

State Auto Financial CORP  
Form 10-K  
March 05, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-K**

- x **Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the fiscal year ended December 31, 2009 or**
- .. **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 000-19289**

**STATE AUTO FINANCIAL CORPORATION**  
**(Exact name of Registrant as specified in its charter)**

**Ohio**  
**(State or other jurisdiction of**  
  
**incorporation or organization)**

**31-1324304**  
**(I.R.S. Employer Identification No.)**

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518 East Broad Street, Columbus, Ohio  
(Address of principal executive offices)

43215-3976  
(Zip Code)

Registrant's telephone number, including area code:

(614) 464-5000

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

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

Common Shares, without par value

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

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

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

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

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

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☐

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

As of June 30, 2009, the last business day of the Registrant's most recently completed second fiscal quarter, the aggregate market value (based on the closing sales price on that date) of the voting stock held by non-affiliates of the Registrant was \$251,721,820.

On February 26, 2010, the Registrant had 39,871,374 Common Shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement relating to the annual meeting of stockholders to be held May 7, 2010 (the "2010 Proxy Statement"), which will be filed within 120 days of December 31, 2009, are incorporated by reference into Part III of this Form 10-K.



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### **IMPORTANT INFORMATION REGARDING FORWARD-LOOKING STATEMENTS**

All statements, other than statements of historical facts, included in this Annual Report on Form 10-K (this Form 10-K) of State Auto Financial Corporation (State Auto Financial or STFC) or incorporated herein by reference, including, without limitation, statements regarding State Auto Financial's future financial position, business strategy, budgets, projected costs, goals and plans and objectives of management for future operations, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally can be identified by the use of forward-looking terminology such as may, will, expect, intend, estimate, anticipate, believe or continue or the negative thereof or variations thereon or similar terminology. Forward-looking statements speak only as the date the statements were made. Although State Auto Financial believes that the expectations reflected in forward-looking statements have a reasonable basis, it can give no assurance that these expectations will prove to be correct. Forward-looking statements are subject to risks and uncertainties that could cause actual events or results to differ materially from those expressed in or implied by the statements. For a discussion of the most significant risks and uncertainties that could cause State Auto Financial's actual results to differ materially from those projected, see Risk Factors in Item 1A of this Form 10-K. Except to the limited extent required by applicable law, State Auto Financial undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

### **IMPORTANT DEFINED TERMS USED IN THIS FORM 10-K**

As used in this Form 10-K, the following terms have the meanings ascribed below:

State Auto Financial or STFC refers to State Auto Financial Corporation;

We, us, our or the Company refers to STFC and its consolidated subsidiaries, namely State Auto Property & Casualty Insurance Company (State Auto P&C), Milbank Insurance Company (Milbank), Farmers Casualty Insurance Company (Farmers), State Auto Insurance Company of Ohio (SA Ohio), State Auto National Insurance Company (SA National), and Stateco Financial Services, Inc. (Stateco);

State Auto Mutual or our parent company refers to State Automobile Mutual Insurance Company, which owns approximately 63.5% of STFC's outstanding common shares;

The Pooled Companies or our Pooled Companies refer to State Auto P&C, Milbank, Farmers, SA Ohio, effective January 1, 2010 SA National (referred to as the STFC Pooled Companies), State Auto Mutual, and certain subsidiaries and affiliates of State Auto Mutual, namely State Auto Florida Insurance Company (SA Florida), State Auto Insurance Company of Wisconsin (SA Wisconsin), Meridian Security Insurance Company (Meridian Security), Meridian Citizens Mutual Insurance Company (Meridian Citizens Mutual), Beacon National Insurance Company (Beacon National), Patrons Mutual Insurance Company of Connecticut (Patrons Mutual), and Litchfield Mutual Fire Insurance Company (Litchfield) (State Auto Mutual, SA Florida, SA Wisconsin, Meridian Security, Meridian Citizens Mutual, Beacon National, Patrons Mutual and Litchfield are referred to as the Mutual Pooled Companies);

The MIGI Insurers refer to Meridian Security and Meridian Citizens Mutual, and the MIGI Companies refer to the MIGI Insurers and Meridian Insurance Group, Inc. (MIGI);

The Beacon Insurance Group or Beacon Group refers to Beacon National and Beacon Lloyds Insurance Company (Beacon Lloyds);

The Patrons Insurance Group or Patrons Group refers to Patrons Mutual and Litchfield;

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The Rockhill Insurance Group refers to Rockhill Holding Company, its insurance subsidiaries, namely Rockhill Insurance Company, Plaza Insurance Company, American Compensation Insurance Company and Bloomington Compensation Insurance Company, its subsidiary Risk Evaluation & Design, LLC ( RED ), which acts as a managing general underwriter, and its other non-insurance subsidiaries; and

The State Auto Group refers to the Pooled Companies, SA National and Beacon Lloyds.

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**PART I**

**Item 1. Business**

**(a) General Development of Business**

State Auto Financial is an Ohio domiciled super-regional property and casualty insurance holding company incorporated in 1990. We are primarily engaged in writing both personal and business lines of insurance. State Auto Financial owns 100% of State Auto P&C, Milbank, Farmers, SA Ohio, and SA National, each of which is a property and casualty insurance company, and Stateco, which provides investment management services to affiliated insurance companies. Our operations are headquartered in Columbus, Ohio.

Our parent company is State Auto Mutual, an Ohio domiciled super-regional mutual property and casualty insurance company organized in 1921. It owns approximately 63.5% of State Auto Financial's outstanding common shares. State Auto Mutual also owns 100% of SA Florida and SA Wisconsin, each of which is a property and casualty insurance company, and 100% of MIGI, a holding company which owns 100% of Meridian Security, a property and casualty insurance company. MIGI is a party to an affiliation agreement with Meridian Citizens Mutual, a mutual property and casualty insurance company. In 2007, MIGI acquired 100% of the Beacon Insurance Group and State Auto Mutual affiliated with the Patrons Insurance Group. All of the companies in the Beacon Insurance Group and Patrons Insurance Group are property and casualty insurers.

The State Auto Group markets a broad line of property and casualty insurance products through independent insurance agencies primarily in the Midwestern, Southern, Southwestern, and Eastern states. Our products include standard personal and commercial automobile, nonstandard personal automobile, homeowners and farmowners, commercial multi-peril, workers' compensation, commercial general liability and property insurance. Our Pooled Companies and SA National are rated A+ (Superior) by the A.M. Best Company.

**(b) Financial Information about Segments**

Our reportable segments are personal insurance, business insurance (the "insurance segments"), and investment operations. The three segments reflect the manner in which we manage our business and report our results internally to our principal operating decision makers. See detailed discussion regarding our segments at Item 7 of this Form 10-K "Management's Discussion and Analysis of Financial Condition and Results of Operations" Overview and Note 16 to our Consolidated Financial Statements included in Item 8 of this Form 10-K.

**(c) Narrative Description of Business**

**Property and Casualty Insurance**

**Pooling Arrangement**

Our Pooled Companies are parties to a quota share reinsurance agreement which we refer to as the "Pooling Arrangement." In general, under the Pooling Arrangement, State Auto Mutual assumes premiums, losses and expenses from each of the remaining Pooled Companies and in turn cedes to each of the Pooled Companies a specified portion of premiums, losses and expenses based on each of the Pooled Companies' respective pooling percentages. State Auto Mutual then retains the balance of the pooled business. The participation percentage for the STFC Pooled Companies has remained at 80% since 2001. See the detailed discussion of our Pooling Arrangement at Item 7 of this Form 10-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations" Pooling Arrangement.

**Management Agreement**

Through various management and cost sharing agreements, State Auto P&C provides the employees to perform all organizational, operational and management functions for the State Auto Group while State Auto Mutual provides certain operating facilities, including our corporate headquarters.

