

BARCODE: Audited Financial Report

DOC#: 22000 PLACEMENT/PAGE:

COMPANY NAME: LUMBERMENS MUTUAL CASUALTY COMPANY



## **LUMBERMENS MUTUAL CASUALTY COMPANY**

**Statutory Statements of Admitted Assets, Liabilities, and Surplus and Schedules**

**December 31, 2006 and 2005**

**(With Independent Auditors' Report Thereon)**



**KPMG LLP**  
303 East Wacker Drive  
Chicago, IL 60601-5212

## **Independent Auditors' Report**

The Board of Directors  
Lumbermens Mutual Casualty Company:

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of Lumbermens Mutual Casualty Company (the Company) as of December 31, 2006 and 2005. These statutory financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these statutory financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the statutory financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall statutory financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note 2 to the statutory financial statements, the Company prepared these statutory financial statements using accounting practices prescribed or permitted by the Illinois Department of Financial and Professional Regulation-Division of Insurance (Division of Insurance), which practices differ from U.S. generally accepted accounting principles. The effects on the statutory financial statements of the variances between the statutory accounting practices and U.S. generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the statutory financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Lumbermens Mutual Casualty Company as of December 31, 2006 and 2005.

Also, in our opinion, the statutory financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of Lumbermens Mutual Casualty Company as of December 31, 2006 and 2005, on the basis of accounting described in Note 2.

As discussed in Note 2 to the statutory financial statements, the Division of Insurance has prescribed or permitted certain accounting practices under a Corrective Order which result in an increase to policyholder surplus of \$453 million and \$571 million as of December 31, 2006 and 2005, respectively. These accounting practices differ from the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual*.

Our audits were made for the purpose of forming an opinion on the basic statutory financial statements taken as a whole. The supplementary information included on the Supplemental Schedule of Investments, Supplemental Schedule of Investment Risk Interrogatories, and Reinsurance Risk Interrogatories Schedule is presented for purposes of additional analysis and is not a required part of the basic statutory financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic statutory financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole.

The accompanying statutory financial statements and supplementary information have been prepared assuming that the Company will continue as a going concern. As discussed in Note 9 to the statutory financial statements, the Division of Insurance imposes risk-based capital (RBC) requirements on insurance enterprises, including the Company. As of December 31, 2006 and 2005, the Company's total adjusted capital, as reported in the 2006 and 2005 Annual Statements filed with the Division of Insurance, is at the "authorized control level" and the "mandatory control level", respectively, based on the RBC calculation required by the Division of Insurance. At the "authorized control level" and the "mandatory control level", the Division of Insurance has substantial authority to exercise control over the Company, its subsidiaries and affiliates. The Division of Insurance is mandated to place a company at the "mandatory control level" under its control, except where, as is the case with the Company, such Company is a property and casualty insurance company that is no longer writing new business and is running off its existing business, in which case the Director of the Division of Insurance has discretion to allow the continued run-off. In the first half of 2003, as a result of a combination of various business factors including certain ratings downgrades and the Company's deteriorating statutory surplus, the Company substantially ceased underwriting activities. Since July 2003, the Company and most of its subsidiaries and affiliates have been subject to a Corrective Order by the Division of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Division of Insurance. On March 19, 2004, the Company submitted to the Division of Insurance its commercial run-off plan which was approved on June 9, 2004.

The Division of Insurance could seek to place the Company in formal proceeding (receivership, rehabilitation, or other) at any time based on the Company's financial condition or operating performance. This risk of a proceeding would be further increased if the Company fails to execute successfully on its commercial run-off plan, if the Company fails to have sufficient liquid assets to meet its current obligations, or if the Company's reported statutory liabilities at any time would exceed its reported statutory assets as discussed in Note 11 to the statutory financial statements.

There are a number of factors that could adversely affect the Company's surplus and liquidity position and its adequacy through future years. There can be no assurance that the Company will be successful to the extent necessary to avoid a negative surplus in future years. In addition, as of December 31, 2006, the Company has approximately \$909 million of invested assets that are encumbered by being on deposit or held in trust or escrow arrangements and access to these amounts is subject to certain limitations.



The matters discussed in the preceding paragraphs raise substantial doubt about the ability of the Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, the most important of which is regulatory action, including the continued acceptance of the Company's commercial run-off plan and the continued permission to apply the aforementioned prescribed or permitted accounting practices. Management's plans in regards to these matters are described throughout the notes to the statutory financial statements. The accompanying statutory financial statements and the supplementary information do not include any adjustments that might result from the outcome of this uncertainty.

KPMG LLP

May 29, 2007

**LUMBERMENS MUTUAL CASUALTY COMPANY**  
Statutory Statements of Admitted Assets, Liabilities, and Surplus  
December 31, 2006 and 2005

<b>Admitted Assets</b>	<u><b>2006</b></u>	<u><b>2005</b></u>
Cash, cash equivalents, and short-term investments	\$ 130,978,945	308,270,902
Common stocks:		
Affiliated	85,535,429	91,424,689
Unaffiliated	2,256,556	2,436,585
Bonds	1,394,363,713	1,551,961,871
Mortgage loans on real estate	—	804,176
Real estate held for sale	4,172,747	4,241,182
Receivable for securities sold	—	32,476,418
Other invested assets	28,898,383	28,686,507
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Total cash and invested assets	1,646,205,773	2,020,302,330
Reinsurance recoverable on paid losses and loss adjustment expenses	236,048,560	301,210,228
Other admitted assets	66,420,523	90,573,898
Agents' balances and uncollected premiums	56,982,368	122,546,254
Accrued retrospective premiums	34,138,540	58,656,689
Amounts billed and receivable under high deductible policies	28,306,088	32,433,674
Investment income due and accrued	13,876,735	15,771,735
Equities and deposits in pools and associations	13,539,537	11,159,766
Reinsurance accounted for as a deposit	12,798,675	20,053,594
Funds held by or deposited with reinsured companies	12,677,226	10,558,018
Funds held by claim service provider	12,254,905	16,548,677
Receivable from subsidiaries and affiliates	3,209,996	—
	<hr/>	<hr/>
Total admitted assets	<u><u>\$ 2,136,458,926</u></u>	<u><u>2,699,814,863</u></u>

See accompanying notes to statutory statements of admitted assets, liabilities, and surplus.

<b>Liabilities and Surplus</b>	<b>2006</b>	<b>2005</b>
	<u>2006</u>	<u>2005</u>
Liabilities:		
Losses and loss adjustment expenses	\$ 1,575,632,542	1,974,312,431
Amounts withheld for others	153,814,393	183,081,209
Accounts payable and other liabilities	88,170,204	164,401,923
Taxes, licenses, and fees payable	43,722,214	48,881,275
Reinsurance payable on paid losses and loss adjustment expenses	33,129,868	36,560,978
Other expenses payable	22,763,756	21,309,938
Ceded reinsurance premiums payable	12,639,888	19,035,927
Unearned premium	9,463,192	19,045,951
Remittances and items not allocated	7,281,322	12,222,013
Federal and foreign income taxes	6,053,607	8,256,345
Net adjustments in assets and liabilities due to foreign exchange rates	4,993,035	5,339,676
Funds held under reinsurance treaties	3,787,577	10,619,735
Commissions payable	1,414,716	989,595
Reinsurance funds held related to retroactive reinsurance	—	14,253,055
Payable to subsidiaries	—	13,191,661
Total liabilities	<u>1,962,866,314</u>	<u>2,531,501,712</u>
Guaranty fund	1,500,000	1,500,000
Surplus notes	698,355,598	698,355,598
Unassigned deficit	<u>(526,262,986)</u>	<u>(531,542,447)</u>
Total surplus	<u>173,592,612</u>	<u>168,313,151</u>
Total liabilities and surplus	<u>\$ 2,136,458,926</u>	<u>2,699,814,863</u>

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

### (1) Business Operations

Lumbermens Mutual Casualty Company (the Company) is a mutual property and casualty insurance company domiciled in the state of Illinois. The Company is the lead company of a group of insurers, now in run-off status, which have operated under the trade name of the Kemper Insurance Companies (Kemper).

