RLI CORP
Form 10-Q
October 31, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2007

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: 001-09463

RLI Corp.

(Exact name of registrant as specified in its charter)

ILLINOIS	**37-0889946**
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization)	Identification Number)
9025 North Lindbergh Drive, Peoria, IL	**61615**
(Address of principal executive offices)	(Zip Code)

(309) 692-1000

(Registrant s telephone number, including area code)

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

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer o Non-accelerated filer o

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of October 19, 2007 the number of shares outstanding of the registrant s Common Stock was 23,291,284.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

(in thousands, except per share data)	For the Three-Month Period Ended September 30, 2007		2006	
Net premiums earned	$	134,111	$	138,245
Net investment income		20,433		18,316
Net realized investment gains		3,822		2,822
		158,366		159,383
Losses and settlement expenses		16,977		70,018
Policy acquisition costs		38,685		36,320
Insurance operating expenses		12,082		10,573
Interest expense on debt		1,913		1,662
General corporate expenses		3,401		1,898
		73,058		120,471
Equity in earnings of unconsolidated investees		2,047		4,650
Earnings before income taxes		87,355		43,562
Income tax expense		25,816		13,184
Net earnings	$	61,539	$	30,378
Other comprehensive earnings net of tax		9,861		25,231
Comprehensive earnings	$	71,400	$	55,609
Earnings per share:				
Basic:				
Basic net earnings per share	$	2.61	$	1.24
Basic comprehensive earnings per share	$	3.03	$	2.26
Diluted:				
Diluted net earnings per share	$	2.56	$	1.21
Diluted comprehensive earnings per share	$	2.97	$	2.21
Weighted average number of common shares outstanding				
Basic		23,541		24,590
Diluted		24,029		25,131
Cash dividends declared per common share	$	0.22	$	0.19

The accompanying notes are an integral part of the unaudited interim financial statements.

RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Earnings and Comprehensive Earnings

(Unaudited)

(in thousands, except per share data)	For the Nine-Month Period Ended September 30, 2007		2006	
Net premiums earned	$	409,576	$	391,499
Net investment income		58,500		52,580
Net realized investment gains		23,414		8,753
		491,490		452,832
Losses and settlement expenses		131,609		211,661
Policy acquisition costs		115,276		106,126
Insurance operating expenses		31,626		29,510
Interest expense on debt		4,968		5,054
General corporate expenses		7,441		5,407
		290,920		357,758
Equity in earnings of unconsolidated investees		7,770		12,257
Earnings before income taxes		208,340		107,331
Income tax expense		64,431		28,375
Net earnings	$	143,909	$	78,956
Other comprehensive earnings (loss) net of tax		(4,491)		13,437
Comprehensive earnings	$	139,418	$	92,393
Earnings per share:				
Basic:				
Basic net earnings per share	$	6.03	$	3.14
Basic comprehensive earnings per share	$	5.84	$	3.68
Diluted:				
Diluted net earnings per share	$	5.91	$	3.06
Diluted comprehensive earnings per share	$	5.72	$	3.58
Weighted average number of common shares outstanding				
Basic		23,861		25,116
Diluted		24,367		25,783
Cash dividends declared per common share	$	0.64	$	0.55

The accompanying notes are an integral part of the unaudited interim financial statements.