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Our primary management agreement, which we refer to as the 2005 Management Agreement, has a ten year term and renews for an additional ten-year period unless terminated sooner in accordance with its terms. If the 2005 Management Agreement was terminated for any reason, we would have to relocate our facilities to continue our operations. However, we do not currently anticipate the termination of the 2005 Management Agreement. See **Properties** included in Item 2 of this Form 10-K.

### **Marketing**

As of January 1, 2010, the State Auto Group marketed its products in 34 states and the District of Columbia through independent insurance agencies. Other than a managing general underwriting arrangement with our affiliate RED, none of the companies in the State Auto Group has any contracts with managing general agencies. See Item 7 of this Form 10-K, **Management's Discussion and Analysis of Financial Condition and Results of Operations Overview**.

We view our independent insurance agents as our primary customers, because they are in a position to recommend either our insurance products or those of a competitor to their customers. We strongly support the independent agency system and believe its maintenance is essential to our present and future success. As such, we continually develop programs and procedures to enhance our agency relationships, including the following: regular travel by senior management and regional office staff to meet with agents, in person, in their home states; training opportunities; and incentives related to profit and growth. In addition, we share the cost of approved advertising with selected agencies.

We actively help our agencies develop the professional sales skills of their staffs. Our training programs include both products and sales training conducted in our home office. Further, our training programs include disciplined follow-up and coaching for an extended time. Other targeted training sessions are held in our regional office locations from time to time, as well as in our agents' offices.

We provide our agents with defined travel and cash incentives if they achieve certain sales and underwriting profit levels. Further, we recognize our very top agencies measured by consistent profitability, achievement of written premium thresholds and growth as Inner Circle Agencies. Inner Circle Agencies are rewarded with additional trip and financial incentives.

We have made continuing efforts to use technology to make it easier for our agents to do business with us. We offer internet-based (i) rating, (ii) policy application submission, (iii) execution of changes to policies for certain products and (iv) claims submission. In addition, we provide our agents with the opportunity to maintain policyholder records electronically, avoiding the expense of preparing and storing paper records. We believe that, since agents and their customers realize better service and efficiency through automation, they value their relationship with us. Automation can make it easier for an agent to do business with us, which attracts prospective agents and enhances existing agencies relationships with us.

During 2009, STFC received premiums on products marketed in Alabama, Arizona, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, West Virginia and Wisconsin. During 2009, the ten states that contributed the greatest percentage of our direct premiums written were as follows: Ohio (15.8%), Kentucky (9.5%), Indiana (6.4%), Tennessee (6.3%), Texas (5.1%), Pennsylvania (4.6%), Minnesota (4.5%), Maryland (4.3%), Arkansas (4.1%) and West Virginia (3.7%).

### **Claims**

Our claims division emphasizes timely investigation of claims, settlement of meritorious claims for equitable amounts, maintenance of adequate case reserves for claims, and control of external claims adjustment expenses. Achievement of these goals supports our marketing efforts by providing agents and policyholders with prompt and effective service.



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Claim settlement authority levels are established for each adjuster, supervisor and manager based on his or her level of expertise and experience. Our claims division is responsible for reviewing the claim, obtaining necessary documentation and establishing loss and expense reserves of certain claims. Generally, property or casualty claims estimated to reach \$100,000 or above are sent to our home office to be supervised by claims division specialists. Regions with low volumes of large claims are assigned a lower dollar threshold for referring claims to the home office. In territories in which there is not sufficient volume to justify having full-time adjusters, we use independent appraisers and adjusters to evaluate and settle claims under the supervision of claims division personnel. See Item 7 of this Form 10-K, Management's Discussion and Analysis of Financial Condition and Results of Operations Acquisition and Operating Expenses.

We attempt to minimize claims adjusting costs by settling as many claims as possible through our internal claims staff and, if possible, by settling disputes regarding automobile physical damage and property insurance claims (first party claims) through arbitration. In addition, selected agents have authority to settle small first party claims, which improves claims service.