As further discussed in note 9, the Company's risk-based capital (RBC) ratio, as filed, fell below the "authorized control level" as of December 31, 2002, and has remained below that level to date. The Company's RBC ratio and the reduction of the Company's ratings have had and will continue to have a significant impact on the Company's operations.

### (2) Basis of Presentation and Summary of Significant Accounting Policies

The accompanying statutory statements of admitted assets, liabilities, and surplus (the statutory balance sheets) have been prepared in accordance with the National Association of Insurance Commissioners (the NAIC) *Accounting Practices and Procedures Manual* (the Manual), and in conformity with prescribed accounting practices (including accounting allowances under Corrective Orders) or permitted accounting practices by the Illinois Department of Financial and Professional Regulation – Division of Insurance (the Division of Insurance), which vary in some respects from U.S. generally accepted accounting principles (GAAP). The most significant of these differences are as follows:

- the costs related to acquiring business are charged to income when incurred rather than deferred and amortized over the life of the related insurance policy;
- investments in bonds are generally carried at amortized cost, while under GAAP, such fixed maturity investments are designated at purchase as held-to-maturity, available-for-sale, or trading. Held-to-maturity investments are reported at amortized cost. Available-for-sale and trading investments are reported at fair value with unrealized gains and losses reported in operations for those designated as trading and as a separate component of stockholder's equity, net of applicable deferred income taxes, for those designated as available-for-sale;
- assets are included in the statutory balance sheets at admitted asset value, and nonadmitted assets are excluded through a direct charge against surplus, while under GAAP, such assets would be recognized at the lower of cost or net realizable value;
- majority owned subsidiaries are carried under the equity method and are not consolidated, and adjustments reflecting the equity in earnings of affiliated companies are credited or charged directly to surplus as net unrealized capital gains or losses rather than being recorded through income;
- surplus notes are reflected as a component of surplus rather than as a liability as would be reported under GAAP, and interest on such notes is not recorded as a liability or expense until payment has been approved by the Division of Insurance;
- the realizability of deferred tax assets under GAAP is evaluated utilizing a "more likely than not" standard. A valuation allowance is established for deferred tax assets deemed not realizable using this standard. Under statutory accounting principles, the realizability of deferred tax assets is determined utilizing an admissibility test outlined in Statement of Statutory Accounting Principles (SSAP) No. 10 – *Income Taxes*. Any gross deferred tax assets determined not to be realizable are

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

nonadmitted for statutory accounting purposes. Additionally, changes in the balances of deferred tax assets and liabilities result in increases or decreases in net income under GAAP, whereas under statutory accounting principles, these changes are charged or credited to surplus;

- ceded reinsurance balances are netted against direct and assumed balances on the statutory balance sheets rather than shown gross under GAAP;
- liabilities for losses and loss adjustment expenses (LAE) are discounted using discount rates prescribed by the Division of Insurance;
- certain assets and liabilities originated in foreign currency are adjusted to U.S. dollars through a direct charge to surplus; and
- the correction of errors related to previously issued financial statements is charged directly to surplus rather than restating prior period results.

The effects of such differences between these statutory accounting practices and GAAP have not been determined but are presumed to be material.

#### *Prescribed and Permitted Practices*

The Company's reported surplus at December 31, 2006 and 2005 reflects increases of approximately \$453 million and \$571 million, respectively, over what would have been reported without accounting practices prescribed or permitted by the Division of Insurance.

Pursuant to the prescribed practices in 2006 and 2005, the Company:

- Discounted all its loss and LAE liabilities at 4.2% (The Company's current invested asset book yield approximates the 4.2% discount rate.);
- Reflected as admitted assets the amounts that the Company has prepaid for claim handling services to two third party administrators related to unallocated LAE (ULAE);
- Established a general provision for uncollectible reinsurance, net of discount (This provision has been established using the same 4.2% discount rate used for the Company's discounted underlying loss and LAE liabilities.);
- Recognized amounts due from National Fidelity Life Insurance Company as a contra liability for the amount due to the extent of direct claim liabilities and the remaining balance as an admitted receivable to reflect the "economic basis" of certain reinsurance annuity contracts;
- Discounted the liability for loss-based assessments and premium deficiency at 4.2%; and
- Admitted an anticipated refund from the California Insurance Guarantee Association (CIGA) as a receivable (The Company subsequently received this refund in February 2007.);

Pursuant to the permitted practices in 2006 and 2005:

- The Company is permitted to account for certain reinsurance contracts that meet the definition of retroactive reinsurance agreements as prospective reinsurance agreements.



## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

- The Company is permitted to forego the requirement to obtain financial statements prepared on the basis of GAAP for the Company's overseas insurance subsidiaries and U.S. noninsurance company subsidiaries. The Company believes that the statutory carrying values of these subsidiaries approximate the carrying values that would be determined under the Manual if GAAP statements were prepared.

The accompanying table details the effects on surplus as of December 31, 2006 and 2005 of the prescribed and permitted practices as described above by reconciling the reported positive surplus of the Company to the negative surplus that would have been reported in the absence of prescribed and permitted practices:

	<b>Surplus</b>	
	<b>2006</b>	<b>2005</b>
	(In millions)	
As reported herein	\$ 174	168
Increase (decrease) as a result of prescribed and permitted practices:		
Discount liability for loss and LAE	(379)	(468)
Prepaid ULAE	(33)	(45)
Provision for uncollectible reinsurance	10	(4)
Annuity reinsurance contracts	(9)	(12)
Discount loss-based assessment and premium deficiency liability	(17)	(17)
CIGA admitted asset	(16)	(16)
Retroactive reinsurance agreements	—	—
Subsidiary GAAP Financials	(9)	(9)
Total prescribed and permitted practices	(453)	(571)
Manual basis	\$ (279)	(403)

### ***Correction of Errors***

In accordance with SSAP No. 3, *Accounting for Changes and Corrections of Errors*, the Company has reflected as a direct benefit to surplus corrections of errors of \$262 thousand, as of December 31, 2005, which related to certain expenses of American Manufacturers Mutual Insurance Company (AMM) that had been expensed and paid by the Company in 2004.

### ***Invested Assets and Related Income***

Bonds, cash equivalents, and short-term investments are generally valued at amortized cost; however, bonds rated NAIC 3 or below are carried at the lower of amortized cost or fair value. The amortized cost of bonds is adjusted for amortization of premiums and accretion of discounts using a level effective yield method to maturity, or in the case of loan-backed securities, over the estimated life of the security. Amortization of the discount or premium from loan-backed securities is recognized retrospectively based on the estimated timing and amount of prepayments of the underlying assets and is adjusted to reflect differences which arise between the prepayments originally anticipated and the actual prepayments received and currently anticipated. Prepayment assumptions used for loan-backed securities were obtained

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

from an external securities information service and are consistent with the current interest rate and economic environment.

The Company defines cash and cash equivalents as cash in banks or short-term, highly liquid investments that are both readily convertible to cash and have original maturities of three months or less. The Company considers all other highly liquid investments with an original maturity of one year or less to be short-term investments.

Unaffiliated common and preferred stocks are generally carried at fair value with unrealized gains and losses recorded in surplus.

Affiliated common stocks are generally carried at the underlying statutory equity of the respective entity's financial statements.

Mortgage loans are carried at their unpaid principal balance, net of any impairments. Other invested assets include notes receivable and joint venture interests. Notes receivable are carried at their unpaid principal balance, net of impairments. Joint ventures in which the Company has a less than 10% ownership interest are carried at underlying GAAP equity. Joint ventures in which the Company has a greater than 10% ownership interest are carried at the underlying statutory equity of the joint venture's financial statements. The Company also has a real estate joint venture which is accounted for as a real estate acquisition, development and construction arrangement (ADC) and accordingly is carried at its estimated fair value, net of anticipated costs to sell, which approximates its underlying statutory equity.

Real estate owned is held for sale and is valued at the lower of its carrying amount or fair value less estimated costs to sell.

The Company does not accrue interest income on fixed maturities deemed to be impaired on an other-than-temporary basis, or on real estate-related investments, when it determines that the likelihood of collection of interest is doubtful.