RLI Corp. and Subsidiaries Condensed Consolidated Balance Sheets

(in thousands, except share data)		**September 30 2007 (unaudited)**		**December 31, 2006**
ASSETS				
Investments				
Fixed maturities				
Available-for-sale, at fair value	$	1,332,646	$	1,234,571
Held-to-maturity, at amortized cost		79,091		106,310
Trading, at fair value		15,041		14,960
Equity securities, at fair value		370,379		368,195
Preferred stock, at fair value		39,260		
Short-term investments, at cost		84,815		104,205
Total investments		1,921,232		1,828,241
Accrued investment income		18,626		18,628
Premiums and reinsurance balances receivable		103,248		126,021
Ceded unearned premium		75,556		97,596
Reinsurance balances recoverable on unpaid losses		520,716		525,671
Deferred policy acquisition costs		82,010		73,817
Property and equipment		18,838		20,590
Investment in unconsolidated investees		38,538		36,667
Goodwill and indefinite-lived intangibles		26,214		26,214
Other assets		7,270		17,851
TOTAL ASSETS	$	2,812,248	$	2,771,296
LIABILITIES AND SHAREHOLDERS EQUITY				
Liabilities:				
Unpaid losses and settlement expenses	$	1,291,133	$	1,318,777
Unearned premiums		373,400		387,811
Reinsurance balances payable		68,364		85,046
Notes payable, short-term debt		52,644		
Income taxes-current		9,154		8,318
Income taxes-deferred		28,806		27,069
Bonds payable, long-term debt		100,000		100,000
Other liabilities		68,571		87,755
TOTAL LIABILITIES	$	1,992,072	$	2,014,776
Shareholders Equity				
Common stock ($1 par value)				
(31,857,640 shares issued at 9/30/07)				
(31,689,740 shares issued at 12/31/06)		31,858		31,690
Paid-in capital		191,537		187,632
Accumulated other comprehensive earnings		100,652		105,145
Retained earnings		722,906		594,147
Deferred compensation		7,762		7,744
Less: Treasury shares at cost				
(8,537,356 shares at 9/30/07)		(234,539)		(169,838)
(7,416,762 shares at 12/31/06)				
TOTAL SHAREHOLDERS EQUITY		820,176		756,520
TOTAL LIABILITIES AND SHAREHOLDER S EQUITY	$	2,812,248	$	2,771,296

The accompanying notes are an integral part of the unaudited interim financial statements.

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RLI Corp. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)	**For the Nine-Month Period Ended September 30, 2007**	**2006**
Net cash provided by operating activities	$ 111,228	$ 142,765
Cash Flows from Investing Activities		
Investments purchased	(324,898)	(467,896)
Investments sold	133,940	332,930
Investments called or matured	91,365	79,071
Net change in short term investments	2,218	1,921
Changes in notes receivable	9,500	1,500
Net property and equipment purchased	(510)	(2,529)
Net cash used in investing activities	$ (88,385)	$ (55,003)
Cash Flows from Financing Activities		
Cash dividends paid	$ (14,876)	$ (13,381)
Payment on short-term debt		(10,557)
Proceeds from issuance of short-term debt	52,644	35
Stock option plan share issuance	2,141	3,634
Excess tax benefit from exercise of stock options	1,931	1,549
Treasury shares purchased	(64,683)	(69,042)
Net cash used in financing activities	$ (22,843)	$ (87,762)
Net increase in cash		
Cash at the beginning of the year		
Cash at September 30	$	$

The accompanying notes are an integral part of the unaudited interim financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - The unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial reporting and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. As such, these unaudited condensed consolidated interim financial statements should be read in conjunction with our 2006 Annual Report on Form 10-K. Management believes that the disclosures are adequate to make the information presented not misleading, and all normal and recurring adjustments necessary to present fairly the financial position at September 30, 2007 and the results of its operations for all periods presented have been made. The results of operations for any interim period are not necessarily indicative of the operating results for a full year.

The preparation of the unaudited condensed consolidated financial statements requires management to make estimates and assumptions relating to the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the unaudited condensed consolidated financial statements, and the reported amounts of revenue and expenses during the period. These estimates are inherently subject to change and actual results could differ from these estimates.

Earnings Per Share: Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the dilution that could occur if securities or other contracts to issue common stock or common stock equivalents were exercised or converted into common stock. When inclusion of common stock equivalents increases the earnings per share or reduces the loss per share, the effect on earnings is anti-dilutive. Under these circumstances, the diluted net earnings or net loss per share is computed excluding the common stock equivalents.