Our claim representatives use third party, proprietary bodily injury evaluation software to help them value bodily injury claims, except for the most severe injury cases. Our Claims Contact Centers allow us to improve claims efficiency and economy by concentrating the handling of smaller, less complex claims in a centralized environment. We provide claim service 24 hours a day, seven days a week, either through associates in our Claims Contact Centers, which are located in Des Moines, Iowa and Columbus, Ohio, or for a few overnight hours, through a third party service provider.

### **Reserves**

Loss reserves are management's best estimate at a given point in time of what we expect to pay to settle all losses incurred as of the end of the accounting period, based on facts, circumstances and historical trends then known. During the loss settlement period, additional facts regarding individual claims may become known, and consequently it often becomes necessary to revise the estimates of liability. The results of our operations and financial condition could be impacted, perhaps significantly, in the future if the ultimate payments required to settle claims vary from the liability currently recorded.

We maintain reserves for the eventual payment of losses and loss expenses for both reported claims and incurred claims that have not yet been reported. Loss expense reserves are intended to cover the ultimate costs of settling all losses, including investigation, litigation and in-house claims processing costs associated with such losses.

Reserves for reported losses are initially established on either a case-by-case or formula basis depending on the type and circumstances of the loss. The case-by-case reserve amounts are determined based on our reserving practices, which take into account the type of risk, the circumstances surrounding each claim and applicable policy provisions. The formula reserves are based on historical paid loss data for similar claims with provisions for trend changes caused by inflation. Loss and loss expense reserves for incurred claims that have not yet been reported are estimated based on many variables including historical and statistical information, changes in exposure units, inflation, legal developments, storm loss estimates and economic conditions. Case and formula basis loss reserves are reviewed on a regular basis. As new data becomes available, estimates are updated resulting in adjustments to loss reserves. Generally, reported losses initially reserved on a formula basis which have not settled after six months, are case reserved at that time. Although our management uses many resources to calculate reserves, there is no precise method for determining the ultimate liability. We do not discount loss reserves for financial statement purposes. For additional information regarding our reserves, see Item 7 of this Form 10-K, Management's Discussion and Analysis of Financial Condition and Results of Operations Loss and LAE.

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The following table presents our one-year development information on changes in the reserve for loss and loss expenses for each of the three years in the period ended December 31:

(\$ millions)	Year Ended December 31		
	2009	2008	2007
Beginning of Year:			
Loss and loss expenses payable	\$ 791.2	658.3	674.5
Less: Reinsurance recoverable on losses and loss expenses payable <sup>(1)</sup>	21.2	11.2	13.5
<i>Net losses and loss expenses payable<sup>(2)</sup></i>	<b>770.0</b>	647.1	661.0
Impact of pooling change, January 1, 2008		51.3	
Provision for losses and loss expenses occurring:			
Current year	899.5	874.0	645.5
Prior years <sup>(3)</sup>	(56.2)	(27.3)	(54.7)
<i>Total</i>	<b>843.3</b>	846.7	590.8
Loss and loss expense payments for claims occurring during:			
Current year	524.8	518.7	368.7
Prior years	269.1	256.4	236.0
<i>Total</i>	<b>793.9</b>	775.1	604.7
End of Year:			
Net losses and loss expenses payable	819.4	770.0	647.1
Add: Reinsurance recoverable on losses and loss expenses payable <sup>(4)</sup>	20.8	21.2	11.2
<i>Losses and loss expenses payable<sup>(5)</sup></i>	<b>\$ 840.2</b>	791.2	658.3

(1) Includes amounts due from affiliates of \$0.6 million, \$1.2 million, and \$2.7 million at beginning of year 2009, 2008, and 2007, respectively.

(2) Includes net amounts assumed from affiliates of \$343.0 million, \$257.2 million, and \$281.7 million at beginning of year 2009, 2008, and 2007, respectively.

(3) This line item shows decreases in the current calendar year in the provision for losses and loss expenses attributable to claims occurring in prior years. See discussion regarding the calendar year developments at Item 7 of this Form 10-K Management's Discussion and Analysis section at 2009 Compared to 2008 Loss and LAE and 2008 Compared to 2007 Loss and LAE.

(4) Includes amounts due from affiliates of \$0.1 million, \$0.6 million, and \$1.2 million at end of year 2009, 2008, and 2007, respectively.

(5) Includes net amounts assumed from affiliates of \$346.2 million, \$343.0 million, and \$257.2 million at end of year 2009, 2008, and 2007, respectively.

The following table sets forth our development of reserves for losses and loss expenses from 1999 through 2009. Net liability for losses and loss expenses payable sets forth the estimated liability for unpaid losses and loss expenses recorded at the balance sheet date, net of reinsurance recoverable, for each year shown. This liability represents the estimated amount of losses and loss expenses for claims incurred during the current year or incurred during prior years that are unpaid at the balance sheet date, including losses incurred but not reported to us.

The upper section of the table shows the cumulative amounts paid with respect to the previously reported reserve as of the end of each succeeding year. For example, through December 31, 2009, we have paid 110.8% of the losses and loss expenses that had been incurred but not paid, as estimated at December 31, 1999.

The lower portion of the table shows the current estimate of the previously reported reserve based on experience as of the end of each succeeding year. The estimate is increased or decreased as more information becomes known about the claims incurred.

The amounts on the cumulative redundancy (deficiency) line represent the aggregate change in the estimates over all prior years. For example, the year end 1999 reserve has developed \$67.0 million or 30.2%



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deficient through December 31, 2009. This \$67.0 million amount has been included in operating results over the ten years and did not have a significant effect on income in any one year.

In evaluating the information in the table, it should be noted that each amount includes the effects of all changes in amounts for prior periods. For example, the amount of the redundancy or deficiency evaluated at December 31, 2001, on claims incurred in 1999 includes the cumulative redundancy or deficiency for years 1999, 2000 and 2001. Conditions and trends that have affected the development of the liability in the past may not necessarily occur in the future. Accordingly, it may not be appropriate to extrapolate future redundancies or deficiencies based on this table.

In 1999, 2000 and 2001, the Pooling Arrangement was amended to increase our share of premiums, losses and expenses. An amount of assets equal to the increase in net liabilities was transferred to us from our parent company in 1999, 2000 and 2001 in conjunction with each year's respective pooling change. In 2005, the MIGI Insurers were added to the pool and our share of their net liabilities and assets were transferred to us from them. In 2008, Beacon National, the Patrons Insurance Group, State Auto middle market business and voluntary assumed reinsurance from parties affiliated with State Auto Mutual were added to the pool and accordingly net assets equal to the increase in net liabilities were transferred to us from them. The amount of the assets transferred on the reserve liabilities assumed in 1999, 2000, 2001, 2005 and 2008 has been netted against and has reduced the cumulative amounts paid for years prior to 1999, 2000, 2001, 2005 and 2008, respectively.

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(\$ millions)

	Years Ended December 31										
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Net liability for losses and loss expenses payable	\$ 221.7	\$ 236.7	\$ 509.9	\$ 592.1	\$ 628.8	\$ 655.9	\$ 711.3	\$ 661.0	\$ 647.1	\$ 770.0	\$ 819.4
Paid (cumulative) as of:											
One year later	41.8%	5.9%	43.4%	41.2%	36.7%	31.6%	34.9%	34.9%	31.7%	34.9%	
Two years later	43.0%	52.7%	65.3%	60.8%	53.2%	48.4%	51.1%	50.5%	49.4%		
Three years later	71.9%	79.9%	78.4%	71.4%	63.3%	59.6%	60.9%	60.4%			
Four years later	86.9%	95.5%	84.4%	77.3%	70.6%	66.1%	66.0%				
Five years later	96.1%	101.6%	88.5%	82.3%	74.3%	69.2%					
Six years later	99.0%	107.0%	92.3%	85.1%	76.0%						
Seven years later	102.4%	112.2%	94.7%	86.4%							
Eight years later	106.0%	116.4%	95.9%								
Nine years later	109.3%	117.9%									
Ten years later	110.8%										