#### ***Premium Balances***

Premiums are earned on a daily pro-rata basis over the term of the policies. Unearned premiums are stated after deduction for premiums ceded to reinsurers. Premiums received in advance are recorded as a liability and are not considered income until due. Agents' balances and uncollected premiums receivable are recorded at the effective date of the underlying contract or in the case of audit premiums in accordance with the terms of the underlying contracts. Such receivables are recorded net of balances over 90-days past due and such other balances as required by the Manual. The Company evaluates the collectibility of all receivables for possible impairment. When the Company determines it is probable a receivable balance will not be collected, such amount is written off. The Company anticipates investment income as a factor in determining the premium deficiency liability. As of December 31, 2006 and 2005, the Company recorded an ending premium deficiency liability of \$4.0 million and \$5.6 million, respectively, net of discount.

The Company has recorded an admitted asset for accrued retrospective premiums which includes amounts due the Company for additional premiums for loss sensitive programs and dividend recalls. Such amounts have been estimated based on actuarial techniques and as such are subject to periodic re-evaluation.

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

Changes in the valuation of this asset will result in a corresponding benefit or expense on dividends to policyholders, but do not reflect any agreement or expectation to pay any such dividends.

#### *Liability for Losses and Loss Adjustment Expenses*

The Company records liabilities for unpaid claims, losses, and related LAE based upon management's best estimate of aggregate case-basis estimates for losses reported, estimates received from ceding reinsurers, and estimates of incurred but not reported (IBNR) losses related to direct and assumed business, less amounts ceded to reinsurers. Liabilities for unreported losses are established using various statistical and actuarial techniques reflecting historical patterns of development of paid and reported losses adjusted for current trends.

The Division of Insurance has prescribed an accounting practice under a Corrective Order pursuant to which the Company discounts all its loss and LAE liabilities at 4.2% in the accompanying statutory balance sheets as of December 31, 2006 and 2005. At December 31, 2006 and 2005, the total amount of the discounts related to this prescribed practice included in the accompanying statutory balance sheets are \$379 million and \$468 million, respectively.

Because the ultimate settlement of claims is subject to future events, no single loss or LAE liability can be considered accurate with certainty. The Company's analysis of the reasonableness of loss or LAE liability estimates includes an analysis of the amount of variability in the estimate. The Company develops its estimate considering a range of liability estimates bounded by a high and a low estimate. The high and low ends of the range do not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management's best estimate therefore does not include the set of all possible outcomes but only those outcomes that are considered reasonable.

The Company reflects its liability for losses net of anticipated salvage and subrogation recoveries. Those anticipated recoveries were \$32.3 million and \$64.8 million at December 31, 2006 and 2005, respectively.

Management believes the liabilities for losses and LAE are adequate to cover the ultimate liability; however, due to the underlying risks and high degree of uncertainty associated with the determination of the liability for losses, such estimates may be more or less than the amounts ultimately paid when the claims are settled. In the event reinsurance companies are unable to pay their portion of any claim under reinsured policies, the Company would remain liable for such payments.

#### *Federal and Foreign Income Taxes*

The Company files a consolidated federal income tax return with its subsidiaries. Federal and foreign income taxes are charged to operations based on income that is currently taxable. The Company provides, as a component of surplus, an estimate of deferred income tax assets and liabilities which reflect the expected future tax consequences of unrealized capital gains or losses and the temporary differences generated between statutory accounting and the tax bases of assets and liabilities that are anticipated to reverse within one year or can be recovered through loss carrybacks.

The Company has a tax allocation agreement which provides that current federal income taxes will generally be paid to or recovered from the Company on the basis of each subsidiary company's taxable income or taxable loss as if the subsidiary were filing a separate federal income tax return. In the event of a

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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federal income tax benefit on a separate return basis which is greater than the subsidiary company's actual amount recoverable on a consolidated return basis, the amount recoverable will be apportioned among all such companies entitled to a recovery on a pro rata basis. Settlement among the companies occurs within a reasonable time period following the filing of the consolidated federal tax return. Based upon the Company's and its affiliates current financial position, all settlements of inter-company tax balances are subject to approval by the Division of Insurance.

### *Nonadmitted Assets*

Assets included in the statutory balance sheets are at admitted asset value. Certain assets designated as "nonadmitted assets" are excluded from the statutory balance sheets and are charged to unassigned surplus at December 31, 2006 and 2005 as follows:

	<b>2006</b>	<b>2005</b>
	(In millions)	
Deferred tax assets	\$ 701.7	760.0
Premiums receivable	34.4	60.6
Other assets nonadmitted	29.7	46.6
Total nonadmitted assets	\$ 765.8	867.2

### *Provision for Uncollectible Reinsurance*

The Division of Insurance has prescribed an accounting practice under a Corrective Order pursuant to which the Company has established a general provision for uncollectible reinsurance. Changes in this liability are charged directly against surplus.

The general provision for uncollectible reinsurance, net of discount, was \$55.0 million and \$121.6 million at December 31, 2006 and 2005, respectively. The Schedule F penalty otherwise prescribed would have been \$45.4 million and \$125.9 million at December 31, 2006 and 2005, respectively.

### *Use of Estimates*

The preparation of the statutory balance sheets requires management to make estimates and assumptions that affect the reported statutory balance sheet amounts as well as the disclosure of contingent assets and liabilities. Accordingly, actual results could differ from those estimates.

As further discussed in the accompanying notes to the statutory balance sheets, significant estimates and assumptions affect various provisions including losses and policyholder dividends. The liabilities for losses and LAE and related reinsurance recoverables, although supported by actuarial analysis and other data, are ultimately based on management's reasoned expectations of future events. As further described in note 4, estimates of losses and LAE related to environmental and asbestos claims are also subject to a greater degree of uncertainty and variability. Policyholder dividend recalls (accrued retrospective premiums) are estimated based on similar assumptions used to estimate the ultimate liabilities for losses and LAE. Currently, under the Corrective Order, the Company is prohibited from paying policyholder dividends. Additionally, valuation of the Company's real estate-related investments is subjective and estimated by

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Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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management based upon current and expected future real estate market conditions and other factors. Actual results could differ from those estimates.

**(3) Invested Assets and Investments in Subsidiaries**

***Bonds***

The fair values of the Company's bonds have been determined using prices provided by the Securities Valuation Office of the NAIC (the SVO), or when such values are not available from the SVO, using prices from independent pricing services that use market quotations, prices provided by brokers, or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics, or prices determined in good faith by the Company's engaged portfolio manager. Such values are referred to in the accompanying tables as "NAIC fair value."

The statement value and NAIC fair value of bonds at December 31, 2006 and 2005 were as follows:

	<b>2006</b>			
<b>Statement value</b>	<b>Gross unrealized gains</b>	<b>Gross unrealized losses</b>	<b>NAIC fair value</b>	
	(In thousands)			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$ 502,416	40	(12,364)	490,092
State, political subdivision, and special revenue obligations	52,582	773	(198)	53,157
Debt securities issued by foreign governments	2,312	1	(74)	2,239
Corporate securities	575,274	171	(32,583)	542,862
Asset-backed securities	97,424	433	(80)	97,777
Mortgage-backed securities	164,356	58	(422)	163,992
Total bonds	\$ 1,394,364	1,476	(45,721)	1,350,119

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Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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	2005			NAIC fair value
	Statement value	Gross unrealized gains	Gross unrealized losses	
	(In thousands)			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$ 860,816	220	(18,002)	843,034
State, political subdivision, and special revenue obligations	71,679	2,171	(306)	73,544
Debt securities issued by foreign governments	2,395	3	(81)	2,317
Corporate securities	425,723	1,192	(36,513)	390,402
Asset-backed securities	110,796	447	(117)	111,126
Mortgage-backed securities	80,553	75	(498)	80,130
Total bonds	\$ 1,551,962	4,108	(55,517)	1,500,553

Bonds in an unrealized loss position are regularly reviewed for other-than-temporary declines in value. Factors considered in determining whether a decline is other-than-temporary include the length of time a bond has been in an unrealized loss position and the reasons for the decline in value. Assessments include judgments about an obligor's current and projected financial position, an issuer's current and projected ability to service and repay its debt obligations, the existence of, and realizable value for, any collateral backing the obligations, and the macro-economic and micro-economic outlooks for specific industries and issuers. Assessing the duration of loan-backed securities can also involve assumptions regarding underlying collateral such as prepayment rates, default and recovery rates, and third party servicing abilities.

In performing its other-than-temporary impairment reviews, the Company, in consultation with its engaged portfolio manager, considers the relevant facts and circumstances relating to each investment and exercises judgment in determining whether a bond is other-than-temporarily impaired. Among the factors considered is whether the decline in fair value results from a change in the quality of the security itself, or from a downward movement in the market as a whole, and the likelihood of recovering the carrying value based on the current and short-term prospects of the issuer. Unrealized losses that are considered to be primarily the result of market conditions, such as increasing interest rates, unusual market volatility or industry-related events, and where the Company also believes there exists a reasonable expectation of recovery and, furthermore, has the intent to hold the investment until maturity or the market recovery, are usually determined to be temporary.

The bonds shown in the below table, nearly all of which are rated "A" or better, or are U.S. government obligations or are U.S. government agency mortgage-backed obligations and, therefore, have minimal credit risk, are subject to normal market fluctuations. The Company intends to hold them until they mature or recover in value. However, if the specific facts and circumstances surrounding a bond, or the outlook for its industry sector or the economy change, the Company may sell the bond and realize a loss.

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Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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The risks inherent in reviewing the impairment of any investment include the risk that market results may differ from expectations; facts and circumstances may change in the future and differ from estimates and assumptions; or the Company may later decide to sell the security as a result of changed circumstances.

As of December 31, 2006 and 2005, the gross unrealized losses that were in that position for more than twelve months and for less than twelve months were as follows:

	2006			2005		
	Number of issues	Gross unrealized losses	NAIC fair value	Number of issues	Gross unrealized losses	NAIC fair value
	(In thousands)					
Bonds in a loss position more than 12 months:						
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18	\$ (12,211)	451,866	18	\$ (12,761)	501,105
State, political subdivision, and special revenue obligations	3	(162)	5,571	4	(210)	11,251
Debt securities issued by foreign governments	1	(74)	2,163	1	(81)	2,238
Corporate securities <sup>1</sup>	24	(30,531)	310,966	17	(35,529)	255,156
Asset-backed securities	2	(8)	6,907	—	—	—
Mortgage-backed securities	14	(354)	25,521	5	(49)	11,440
	62	(43,340)	802,994	45	(48,630)	781,190
Bonds in a loss position less than 12 months:						
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	2	(153)	24,125	25	(5,241)	295,939
State, political subdivision, and special revenue obligations	2	(36)	3,584	3	(96)	23,215
Corporate securities <sup>2</sup>	18	(2,052)	172,382	12	(984)	56,622
Asset-backed securities	4	(72)	38,079	13	(117)	98,463
Mortgage-backed securities	9	(68)	66,643	54	(449)	37,988
	35	(2,381)	304,813	107	(6,887)	512,227
Total bonds in a loss position	97	\$ (45,721)	1,107,807	152	\$ (55,517)	1,293,417

<sup>1</sup> Includes two Berkshire Hathaway Group (Berkshire) (which is rated “AAA”) bonds with gross unrealized losses of \$28,885 thousand and \$34,331 thousand and with NAIC fair values of \$217,981 thousand and \$212,535 thousand at December 31, 2006 and 2005, respectively (see note 5).

<sup>2</sup> Includes one Berkshire bond with gross unrealized losses of \$1,676 thousand and \$0 and with NAIC fair values of \$24,535 thousand and \$0 at December 31, 2006 and 2005, respectively (see note 5).

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The following table sets forth the maturity aging schedule of bonds at December 31, 2006. The actual maturities may differ from the contractual maturities because debtors may have the right to call or prepay obligations with or without call or prepayment penalties.

	<b>Statement value</b>	<b>NAIC fair value</b>
	(In thousands)	
One year or less	\$ 263,226	260,903
Over one year through five years	440,348	433,629
Over five years through ten years	179,555	174,303
Over ten years	297,425	267,606
Securities not due at a single maturity date	213,810	213,678
Total bonds	\$ 1,394,364	1,350,119

At December 31, 2006 and 2005, cash, short-term investments and bonds carried at \$614.4 million and \$745.2 million, respectively, were on deposit with government authorities as required by law. The Company's cash and invested assets were also encumbered at December 31, 2006 and 2005, by \$293.9 million and \$327.5 million, respectively, related to various collateral requirements.

Proceeds from sales of investments in bonds prior to maturity during 2006 and 2005 were \$231.9 million and \$304.0 million, respectively.

***Equity Securities***

Gross unrealized gains on equity securities (common stocks and preferred stocks), excluding affiliated companies, at December 31, 2006 and 2005 amounted to \$81 thousand and \$59 thousand, respectively. Gross unrealized losses on equity securities at December 31, 2006 and 2005 amounted to \$0 and \$11 thousand, respectively. The cost of equity securities held at December 31, 2006 and 2005, excluding affiliated companies, was \$2.2 million and \$2.4 million, respectively. Consideration on sales of unaffiliated equity securities totaled \$1.5 million in 2006 and \$53 thousand in 2005.



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### *Investments in Affiliated Companies*

The Company's investments in common stocks of affiliated companies at December 31, 2006 and 2005 are summarized below:

	2006		2005	
	Cost	Statement value	Cost	Statement value
	(In thousands)			
American Motorists Insurance Co. <sup>1</sup>	\$ —	25,846	—	30,372
Specialty Surplus Insurance Co.	23,609	21,714	26,895	29,307
Kemper Casualty Insurance Co.	22,506	28,496	22,506	22,448
Kemper International Corp.	6,462	7,553	6,998	6,998
All other	1,798	1,926	1,938	2,300
	\$ 54,375	85,535	58,337	91,425

<sup>1</sup> The Company's cost basis in American Motorists Insurance Company (AMICO) was reduced to \$0 as a result of return of capital dividends received in 2004.

### *Significant Transactions Involving Affiliates*

#### **Subsidiary Mergers and Dissolutions**

During 2006, Universal Bonding Insurance Company (UBIC), the Company's indirectly wholly owned, New Jersey-domiciled, subsidiary, merged into one of the Company's wholly owned Illinois-domiciled subsidiaries, Kemper Casualty Insurance Company (KCIC). KCIC was the surviving entity in the merger. Since 2002, UBIC was carried at no value on the books of the Company. The merger and related transactions resulted in a surplus benefit to the Company of approximately \$18.4 million in 2006. This benefit is primarily due to the related cancellation of a \$12.3 million intercompany liability previously recorded as owed by the Company to UBIC. Surplus notes originally issued by UBIC to the Company in 2002 and 2003 were also canceled in 2006 without any impact to the surplus of the Company. As a result of the merger itself, KCIC's (and the Company's) surplus increased by approximately \$6.1 million (part of the \$18.4 million) reflecting UBIC's net assets and a slight benefit from the application of accounting practices prescribed or permitted by the Division of Insurance.

During 2005, the Company voluntarily dissolved 20 of its direct and indirect noninsurance company subsidiaries, primarily nonoperating holding companies and insurance agencies that no longer served a purpose since the Company is in run-off. These actions simplified the Company's organization chart and reduced certain operating expenses. As a result of these transactions, the cost basis of Specialty Surplus Insurance Company (SSIC) and KCIC carried over from the investment in the previously held holding companies.

#### **International Operations**

During the last two years, the Company has had seven international insurance operations in six countries. Three of the seven, specifically the Company's Japanese branch and its Bermuda and Singapore

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subsidiaries, were voluntarily liquidated in 2005 and 2006, respectively. The Company's four continuing international operations consist of the following: two branches in Canada, one being a branch of the Company and the other a branch of the Company's wholly owned, Illinois-domiciled, subsidiary, AMICO; and two insurance company subsidiaries in Belgium and Australia. These four operations accounted for approximately \$38.7 million, or approximately 22.2%, of the Company's surplus at December 31, 2006. International operations had accounted for approximately \$50.0 million, or 29.7%, of the Company's surplus at December 31, 2005. The decline in surplus located overseas primarily was due to the repatriation of cash from certain of the overseas operations. Repatriations totaled approximately \$8.3 million in 2006 and \$12.5 million in 2005.

At December 31, 2006 and 2005, respectively, the Company's Canadian branch accounted for \$30.1 million and \$37.0 million of the Company's surplus. Approximately \$37.5 million of the \$48.0 million of assets of the Company's Canadian branch at December 31, 2006 are encumbered in trust. The trust is required by Canadian regulators who must approve any releases of the vested assets from the trust, including releases to pay claims. The regulators are currently approving payments of the branch's expenses and liabilities from vested trust assets, and starting in the fourth quarter of 2006, the Canadian regulators have conditionally agreed to release approximately \$2.2 million per quarter through 2007. The \$2.2 million released in 2006 was then repatriated to the Company's unencumbered U.S. accounts. In 2005, using Canadian trust assets, the Company settled a \$21 million liability it owed to the purchaser of its Canadian personal lines business sold in 2001.

At December 31, 2006 and 2005, respectively, AMICO's Canadian branch accounted for \$1.1 million and \$5.6 million of the Company's surplus. In 2006, the AMICO branch in Canada completed an assumption reinsurance transaction and repatriated to the U.S. approximately \$4.8 million. The Company anticipates that AMICO's Canadian branch will be fully liquidated in 2007, which will allow for the repatriation of the remaining \$1.1 million. At year-end 2005, in connection with the then pending assumption reinsurance transaction, the Company separately commuted certain non-Canadian reinsurance contracts, resulting in a surplus gain to the Company of \$4.6 million.

At December 31, 2006 and 2005, respectively, the Company's Belgium subsidiary, Kemper, S.A. (Societe Anonyme), accounted for \$4.7 million and \$3.9 million of the Company's surplus.

At December 31, 2006 and 2005, respectively, the Company's Australian subsidiary, Kemper Insurance Company Limited (KICL), accounted for \$2.8 million and \$2.6 million of the Company's surplus.

The Company has guaranteed the obligations under policies issued on or after January 1, 2002 by KSA, and under most policies issued by KICL. Most of those Belgium and Australian policies are also reinsured by the Company under excess of loss reinsurance agreements for any net losses in excess of \$50 thousand. The Company is exploring the sale of its Belgium subsidiary but has not entered into any definitive agreement to do so. In the second quarter of 2007, the Company entered into a definitive agreement to sell its Australian subsidiary. Expected to close in the second half of 2007 and result in the commutation of all of the Company's reinsurance of KICL, this transaction would repatriate to the U.S. (provide liquidity to the Company of) approximately \$2 million at a net cost to the Company's surplus of less than half that amount.

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In 2005, the Company completed the liquidation of its Japanese branch with no surplus impact. In the liquidation, the Company repatriated from its Japanese branch approximately \$2.2 million.

In 2006, the Company completed the liquidation of its Singapore subsidiary with no surplus impact. The Company received from its Singapore subsidiary a final liquidating cash dividend of approximately \$0.5 million in 2006. This followed dividends in 2005 consisting of cash of \$4.0 million and return and cancellation of a \$4.7 million loan from the subsidiary to the Company. None of these receipts impacted the Company's surplus, although the cash increased liquidity in the U.S.

Also in 2006, the Company completed the liquidation of its Bermuda subsidiary, the Seven Continents Insurance Company. The liquidation had no impact on surplus in 2006. In 2005, this subsidiary had completed a solvent scheme initiated in 2004; paid the Company \$5.9 million pursuant to, and in connection with the commutation of, its separate cell reinsurance agreement; entered formal voluntary liquidation proceedings; and distributed to its shareholders all its assets other than approximately \$63 thousand to cover final closure expenses through 2006. The Company received from this 2005 distribution net reinsurance recoverables valued at approximately \$500 thousand at December 31, 2005 and cash of \$2.4 million in 2005. The distribution did not impact the Company's surplus in 2005, and the Company collected in cash the distributed reinsurance recoverables in 2006.

#### **Other Affiliate Transactions**

In 2006, following approval by the Division of Insurance, the Company contributed certain real-estate related promissory notes to AMICO, which in turn contributed them to its wholly owned subsidiary, AMICO Realty Corporation, which holds other notes and related real estate investments. The notes had been valued at zero by the Company at December 31, 2006 and 2005, and therefore the transfer to AMICO Realty resulted in no change to either the value of the assets carried on the Company's statutory balance sheets or the Company's surplus. The Company made no capital contributions to subsidiaries during 2005.

Dividend distributions from the Company's insurance subsidiaries to the Company are restricted by various state insurance laws. In Illinois, where most of the Company's subsidiaries are domiciled, if such dividend, together with other distributions during the 12 preceding months, would exceed the greater of (a) 10% of the insurer's statutory surplus as regards policyholders as of the preceding December 31, or (b) the statutorily adjusted net income for the preceding calendar year, then such proposed dividend must be reported to the Director of the Division of Insurance (the Director) at least 30 days prior to the proposed payment date and may be paid only if not disapproved. The Illinois insurance laws also prohibit, in the absence of approval by the Director, the payment of any dividend to the extent the dividend would exceed the stock insurance company's earned surplus (such surplus being calculated as exclusive of most unrealized gains). Corrective Orders issued by the Division of Insurance further restrict the payment of dividends by prohibiting any transfers of assets, including any dividend, to the Company from any affiliate without the approval of the Director.

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The Company recorded return of capital and income dividends from the following subsidiaries during 2006 and 2005:

	<b>2006</b>	<b>2005</b>
	(In thousands)	
SSIC <sup>1</sup>	\$ 10,000	—
AMICO <sup>2</sup>	5,009	—
Kemper International Corporation	536	7,776
American Underwriting Corporation	432	—
LGA-17, Inc.	140	—
Total	\$ 16,117	7,776

<sup>1</sup> SSIC's Board of Directors approved a \$3,286 thousand return of capital dividend and a \$6,714 thousand income dividend paid December 29, 2006 to the Company, its sole shareholder.

<sup>2</sup> AMICO's Board of Directors approved a \$4,973 thousand return of capital dividend and a \$36 thousand income dividend paid December 29, 2006 to the Company, its sole shareholder.

The Company did not have any impairment write-downs on investments in subsidiaries during 2006.

The Company recognized an impairment write-down of \$1.8 million for its investment in Kemper International Corporation during 2005. The write-down was based upon the Company's view that the value of the subsidiary was impaired on an other-than-temporary basis.

***Real Estate Held for Sale***

The Company's remaining real estate owned, an office/warehouse building in Lake Zurich, Illinois, was classified as held for sale.

***Other Invested Assets***

Other invested assets, consisted of the following as of December 31, 2006 and 2005:

	<b>2006</b>	<b>2005</b>
	(In thousands)	
Kemper Lloyds Insurance Co. joint venture	\$ 22,351	21,585
Real estate joint venture	5,315	5,853
Other notes receivable and equity investments	1,232	1,249
Other invested assets	\$ 28,898	28,687

Domiciled in the state of Texas, Kemper Lloyds Insurance Company (Lloyds) is organized and licensed under Texas statutory provisions for Lloyds Plan operations. Historically controlled by officers and employees of the Company, Lloyds cedes 100% of its premiums, losses, and underwriting expenses to the Company.

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The Company has a real estate joint venture, which is accounted for as a real estate ADC arrangement, through a master limited partnership between a subsidiary of the Company and subsidiaries of a former affiliate, which amounted to \$5.3 million and \$5.9 million, or 18% and 20% of the Company's total other invested assets, at December 31, 2006 and 2005, respectively. The partnership's underlying investment consisted primarily of a water development project located in California's Sacramento River Valley. During 2003, the partnership then abandoned its plans for the water development project. The Company recorded impairment write-downs based on the fair value of the undeveloped land net of anticipated costs to sell of \$1.1 million and \$129 thousand during 2006 and 2005, respectively.

During 2006, other notes receivable collections approximated \$1.2 million. Of the balances remaining, the Company had one \$840 thousand note receivable on nonaccrual status as of December 31, 2006 and 2005.

#### **(4) Liability for Losses and Loss Adjustment Expenses**

The Company establishes a liability for losses and LAE to cover its estimated ultimate liability for property and casualty losses and LAE with respect to reported claims and claims IBNR as of the end of each accounting period. These estimates are then reduced for reinsurance recoverables and discounted to present value. As required by applicable accounting rules, no liabilities are established until a loss, including a loss from a catastrophe, occurs. Loss and LAE liabilities are estimates of what the Company expects the ultimate settlement and administration of claims will cost based on facts and circumstances then known, predictions of future events and estimates of future trends in claims severity and frequency, judicial theories of liability, and other factors. The inherent uncertainties of estimating insurance liabilities are generally greater for liability coverages or where judicial and political climates involving certain types of claims are changing, than for property coverages due to the longer periods of time (the tail) that elapse before a definitive determination of ultimate loss may be made.

As of December 31, 2006 and 2005, the Company carried a liability for losses and LAE of \$1.6 billion and \$2.0 billion, respectively, reflecting reinsurance recoverables on unpaid losses of \$1.5 billion and \$2.1 billion and tabular and nontabular discount of \$0.5 billion and \$0.6 billion, respectively.

The Company's exposure to asbestos and environmental claims arises principally from general liability insurance contracts. Establishing liabilities for asbestos and environmental claims is subject to greater uncertainties than those presented by other types of claims. Among the complications are lack of historical data, long reporting delays, uncertainty as to the number and identity of insurers with potential exposure, and unresolved legal issues regarding policy coverage and the extent and timing of any such contractual liability. The legal issues concerning the interpretation of various insurance policy provisions and whether asbestos and environmental losses are or were ever intended to be covered are complex. Courts have reached different and sometimes inconsistent conclusions as to when the loss occurred and what policies provided coverage; what claims are covered; whether there is an insured obligation to defend; how policy limits are determined; how policy exclusions are applied and interpreted; and whether clean-up costs are covered as insured property damage. Based on the foregoing, liabilities for asbestos and environmental claims cannot be estimated with traditional loss reserving techniques. Liabilities for losses including IBNR have been established when sufficient information has been developed to indicate the involvement of a specific insurance policy. The Company estimates the impact of these exposures by establishing case basis liabilities on all known losses and LAE and by computing IBNR losses for future reported claims based on previous experience.

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The total asbestos liability for losses and LAE at December 31, 2006 and 2005 of \$196.3 million and \$227.9 million, respectively, includes IBNR liabilities in the amount of \$92.6 million and \$93.2 million gross of reinsurance recoverables and \$56.3 million and \$47.9 million net of reinsurance recoverables, respectively. These IBNR liabilities and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above.

Pursuant to a prescribed accounting practice, the amount of the discount on asbestos liabilities at December 31, 2006 and 2005 is \$40.2 million and \$44.5 million net of reinsurance recoverables, respectively.

The total environmental liability for losses and LAE at December 31, 2006 and 2005 of \$63.4 million and \$74.4 million, respectively, includes IBNR liabilities in the amount of \$5.0 million and \$11.6 million gross of reinsurance recoverables and \$2.9 million and \$5.7 million net of reinsurance recoverables, respectively. These IBNR liabilities and the comparable amounts for prior years cover both losses and defense and cost containment expenses. The Company also includes adjusting and other expenses in the amounts shown above.

Pursuant to a prescribed accounting practice, the amount of the discount on environmental liabilities at December 31, 2006 and 2005 is \$5.8 million and \$5.7 million net of reinsurance recoverables, respectively.

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***Discounting of Losses and LAE***

The Company discounts its liability for losses and LAE for all lines of business pursuant to a prescribed accounting practice. The Company utilizes a cash-flow methodology approach in determining the amount of this discount which is based on the underlying payout patterns for each line of business. The Company segregates a portion of the discount that is associated with permanent total indemnity benefits. This amount is identified as tabular discount. The discount for these claims is based on industry tabular factors and statutory interest rates. Any supplemental discount associated with the Company's higher interest rate assumption is treated as nontabular discount. The Company's tabular and nontabular discounts by line of business as of December 31, 2006 and 2005 were as follows:

	<b>2006 *Case and IBNR</b>	<b>2005 *Case and IBNR</b>
	(In thousands)	
Tabular discount:		
Workers' compensation	\$ 153,117	157,535
Nontabular discount:		
Homeowners/farmowners	252	414
Private passenger auto/truck liability/medical	1,815	3,820
Commercial auto/truck liability/medical	10,989	15,693
Workers' compensation	233,222	286,858
Commercial multi peril	20,898	31,808
Medical malpractice – claims made	255	8
Medical malpractice – occurrence	37	537
Specialty liability	2,468	939
Other liability – claims made	11,884	9,468
Other liability – occurrence	50,285	94,030
Special property	(462)	285
Auto physical damage	(8)	(8)
Fidelity/surety	1,928	3,859
Other (including credit, A&H)	97	89
Reinsurance nonproportional assumed liability	22,828	22,548
Products liability – claims made	—	4
Products liability – occurrence	22,282	(2,071)
Total	378,770	468,281
Grand total	\$ 531,887	625,816

\*Includes liabilities for losses and loss adjustment expenses.

**(5) Reinsurance**

The Company utilizes a variety of reinsurance agreements to control exposures to large property-casualty losses including: (i) facultative reinsurance, in which reinsurance is provided for all or a portion of the insurance provided by a single policy; (ii) treaty reinsurance, in which reinsurance is provided for a

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specified type or category of risks; (iii) catastrophe reinsurance, in which the ceding company is indemnified for an amount of loss in excess of a specified retention with respect to losses resulting from a catastrophic event; and (iv) aggregate excess of loss reinsurance, in which the ceding company is indemnified against additional losses for defined losses and LAE in excess of a defined loss ratio or loss retention for each accident year.

The Company's aggregate excess of loss reinsurance treaties relate to the 1998 through 2002 accident years, and they cover substantially all of the Company's lines of business. Recoveries under the treaties are payable when the paid covered net losses, as defined in the contracts, exceed the retention. Under the aggregate excess of loss reinsurance treaties, interest expense generally accrues on the funds withheld account at a rate of approximately 7% per annum. There were no ceded premiums under contracts accounted for as prospective reinsurance, net of ceding commission for 2006 and 2005. Additional premiums may also be payable under the terms of certain treaties in future years.

### ***Berkshire Hathaway Insurance Group and Kemper Commercial Insurance Company***

In early 2003, shortly after the Kemper Insurance Companies were downgraded to below an "A" level, National Indemnity Company (NICO), a member of "AAA" rated Berkshire, provided the Company and its affiliates with immediate access to cut-through agreements issued by NICO. The cut-through agreements were applied to certain standard commercial and specialty lines policies of insurance in-force as of December 23, 2002 and to certain new policies issued by certain of the Kemper Insurance Companies on and after December 23, 2002 until September 30, 2003. With respect to each policy to which the NICO cut-through agreement applies, the cut-through allows a Kemper insured to directly submit claims to NICO in the event the respective Kemper Insurance Company (as the issuer of the policy) is unable to pay such claims as a result of its insolvency or a court or regulatory order prohibiting claim payments due to the issuing company's financial condition.

As an agreed condition for NICO to provide the cut-through agreements, the Company and its affiliates immediately provided collateral available to NICO if and to the extent NICO makes any payments under any cut-through agreements. The collateral includes offset rights granted to NICO for reinsurance proceeds payable by either NICO or its affiliate, National Fire & Marine Insurance Company (National Fire), to the Company or its affiliates; a collateral trust initially in an amount of \$251.1 million as of the end of June 2003, which amount was subject to quarterly reductions by payments of claims (losses and LAE) and mid-term cancellations of policies (the trust amount decreased to \$22.4 million at December 31, 2005 and to zero in the third quarter of 2006); and investments of \$257.3 million in Berkshire corporate obligations (Schedule D admitted assets) which the Company has pledged as security to Berkshire. The Berkshire corporate obligations were reduced to \$246.9 million by year-end 2006, with cash in the amount of the reduction being released to the Company in accordance with existing agreements. The investments were further reduced in early 2007, by approximately \$20.2 million, due to a mandatory redemption payment by Berkshire to the Company. If NICO makes no payments under the cut-through agreements, then of the pledged investments, \$100.0 million matures in March 2025, while the remaining amount is subject to mandatory redemption annually provided the Company is paying claims on policies covered by the cut-through agreements and NICO is not required to pay any amounts under any cut-through agreement. Because the Berkshire corporate obligations have been pledged as collateral to Berkshire, the Company does not have the intent or, in the absence of a voluntary agreement from Berkshire, the ability to dispose of the investments prior to maturity or redemption. At December 31, 2006 and 2005, respectively,



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\$80.6 million and \$154.2 million of the Company's gross policy liabilities were protected by the NICO cut-through. As a table below shows, the Company cedes to the Berkshire Hathaway Group (group 31) liabilities totaling \$151.7 million at December 31, 2006. Most of that amount also serves as additional security for any payments that may be made under any NICO cut-through agreements.

NICO also separately provides, for initial and annual fees, an appeals bond facility that the Company and its affiliates use primarily in connection with litigated claims. The Company fully collateralizes the appeal bonds with the pledge of an investment in a Berkshire corporate obligation (Schedule D admitted asset) purchased from Berkshire. At December 31, 2006, the Company has pledged \$26.2 million of its assets as collateral for this purpose.

In connection with a now commuted reinsurance arrangement in 2001, the Company entered into a long-term claim administration agreement with National Fire for the servicing of most of the Company's and its affiliates' existing asbestos and environmental claims. The Company paid \$27.5 million in advance for the future servicing of such claims. In accordance with a prescribed accounting practice more fully described in note 2, the Company reflects as an admitted asset the remaining prepaid amount for claim handling services; that amount has declined to approximately \$9.4 million at December 31, 2006 and \$12.2 million as of December 31, 2005.

#### *Affiliate Assumed Reinsurance*

The significant majority of the business written by members of the Kemper Insurance Companies has historically been ceded to the Company through quota share reinsurance agreements with some Company subsidiaries retaining a portion of the business written and through a quota share pooling agreement by and among the Company, AMICO, and AMM.

AMM is an affiliated mutual insurance company that shares with the Company common management and a substantially overlapping board of directors. AMM has been one of the Kemper Insurance Companies for over 50 years. The Company assumed most of AMM's liabilities, agreed to perform for AMM all insurance policy-related obligations including handling and paying claims, and issued a Company policy to each holder of a policy ever issued by AMM, including any policy no longer in force but excluding any policy that is cut-through reinsured by Unitrin, Inc. The additional Company policy is substantively identical to the policy previously issued by AMM, although the Company policy is nonparticipating and nonvoting with respect to the Company's corporate governance. The additional Company policy assures affected AMM policyholders that their claims will be treated equally with the claims of other Company policyholders not only in the event of a managed run-off of the Company and AMM, but also in the event of any insolvency proceedings with respect to the two companies. AMM remains liable for its policy liabilities in the event the Company does not comply with all the terms of the affected policies. AMM has approximately \$315 million and \$435 million in reinsurance due from the Company as of December 31, 2006 and 2005, respectively.

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***Other Reinsurance Disclosures***

The Company's assumptions from and cessions to unaffiliated reinsurers accounted for as prospective reinsurance were as follows:

	<u>Assumed</u>	<u>Ceded</u>
	(In thousands)	
2006:		
Unearned premiums	\$ 1,280	5,085
Outstanding losses and LAE (including IBNR)	389,828	1,460,320
2005:		
Unearned premiums	\$ 8,980	15,280
Outstanding losses and LAE (including IBNR)	427,661	2,111,270

The Company's assumptions from and cessions to affiliated reinsurers accounted for as prospective reinsurance were as follows:

	<u>Assumed</u>	<u>Ceded</u>
	(In thousands)	
2006:		
Unearned premiums	\$ 11,001	—
Outstanding losses and LAE (including IBNR)	1,527,341	430
2005:		
Unearned premiums	\$ 19,369	—
Outstanding losses and LAE (including IBNR)	2,068,614	5,010

The Company historically has reinsured portions of the risks it underwrote in an effort to control its exposure to losses and protect surplus. The Company ceded to reinsurers a portion of these risks and paid premiums based upon the risk and exposure of the policies subject to such reinsurance. Reinsurance is subject to collectibility in all cases and to aggregate loss limits in certain cases. Although the reinsurer is liable to the extent of the reinsurance limits purchased, the Company remains primarily liable as the direct insurer on all risks reinsured. The Company also holds collateral, including escrow funds, letters of credit, and trust funds, under certain reinsurance agreements. The Company monitors the financial condition of reinsurers on an ongoing basis, and reviews its reinsurance arrangements periodically.

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As of December 31, 2006, the Company had unsecured aggregate recoverables from outside reinsurers for losses paid, losses unpaid, LAE, and unearned premium that exceed 3% of the Company's total surplus with the following reinsurers (and related group members):

<u>Reinsurer</u>	<u>FEIN code</u>	<u>NAIC group #</u>	<u>NAIC code</u>	<u>Net recoverable</u> (In thousands)
Allstate Insurance Co.	36-0719665	8	19232	\$ 9,105
8 Total				<u>9,105</u>
American Home Assurance Co.	13-5124990	12	19380	97
Hartford Steam Boil Inspection & Insurance Co.	06-0384680	12	11452	216
Insurance Co. of the State of Pennsylvania	13-5540698	12	19429	1,769
National Union Fire Insurance Co. of Pittsburgh	25-0687550	12	19445	1,488
Transatlantic Reinsurance Co.	13-5616275	12	19453	14,543
12 Total				<u>18,113</u>
General Reinsurance Corp.	13-2673100	31	22039	43,269
National Fire & Marine Insurance Co.	47-6021331	31	20079	107,925
National Reinsurance Corp.	13-1988169	31	34835	508
31 Total				<u>151,702</u>
Hartford Fire Insurance Co.	06-0383750	91	19682	7,284
91 Total				<u>7,284</u>
Berkley Insurance Co.	47-0574325	98	32603	24,207
Firemen's Insurance Co. of Washington D.C.	53-0067060	98	21784	613
Tri State Insurance Co. of Minnesota	41-1232071	98	31003	496
98 Total				<u>25,316</u>
Clearwater Insurance Co.	13-2781282	158	25070	17,639
Clearwater Select Insurance Co.	23-2745904	158	10019	9,047
North River Insurance Co.	22-1964135	158	21105	2
Odyssey America Reinsurance Co.	47-0698507	158	23680	5,976
Old Lyme Insurance Co. of RI Inc.	13-3306163	158	19160	(1,136)
158 Total				<u>31,528</u>
Employers Reinsurance Corp.	48-0921045	181	39845	39,960
GE Reinsurance Corp.	36-2667627	181	22969	160,923
Swiss Reinsurance Life & Health America Inc.	06-0839705	181	82627	4,650
Swiss Reinsurance America Corp.	13-1675535	181	25364	111,975
Westport Insurance Corp.	13-1941868	181	34207	873
181 Total				<u>318,381</u>