Pursuant to disclosure requirements contained in Statement of Financial Accounting Standards (SFAS) 128, Earnings Per Share, the following represents a reconciliation of the numerator and denominator of the basic and diluted EPS computations contained in the unaudited condensed consolidated financial statements.

(in thousands, except per share data)	For the Nine-Month Period Ended September 30, 2007 Income (Numerator)	Shares (Denominator)	Per Share Amount	For the Nine-Month Period Ended September 30, 2006 Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$ 143,909	23,861	$ 6.03	$ 78,956	25,116	$ 3.14
Effective of Dilutive Securities						
Stock Options	0	506		0	667	
Diluted EPS						
Income available to common shareholders	$ 143,909	24,367	$ 5.91	$ 78,956	25,783	$ 3.06

(in thousands, except per share data)	For the Three-Month Period Ended September 30, 2007 Income (Numerator)	Shares (Denominator)	Per Share Amount	For the Three-Month Period Ended September 30, 2006 Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$ 61,539	23,541	$ 2.61	$ 30,378	24,590	$ 1.24
Effective of Dilutive Securities						
Stock Options	0	488		0	541	
Diluted EPS						
Income available to common shareholders	$ 61,539	24,029	$ 2.56	$ 30,378	25,131	$ 1.21

Adopted Accounting Standards:

SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 (SFAS 155)

On January 1, 2007, we adopted SFAS 155, Accounting for Certain Hybrid Financial Instruments. SFAS 155 amends FASB Statement No. 133 and FASB Statement No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting that eliminates exemptions and provides a means to simplify the accounting for these instruments. Specifically, SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. Companies are required to adopt the provisions of SFAS 155, as applicable, beginning in fiscal year 2007. The adoption of SFAS 155 had no impact on our financial position or results of operations.

FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48)

On January 1, 2007, we adopted the provisions of FIN 48, Accounting for Uncertainty in Income Taxes, which clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 requires an entity to recognize the benefit of tax positions only when it is more likely than not, based on the position s technical merits, that the position would be sustained upon examination by the respective taxing authorities. The tax benefit is measured as the largest benefit that is more than fifty-percent likely of being realized upon final settlement with the respective taxing authorities. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 did not have an impact on our financial position or results of operations as we have taken no significant tax positions which would require accrual or disclosure under the new guidance. Although the IRS is not currently examining any of our income tax returns, tax years 2005 and 2006 remain open and are subject to examination.

Pending Accounting Standards:

SFAS No. 157, Fair Value Measurements (SFAS 157)

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS 157 defines fair value and establishes a framework for measuring fair value in GAAP. The pronouncement describes fair value as being based on a hypothetical transaction to sell an asset or transfer a liability at a specific measurement date, as considered from the perspective of a market participant who holds the asset or owes the liability. In addition, fair value should be viewed as a market-based measurement, not an entity-specific measurement. SFAS 157 becomes effective for fiscal years beginning after November 15, 2007. We are currently reviewing the guidance provided in this standard to determine the impact on our financial position and results of operations.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159)

In February 2007, FASB released Statement 159 titled The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159), which is effective for fiscal years beginning after November 15, 2007, with early adoption permitted. We have not elected early adoption. The Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board s long-term measurement objectives for accounting for financial instruments. We are continuing to evaluate the provisions of this standard, in conjunction with our current investment mix and investment philosophy.

Pension Plan: During 2003 through 2006, our board and management took a series of steps to gradually freeze and terminate our defined benefit pension plan. The plan termination was finalized in 2006. All plan distributions were made in late 2006. During the nine months ended September 30, 2006, we incurred $1,580,000 in pension expense. No expenses were incurred in 2007.

Intangible assets: In accordance with SFAS 142, Goodwill and Other Intangible Assets, the amortization of goodwill and indefinite-lived intangible assets is not permitted. Goodwill and indefinite-lived intangible assets remain on the balance sheet and are tested for impairment on an annual basis, or earlier if there is reason to suspect that their values may have been diminished or impaired. Goodwill and indefinite-lived intangible assets, which relate to our surety segment, are listed separately on the balance sheet and totaled $26.2 million at September 30, 2007 and December 31, 2006. Annual impairment testing was performed during 2007, pursuant to the requirements of SFAS 142. Based upon this review, these assets are not impaired.

Intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite-lived intangible assets that continue to be amortized under SFAS 142 relate to our purchase of customer-related and marketing-related intangibles. These intangibles have useful lives ranging from five to 10 years. Amortization of intangible assets was $0.1 million for the first nine months of 2007 and $0.2 million for the same period of 2006. At September 30, 2007, these assets were fully amortized.

2. STOCK BASED COMPENSATION During 2005, our shareholders approved the RLI Corp. Omnibus Stock Plan (omnibus plan). The purpose of the omnibus plan is to promote our interests and those of our shareholders by providing our key personnel an opportunity to acquire a proprietary interest in the company and reward them for achieving a high level of corporate performance and to encourage our continued success and growth. Awards under the omnibus plan may be in the form of restricted stock, stock options (both incentive and nonqualified), stock appreciation rights, performance units, as well as other stock based awards. Eligibility under the omnibus plan is limited to our employees or employees of any affiliate and to individuals or entities who are not employees but who provide services to us or an affiliate, including services provided in the capacity of consultant, advisor or director. The granting of awards is solely at the discretion of the Executive Resources Committee and the Nominating/Corporate Governance Committee of our Board of Directors. The total number of shares of common stock available for distribution under the omnibus plan may not exceed 1,500,000 shares (subject to adjustment for changes in our capitalization). Since 2005, we have granted 656,100 stock options under this plan, including 216,300 thus far in 2007.

Under the omnibus plan, we grant stock options for shares with an exercise price equal to the fair market value of the shares at the date of grant. Options generally vest and become exercisable ratably over a five-year period and have a ten-year life. The related compensation expense is recognized over the requisite service period. In most instances, the requisite service period and vesting period will be the same. For participants who are retirement eligible, defined by the plan as those individuals whose age and years of service equals 75, the requisite service period is deemed to be met and options are immediately expensed on the date of grant. For participants who will become retirement eligible during the vesting period, the requisite service period over which expense is recognized is the period between the grant date and the attainment of retirement eligibility. Shares issued upon option exercise are newly issued shares.

The following tables summarize option activity in 2007 and 2006:

	Number of Options Outstanding		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life		Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2007	1,632,019	$	31.29			
Options granted	216,300	$	56.10			
Options exercised	(247,124)	$	22.85		$	8,711
Options canceled/forfeited	(5,840)	$	50.98			
Outstanding options at September 30, 2007	1,595,355	$	35.89	6.00	$	33,232
Exercisable options at September 30, 2007	1,219,154	$	30.41	5.02	$	32,074

	Number of Options Outstanding		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life		Aggregate Intrinsic Value (in 000 s)
Outstanding options at January 1, 2006	1,931,627	$	26.53			
Options granted	191,100	$	50.03			
Options exercised	(339,762)	$	19.69		$	11,316
Options canceled/forfeited	(41,900)	$	39.21			
Outstanding options at September 30, 2006	1,741,065	$	30.14	5.66	$	35,955
Exercisable options at September 30, 2006	1,552,065	$	27.72	5.18	$	35,811

The majority of our options are granted annually at the board meeting in May. Thus far in 2007, 216,300 shares were granted with an average exercise price of $56.10 and an average fair value of $15.12. We recognized $1.1 million of expense in the first nine months of 2007 related to options vesting. Since options granted under our plan are non-qualified, we recorded a tax benefit of $0.4 million related to this compensation expense. Total unrecognized compensation expense relating to outstanding and unvested options was $3.7 million, which will be recognized over the remainder of the vesting period.

The fair value of options was estimated using a Black-Scholes based option pricing model with the following grant-date assumptions and weighted average fair values as of September 30: