,261	1,936,441	1,983,158	2,259,994	2,245,496	2,178,129	2,164,595
Re-estimated reinsurance recoverables	1,130,753	1,085,639	1,046,201	1,010,668	973,643	944,508	956,950	920,661	865,065	831,272
Net re-estimated reserves	736,321	800,186	849,217	907,593	962,798	1,038,650	1,303,044	1,324,835	1,313,064	1,333,323
Gross reserves for losses and LAE										
Originally estimated	2,212,368	2,193,439	2,284,542	2,349,981	2,307,755	2,269,710	2,506,478	2,425,658	2,279,729	2,272,363
Gross cumulative amounts paid as of:										
One year later	128,462	137,968	142,632	152,006	152,879	170,626	258,412	269,771	260,799	263,605
Two years later	224,740	243,203	252,379	264,430	272,478	304,146	449,206	466,398	451,359	
Three years later	306,006	331,731	342,748	361,524	377,459	422,862	599,176	616,244		
Four years later	379,881	407,845	424,811	452,955	473,828	522,296	719,433			
Five years later	447,687	480,283	504,918	537,175	556,978	609,775				
Six years later	514,091	554,408	579,585	611,093	632,477					
Seven years later	583,226	624,114	647,276	677,472						
Eight years later	649,241	687,757	707,823							
Nine years later	710,168	744,928								

Ten years later	764,588									
Gross reserves re-estimated as of:										
One year later	2,121,867	2,148,829	2,178,514	2,233,077	2,233,176	2,200,689	2,470,746	2,373,479	2,299,653	2,164,595
Two years later	2,072,205	2,088,437	2,138,648	2,170,292	2,162,695	2,148,399	2,405,837	2,370,646	2,178,129	
Three years later	2,024,790	2,084,764	2,110,481	2,119,764	2,110,615	2,110,230	2,386,424	2,245,496		
Four years later	2,032,553	2,072,428	2,078,223	2,084,854	2,074,466	2,094,050	2,259,994			
Five years later	2,028,211	2,050,124	2,050,937	2,053,869	2,050,177	1,983,158				
Six years later	2,012,943	2,030,945	2,027,187	2,027,729	1,936,441					
Seven years later	2,000,610	2,011,945	2,001,243	1,918,261						
Eight years later	1,986,694	1,990,684	1,895,418							
Nine years later	1,970,936	1,885,825								
Ten years later	1,867,074									
Gross cumulative redundancy:	$345,294	$307,614	$389,124	$431,720	$371,314	$286,552	$246,484	$180,162	$101,600	$107,768

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Reinsurance

Reinsurance is a transaction between insurance companies in which an original insurer, or ceding company, remits a portion of its premiums to a reinsurer, or assuming company, as payment for the reinsurer assuming a portion of the risk. Excess of loss reinsurance may be written in layers, in which a reinsurer or group of reinsurers accepts a band of coverage in excess of a specified amount, or retention, and up to a specified amount. Any liability exceeding the coverage limits of the reinsurance program is retained by the ceding company. The ceding company also bears the credit risk of a reinsurer's insolvency. In accordance with general industry practices, we purchase excess of loss reinsurance to protect against the impact of large individual, irregularly-occurring losses, and aggregate catastrophic losses from natural perils and terrorism. Such reinsurance reduces the magnitude of such losses on our net income and the capital of our insurance subsidiaries.

Excess of Loss Reinsurance

Our current reinsurance program applies to all covered losses occurring between 12:01 a.m. July 1, 2012 and 12:01 a.m. July 1, 2013. The reinsurance program consists of one treaty covering excess of loss and catastrophic loss events in five layers of coverage. Our reinsurance coverage is $195.0 million in excess of our $5.0 million retention on a per occurrence basis, subject to a $2.0 million annual aggregate deductible and certain exclusions. We are solely responsible for any losses we suffer above $200.0 million except those covered by the Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA). Covered losses which occur prior to expiration or cancellation of the agreement continue to be obligations of the subscribing reinsurers, subject to the other conditions in the agreement. The subscribing reinsurers may terminate the agreement only for our breach of the obligations of the agreement. We are responsible for the losses if the subscribing reinsurer cannot or refuses to pay.

The agreement includes certain exclusions for which our subscribing reinsurers are not liable for losses, including but not limited to losses arising from the following: reinsurance assumed by us under obligatory reinsurance agreements; financial guarantee and insolvency; certain nuclear risks; liability as a member, subscriber, or reinsurer of any pool, syndicate, or association, but not assigned risk plans; liability arising from participation or membership in any insolvency fund; loss or damage caused by war or civil unrest other than terrorism; certain workers' compensation business covering persons employed in Minnesota; and any loss or damage caused by any act of terrorism involving biological, chemical, nuclear, or radioactive pollution or contamination. Our underwriting guidelines generally require that insured risks fall within the coverage provided in the reinsurance program. Any risks written outside the reinsurance program require executive review and approval.

The agreement provides that we, or any subscribing reinsurer, may request commutation of any outstanding claim or claims 10 years after the effective date of termination or expiration of the agreements and provide a mechanism for the parties to achieve valuation for commutation. We may require a special commutation of the percentage share of any loss in the reinsurance program of any subscribing reinsurer that is in runoff.

LPT Agreement

In 1999, the Fund entered into a retroactive 100% quota share reinsurance agreement through a loss portfolio transfer transaction with third party reinsurers. The LPT Agreement commenced on June 30, 1999 and will remain in effect until all claims under the covered policies have closed, the agreement is commuted, or terminated, upon the mutual agreement of the parties, or the reinsurers' aggregate maximum limit of liability is exhausted, whichever occurs earlier. The LPT Agreement does not provide for any additional termination terms. On January 1, 2000, EICN assumed all of the assets, liabilities and operations of the Fund, including the Fund's rights and obligations associated with the LPT Agreement.

Under the LPT Agreement, the Fund initially ceded $1.5 billion in liabilities for the incurred but unpaid losses and LAE related to claims incurred prior to July 1, 1995, for consideration of $775.0 million in cash. The LPT Agreement, which ceded to the reinsurers substantially all of the Fund's outstanding losses as of June 30, 1999 for claims with original dates of injury prior to July 1, 1995, provides coverage for losses up to $2.0 billion, excluding losses for burial and transportation expenses. The estimated remaining liabilities subject to the LPT Agreement were approximately $672.3 million and $807.5 million, as of December 31, 2012 and 2011, respectively (See Note 3 in the Notes to our Consolidated Financial Statements for additional detail). Losses and LAE paid with respect to the LPT Agreement totaled approximately $605.1 million and $569.9 million through December 31, 2012 and 2011, respectively.

The reinsurers agreed to assume responsibilities for the claims at the benefit levels which existed in June 1999. The LPT Agreement required each reinsurer to place assets supporting the payment of claims by them in a trust that requires collateral be held at a specified level. The level must not be less than the outstanding reserve for losses and a loss expense allowance equal to 7% of estimated paid losses discounted at a rate of 6%. If the assets held in trust fall below this threshold, we may require the reinsurers to contribute additional assets to maintain the required minimum level of collateral. The value of these assets as of December 31, 2012 and 2011 was $1.0 billion and $0.9 billion, respectively.

The reinsurers currently party to the LPT Agreement are ACE Bermuda Insurance Limited, XL Reinsurance Limited, and National Indemnity Company. The contract provides that during the term of the agreement all reinsurers need to maintain a rating of not less than “A-” as determined by A.M. Best. Currently, each of the reinsurers party to the LPT Agreement has a rating of A- or higher.

We account for the LPT Agreement as retroactive reinsurance. Upon entry into the LPT Agreement, an initial deferred reinsurance gain was recorded as a liability on our consolidated balance sheet as Deferred reinsurance gain–LPT Agreement (Deferred Gain). We are also entitled to receive a contingent profit commission under the LPT Agreement. The contingent profit commission is estimated based on both actual paid results to date and projections of expected paid losses under the LPT Agreement. As of December 31, 2012, our estimate of ultimate expected contingent profit commission was $43.8 million.

Recoverability of Reinsurance

Reinsurance makes the assuming reinsurer liable to the ceding company to the extent of the reinsurance; however, it does not discharge the ceding company from its primary liability to its policyholders in the event the reinsurer is unable to meet its obligations under such reinsurance. We monitor the financial strength of our reinsurers and do not believe that we are currently exposed to any material credit risk through our reinsurance arrangements because our reinsurance is recoverable from generally large, well-capitalized reinsurance companies. At December 31, 2012, $1.0 billion was in trust accounts for reinsurance related to the LPT Agreement and an additional $5.8 million, not related to the LPT Agreement, was collateralized by cash or letters of credit.

The following table provides certain information regarding our ceded reinsurance recoverables for losses and LAE as of December 31, 2012.

Reinsurer	A.M. Best Rating(1)	Total Paid	Total Unpaid Losses and LAE	Total
		(in thousands)		
ACE Bermuda Insurance Limited	A+	$860	$67,234	$68,094
ACE Property & Casualty Insurance Company	A+	16	2,364	2,380
Alterra Bermuda Limited	A	51	2,640	2,691
American Healthcare Indemnity Company	B++	—	2,486	2,486
Aspen Insurance UK Limited	A	13	9,571	9,584
Everest Reinsurance Company	A+	43	1,894	1,937
Finial Reinsurance	A-	—	6,653	6,653
Hannover Rueckversicherung-AG	A+	9	17,759	17,768
Lloyds Syndicates	A	49	51,318	51,367
Munich Reinsurance America, Inc	A+	71	7,884	7,955
National Indemnity Company	A++	4,731	369,789	374,520
National Union Fire Insurance Co of Pittsburg	A	160	1,736	1,896
Partner Reinsurance Europe plc	A+	26	1,547	1,573
Relia Star Life Insurance Company	A	135	2,393	2,528
ST Paul Fire & Marine Insurance Company	A+	39	3,976	4,015
Swiss Reinsurance America Corporation	A+	46	10,517	10,563
Tokio Marine & Nichido Fire Insurance Ltd (US)	A++	39	5,265	5,304
XL Re Limited	A	3,011	235,320	238,331
All Other	Various	168	5,040	5,208
Total		$9,467	$805,386	$814,853

(1) A.M. Best's highest financial strength ratings for insurance companies are “A++” and “A+” (superior), “A” and “A–” (excellent), and "B++" and "B+" (good).

We review the aging of our reinsurance recoverables on a quarterly basis. At December 31, 2012, 1.8% of our reinsurance recoverables on paid losses were greater than 90 days overdue.

Inter-Company Reinsurance Pooling Agreement

Our insurance subsidiaries are parties to an inter-company pooling agreement for statutory reporting purposes. Under this agreement, the results of underwriting operations of each company are transferred to and combined with those of the others and the combined results are then reapportioned. The allocations under the pooling agreement are as follows:

- EICN — 53%
- ECIC — 27%
- EPIC — 10%
- EAC — 10%

Transactions under the pooling agreement are eliminated in consolidation and have no impact on our consolidated GAAP financial statements.

Investments

As of December 31, 2012, the total amortized cost of our investment portfolio was $2.0 billion and the fair value of the portfolio was $2.1 billion. These investments provide a source of income, although short-term changes in interest rates and our current investment strategies affect the amount of investment income we earn and the fair value of our portfolio. Our investment strategy balances consideration of duration, yield, and credit risk.

We seek to maximize total investment returns within the constraints of prudent portfolio management. The asset allocation is reevaluated by the Finance Committee of the Board of Directors on a quarterly basis. We employ Conning Asset Management (Conning) as our independent investment manager. Conning follows our written investment guidelines based upon strategies approved by our Board of Directors. We also utilize Conning's investment advisory services. 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, which in turn, is used in constructing an optimal portfolio.

Additional information regarding our investment portfolio, including our approach to managing investment risk, is set forth under “Item 7 –Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations –Liquidity and Capital Resources –Investments” and “Item 7A –Quantitative and Qualitative Disclosures about Market Risk.”

Marketing and Distribution

We market our workers' compensation insurance products through independent local, regional, and national agents and brokers; through our strategic partnerships and alliances, including our principal partners ADP, Inc. (ADP) and Anthem; and through relationships with national, regional, and local trade groups and associations, including the National Federation of Independent Business.

Independent Insurance Agents and Brokers

We establish and maintain strong, long-term relationships with independent insurance agencies that actively market our products and services. We offer ease of doing business, provide responsive service, and pay competitive commissions. Our sales representatives and underwriters work closely with independent agencies to market and underwrite our business. This results in enhanced understanding of the businesses and risks we underwrite and the needs of prospective customers. We do not delegate underwriting authority to agents or brokers. We are not dependent on any one agency and the loss of any one agency would not be material.

The following table sets forth the number of independent agencies that marketed and sold our insurance products, the percentage of in-force premiums generated by those agencies, and the percentage of in-force premiums generated by our largest agency.

	At December 31,					
	2012		2011		2010	
Number of independent agencies	4,120		3,742		2,610	
Percentage of in-force premiums generated by independent agencies	77.0	%	75.7	%	77.2	%
Percentage of in-force premiums generated by our largest agency	0.9	%	0.9	%	1.2	%

Strategic Partnerships and Alliances

We have developed important strategic relationships with companies that have established sales forces and common markets to expand our reach to alternative distribution channels. We jointly market our workers' compensation insurance products with ADP's payroll services and with Anthem's group health insurance plans. Additionally, we have entered into other strategic partnerships and alliances with payroll service providers and insurance brokerages. These relationships have allowed us to access new customers and to write attractive business in an efficient manner, and we are actively pursuing additional strategic partnership and alliance opportunities. We do not delegate underwriting authority to our strategic distribution partners.

Our strategic partnerships and alliances generated 22.6%, 23.8%, and 22.1% of our in-force premiums as of December 31, 2012, 2011, and 2010, respectively.

ADP. ADP is the largest payroll services provider in the United States servicing small and medium-sized businesses. As part of its services, ADP sells our workers' compensation insurance product along with its payroll and accounting services through its insurance agency and field sales staff primarily to small businesses. The majority of business written is through ADP's small business unit, which has accounts of 1 to 50 employees. We pay ADP fees that are a percentage of premiums received for services provided through the ADP program.

ADP markets workers' compensation insurance using its the Pay-by-Pay® (PBP) program. An advantage of ADP's PBP program is that the policyholder is not required to pay a deposit at the inception of the policy. The workers' compensation premium is deducted each time ADP processes the policyholders' payrolls along with its appropriate federal, state, and local taxes. These characteristics of the PBP program enable us to competitively price the workers' compensation insurance written as a part of that program.

Our relationship with ADP is non-exclusive; however, we believe we are a key strategic partner of ADP for our selected markets and classes of business. Our agreement with ADP may be terminated at any time by either party without cause upon 120 days notice.

Anthem. The Integrated MediComp℠ joint marketing program is an exclusive relationship that allows us to combine our workers' compensation product with Anthem's group health coverage through a single bill in most cases. We believe that, in general, when businesses purchase this combination of coverage, their employees make fewer workers' compensation claims because those employees are insured for non-work related illnesses or injuries and thus are less likely to seek treatment for a non-work related illness or injury through their employers' workers' compensation insurance policy. As the largest group health carrier in California, Anthem has negotiated favorable rates with its medical providers and associated facilities, which we benefit from through reduced claims costs. We pay Anthem fees that are a percentage of premiums received for services provided under the Integrated MediComp program.

Our agreement with Anthem automatically renews for one-year periods unless terminated by either party with at least 60 days notice prior to the expiration of the then current term and has been renewed through January 1, 2014.

Competition and Market Conditions

The insurance industry is highly competitive, and there is significant competition in the national workers' compensation industry that is based on price and quality of services. We compete with other specialty workers' compensation carriers, state agencies, multi-line insurance companies, professional employer organizations, third-party administrators, self-insurance funds, and state insurance pools. Many of our competitors are significantly larger, are more widely known, and/or possess considerably greater financial resources. Our primary competitors in California are The Hartford Financial Services Group, Inc., Travelers Insurance Group Holdings, Inc., Zurich Insurance Group Ltd., and Berkshire Hathaway Homestate Companies.

Our competitive advantages include our strong reputation in the markets in which we operate, excellent claims service, experienced and professional independent agents and brokers, our strategic partnerships and alliances, and the ease of doing business with us. We also strive to maintain the high quality of our care management services, and to provide consultation services to our agents and insureds on loss prevention and loss reduction strategies. We also compete on price, based on our actuarial analysis of current and anticipated loss cost trends.

The workers' compensation sector continued to see average medical and indemnity claims costs increase in 2011, the most recent year for which industry data is available. We continue to have concerns related to the volatility and uncertainty in the financial markets and economic conditions generally.

Regulation

State Insurance Regulation

Insurance companies are subject to regulation and supervision by the insurance regulator in the state in which they are domiciled and, to a lesser extent, other states in which they conduct business. Our insurance subsidiaries are subject to regulation by the states in which our insurance subsidiaries are domiciled or transact business. These state agencies have broad regulatory, supervisory, and administrative powers, including among other things, the power to grant and revoke licenses to transact business, license agencies, set the standards of solvency to be met and maintained, determine the nature of, and limitations on, investments and dividends, approve policy forms and rates in some states, periodically examine financial statements, determine the form and content of required financial statements, set the rates that we may charge in some states, and periodically examine market conduct.

Detailed annual and quarterly financial statements, prepared in accordance with statutory accounting principles (SAP), and other reports are required to be filed with the insurance regulator in each of the states in which we are licensed to transact business. The California Department of Insurance (California DOI), Florida Office of Insurance Regulation (Florida OIR), and Nevada Division of Insurance (Nevada DOI) periodically examine the statutory financial statements of their respective domiciliary insurance companies. In 2012, the California DOI, Florida OIR, and Nevada DOI completed financial examinations for ECIC, EPIC and EAC, and EICN, respectively. There were no material findings.

Many states have laws and regulations that limit an insurer's ability to withdraw from a particular market. For example, states may limit an insurer's ability to cancel or not renew policies. Furthermore, certain states prohibit an insurer from withdrawing one or more lines of business from the state, except pursuant to a plan that is approved by the state insurance regulator. The state insurance regulator may disapprove a plan that may lead to market disruption. We are subject to laws and regulations of this type, and these laws and regulations may restrict our ability to exit unprofitable markets.

Holding Company Regulation. Nearly all states have enacted legislation that regulates insurance holding company systems. Each insurance company in a holding company system is required to register with the insurance regulator of its state of domicile and furnish information concerning the operations of companies within the holding company system that may materially affect the operations, management or financial condition of the insurers within the system. All transactions within a holding company system affecting an insurer must have fair and reasonable terms, the charges or fees for services performed must be reasonable, the insurer's total statutory surplus following any transaction must be both reasonable in relation to its outstanding liabilities and adequate for its needs, and are subject to other standards and requirements established by law and regulation. Notice to state insurance regulators is required prior to the consummation of certain affiliated and other transactions involving our insurance subsidiaries and such transactions may be disapproved by the state insurance regulators.

Pursuant to applicable insurance holding company laws, EICN is required to register with the Nevada DOI, ECIC is required to register with the California DOI, and EPIC and EAC are required to register with the Florida OIR. Under these laws, the respective state insurance departments may examine us at any time, require disclosure of material transactions and require prior notice for, or approval of, certain transactions.

Change of Control. Our insurance subsidiaries are domiciled in Florida, California and Nevada. The insurance laws of these states generally require that any person seeking to acquire control of a domestic insurance company obtain the prior approval of the state's insurance commissioner. In Florida, "control" is generally presumed to exist through the direct or indirect ownership of 5% or more of the voting securities of a domestic insurance company or of any entity that controls a domestic insurance company. In California and Nevada, "control" is presumed to exist through the direct or indirect ownership of 10% or more of the voting securities of a domestic insurance company or of any entity that controls a domestic insurance company. In addition, insurance laws in many states in which we are licensed require pre-notification to the state's insurance commissioner of a change in control of a non-domestic insurance company licensed in those states.

Statutory Accounting and Solvency Regulations. State insurance regulators closely monitor the financial condition of insurance companies reflected in financial statements based on SAP and can impose significant financial and operating restrictions on an insurance company that becomes financially impaired under SAP guidelines. State insurance regulators can generally impose restrictions or conditions on the activities of a financially impaired insurance company, including: the transfer or disposition of assets; the withdrawal of funds from bank accounts; payment of dividends or other distributions; the extension of credit or the advancement of loans; and investments of funds, including business acquisitions or combinations.

Financial, Dividend, and Investment Restrictions. State laws require insurance companies to maintain minimum levels of surplus and place limits on the amount of premiums a company may write based on the amount of that company's surplus. These limitations may restrict the rate at which our insurance operations can grow.

State laws also require insurance companies to establish reserves for payments of policyholder liabilities and impose restrictions on the kinds of assets in which insurance companies may invest. These restrictions may require us to invest in assets more conservatively than we would if we were not subject to state law restrictions and may prevent us from obtaining as high a return on our assets as we might otherwise be able to realize absent the restrictions.

The ability of EHI to pay dividends on our common stock and to pay other expenses will be dependent to a significant extent upon the ability of EICN and EPIC to pay dividends to their immediate holding company, Employers Group, Inc. (EGI) and, in turn, the ability of EGI to pay dividends to EHI. Additional information regarding financial,

dividend, and investment restrictions is set forth in Note 17 in the Notes to our Consolidated Financial Statements.
Insurance Assessments. All of the states where our insurance subsidiaries are licensed to transact business require property and casualty insurers doing business within the state to pay various insurance assessments. We accrue a liability for estimated insurance assessments as direct premiums are written, losses are recorded, or as other events occur in accordance with various states' laws and regulations, and defer these costs and recognize them as an expense as the related premiums are earned. Various mechanisms exist in some of these states for assessed insurance companies to recover certain assessments. Additional information regarding insurance assessments is set forth in Note 14 to our Consolidated Financial Statements.
Pooling Arrangements. As a condition to conduct business in some states, insurance companies are required to participate in mandatory workers' compensation shared market mechanisms, or pooling arrangements, which provide workers' compensation

insurance coverage to private businesses that are otherwise unable to obtain coverage due, for example, to their prior loss experiences.

The National Association of Insurance Commissioners (NAIC). NAIC is a group formed by state insurance regulators to discuss issues and formulate policy with respect to regulation, reporting, and accounting of and by U.S. insurance companies. Although the NAIC has no legislative authority and insurance companies are at all times subject to the laws of their respective domiciliary states and, to a lesser extent, other states in which they conduct business, the NAIC is influential in determining the form in which such laws are enacted. Model Insurance Laws, Regulations and Guidelines (Model Laws) have been promulgated by the NAIC as a minimum standard by which state regulatory systems and regulations are measured. Adoption of state laws that provide for substantially similar regulations to those described in the Model Laws is a requirement for accreditation of state insurance regulatory agencies by the NAIC. Under the Model Laws, insurers are required to maintain minimum levels of capital based on their investments and operations. These risk-based capital (RBC) requirements provide a standard by which regulators can assess the adequacy of an insurance company's capital and surplus relative to its operations. An insurance company must maintain capital and surplus of at least 200% of the RBC computed by the NAIC's RBC model, known as the "Authorized Control Level" of RBC. At December 31, 2012, each of our insurance subsidiaries had total adjusted capital in excess of the minimum RBC requirements.

The key financial ratios of the NAIC's Insurance Regulatory Information System (IRIS) were developed to assist state regulators in overseeing the financial condition of insurance companies. These ratios are reviewed by financial examiners of the NAIC and state insurance regulators for the purposes of detecting financial distress and preventing insolvency and to select those companies that merit highest priority in the allocation of the regulators' resources. IRIS identifies 13 key financial ratios and specifies a "usual range" for each. Departure from the usual ranges on four or more of the ratios can lead to inquiries from individual state insurance regulators as to certain aspects of an insurer's business. None of our insurance subsidiaries are currently subject to any action by any state regulator with respect to IRIS ratios.

Federal Regulation

We are affected by a variety of federal legislative and regulatory measures and judicial decisions.

The Terrorism Risk Insurance Act of 2002 (the 2002 Act) was enacted in November 2002. The principal purpose of the 2002 Act was to create a role for the Federal government in the provision of insurance for losses sustained in connection with foreign terrorism. The 2002 Act was extended by TRIPRA, with the inclusion of some adjustments. The workers' compensation laws of the various states generally do not permit the exclusion of coverage for losses arising from terrorism or nuclear, biological, chemical, or radiological attacks. In addition, we are not able to limit our losses arising from any one catastrophe or any one claimant. Our reinsurance policies exclude coverage for losses arising out of nuclear, biological, chemical or radiological attacks. Under TRIPRA, federal protection may be provided to the insurance industry for certain acts of foreign and domestic terrorism, including nuclear, biological, chemical or radiological attacks.

The impacts of any future terrorist acts are unpredictable, and the ultimate impact on our insurance subsidiaries, if any, of losses from any future terrorist acts will depend upon their nature, extent, location, and timing. We monitor the geographic concentration of our policyholders to help mitigate the risk of loss from terrorist acts.

Item 1A. Risk Factors

Investing in our common stock involves risks. In evaluating our company, you should carefully consider the risks described below, together with all the information included or incorporated by reference in this annual report. The risks facing our company include, but are not limited to, those described below. Additional risks that we are not presently aware of or that we currently believe are immaterial may also impair our business operations. The occurrence of one or more of these events could significantly and adversely affect our business, financial condition, results of operations, cash flows, and stock price and you could lose all or part of your investment.

Risks Related to Our Business

Difficult conditions in the economy and capital markets may adversely affect our profitability, financial condition, and results of operations.

The financial market volatility experienced worldwide that began in 2008 continued into 2012. Although the U.S. and foreign governments have taken various actions to stabilize financial markets, it is uncertain whether those actions will be effective over the long-term. Financial market volatility could continue, resulting in a prolonged negative economic impact.

We cannot predict future market conditions or their impact on our stock price, investment portfolio, or our workers' compensation business. In addition, continuing financial market volatility and economic downturn could have a material adverse affect on our insureds, agents, claimants, reinsurers, vendors, and competitors. Depending on financial market conditions, we could incur additional realized and unrealized losses in the future in our investment portfolio, which could have a material adverse effect on our results of operations and financial condition.

Our liability for losses and LAE is based on estimates and may be inadequate to cover our actual losses and expenses.

We must establish and maintain reserves for our estimated losses and LAE. We establish loss reserves in our financial statements that represent an estimate of amounts needed to pay and administer claims with respect to insured claims that have occurred, including claims that have occurred but have not yet been reported to us. Loss reserves are estimates of the ultimate cost of individual claims based on actuarial estimation techniques, are inherently uncertain, and do not represent an exact measure of liability.

Several factors contribute to the uncertainty in establishing estimated losses, including the length of time to settle long-term, severe cases, claim cost inflation (deflation) trends, and uncertainties in the long-term outcome of legislative reforms. Judgment is required in applying actuarial techniques to determine the relevance of historical payment and claim settlement patterns under current facts and circumstances. In certain states, we have a relatively short operating history and must rely on a combination of industry experience and our specific experience regarding claims emergence and payment patterns, medical cost inflation, and claim cost trends, adjusted for future anticipated changes in claims-related and economic trends, as well as regulatory and legislative changes, to establish our best estimate of reserves for losses and LAE. As we receive new information and update our assumptions over time regarding the ultimate liability, our loss reserves may prove to be inadequate to cover our actual losses. Any changes in these estimates could be material and could have an adverse effect on our results of operations and financial condition during the period the changes are made.

The insurance business is subject to extensive regulation and legislative changes, which impact the manner in which we operate our business.

Our insurance business is subject to extensive regulation by the applicable state agencies in the jurisdictions in which we operate, most significantly by the insurance regulators in California, Florida, and Nevada, the states in which our insurance subsidiaries are domiciled. As of December 31, 2012, over one-half of our in-force premiums were generated in California. Accordingly, we are particularly affected by regulation in California. The passage of any form of rate regulation in California could impair our ability to operate profitably in California, and any such impairment could have a material adverse effect on our financial condition and results of operations.

More generally, insurance regulators have broad regulatory powers designed to protect policyholders and claimants, not stockholders or other investors. Regulations vary from state to state, but typically address or include:

- standards of solvency, including RBC measurements;
- restrictions on the nature, quality, and concentration of investments;
- restrictions on the types of terms that we can include in the insurance policies we offer;
- mandates that may affect wage replacement and medical care benefits paid under the workers' compensation system;
- requirements for the handling and reporting of claims and procedures for adjusting claims;
- restrictions on the way rates are developed and premiums are determined;
- the manner in which agents may be appointed;
- establishment of liabilities for unearned premiums, unpaid losses and LAE, and for other purposes;
- limitations on our ability to transact business with affiliates;
- mergers, acquisitions, and divestitures involving our insurance subsidiaries;
- licensing requirements and approvals that affect our ability to do business;
- compliance with all applicable privacy laws;
- potential assessments for the settlement of covered claims under insurance policies issued by impaired, insolvent, or failed insurance companies or other assessments imposed by regulatory agencies; and
- the amount of dividends that our insurance subsidiaries may pay to EGI and, in turn, the ability of EGI to pay dividends to EHI.

Workers' compensation insurance is statutorily provided for in all of the states in which we do business. State laws and regulations specify the form and content of policy coverage and the rights and benefits that are available to injured workers, their representatives, and medical providers. In “administered pricing” states, insurance rates are set by the state insurance regulators and are adjusted periodically. Rate competition is generally not permitted in these states. Of

the states in which we currently operate, Florida, Wisconsin, and Idaho are administered pricing states. Additionally, we are exposed to the risk that other states in which we operate will adopt administered pricing laws.
Legislation and regulation impact our ability to investigate fraud and other abuses of the workers' compensation system in the states in which we do business. Our relationships with medical providers are also impacted by legislation and regulation, including penalties for failure to make timely payments.

Federal legislation typically does not directly impact our workers' compensation business, but our business can be indirectly affected by changes in healthcare, occupational safety and health, and tax and financial regulations. Since healthcare costs are the largest component of our loss costs, we may be impacted by changes in healthcare legislation, such as the Affordable Care Act, which could effect healthcare costs in the future. There is also the possibility of federal regulation of insurance.

This extensive regulation of our business may affect the cost or demand for our products and may limit our ability to obtain rate increases or to take other actions that we might desire to maintain our profitability. In addition, we may be unable to maintain all required approvals or comply fully with applicable laws and regulations, or the relevant governmental authority's interpretation of such laws and regulations. If that were to occur, we might lose our ability to conduct business in certain jurisdictions. Further, changes in the level of regulation of the insurance industry or changes in laws or regulations or interpretations by regulatory authorities could impact our operations, require us to bear additional costs of compliance, and impact our profitability.

If we fail to price our insurance policies appropriately, our business competitiveness, financial condition, and results of operations could be materially adversely affected.

Premiums are based on the particular class of business and our estimates of expected losses and LAE and other expenses related to the policies we underwrite. We analyze many factors when pricing a policy, including the policyholder's prior loss history and industry classification. Inaccurate information regarding a policyholder's past claims experience could put us at risk for mispricing our policies, which could have a material adverse effect on our business, financial condition, and results of operations. For example, when initiating coverage on a policyholder, we must rely on the information provided by the policyholder or the policyholder's previous insurer(s) to properly estimate future claims expense. In order to set premium rates accurately, we must utilize an appropriate pricing model which correctly assesses risks based on their individual characteristics and takes into account actual and projected industry characteristics.

Our concentration in California ties our performance to the business, economic, demographic, natural perils, competitive, and regulatory conditions in that state.

Our business is concentrated in California, where we generated 59% of our in-force premiums as of December 31, 2012. Accordingly, unfavorable business, economic, demographic, natural perils, competitive, or regulatory conditions in California could negatively impact our business.

California has been greatly affected by the overall economic downturn and tightening of the credit markets. The economic condition of the state has resulted in high unemployment and decreased payrolls. In addition, many California businesses are dependent on tourism revenues, which are, in turn, dependent on a robust economy. The downturn in the national economy and the economy of California, or any other event that causes deterioration in tourism, could adversely impact small businesses, such as restaurants, that we have targeted as customers. The departure from California or insolvency of a significant number of small businesses could also have a material adverse effect on our financial condition and results of operations. California is also exposed to climate and environmental changes, natural perils such as earthquakes, along with the possibility of pandemics or terrorist acts. Accordingly, we could suffer losses as a result of catastrophic events in this state. Because our business is concentrated in this manner, we may be exposed to economic and regulatory risks or risk from natural perils that are greater than the risks associated with companies with greater geographic diversification.

We rely on independent insurance agents and brokers.

We market and sell our insurance products primarily through independent, non-exclusive insurance agents and brokers. These agents and brokers are not obligated to promote our products and can and do sell our competitors' products. In addition, these agents and brokers may find it easier to promote the broader range of programs of some of our competitors than to promote our single-line workers' compensation insurance products. The loss of a number of our independent agents and brokers or the failure or inability of these agents to successfully market our insurance programs could have a material adverse effect on our business, financial condition and results of operations.

We rely on relationships with our principal strategic partners.

We have agreements with two principal strategic partners, ADP and Anthem, to market and service our insurance products through their sales forces and insurance agencies. ADP and Anthem generated 10.3% and 10.1%, respectively, of our total in-force premiums as of December 31, 2012. Our agreement with ADP is not exclusive, and ADP may terminate the agreement without cause upon 120 days notice. Although our distribution agreements with Anthem are exclusive, Anthem may terminate its agreements with us if the A.M. Best financial strength rating of ECIC is downgraded and we are not able to provide coverage through a carrier with an A.M. Best financial strength rating of “B++” or better. Anthem may also terminate its agreements with us without cause upon 60 days notice. The termination of any of our principal strategic partnership agreements, our failure to maintain good relationships with our principal strategic partners, or their failure to successfully market our products may materially reduce our revenues and could have a material adverse effect on our results of operations. In addition, we are subject to the risk that our principal strategic partners may face financial difficulties, reputational issues, or problems with respect to their own products and services, which may lead to decreased sales of our products and services. Moreover, if either of our principal strategic partners consolidates or aligns itself with another company or changes its products that are currently offered with our workers' compensation insurance product, we may lose business or suffer decreased revenues.

We are also subject to credit risk with respect to ADP and Anthem, as they collect premiums on our behalf for the workers' compensation products that are marketed together with their own products. Any failure to remit such premiums to us or to remit such amounts on a timely basis could have an adverse effect on our results of operations.

A downgrade in our financial strength rating could reduce the amount of business that we are able to write or result in the termination of certain of our agreements with our strategic partners.

Rating agencies rate insurance companies based on financial strength as an indication of an ability to pay claims. Our insurance subsidiaries are currently assigned a group letter rating of "A–" (Excellent) by A.M. Best, which is the rating agency that we believe has the most influence on our business. This rating is assigned to companies that, in the opinion of A.M. Best, have demonstrated an excellent overall performance when compared to industry standards. A.M. Best considers "A–" rated companies to have an excellent ability to meet their ongoing obligations to policyholders. This rating does not refer to our ability to meet non-insurance obligations.

The financial strength ratings of A.M. Best and other rating agencies are subject to periodic review using, among other things, proprietary capital adequacy models, and are subject to revision or withdrawal at any time. Insurance financial strength ratings are directed toward the concerns of policyholders and insurance agents and are not intended for the protection of investors or as a recommendation to buy, hold, or sell securities. Our competitive position relative to other companies is determined in part by our financial strength rating. A reduction in our A.M. Best rating could adversely affect the amount of business we could write, as well as our relationships with independent agents and brokers and strategic partners.

In view of the difficulties experienced recently by many financial institutions, including some of our competitors in the insurance industry, we believe that it is possible that external rating agencies, such as A.M. Best, may increase their scrutiny of financial institutions, increase the frequency and scope of their reviews, request additional information from the companies that they rate, including additional information regarding the valuation of investment securities held, and may adjust upward the capital and other requirements employed in their models for maintenance of certain rating levels. We cannot predict what actions rating agencies may take, or what actions we may take in response to the actions of rating agencies.

One of our strategic partners, Anthem, requires that we offer workers' compensation coverage through a carrier with a financial strength rating of "B++" or better by A.M. Best. We currently offer this coverage through our subsidiary, ECIC. Our inability to offer such coverage could cause a reduction in the number of policies we write. If ECIC's financial strength rating were downgraded, and we were not able to enter into an agreement to provide coverage through a carrier rated "B++" or better by A.M. Best, Anthem could terminate its distribution agreements with us. We cannot assure you that we would be able to enter such an agreement if our rating was downgraded.

If we are unable to obtain reinsurance or collect on ceded reinsurance, our ability to write new policies and to renew existing policies could be adversely affected and our financial condition and results of operations could be materially adversely affected.

At December 31, 2012, we had $815 million of reinsurance recoverables for paid and unpaid losses and LAE of which $9 million was due to us on paid claims.

We purchase reinsurance to protect us against the costs of severe claims and catastrophic events, including natural perils and acts of terrorism, excluding nuclear, biological, chemical, and radiological events. On July 1, 2012, we entered into a new reinsurance program that is effective through June 30, 2013. The reinsurance program consists of one treaty covering excess of loss and catastrophic loss events in five layers of coverage. Our reinsurance coverage is $195 million in excess of our $5 million retention on a per occurrence basis, subject to a $2 million annual aggregate deductible and certain exclusions.

The availability, amount, and cost of reinsurance depend on market conditions and our loss experience and may vary significantly. We cannot be certain that our reinsurance agreements will be renewed or replaced prior to their expiration upon terms satisfactory to us. If we are unable to renew or replace our reinsurance agreements upon terms satisfactory to us, our net liability on individual risks would increase and we would have greater exposure to catastrophic losses, which could have a material adverse affect on our financial condition and results of operations.

In addition, we are subject to credit risk with respect to our reinsurers, and they may refuse to pay or delay payment of losses we cede to them. We remain liable to our policyholders even if we are unable to make recoveries that we believe we are entitled to under our reinsurance contracts. Losses may not be recovered from our reinsurers until claims are paid and, in the case of long-term workers' compensation cases, the creditworthiness of our reinsurers may change before we can recover amounts that we are entitled to. The inability of any of our reinsurers to meet their financial obligations could have a material adverse affect on our financial condition and results of operations.

We obtained reinsurance covering the losses incurred prior to July 1, 1995, and we could be liable for all of those losses if the coverage provided by the LPT Agreement proves inadequate or we fail to collect from the reinsurers party to such transaction.

On January 1, 2000, EICN assumed all of the assets, liabilities, and operations of the Fund, including losses incurred by the Fund prior to such date. EICN also assumed the Fund's rights and obligations associated with the LPT Agreement that the Fund entered into with third party reinsurers with respect to its losses incurred prior to July 1, 1995, see "Item 1 –Business –Reinsurance –LPT Agreement." We could be liable for all of those losses if the coverage provided by the LPT Agreement proves inadequate or we fail to collect from the reinsurers party to such transaction. As of December 31, 2012, the estimated remaining liabilities subject to the LPT Agreement were $672 million. If we are unable to collect on these reinsurance recoverables, our financial condition and results of operations could be materially adversely affected.

The reinsurers under the LPT Agreement agreed to assume responsibilities for the claims at the benefit levels which existed in June 1999. Accordingly, if the Nevada legislature were to increase the benefits payable for the pre-July 1, 1995 claims, we would be responsible for the increased benefit costs to the extent of the legislative increase. If the credit rating of any of the third party reinsurers that are party to the LPT Agreement were to fall below "A–" as determined by A.M. Best or one of the reinsurers becomes insolvent, we would be responsible for replacing any such reinsurer or would be liable for the claims that otherwise would have been transferred to such reinsurer. For example, in 2002, the rating of one of the original reinsurers under the LPT Agreement, Gerling Global International Reinsurance Company Ltd. (Gerling), dropped below the mandatory "A–" rating to "B+." Accordingly, we entered into an agreement to replace Gerling with National Indemnity Company at a cost to us of $33 million. We can give no assurance that circumstances requiring us to replace one or more of the current reinsurers under the LPT Agreement will not occur in the future, that we will be successful in replacing such reinsurer or reinsurers in such circumstances, or that the cost of such replacement or replacements will not have a material adverse effect on our results of operations or financial condition.

The LPT Agreement also required the reinsurers to each place assets supporting the payment of claims by them in individual trusts that require that collateral be held at a specified level. The collateralization level must not be less than the outstanding reserve for losses and a loss expense allowance equal to 7% of estimated paid losses discounted at a rate of 6%. If the assets held in trust fall below this threshold, we can require the reinsurers to contribute additional assets to maintain the required minimum level. The value of these assets at December 31, 2012 was $1.0 billion. If the value of the collateral in the trusts drops below the required minimum level and the reinsurers are unable to contribute additional assets, we could be responsible for substituting a new reinsurer or paying those claims without the benefit of reinsurance. One of the reinsurers has collateralized its obligations under the LPT Agreement by placing shares of stock of a publicly held corporation, with a value of $804 million at December 31, 2012, in a trust to secure the reinsurer's obligation of $370 million. The value of this collateral is subject to fluctuations in the market price of such stock. The other reinsurers have placed treasury and fixed maturity securities in trusts to collateralize their obligations.

Intense competition and the fact that we write only a single line of insurance could adversely affect our ability to sell policies at rates we deem adequate.

The market for workers' compensation insurance products is highly competitive. Competition in our business is based on many factors, including premiums charged, services provided, financial ratings assigned by independent rating agencies, speed of claims payments, reputation, policyholder dividends, perceived financial strength, and general experience. In some cases, our competitors offer lower priced products than we do. If our competitors offer more competitive premiums, dividends or payment plans, services or commissions to independent agents, brokers, and other distributors, we could lose market share or have to reduce our premium rates, which could adversely affect our profitability. We compete with regional and national insurance companies, professional employer organizations, third-party administrators, self-insured employers, and state insurance funds. Our main competitors vary from state to state, but are usually those companies that offer a full range of services in underwriting, loss control, and claims. We compete on the basis of the services that we offer to our policyholders and on ease of doing business rather than solely on price.

Many of our competitors are significantly larger and possess greater financial, marketing, and management resources than we do. Some of our competitors benefit financially by not being subject to federal income tax. Intense competitive pressure on prices can result from the actions of even a single large competitor. Competitors with more surplus than us have the potential to expand in our markets more quickly than we can. Greater financial resources also permit an insurer to gain market share through more competitive pricing, even if that pricing results in reduced underwriting margins or an underwriting loss.

Many of our competitors are multi-line carriers that can price the workers' compensation insurance they offer at a loss in order to obtain other lines of business at a profit. This creates a competitive disadvantage for us, as we only offer a single line of insurance. For example, a business may find it more efficient or less expensive to purchase multiple lines of commercial insurance coverage from a single carrier.

The property and casualty insurance industry is cyclical in nature and is characterized by periods of so-called “soft” market conditions in which premium rates are stable or falling, insurance is readily available, and insurers' profits decline, and by periods of so-called “hard” market conditions, in which rates rise, insurance may be more difficult to find, and insurers' profits increase. According to the Insurance Information Institute, since 1970, the property and casualty insurance industry experienced hard market conditions from 1975 to 1978, 1984 to 1987, and 2001 to 2004. Although the financial performance of an individual insurance

company is dependent on its own specific business characteristics, the profitability of most workers' compensation insurance companies generally tends to follow this cyclical market pattern. We believe the workers' compensation industry currently has excess underwriting capacity resulting in lower rate levels and smaller profit margins.
Because of cyclicality in the workers' compensation market, due in large part to competition, capacity, and general economic factors, we cannot predict the timing or duration of changes in the market cycle. We continue to experience price competition in our target markets. This cyclical pattern has in the past and could in the future adversely affect our financial condition and results of operations. If we are unable to compete effectively, our business, financial condition, and results of operations could be materially adversely affected.
We may be unable to realize our investment objectives and economic conditions in the financial markets could lead to investment losses.
Investment income is an important component of our revenue and net income. Our investment portfolio is managed by an independent asset manager that operates under investment guidelines approved by our Board of Directors. Although these guidelines stress diversification and capital preservation, our investments are subject to a variety of risks that are beyond our control, including risks related to general economic conditions, interest rate fluctuations, and market volatility. Interest rates are highly sensitive to many factors, including governmental monetary policies and domestic and international economic and political conditions. These and other factors affect the capital markets and, consequently, the value of our investment portfolio.
We are exposed to significant financial risks related to the capital markets, including 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 interest rate risk, credit spread risk, credit risk, and equity price risk. For more information regarding market risk, interest rate risk, or equity price risk, see "Item 7A–Quantitative and Qualitative Disclosures About Market Risk."
The outlook for our investment income is dependent on the future direction of interest rates, maturity schedules, and cash flow from operations that is available for investment. The fair values of fixed maturity securities that are “available-for-sale” fluctuate with changes in interest rates and cause fluctuations in our stockholders' equity. Any significant decline in our investment income or the value of our investments as a result of changes in interest rates, deterioration in the credit of companies in which we have invested, decreased dividend payments, general market conditions, or events that have an adverse impact on any particular industry or geographic region in which we hold significant investments could have an adverse effect on our net income and, as a result, on our stockholders' equity and policyholder surplus.
The valuation of our investments, including the determination of the amount of impairments, include estimates and assumptions and could result in changes to investment valuations that may adversely affect our financial condition and results of operations. The use of internally developed valuation techniques may have a material effect on the estimated fair value amounts of our investments and our financial condition.
Additionally, we regularly review our entire investment portfolio, including the identification of other-than-temporary declines in fair value. The determination of the amount of impairments taken on our investments is based on our periodic evaluation and assessment of our investments and known and inherent risks associated with the various asset classes. There can be no assurance that we have accurately determined the level of other-than-temporary impairments reflected in our financial statements and additional impairments may need to be taken in the future. Historical trends may not be indicative of future impairments.
We may require additional capital in the future, which may not be available to us or may be available only on unfavorable terms.
Our future capital requirements will depend on many factors, including state regulatory requirements, our ability to write new business successfully, and to establish premium rates and reserves at levels sufficient to cover losses. If we have to raise additional capital, equity or debt financing may not be available on terms that are favorable to us. In the case of equity financings, there could be dilution to our stockholders and the securities may have rights, preferences, and privileges senior to our common stock. In the case of debt financings, we may be subject to covenants that restrict our ability to freely operate our business. If we cannot obtain adequate capital on favorable terms or at all, we may be unable to implement our future growth or operating plans and our business, financial condition, and results of

operations could be materially adversely affected.

The capital and credit markets continue to experience volatility and disruption that have negatively affected market liquidity conditions. In some cases, the markets have produced downward pressure on stock prices and limited the availability of credit for certain issuers without regard to those issuers' underlying financial strength. As a result, we may be forced to delay raising capital or be unable to raise capital on favorable terms, or at all, which could decrease our profitability, significantly reduce our financial flexibility, and cause rating agencies to reevaluate our financial strength ratings.

We are a holding company with no direct operations. We depend on the ability of our subsidiaries to transfer funds to us to meet our obligations, and our insurance subsidiaries' ability to pay dividends to us is restricted by law.
EHI is a holding company that transacts substantially all of its business through operating subsidiaries. Its primary assets are the shares of stock of our insurance subsidiaries. The ability of EHI to meet obligations on outstanding debt, to pay stockholder dividends and to make other payments, depends on the surplus and earnings of our subsidiaries and their ability to pay dividends or to advance or repay funds, and upon the ability of our insurance subsidiaries, to pay dividends to EGI and, in turn, the ability of EGI to pay dividends to EHI.
Payments of dividends by our insurance subsidiaries are restricted by state insurance laws, including laws establishing minimum solvency and liquidity thresholds, and could be subject to contractual restrictions in the future, including those imposed by indebtedness we may incur in the future. As a result, we may not be able to receive dividends from these subsidiaries and we may not receive dividends in the amounts necessary to meet our obligations or to pay dividends on our common stock.
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 significant consequences, including:
- making it more difficult for us to satisfy our financial obligations;
- 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;
- affecting the way we manage our business due to restrictive covenants;
- requiring us to provide collateral which restricts our use of funds;
- requiring us to use a portion of our cash flow from operations to pay principal and interest on our debt; 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.

We rely on our information technology and telecommunication systems, and the failure of these systems or cyber attacks on our systems could materially and adversely affect our business.
Our business is highly dependent upon the successful and uninterrupted functioning of our information technology and telecommunications systems. We rely on these systems to process new and renewal business, provide customer service, administer and make payments on claims, facilitate collections, and to automatically underwrite and administer the policies we write. The failure of any of our systems could interrupt our operations or materially impact our ability to evaluate and write new business. Our information technology and telecommunications systems interface with and depend on third-party systems, and we could experience service denials if demand for such services exceeds capacity or such third-party systems fail or experience interruptions.
Certain events outside of our control, including cyber attacks on our systems, could render our systems inoperable such that we would be unable to service our agents, insureds, and injured workers, or meet certain regulatory requirements. If such an event were to occur and our systems were unable to be restored or secured within a reasonable timeframe, our business, financial condition, and results of operations could be adversely affected. Additionally, cyber attacks resulting in a breach of security could jeopardize the privacy, confidentiality, and integrity of our data or our customers' data, which could harm our reputation and expose us to possible liability.
Acts of terrorism and catastrophes could materially adversely impact our financial condition and results of operations.
Under our workers' compensation policies and applicable laws in the states in which we operate, we are required to provide workers' compensation benefits for losses arising from acts of terrorism. The impact of any terrorist act is unpredictable, and the ultimate impact on us would depend upon the nature, extent, location, and timing of such an act. We would be particularly adversely affected by a terrorist act affecting any metropolitan area where our policyholders have a large concentration of workers.
Notwithstanding the protection provided by the reinsurance we have purchased and any protection provided by the 2002 Act, or its extension, the TRIPRA, the risk of severe losses to us from acts of terrorism has not been eliminated because our excess of loss reinsurance treaty program contains various sub-limits and exclusions limiting our reinsurers' obligation to cover losses caused by acts of terrorism. Our excess of loss reinsurance treaties do not protect against nuclear, biological, chemical, or radiological events. If such an event were to impact one or more of the

businesses we insure, we would be entirely responsible for any workers' compensation claims arising out of such event, subject to the terms of the 2002 Act and the TRIPRA and could suffer substantial losses as a result.

Our operations also expose us to claims arising out of catastrophes because we may be required to pay benefits to workers who are injured in the workplace as a result of a catastrophe. Catastrophes can be caused by various unpredictable events, either natural or man-made. Any catastrophe occurring in the communities in which we operate or that have significant impacts on one or more of our targeted classes of business could expose us to potentially substantial losses and, accordingly, could have a material adverse effect on our financial condition and results of operations.

Administrative proceedings or legal actions involving our insurance subsidiaries could have a material adverse effect on our business, financial condition and results of operations.

Our insurance subsidiaries are involved in various administrative proceedings and legal actions in the normal course of their insurance operations. Our subsidiaries have responded to the actions and intend to defend against these claims. These claims concern issues including eligibility for workers' compensation insurance coverage or benefits, the extent of injuries, wage determinations, and disability ratings. Adverse decisions in multiple administrative proceedings or legal actions could require us to pay significant amounts in the aggregate or to change the manner in which we administer claims, which could have a material adverse effect on our financial condition and results of operations.

Our business is largely dependent on the efforts of our management because of its industry expertise, knowledge of our markets, and relationships with the independent agents and brokers that sell our products.

Our success depends in substantial part upon our ability to attract and retain qualified executive officers, experienced underwriting personnel, and other skilled employees who are knowledgeable about our business. The current success of our business is dependent in significant part on the efforts of Douglas D. Dirks, our President and Chief Executive Officer, and William E. Yocke, our Executive Vice President and Chief Financial Officer. Many of our regional and local officers are also important to our operations because of their industry expertise, knowledge of our markets, and relationships with the independent agents and brokers who sell our products. We have entered into employment agreements with certain of our key executives. Currently, we maintain key man life insurance for our Chief Executive Officer. If we were to lose the services of members of our management team or key regional or local officers, we may be unable to find replacements satisfactory to us and our business. As a result, our operations may be disrupted and our financial performance and results of operations may be adversely affected.

Assessments and other surcharges for guaranty funds, second injury funds, and other mandatory pooling arrangements may reduce our profitability.

All states require insurance companies licensed to do business in their state to bear a portion of the unfunded obligations of insolvent insurance companies. These obligations are funded by assessments that can be expected to continue in the future in the states in which we operate. Many states also have laws that established second injury funds to provide compensation to injured employees for aggravation of a prior condition or injury, which are funded by either assessments based on paid losses or premium surcharge mechanisms. In addition, as a condition to the ability to conduct business in some states, insurance companies are required to participate in mandatory workers' compensation shared market mechanisms or pooling arrangements, which provide workers' compensation insurance coverage from private insurers. The effect of these assessments and mandatory shared market mechanisms or changes in them could reduce our profitability in any given period or limit our ability to grow our business.

State insurance laws, certain provisions of our charter documents, and Nevada corporation law could prevent or delay a change of control that could be beneficial to us and our stockholders.

Our insurance subsidiaries are domiciled in Florida, California, and Nevada. The insurance laws of these states generally require that any person seeking to acquire control of a domestic insurance company obtain the prior approval of the state's insurance commissioner. In Florida, "control" is generally presumed to exist through the direct or indirect ownership of 5% or more of the voting securities of a domestic insurance company or of any entity that controls a domestic insurance company. In California and Nevada, "control" is presumed to exist through the direct or indirect ownership of 10% or more of the voting securities of a domestic insurance company or of any entity that controls a domestic insurance company. In addition, insurance laws in many states in which we are licensed require pre-notification to the state's insurance commissioner of a change in control of a non-domestic insurance company licensed in those states. Because we have insurance subsidiaries domiciled in Florida, California, and Nevada, any transaction that would constitute a change in control of us would generally require the party acquiring control to obtain the prior approval of the insurance commissioners of these states and may require pre-notification of the change of control in these or other states. The time required to obtain these approvals may result in a material delay of, or deter, any such transaction. These laws may discourage potential acquisition proposals or tender offers, and may delay, deter, or prevent a change of control, even if the acquisition proposal or tender offer is favorable to our stockholders.

Provisions of our amended and restated articles of incorporation and amended and restated by-laws could discourage, delay, or prevent a merger, acquisition, or other change in control of us, even if our stockholders might consider such a change in control to be favorable. These provisions could also discourage proxy contests and make it more difficult for stockholders to elect Directors and take other corporate actions. In particular, our amended and restated articles of incorporation and amended and restated by-laws include provisions:

- dividing our Board of Directors into three classes;
- eliminating the ability of our stockholders to call special meetings of stockholders;
- permitting our Board of Directors to issue preferred stock in one or more series;
- imposing advance notice requirements for nominations for election to our Board of Directors or for proposing matters that can be acted upon by stockholders at the stockholder meetings;

- prohibiting stockholder action by written consent, thereby limiting stockholder action to that taken at a meeting of our stockholders; and
- providing our Board of Directors with exclusive authority to adopt or amend our by-laws.

These provisions may make it difficult for stockholders to replace Directors and could have the effect of discouraging a future takeover attempt that is not approved by our Board of Directors, but which stockholders might consider favorable. Additionally, these provisions could limit the price that investors are willing to pay in the future for shares of our common stock.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our principal executive offices are 79,533 square feet located in leased premises in Reno, Nevada. As of February 1, 2013, we leased 253,401 square feet of office space in 10 states. We believe that our existing office space is adequate for our current needs. We will continue to enter into or exit lease agreements to address future space requirements, as necessary.

Item 3. Legal Proceedings

From time to time, we are 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 result of operations, liquidity, or financial position.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information, Holders, and Stockholder Dividends

Our common stock is listed on the New York Stock Exchange (NYSE) under the symbol "EIG." There were 1,315 holders of record as of February 21, 2013. High and low sales prices and cash dividends declared for the last two fiscal years were as follows:

	2012			2011		
	Stock Price		Cash	Stock Price		Cash
Quarter Ended	High	Low	Dividends Declared	High	Low	Dividends Declared
March 31	$19.00	$15.89	$0.06	$20.91	$16.34	$0.06
June 30	18.14	16.46	0.06	21.00	15.51	0.06
September 30	19.41	17.07	0.06	17.02	10.73	0.06
December 31	20.74	17.50	0.06	18.69	12.00	0.06

We currently expect that cash dividends will continue to be paid in the future; however, any determination to pay additional or future dividends will be at the discretion of our Board of Directors and will be dependent upon:

- the surplus and earnings of our subsidiaries and their ability to pay dividends and/or other statutorily permissible payments to us;
- our results of operations and cash flows;
- our financial position and capital requirements;
- general business conditions;
- any legal, tax, regulatory, and/or contractual restrictions on the payment of dividends; and
- any other factors our Board of Directors deems relevant.

There were no unregistered sales of equity securities during the fiscal year that ended December 31, 2012.

Issuer Purchases of Equity Securities

The following table summarizes the repurchase of our common stock for the quarter ended December 31, 2012:

Period	Total Number of Shares Purchased	Average Price Paid Per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Program(2) (in millions)
October 1 - October 31, 2012	1,300	$17.99	1,300	$51.6
November 1 - November 30, 2012	21,524	17.95	21,524	51.2
December 1 - December 31, 2012	—	—	—	51.2
Total	22,824	17.95	22,824	

(1) Includes commissions paid on stock repurchases.

(2) In November 2010, the Board of Directors authorized a share repurchase program for up to $100 million of our common stock from November 8, 2010 through June 30, 2012 (the 2011 Program). In November 2011, the Board of Directors authorized a $100 million expansion of the 2011 Program, to $200 million, and extended the repurchase authority pursuant to the 2011 Program through June 30, 2013. We expect that shares of common stock may be purchased at prevailing market prices through a variety of methods, including open market or private transactions, in accordance with applicable laws and regulations and as determined by management. The timing and actual number of shares repurchased will depend on a variety of factors, including the share price, corporate and regulatory requirements, and other market and economic conditions. Repurchases under the 2011 Program may be commenced, modified, or suspended from time-to-time without prior notice, and the 2011 Program may be

suspended or discontinued at any time. This table does not include shares tendered to satisfy the exercise price in connection with cashless exercises of employee stock options or shares tendered to satisfy tax withholding obligations in connection with employee equity awards.

Through December 31, 2012, we repurchased a total of 9,426,131 shares of common stock under the 2011 Program at an average price of $15.79 per share, including commissions, for a total of $148.8 million.

Performance Graph

The following information compares the cumulative total return on $100 invested in the common stock of EHI, ticker symbol EIG, for the period commencing on December 31, 2007 and ending on December 31, 2012 with the cumulative total return on $100 invested in each of the Standard and Poor's 500 Index (S&P 500) and the Standard and Poor's 500 Property-Casualty Insurance Index (S&P P&C Insurance Index). The calculation of cumulative total return assumes the reinvestment of dividends. The following graph and related information shall not be deemed to be "soliciting material" or to be "filed" with the SEC, nor shall such information be incorporated by reference into any filing pursuant to the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that we specifically incorporate it by reference into such filing.

	Period Ending					
	12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012
Employers Holdings Inc	100.00	100.18	95.06	110.05	115.61	133.34
S&P 500	100.00	63.00	79.67	91.67	93.61	108.59
S&P P&C Insurance Index	100.00	70.59	79.30	86.39	86.18	103.51

Item 6. Selected Financial Data

The following selected historical consolidated financial data should be read in conjunction with "Item 7–Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations" and the consolidated financial statements and related notes included elsewhere in this annual report on Form 10-K.

The 2008 through 2011 information presented in the following tables has been restated as a result of the revised manner in which we account for the contingent profit commission to which we are entitled under the LPT Agreement, as is more fully described in the "Explanatory Note" immediately preceding Part I, Item 1 and in Note 2 to our consolidated financial statements in Part II, Item 8.

	Years Ended December 31,				
(in thousands, except per share amounts and ratios)		2011	2010	2009[1]	2008[1][2]
Income Statement Data	2012	As Restated	As Restated	As Restated (unaudited)	As Restated (unaudited)
Revenues:					
Net premiums earned	$501,464	$363,424	$321,786	$404,247	$328,947
Net investment income	72,363	80,117	83,032	90,484	78,062
Realized gains (losses) on investments, net	5,048	20,161	10,137	791	(11,524)
Other income	307	452	649	413	1,293
Total revenues	579,182	464,154	415,604	495,935	396,778
Net income before income taxes	97,544	46,517	66,992	84,023	113,310
Income tax expense (benefit)	(9,347)	(2,106)	3,523	9,277	10,266
Net income	$106,891	$48,623	$63,469	$74,746	$103,044
Earnings per common share					
Basic	$3.40	$1.30	$1.53	$1.63	$2.09
Diluted	3.37	1.30	1.53	1.62	2.09
Selected Operating Data					
Gross premiums written[3]	$580,327	$418,512	$322,277	$379,949	$318,392
Net premiums written[4]	$569,676	$410,038	$313,098	$368,290	$308,317
Combined ratio[5]	95.3%	113.9%	106.6%	100.1%	85.5%
Net income before impact of the LPT Agreement[6][7][8]	$6,957	$29,324	$43,754	$49,989	$83,364
Earnings per common share before impact of the LPT Agreement[8]					
Basic	$0.22	$0.79	$1.06	$1.09	1.69
Diluted	0.22	0.78	1.06	1.08	1.69
Dividends declared	0.24	0.24	0.24	0.24	0.24

	As of December 31,				
(in thousands)		2011	2010	2009[1]	2008[1][2]
Balance Sheet Data	2012	As Restated	As Restated	As Restated (unaudited)	As Restated (unaudited)
Cash and cash equivalents	$140,661	$252,300	$119,825	$188,883	$197,429
Total investments	2,149,514	1,950,745	2,080,494	2,029,560	2,042,941
Reinsurance recoverable on paid and unpaid losses	814,853	951,569	970,458	1,064,843	1,087,738
Total assets	3,511,339	3,482,310	3,480,665	3,677,248	3,825,098
Unpaid losses and loss adjustment expense	2,231,540	2,272,363	2,279,729	2,425,658	2,506,478
Deferred reinsurance gain–LPT Agreement[6][7]	281,043	365,963	383,399	402,352	414,479
Notes payable	112,000	122,000	132,000	132,000	182,000
Total liabilities	2,971,958	3,020,327	3,003,062	3,192,032	3,385,278
Total equity	539,381	461,983	477,603	485,216	439,820
Other Financial Data					

Total equity including deferred reinsurance gain–LPT Agreement(6)(7)(9)	$820,424	$827,946	$861,002	$887,568	$854,299

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(1) The following table presents the summary impacts of the restatement adjustments on our previously reported consolidated net income and earnings per share for the years ended December 31, 2009 and 2008, and total assets, liabilities, and stockholders' equity as of December 2009 and 2008:

	December 31,	
(in thousands, except per share data)	2009	2008
Net income (previously reported)	$83,021	$101,785
Adjustment	(8,275)	1,259
Net income (as restated)	$74,746	$103,044
Earnings per common share:		
Basic (previously reported)	$1.81	$2.07
Adjustment	(0.18)	0.02
Basic (as restated)	$1.63	$2.09
Diluted (previously reported)	$1.80	$2.07
Adjustment	(0.18)	0.02
Diluted (as restated)	$1.62	$2.09
Total assets (previously reported)	$3,676,653	$3,825,098
Adjustment	595	—
Total assets (as restated)	$3,677,248	$3,825,098
Total liabilities (previously reported)	$3,178,254	$3,380,370
Adjustment	13,778	4,908
Total liabilities (as restated)	$3,192,032	$3,385,278
Total stockholders' equity (previously reported)	$498,399	$444,728
Adjustment	(13,183)	(4,908)
Total stockholders' equity (as restated)	$485,216	$439,820

(2) On October 31, 2008, we acquired 100% of the outstanding common stock of AmCOMP Incorporated (AmCOMP). The income statement data for the year ended December 31, 2008 includes the operating results of AmCOMP from November 1, 2008 through December 31, 2008. The balance sheet data as of December 31, 2008 includes the assets and liabilities acquired from AmCOMP.

(3) Gross premiums written is the sum of direct premiums written and assumed premiums written before the effect of ceded reinsurance. Direct premiums written are the premiums on all policies our insurance subsidiaries have issued during the year. Assumed premiums written are premiums that our insurance subsidiaries have received from any authorized state-mandated pools and a previous fronting facility.

(4) Net premiums written is the sum of direct premiums written and assumed premiums written less ceded premiums written. Ceded premiums written is the portion of direct premiums written that we cede to our reinsurers under our reinsurance contracts. (See Note 12 in the Notes to our Consolidated Financial Statements.)

(5) Combined ratio is the sum of the losses and LAE expense, the commission expense, dividends to policyholders, and the underwriting and other operating expenses, all divided by net earned premiums. Because we only have one operating segment, holding company expenses are included in the combined ratio.

(6) In connection with our January 1, 2000 assumption of the assets, liabilities and operations of the Fund, our Nevada insurance subsidiary assumed the Fund's rights and obligations associated with the LPT Agreement, a retroactive 100% quota share reinsurance agreement with third party reinsurers, which substantially reduced our exposure to losses for pre-July 1, 1995 Nevada insured risks. Pursuant to the LPT Agreement, the Fund initially ceded $1.5 billion in liabilities for incurred but unpaid losses and LAE, which represented substantially all of the Fund's outstanding losses as of June 30, 1999 for claims with original dates of injury prior to July 1, 1995.

(7) 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. Amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries over the life of the LPT Agreement, except for the contingent profit commission, which is amortized through June 30, 2024. The amortization is reflected in losses and LAE. We periodically reevaluate the remaining direct reserves subject to the LPT Agreement and the expected losses and LAE subject to the contingent profit commission under the LPT Agreement. Our reevaluations result in corresponding adjustments, if needed, to reserves, ceded reserves, contingent commission receivable, and the Deferred Gain, with the net effect being an increase or decrease, as the case may be, to net income.

(8) We define net income before impact of the LPT Agreement as net income before the impact of: (a) amortization of Deferred Gain; (b) adjustments to the LPT Agreement ceded reserves; and (c) adjustments to contingent commission receivable–LPT Agreement. These are not measurements of financial performance under GAAP, but rather reflect the difference in accounting treatment between SAP and GAAP, and should not be considered in isolation or as an alternative to any other measure of performance derived in accordance with GAAP.

We present net income before impact of the 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 affect our ongoing operations and consequently we believe these presentations are useful in providing a meaningful understanding of our operating performance. In addition, we believe these non-GAAP measures, as we have defined them, are helpful to our management in identifying trends in our performance because the item excluded has limited significance in our current and ongoing operations.

The table below shows the reconciliation of net income to net income before impact of the LPT Agreement for the periods presented:

	Years Ended December 31,				
		2011	2010	2009	2008
(in thousands)	2012	As Restated	As Restated	As Restated	As Restated
Net income	$106,891	$48,623	$63,469	$74,746	$103,044
Less amortization of the Deferred Gain	16,976	18,249	19,323	19,050	18,952
Less impact of the LPT Reserve Adjustment[(a)]	73,349	—	—	—	—
Less impact of the LPT Contingent Commission Adjustment[(b)]	9,609	1,050	392	5,707	728
Net income before impact of the LPT Agreement	$6,957	$29,324	$43,754	$49,989	$83,364

(a) Any adjustment to the estimated reserves ceded under the LPT Agreement results in a cumulative adjustment to the Deferred Gain, which is also included in losses and LAE incurred in the consolidated statement of income and comprehensive income, such that the Deferred Gain reflects the balance that would have existed had the revised reserves been recognized at the inception of the LPT Agreement (LPT Reserve Adjustment). (See Note 3 in the Notes to our Consolidated Financial Statements.)

(b) Any adjustment to the contingent profit commission under the LPT Agreement results in a cumulative adjustment to the Deferred Gain, which is also recognized in losses and LAE incurred in the consolidated statement of income and comprehensive income, such that the Deferred Gain reflects the balance that would have existed had the revised contingent profit commission been recognized at the inception of the LPT Agreement. (LPT Contingent Commission Adjustment). (See Note 3 in the Notes to our Consolidated Financial Statements.)

(9) We define total equity including the Deferred Gain as total equity plus the Deferred Gain. Total equity including the Deferred Gain is not a measurement of financial position under GAAP and should not be considered in isolation or as an alternative to total equity or any other measure of financial health derived in accordance with GAAP.

We present total equity including the Deferred Gain because we believe that it is an important supplemental measure of financial position to be used by analysts, investors and other interested parties in evaluating us. The LPT Agreement was a non-recurring transaction and the treatment of the Deferred Gain does not result in ongoing cash benefits or charges to our current operations and consequently we believe this presentation is useful in providing a meaningful understanding of our financial position.

The table below shows the reconciliation of total equity to total equity including the Deferred Gain for the periods presented:

	As of December 31,				
		2011	2010	2009	2008
(in thousands)	2012	As Restated	As Restated	As Restated	As Restated
Total equity	$539,381	$461,983	$477,603	$485,216	$439,820
Deferred Gain	281,043	365,963	383,399	402,352	414,479
Total equity including the Deferred Gain	$820,424	$827,946	$861,002	$887,568	$854,299

Item 7. Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the consolidated financial statements and the accompanying notes thereto included in Item 8 and Item 15 of this report. In addition to historical information, the following discussion contains forward-looking statements that are subject to risks and uncertainties and other factors described in Item 1A of this report. Our actual results in future periods may differ from those referred to herein due to a number of factors, including the risks described in the sections entitled “Risk Factors” and “Forward-Looking Statements” elsewhere in this report.

This Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations contains restated results related to the modification of our method of accounting for the contingent profit commission under the LPT Agreement. See "Explanatory Note" immediately preceding Part I, Item 1 and Note 2, "Revision of Previously Issued Consolidated Financial Statements," to our Consolidated Financial Statements in Part II, Item 8 for a detailed discussion of the modification and effect of the restatement.

Overview

We are a Nevada holding company. Through our insurance subsidiaries, we provide workers’ compensation insurance coverage to select, small businesses in low to medium hazard industries. Workers’ compensation insurance is provided under a statutory system wherein most employers are required to provide coverage for their employees’ medical, disability, vocational rehabilitation, and/or death benefit costs for work-related injuries or illnesses. We provide workers’ compensation insurance in 31 states and the

District of Columbia, with a concentration in California, where over one-half of our business is generated. Our revenues are primarily comprised of net premiums earned, net investment income, and net realized gains on investments.

We target small businesses, as we believe that this market is traditionally characterized by fewer competitors, more attractive pricing, and stronger persistency when compared to the U.S. workers' compensation insurance industry in general. We believe we are able to price our policies at levels which are competitive and profitable over the long-term. Our underwriting approach is to consistently underwrite small business accounts at appropriate and competitive prices without sacrificing long-term profitability and stability for short-term top-line revenue growth.

Results of Operations

Overall, net income was $106.9 million, $48.6 million, and $63.5 million in 2012, 2011, and 2010, respectively and we recognized underwriting income (losses) of $23.3 million, $(50.6) million, and $(21.1) million for the same periods, respectively. Underwriting income or loss is determined by deducting losses and LAE, commission expense, policyholder dividends, and underwriting and other operating expenses from net premiums earned. Key factors that affected our financial performance during 2012 and 2011, each compared to the previous year, respectively, include:

- Gross premiums written increased 39% and 30%;
- Net premiums earned increased 38% and 13%;
- Losses and LAE increased 10% and 36%;
- Underwriting and other operating expenses declined 21% and increased 5%; and
- Income tax expenses decreased $7.2 million to an income tax benefit of $9.3 million in 2012 and decreased $5.6 million to an income tax benefit of $2.1 million in 2011.

Our results of operations in 2012 were also impacted by: (1) favorable development in the estimated reserves ceded under the LPT Agreement. The adjustment to the estimated reserves ceded resulted in a $73.3 million cumulative adjustment to the Deferred Gain, which reduced our losses and LAE by the same amount during the fourth quarter of 2012 (LPT Reserve Adjustment); (2) an increase in the contingent commission receivable and the Deferred Gain under the LPT Agreement that resulted in an $8.6 million cumulative adjustment, which reduced our losses and LAE during the fourth quarter of 2012 (LPT Contingent Commission Adjustment); and (3) guidance issued by the Financial Accounting Standards Board that, beginning in 2012, changed the definition of policy acquisition costs which may be capitalized. Our underwriting and other operating expenses increased $7.1 million during 2012 as a result of this change (see Note 5 in the Notes to Consolidated Financial Statements for additional information).

A primary measure of our performance is our ability to increase stockholders' equity, including the impact of the Deferred Gain, over the long-term. The following table shows our stockholders' equity including the Deferred Gain, stockholders' equity on a GAAP basis, and number of common shares outstanding at December 31:

(in thousands, except share data)	2012	2011 As Restated
Stockholders' equity including the Deferred Gain[1]	$820,424	$827,946
GAAP stockholders' equity	$539,381	$461,983
Common shares outstanding	30,771,479	32,996,809

(1) Stockholders' equity including the Deferred Gain is a non-GAAP measure that is defined as total stockholders' equity plus the Deferred Gain, which we believe is an important supplemental measure of our capital position.

Our goal is to maintain our focus on disciplined underwriting and to continue to pursue profitable growth opportunities across market cycles; however, we continue to be affected by persistently low investment yields and continuing high levels of unemployment nationally. We do not believe overall economic conditions will change significantly in the near-term.

The comparative components of net income are set forth in the following table.

	Years Ended December 31,		
(in thousands)	2012	2011 As Restated	2010 As Restated
Net premiums earned	$501,464	$363,424	$321,786
Net investment income	72,363	80,117	83,032
Realized gains on investments, net	5,048	20,161	10,137
Other income	307	452	649
Total revenues	579,182	464,154	415,604
Losses and LAE	287,910	262,511	193,297
Commission expense	65,580	47,344	39,280
Policyholder dividends	3,204	3,423	4,316
Underwriting and other operating expenses	121,440	100,717	106,026
Interest expense	3,504	3,642	5,693
Income tax (benefit) expense	(9,347)	(2,106)	3,523
Total expenses	472,291	415,531	352,135
Net income	$106,891	$48,623	$63,469
Less amortization of the Deferred Gain	16,976	18,249	19,323
Less impact of the LPT Reserve Adjustment[1]	73,349	—	—
Less impact of the LPT Contingent Commission Adjustment[2]	9,609	1,050	392
Net income before impact of the LPT Agreement[3]	$6,957	$29,324	$43,754

(1) Any adjustment to the estimated reserves ceded under the LPT Agreement results in a cumulative adjustment to the Deferred Gain, which is also included in losses and LAE incurred in the consolidated statement of income and comprehensive income, such that the Deferred Gain reflects the balance that would have existed had the revised reserves been recognized at the inception of the LPT Agreement. (See Note 3 in the Notes to our Consolidated Financial Statements.)

(2) Any adjustment to the contingent profit commission under the LPT Agreement results in a cumulative adjustment to the Deferred Gain, which is also recognized in losses and LAE incurred in the consolidated statement of income and comprehensive income, such that the Deferred Gain reflects the balance that would have existed had the revised contingent profit commission been recognized at the inception of the LPT Agreement. (See Note 3 in the Notes to our Consolidated Financial Statements.)

(3) We define net income before impact of the LPT Agreement as net income before the impact of: (a) amortization of Deferred Gain; (b) adjustments to LPT Agreement ceded reserves; and (c) adjustments to contingent commission receivable –LPT Agreement. Deferred Gain reflects the unamortized gain from our LPT Agreement. Under GAAP, this gain is deferred and is being amortized using the recovery method. Amortization is determined by the proportion of actual reinsurance recoveries to total estimated recoveries over the life of the LPT Agreement, except for the contingent profit commission, which is amortized through June 30, 2024. The amortization is reflected in losses and LAE. We periodically reevaluate the remaining direct reserves subject to the LPT Agreement and the expected losses and LAE subject to the contingent profit commission under the LPT Agreement. Our reevaluations result in corresponding adjustments, if needed, to reserves, ceded reserves, contingent commission receivable, and the Deferred Gain, with the net effect being an increase or decrease, as the case may be, to net income. Net income before impact of the LPT Agreement is not a measurement of financial performance under GAAP, but rather reflects the difference in accounting treatment between statutory and GAAP, and should not be considered in isolation or as an alternative to net income before income taxes or net income or any other measure of performance derived in accordance with GAAP.

We present net income before impact of the 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, under which the Deferred Gain does not effect our ongoing operations, 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.

Net Premiums Earned

Net premiums earned were $501.5 million, $363.4 million, and $321.8 million for the years ended December 31, 2012, 2011, and 2010, respectively. The increase in net premiums earned over the past three years was primarily due to increasing policy count and rate increases. In 2011, our net premiums earned were also impacted by a $14.9 million increase in the accrual for final audit premiums. Changes in the accrual for final audit premium are driven by various factors, including general economic conditions such as unemployment and payroll trends.

The following table shows the percentage change in our in-force premiums, policy count, average policy size, payroll exposure upon which our premiums are based, and net rate as of December 31, 2012 and 2011, respectively:

	Percentage Increase 2012 Over 2011	Percentage Increase (Decrease) 2011 Over 2010
In-force premiums	36.4 %	22.7 %
In-force policy count	31.5	36.2
Average in-force policy size	3.7	(9.9)
In-force payroll exposure	25.9	24.4
Net rate[(1)]	8.3	(1.4)

(1) Net rate, defined as total in-force premiums divided by total insured payroll exposure, is a function of a variety of factors, including rate changes, underwriting risk profiles and pricing, and changes in business mix related to economic and competitive pressures.

We expect that total premiums in 2013 across our markets will reflect:

- overall rate increases;
- decelerating policy count growth; and
- increasing average policy size.

Net Investment Income and Realized Gains on Investments

We invest our holding company assets, statutory surplus, and the funds supporting our insurance liabilities, including unearned premiums and unpaid losses and LAE. We invest in fixed maturity securities, equity securities, and cash equivalents. Net investment income includes interest and dividends earned on our invested assets and amortization of premiums and discounts on our fixed maturity securities, less bank service charges and custodial and portfolio management fees. We have established a high quality/short duration bias in our investment portfolio.

Net investment income was $72.4 million, $80.1 million, and $83.0 million for the years ended December 31, 2012, 2011, and 2010, respectively. The decrease in net investment income over the past three years was primarily related to a decrease in the average pre-tax book yield on invested assets. The average pre-tax book yield on invested assets was 3.7%, 4.1%, and 4.2% at December 31, 2012, 2011, and 2010, respectively, while the tax-equivalent yield on invested assets was 4.4%, 5.0%, and 5.3% as of the same dates, respectively.

Realized gains and losses on our investments are reported separately from our net investment income. Realized gains and losses on investments include the gain or loss on a security at the time of sale compared to its original or adjusted cost (equity securities) or amortized cost (fixed maturity securities). Realized losses are also recognized when securities are written down as a result of an other-than-temporary impairment.

Realized gains on investments were $5.0 million, $20.2 million, and $10.1 million for the years ended December 31, 2012, 2011, and 2010, respectively. The increase in realized gains on investments for the year ended December 31, 2011 compared to 2010 resulted from a strategic rebalancing of our investment portfolio to increase portfolio allocations to taxable fixed income sectors, shorten portfolio duration following the decline in interest rates in the second half of 2011, and increase the allocation to high dividend equity securities. We also evaluated our portfolio allocation during the fourth quarter of 2010 and elected to shift $20.0 million of our equity securities into a high dividend yield portfolio, which resulted in a $9.2 million gain.

Additional information regarding our Investments is set forth under “–Liquidity and Capital Resources–Investments.”

Combined Ratio

The combined ratio, expressed as a percentage, is a key measurement of underwriting profitability. The combined ratio is the sum of the loss and LAE ratio, the commission expense ratio, policyholder dividends ratio, and underwriting and other operating expenses ratio. When the combined ratio is below 100%, we have recorded underwriting income, and conversely, when the combined ratio is greater than 100%, we cannot be profitable without investment income. Because we only have one operating segment, holding company expenses are included in our calculation of the combined ratio.

The following table provides the calculation of our calendar year combined ratios.

	Years Ended December 31,		
	2012	2011 As Restated	2010 As Restated
Loss and LAE ratio	57.4 %	72.2 %	60.1 %
Underwriting and other operating expenses ratio	24.2	27.8	33.0
Commission expense ratio	13.1	13.0	12.2
Policyholder dividends ratio	0.6	0.9	1.3
Combined ratio	95.3 %	113.9 %	106.6 %

Loss and LAE Ratio. Expressed as a percentage, this is the ratio of losses and LAE to net premiums earned.

We analyze our loss and LAE ratios on both a calendar year and accident year basis. A calendar year loss and LAE ratio is calculated by dividing the losses and LAE incurred during the calendar year, regardless of when the underlying insured event occurred, by the net premiums earned during that calendar year. The calendar year loss and LAE ratio includes changes made during the calendar year in reserves for losses and LAE established for insured events occurring in the current and prior years. A calendar year loss and LAE ratio is calculated using premiums and losses and LAE that are net of amounts ceded to reinsurers. The calendar year loss and LAE ratio for a particular year will not change in future periods.

The accident year loss and LAE ratio, or losses and LAE for insured events that occurred during a particular year divided by the premiums earned for the year, is calculated by dividing the losses and LAE, regardless of when such loss and LAE are incurred, for insured events that occurred during a particular year by the net premiums earned for that year. The accident year losses and LAE ratio is calculated using premiums and losses and LAE that are net of amounts ceded to reinsurers. The accident year loss and LAE ratio for a particular year can decrease or increase when recalculated in subsequent periods as the reserves established for insured events occurring during that year develop favorably or unfavorably; and is an operating ratio based on our statutory financial statements and is not derived from our GAAP financial information.

We analyze our calendar year loss and LAE ratio to measure our profitability in a particular year and to evaluate the adequacy of our premium rates charged in a particular year to cover expected losses and LAE from all periods, including development (whether favorable or unfavorable) of reserves established in prior periods. In contrast, we analyze our accident year loss and LAE ratios to evaluate our underwriting performance and the adequacy of the premium rates we charged in a particular year in relation to ultimate losses and LAE from insured events occurring during that year. The loss and LAE ratios provided in this report are calendar year basis, except where they are expressly identified as accident year loss and LAE ratios.

Losses and LAE represents our largest expense item and includes claim payments made, amortization of the Deferred Gain, 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.

Our indemnity claims frequency (the number of claims expressed as a percentage of payroll) is unchanged year-over-year and our loss experience indicates an downward trend in medical and indemnity costs that are reflected in our current accident year loss estimate. We believe our current accident year loss estimate is adequate; however, ultimate losses will not be known with any certainty for many years. We assume that increasing medical and indemnity cost trends will continue to impact our long-term claims costs and current accident year loss estimate, which may be offset by rate increases. Additional information regarding our reserves for losses and LAE is set forth under "–Critical Accounting Policies–Reserves for Losses and LAE."

Overall, losses and LAE were $287.9 million, $262.5 million, and $193.3 million for the years ended December 31, 2012, 2011, and 2010, respectively. The increase from 2011 to 2012 was primarily due to an increase in net earned premiums, which was partially offset by a $73.3 million favorable LPT Reserve Adjustment and an $8.6 million LPT Contingent Commission Adjustment in the fourth quarter of 2012. The increase from 2010 to 2011 was primarily due to an increase in the current accident year loss estimate, an increase in net earned premiums, and the impact of favorable prior accident year loss development in 2010. Prior accident year loss development in 2012 and 2011 was primarily related to our assigned risk business. Our accident year loss estimates were 77.0%, 77.2%, and 70.6% for the years ended December 31, 2012, 2011, and 2010, respectively. The accident year loss estimate for the year ended December 31, 2010 excludes a $1.6 million expense related to the commutation of certain reinsurance treaties and a $0.9 million expense related to the write-off of certain reinsurance recoverables. The increase in the current accident year loss estimate in 2011 was primarily due to increased loss costs in California.

The table below reflects losses and LAE reserve adjustments.

	Years Ended December 31,		
(in millions)	2012	2011 As Restated	2010 As Restated
Prior accident year (unfavorable) favorable development, net[1]	$(1.8)	$(1.1)	$16.6
Amortization of the Deferred Gain	$17.0	$18.2	$19.3
Impact of the LPT Reserve Adjustment	73.3	—	—
Impact of the LPT Contingent Commission Adjustment	9.6	1.1	0.4

(1) Prior accident year (unfavorable) favorable development, net, excludes a $1.6 million expense related to the commutation of certain reinsurance treaties and a $0.9 million expense related to the write-off of certain reinsurance recoverables, which are included in losses and LAE for the year ended December 31, 2010.

Excluding the impact from the LPT Agreement, losses and LAE would have been $387.8 million, $281.8 million, and $213.0 million, or 77.3%, 77.5%, and 66.2% of net premiums earned, for the years ended December 31, 2012, 2011, and 2010, respectively.

Underwriting and Other Operating Expenses Ratio. The underwriting and other operating expenses ratio is the ratio (expressed as a percentage) of underwriting and other operating expenses to net premiums earned and measures an insurance company's operational efficiency in producing, underwriting, and administering its insurance business. Underwriting and other operating expenses are those costs that we incur to underwrite and maintain the insurance policies we issue, excluding commission. These expenses include premium taxes and certain other general expenses that vary with, and are primarily related to, producing new or renewal business. Other underwriting expenses include changes in estimates of future write-offs of premiums receivable, general administrative expenses such as salaries and benefits, rent, office supplies, depreciation, and all other operating expenses not otherwise classified separately. Policy acquisition costs are variable based on premiums earned; however, other operating costs are more fixed in nature and become a smaller percentage of net premiums earned as premiums increase.

Underwriting and other operating expenses were $121.4 million, $100.7 million, and $106.0 million for the years ended December 31, 2012, 2011, and 2010, respectively. During the year ended December 31, 2012, bonus and equity compensation expenses increased $7.2 million, our premium taxes and assessments increased $3.1 million, and bad debt expense increased $2.1 million, partially offset by a $1.6 million decrease in professional fees, compared to the same period of 2011.

Additionally, implementation of the new accounting guidance for deferred policy acquisition costs (DAC) resulted in a $7.1 million increase in our underwriting and other operating expenses for the year ended December 31, 2012. This increase was partially offset by a $1.4 million net reduction in underwriting and other operating expenses for the year ended December 31, 2012, related to a change in estimate for guarantee fund assessments.

Excluding the impact of the new DAC guidance and the change in estimate for guarantee fund assessments, underwriting and other operating expenses would have increased $15.0 million for the year ended December 31, 2012 compared to 2011.

In the first quarter of 2010, we incurred charges of $0.9 million related to staffing reductions to adjust our insurance operations to reflect activity levels at that time. Subsequently, in the third quarter of 2010, we announced the reorganization of our operations to eliminate duplicative services and better align resources with business activity and growth opportunities at that time. In connection with those efforts and with general cost control efforts, we eliminated approximately 160 positions. In conjunction with that reorganization, we recorded restructuring charges of $5.2 million in 2010, including $3.0 million related to workforce reductions and $2.2 million related to leases for facilities that were vacated during the year.

During the year ended December 31, 2011, compensation and facilities related expenses declined $8.9 million and $3.3 million, respectively, partially offset by a $5.2 million increase in premium taxes and assessments, compared to the same period of 2010. Underwriting and other operating expenses also included one-time charges totaling $1.2 million during 2011 for professional service fees related to acquisition due diligence activity. Excluding total restructuring items incurred in 2010 and the one-time professional services fees incurred in 2011, underwriting and other operating expenses decreased $0.4 million for the year ended December 31, 2011 compared to 2010.

Commission Expense Ratio. The commission expense ratio is the ratio (expressed as a percentage) of commission expense to net premiums earned and measures the cost of compensating agents and brokers for the business we have underwritten.

Commission expense includes direct commissions to our agents and brokers for the premiums that they produce for us, as well as incentive payments, other marketing costs, and fees.

Our commission expense was $65.6 million, $47.3 million, and $39.3 million for the years ended December 31, 2012, 2011, and 2010, respectively. The increases in commission expense from 2010 through 2012 were primarily due to higher net premiums earned, as well as higher agency incentive commissions due to increased agent production in 2012. Additionally, in 2010, we reduced the estimate of certain administrative fees due to Anthem under our joint marketing agreements by $3.0 million, which decreased the commission expense. This decrease was partially offset by the re-negotiation of the terms of a separate reinsurance agreement resulting in an additional $1.8 million in commission expense in 2010. Excluding the impact of the change in accrual for fees due to Anthem, and the re-negotiated reinsurance agreement, commission expense would have been 12.6% of net premiums earned for the year ended December 31, 2010.

Policyholder Dividends Ratio. The policyholder dividends ratio is the ratio (expressed as a percentage) of policyholder dividends to net premiums earned and measures the cost of returning premium to policyholders in the form of dividends.

In administered pricing states such as Florida and Wisconsin, insurance rates are set by state insurance regulators. Rate competition generally is not permitted and policyholder dividend programs are an important competitive factor in these states. We offer dividend programs to eligible policyholders, under which a portion of the policyholders' premium may be returned in the form of dividends.

Policyholder dividends were $3.2 million, $3.4 million, and $4.3 million for the years ended December 31, 2012, 2011, and 2010, respectively. Policyholder dividends fluctuate from time to time due to changes in premium levels on dividend policies and the eligibility of policyholders to receive dividend payments.

Interest Expense

We incur interest expenses on notes payable. We also had an interest rate swap agreement on our credit facility with Wells Fargo Bank, National Association (Wells Fargo), which expired on September 30, 2010.

Interest expense was $3.5 million, $3.6 million, and $5.7 million for the years ended December 31, 2012, 2011, and 2010, respectively. The decrease in interest expense from 2010 to 2011 was primarily due to the expiration of the interest rate swap that was in place in 2010. The decrease in interest expense from 2011 to 2012 was primarily due to the reduction in principal balance on our credit facility with Wells Fargo by $10 million in the fourth quarter of 2011.

Income Tax Expense

Income tax expense (benefit) was $(9.3) million, $(2.1) million, and $3.5 million for the years ended December 31, 2012, 2011, and 2010, respectively. The effective tax rate was (9.6)%, (4.5)%, and 5.3% for the years ended December 31, 2012, 2011, and 2010, respectively. The decreased tax expense from 2010 through 2012 is primarily due to increases in tax exempt income as a percentage of pre-tax net income, which was 129.7%, 121.4%, and 86.6% for the years ended December 31, 2012, 2011, and 2010, respectively.

The increased tax exempt income as a percentage of pre-tax net income for the year ended December 31, 2012, compared to 2011, was primarily due to the impact of the $73.3 million favorable LPT Reserve Adjustment and a $15.0 million increase to the LPT contingent profit commission in 2012. The increased tax exempt income as a percentage of pre-tax net income for the year ended December 31, 2011, compared to 2010, was primarily due to a $21.0 million decrease in pre-tax income.

Liquidity and Capital Resources

Parent Company

Operating Cash and Cash Equivalents. We are a holding company and our ability to fund our operations is contingent upon existing capital and our insurance subsidiaries' abilities to pay dividends up to the holding company. Payment of dividends by our insurance subsidiaries is restricted by state insurance laws, including laws establishing minimum solvency and liquidity thresholds. We require cash to pay stockholder dividends, repurchase common stock, make interest and principal payments on our outstanding debt obligations, provide additional surplus to our insurance subsidiaries, and fund our operating expenses.

In September 2012, EHI made a cash capital contribution totaling $70 million to its operating subsidiaries to support future growth and maintain the subsidiaries' financial strength ratings.

Based on reported capital, surplus, and dividends paid within the last 12 months, the maximum dividends that may be paid by EICN and EPIC in 2013, without prior approval by the respective state insurance regulator, are $29.5 million and $20.6 million, respectively.

The holding company had $85.2 million of cash and cash equivalents and fixed maturity securities maturing within the next 24 months at December 31, 2012. Ten million dollars of our line of credit is payable on each of December 31, 2013 and December 31, 2014. We believe that the liquidity needs of the holding company over the next 24 months will be met with cash, maturing investments, and dividends from our insurance subsidiaries.

Share Repurchases. In November 2010, our Board of Directors authorized a share repurchase program for repurchases of up to $100 million of common stock from November 8, 2010 through June 30, 2012 (the 2011 Program). In November 2011, the Board of Directors authorized a $100 million expansion of the 2011 Program, to $200 million, and extended the repurchase authority pursuant to the 2011 Program through June 30, 2013. Repurchases under the 2011 Program may be commenced or suspended from time-to-time without prior notice, and the 2011 Program may be suspended or discontinued at any time. Through December 31, 2012, we repurchased a total of 9,426,131 shares of common stock under the 2011 Program at an average price of $15.79 per share, including commissions, for a total of $148.8 million.

Outstanding Debt. In December 2010, we entered into the Third Amended and Restated Credit Agreement with Wells Fargo (Amended Credit Facility) under which we were provided with: (a) $100.0 million line of credit through December 31, 2011; (b) $90.0 million line of credit from January 1, 2012 through December 31, 2012; (c) $80.0 million line of credit from January 1, 2013 through December 31, 2013; (d) $70 million line of credit from January 1, 2014 through December 31, 2014; and (e) $60 million line of credit from January 1, 2015 through December 31, 2015. Amounts outstanding bear interest at a rate equal to, at our option: (a) a fluctuating rate of 1.75% above prime rate or (b) a fixed rate that is 1.75% above the LIBOR rate then in effect. The Amended Credit Facility is secured by fixed maturity securities and restricted cash and cash equivalents that had a fair value of $110.4 million and $126.7 million at December 31, 2012 and 2011, respectively. The Amended Credit Facility contains customary non-financial covenants and requires us to maintain $5.0 million of cash and cash equivalents at all times at the holding company. We are currently in compliance with all applicable covenants. In accordance with the terms of the contract, we repaid $10.0 million of the line of credit provided by the Amended Credit Facility on December 28, 2012.

Our total outstanding debt was $112.0 million and $122.0 million as of December 31, 2012 and 2011, respectively. Interest and fees on debt obligations totaled $3.5 million, $3.6 million, and $5.7 million in 2012, 2011, and 2010, respectively.

Our capital structure is comprised of outstanding debt and stockholders' equity. As of December 31, 2012, our capital structure consisted of an $80.0 million principal balance on our Amended Credit Facility, $32.0 million in surplus notes maturing in 2034, and $820.4 million of stockholders' equity, including the Deferred Gain. Outstanding debt was 12.0% of total capitalization, including the Deferred Gain, as of December 31, 2012.

Operating Subsidiaries

Operating Cash and Cash Equivalents. The primary sources of cash for our insurance operating subsidiaries are funds generated from underwriting operations, investment income, maturities and sales of investments, and capital contributions from the parent holding company. The primary uses of cash are payments of claims and operating expenses, purchases of investments, and payments of dividends to the parent holding company, which are subject to state insurance laws and regulations.

Our insurance subsidiaries had $330.0 million of cash and cash equivalents and fixed maturity securities maturing within the next 24 months at December 31, 2012. We believe that our subsidiaries' liquidity needs over the next 24 months will be met with cash from operations, investment income, and maturing investments.

We purchase reinsurance to protect us against the costs of severe claims and catastrophic events. On July 1, 2012, we entered into a new reinsurance program that is effective through June 30, 2013. The reinsurance program consists of one treaty covering excess of loss and catastrophic loss events in five layers of coverage. Our reinsurance coverage is $195.0 million in excess of our $5.0 million retention on a per occurrence basis, subject to a $2.0 million annual aggregate deductible and certain exclusions. We believe that our reinsurance program meets our needs and that we are sufficiently capitalized.

Our insurance subsidiaries are required by law to maintain a certain minimum level of surplus on a statutory basis. Surplus is calculated by subtracting total liabilities from total admitted assets. The amount of capital in our insurance subsidiaries is maintained relative to standardized capital adequacy measures such as risk-based capital (RBC), as established by the National Association of Insurance Commissioners. The RBC standard was designed to provide a measure by which regulators can assess the adequacy of an insurance company's capital and surplus relative to its operations. An insurance company must maintain capital and surplus of at least 200% of RBC. Each of our insurance subsidiaries had total adjusted capital in excess of the minimum RBC requirements that correspond to any level of regulatory action at December 31, 2012.

Various state regulations require us to keep securities or letters of credit on deposit with certain states in which we do business. Securities having a fair market value of $530.6 million and $522.6 million were on deposit at December 31, 2012 and 2011, respectively. These laws and regulations govern both the amount and type of fixed maturity security that is eligible for 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 we assumed. The fair value of securities held in trust for the benefit of ceding reinsurers was $35.0 million and $40.3 million at December 31, 2012 and 2011, respectively.

Cash Flows

We monitor cash flows at both the consolidated and subsidiary levels. We use trend and variance analyses to project future cash needs, making adjustments to our forecasts as appropriate.

The table below shows our net cash flows.

	Years Ended December 31,		
	2012	2011	2010
Cash and cash equivalents provided by (used in):	(in thousands)		
Operating activities	$131,771	$43,215	$56,981
Investing activities	(184,946)	199,159	(51,327)
Financing activities	(58,464)	(109,899)	(74,662)
(Decrease) increase in cash and cash equivalents	$(111,639)	$132,475	$(69,008)

Operating Activities. Major components of net cash provided by operating activities in 2012 included net premiums received of $508.7 million, investment income received of $79.6 million, and amounts recovered from reinsurers of $38.2 million. These were partially offset by claims payments of $315.1 million, underwriting and other operating expenses paid of $116.8 million (including premium taxes paid of $16.9 million), and commissions paid of $55.2 million.

Major components of net cash provided by operating activities in 2011 included net premiums received of $358.4 million, investment income received of $90.8 million, and amounts recovered from reinsurers of $46.1 million. These were partially offset by claims payments of $316.4 million, underwriting and other operating expenses paid of $93.7 million (including $7.6 million of premium taxes paid), and commissions paid of $36.3 million.

Major components of net cash provided by operating activities in 2010 included net premiums received of $321.3 million and investment income received of $89.2 million, partially offset by claims payments of $263.2 (net of reinsurance recoverables), and underwriting and other operating expenses paid of $91.5 million.

Investing Activities. In 2012, net cash used in investing activities was primarily related to the investment of premiums received and the reinvestment of funds from maturities and redemptions. The major sources of net cash provided by investing activities in 2011 were the sale of certain fixed maturity securities and from maturities and redemptions of other investments during the year. In 2010, net cash used in investing activities was primarily related to the reinvestment of funds from maturities and redemptions.

Financing Activities. The majority of cash used in financing activities in 2012, 2011 and 2010 was to repurchase $41.8 million, $92.0 million, and $63.6 million of our common stock, respectively, and to pay dividends to stockholders. Additionally, cash was used to pay down $10.0 million on the line of credit provided by the Amended Credit Facility in 2012 and 2011.

Investments

The amortized cost of our investment portfolio was $1.95 billion and the fair value was $2.15 billion as of December 31, 2012.

We employ an investment strategy that emphasizes asset quality and considers the durations 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 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 (through dividends and share repurchases), and fund growth.

As of December 31, 2012, our investment portfolio, which is classified as available-for-sale, consisted of 94.2% 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. Our fixed maturity securities (excluding cash and cash equivalents) had a duration of 4.2 at December 31, 2012. 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 investment guidelines require that the minimum weighted average quality of our fixed maturity securities portfolio shall be “AA-.” Our fixed maturity securities portfolio had a weighted average quality of “AA-” as of December 31, 2012, with 65.9% of the market value rated “AA” or better.

We carry our portfolio of equity securities on our balance sheet at fair value. We minimize our exposure to equity price risk by investing primarily in the equity securities of mid-to-large capitalization issuers and by diversifying our equity holdings across several industry sectors. Equity securities represented 5.8% of our investment portfolio at December 31, 2012.

Given the economic uncertainty and continuing market volatility, we believe that our current asset allocation best meets our strategy to preserve capital for policyholders, to provide sufficient income to support insurance operations, and to effectively grow book value over a long-term investment horizon.

We seek to maximize total investment returns within the constraints of prudent portfolio management. The asset allocation is reevaluated by the Finance Committee of the Board of Directors on a quarterly basis. We employ Conning Asset Management (Conning) to act as our independent investment manager. Conning follows our written investment guidelines based upon strategies approved by the 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 to develop portfolio targets and objectives, which in turn are used in constructing an optimal portfolio.

The following table shows the estimated fair value, the percentage of the fair value to total invested assets, and the average tax equivalent yield based on the fair value of each category of invested assets as of December 31, 2012.

Category	Estimated Fair Value	Percentage of Total		Yield	
	(in thousands, except percentages)				
U.S. Treasuries	$152,490	7.1	%	2.4	%
U.S. Agencies	93,967	4.3		3.2	
States and municipalities	758,516	35.3		5.8	
Corporate securities	676,243	31.5		3.8	
Residential mortgaged-backed securities	252,852	11.8		4.2	
Commercial mortgaged-backed securities	56,120	2.6		3.1	
Asset-backed securities	34,240	1.6		1.2	
Equity securities	125,086	5.8		4.4	
Total investments	$2,149,514	100.0	%		
Weighted average yield				4.4	%

The following table shows the percentage of total estimated fair value of our fixed maturity securities as of December 31, 2012 by credit rating category, using the lower of ratings assigned by Moody's Investor Service and/or Standard & Poor's.

Rating	Percentage of Total Estimated Fair Value	
“AAA”	16.6	%
“AA”	49.3	
“A”	24.5	
“BBB”	9.5	
Below Investment Grade	0.1	
Total	100.0	%

Investments that we currently own could be subject to default by the issuer or could suffer declines in fair value that become other-than-temporary. We regularly assess individual securities as part of our ongoing portfolio management, including the identification of other-than-temporary declines in fair value. Our other-than-temporary assessment includes reviewing the extent and duration of declines in fair value of investments below amortized cost, historical and projected financial performance and near-term prospects of the issuer, the outlook for industry sectors, credit rating, and macro-economic changes. We also make a determination as to whether it is not more likely than not that we will be required to sell the security before its fair value recovers above cost, or to maturity.

Based on our review of fixed maturity and equity securities, we believe that we appropriately identified the declines in the fair values of our unrealized losses at December 31, 2012 and 2011. We determined that the unrealized losses on fixed maturity securities were primarily the result of prevailing interest rates and not the credit quality of the issuers. The fixed maturity securities whose fair value was less than amortized cost were not determined to be other-than-temporarily impaired given the severity and duration of the impairment, the credit quality of the issuers, the Company’s intent to not sell the securities, and a determination that it is not more likely than not that the Company will be required to sell the securities until fair value recovers to above cost, or to maturity.

Based on reviews of the equity securities as of December 31, 2012 and 2011, the Company recognized total impairments of $0.7 million and $0.1 million in the fair values of eleven and four equity securities as a result of the severity and duration of the change in fair values of those securities as of December 31, 2012 and 2011, respectively.

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
At December 31, 2012	(in thousands)			
Fixed maturity securities				
U.S. Treasuries	$138,839	$13,651	$—	$152,490
U.S. Agencies	88,202	5,765	—	93,967
States and municipalities	689,776	68,740	—	758,516
Corporate securities	627,047	49,461	(265)	676,243
Residential mortgage-backed securities	236,461	16,488	(97)	252,852
Commercial mortgage-backed securities	54,755	1,410	(45)	56,120
Asset-backed securities	34,062	211	(33)	34,240
Total fixed maturity securities	1,869,142	155,726	(440)	2,024,428
Equity securities	81,067	45,399	(1,380)	125,086
Total investments	$1,950,209	$201,125	$(1,820)	$2,149,514
At December 31, 2011				
Fixed maturity securities				
U.S. Treasuries	$122,144	$15,222	$(1)	$137,365
U.S. Agencies	101,520	6,942	(14)	108,448
States and municipalities	719,431	70,391	(186)	789,636
Corporate securities	467,470	35,745	(1,546)	501,669
Residential mortgage-backed securities	262,961	19,154	(604)	281,511
Commercial mortgage-backed securities	20,756	910	(1)	21,665
Asset-backed securities	11,934	471	—	12,405
Total fixed maturity securities	1,706,216	148,835	(2,352)	1,852,699
Equity securities	64,962	34,639	(1,555)	98,046
Total investments	$1,771,178	$183,474	$(3,907)	$1,950,745

The amortized cost and estimated fair value of fixed maturity securities at December 31, 2012, by contractual maturity, are shown below. Expected maturities differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
	(in thousands)	
Due in one year or less	$113,909	$115,939
Due after one year through five years	641,161	684,751
Due after five years through ten years	587,349	655,031
Due after ten years	201,445	225,495
Mortgage and asset-backed securities	325,278	343,212
Total	$1,869,142	$2,024,428

Net realized and unrealized investment gains (losses) on fixed maturity and equity securities were as follows:

	December 31,		
	2012	2011	2010
Net realized gains:	(in thousands)		
Fixed maturity securities	$3,774	$19,315	$710
Equity securities	1,274	846	9,427
	$5,048	$20,161	$10,137
Change in unrealized gains (losses):			

Fixed maturity securities	$8,803	$47,897	$(2,632)