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

<u>Reinsurer</u>	<u>FEIN code</u>	<u>NAIC group #</u>	<u>NAIC code</u>	<u>Net recoverable</u> (In thousands)
Trinity Universal Insurance Co.	75-0620550	215	19887	\$ 27,513
Unitrin Preferred Insurance Co.	13-5460208	215	25909	1,343
215 Total				<u>28,856</u>
Continental Casualty Co.	36-2114545	218	20443	14,799
Encompass Insurance Co. of America	36-3976913	218	10071	500
218 Total				<u>15,299</u>
Reliastar Life Insurance Co.	41-0451140	229	67105	66,760
229 Total				<u>66,760</u>
American Reinsurance Co.	13-4924125	361	10227	137,693
361 Total				<u>137,693</u>
RSUI Indemnity Co.	16-0366830	501	22314	12,272
501 Total				<u>12,272</u>
Ace American Reinsurance Co.	23-1740414	626	22705	292
Ace American Insurance Co.	95-2371728	626	22667	3,495
Ace Property & Casualty Insurance Co.	06-0237820	626	20699	4,924
Insurance Co. of North America	23-0723970	626	22713	12,010
Westchester Fire Insurance Co.	13-5481330	626	21121	11
626 Total				<u>20,732</u>
General Security National Insurance Co.	13-3029255	749	39322	3,624
SCOR Reinsurance Co.	75-1444207	749	30058	22,772
749 Total				<u>26,396</u>
Everest Reinsurance Co.	22-2005057	1,120	26921	9,567
1120 Total				<u>9,567</u>
American Employers Insurance Co.	04-1027270	1,129	20613	315
Folksamerica Reinsurance Co.	13-2997499	1,129	38776	9,679
1129 Total				<u>9,994</u>
Insurance Corp. of NY	13-5339725	1,314	18341	(8,328)
Trenwick America Reinsurance Corp.	06-1117063	1,314	34894	44,451
1314 Total				<u>36,123</u>

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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<u>Reinsurer</u>	<u>FEIN code</u>	<u>NAIC group #</u>	<u>NAIC code</u>	<u>Net recoverable</u> (In thousands)
Alea North American Specialty Insurance Co.	06-1022232	1,325	24899	\$ 6,097
Alea North America Insurance Co.	51-0335732	1,325	44776	1,914
1325 Total				<u>8,011</u>
Converium Reinsurance North America Inc.	06-1325038	3,018	39136	118,258
3018 Total				<u>118,258</u>
Discover Prop & Cas Insurance Co.	36-2999370	3,548	36463	22
Gulf Insurance Co.	43-6028696	3,548	22217	2,120
Northland Insurance Co.	41-6009967	3,548	24015	234
St. Paul Fire & Marine Insurance Co.	41-0406690	3,548	24767	10,064
Travelers Indemnity. Co.	06-0566050	3,548	25658	557
US Fidelity & Guaranty Co.	52-0515280	3,548	25887	1,589
3548 Total				<u>14,586</u>
Associated Aviation Underwriters	AA-9995013			53,769
Excess and Casualty Reinsurance Assn.	AA-9995022			7,826
Texas Workes Compensation	AA-9991444			15,795
Workers Compensation Reinsurance Assn.	41-1357750		10181	8,585
Grand total				\$ <u>1,151,951</u>

***Reinsurance Assumed and Ceded***

The estimated maximum amount of return commission due reinsurers if all of the Company's reinsurance was canceled as of December 31, 2006 is as follows:

	<u>Assumed reinsurance</u>		<u>Ceded reinsurance</u>		<u>Net</u>	
	<u>Unearned premium liability</u>	<u>Commission equity</u>	<u>Unearned premium liability</u>	<u>Commission equity</u>	<u>Unearned premium liability</u>	<u>Commission equity</u>
Affiliates	\$ 11,001,027	718,071	—	—	11,001,027	718,071
All other	1,280,359	(3,110,789)	5,084,880	(2,593,179)	(3,804,521)	(517,610)
Total	\$ <u>12,281,386</u>	<u>(2,392,718)</u>	<u>5,084,880</u>	<u>(2,593,179)</u>	<u>7,196,506</u>	<u>200,461</u>

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

### *Reinsurance Recoverable in Dispute*

The Company has reinsurance recoverable balances as of December 31, 2006 with the following reinsurers which are in dispute and in the aggregate exceed 10% of the Company's policyholder surplus:

Name of reinsurer	Total amount in dispute (including IBNR)	Notification	Arbitration	Litigation
American Reinsurance Co.	\$ 10,570,489	416,705	5,294,115	4,859,669
Converium Reins. North America, Inc.	7,316,661	—	7,316,661	—
Reliastar Life Insurance Co.	6,411,402	6,411,402	—	—
Ace American Insurance/Cigna Insurance Co.	2,509,835	2,509,835	—	—
Front Range Insurance Co.	1,990,056	—	—	1,990,056
Insurance Co. of North America	1,473,633	1,473,633	—	—
SCOR Reinsurance Co.	1,247,939	639,560	608,379	—
Pohjola Yhtymä Oyj (Pohola Grp Plc)	1,031,557	1,031,557	—	—
Employers Reinsurance Corp.	996,853	996,853	—	—
Continental Casualty Co.	665,422	665,422	—	—
Employers Insurance of Wausau A Mutual Co.	453,003	453,003	—	—
Swiss Reinsurance America Corp.	431,587	431,587	—	—
Argonaut Insurance Co.	329,260	329,260	—	—
Odyssey Reinsurance Corp.	298,185	298,185	—	—
Ace American Reinsurance Co. (FKA Cigna Reins. Co.)	292,083	292,083	—	—
National Casualty Co.	275,494	275,494	—	—
Partner Reinsurance New York	207,341	207,341	—	—
AXA Versicherung AG (Colonia Versicherung AG)	196,694	196,694	—	—
GE Reinsurance Co.	192,203	192,203	—	—
Excess Insurance Co. Ltd.	158,577	158,577	—	—
Great American Insurance Co.	124,750	124,750	—	—
General Reinsurance Corp.	77,370	77,370	—	—
Arch Reinsurance Co.	61,038	61,038	—	—
Travelers Indemnity Co.	55,389	55,389	—	—
Nationwide Mutual Insurance Co.	26,939	26,939	—	—
Transatlantic Reinsurance Co.	25,432	25,432	—	—
Canadian Reins. Co. (FKA Swiss Re Canada)	23,465	23,465	—	—
American Employers Insurance Co.	4,443	4,443	—	—
Gothae Versicherungsbank Vag	780	780	—	—
Total	\$ 37,447,880	17,379,000	13,219,155	6,849,725

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

***Reinsurance Accounted for as a Deposit***

The Company entered into various reinsurance agreements in previous years which were determined to be of a deposit type nature. The Company had a total remaining deposit balance of \$12.8 million and \$20.1 million at December 31, 2006 and 2005, respectively.

**(6) Federal and Foreign Income Taxes**

The components of the Company's net deferred tax asset as of December 31, 2006 and 2005 were as follows:

	<b>2006</b>	<b>2005</b>
	(In thousands)	
Total of gross deferred tax assets	\$ 704,530	763,361
Total of gross deferred tax liabilities	(2,841)	(3,393)
Net deferred tax asset	701,689	759,968
Deferred tax asset nonadmitted	(701,689)	(759,968)
Net admitted deferred tax asset	\$ —	—
Decrease/(increase) in nonadmitted asset	\$ 58,279	(31,116)

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

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The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities as of December 31, 2006 and 2005 were as follows:

	<b>2006</b>	<b>2005</b>
	(In thousands)	
Deferred tax assets:		
Loss carryforwards	\$ 563,767	544,404
Receivables	41,545	83,627
Investments	37,546	58,938
Accrued liabilities	24,064	24,402
Reserves	15,060	24,834
Section 197 intangibles	9,011	12,088
Other	13,537	15,068
Total deferred tax assets	704,530	763,361
Nonadmitted deferred tax assets	(701,689)	(759,968)
Admitted deferred tax assets	2,841	3,393
Deferred tax liabilities:		
Salvage and subrogation	(1,601)	(2,281)
Investments	(1,240)	(1,112)
Total deferred tax liabilities	(2,841)	(3,393)
Net admitted deferred tax asset	\$ —	—

The change in net deferred income taxes as of December 31, 2006 and 2005 was comprised of the following:

	<b>2006</b>	<b>2005</b>	<b>Change</b>
	(In thousands)		
Total deferred tax assets	\$ 704,530	763,361	(58,831)
Total deferred tax liabilities	(2,841)	(3,393)	552
Net deferred tax asset	\$ 701,689	759,968	(58,279)
Tax effect of unrealized gains or losses			—
Decrease in net deferred income tax in surplus			\$ (58,279)



**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

At December 31, 2006, the Company had \$1.6 billion of operating loss carryforward which originated and expires as follows:

<u>Origination year</u>	<u>Expiration year</u>	<u>Amount</u> (In thousands)
2000	2020	\$ 179,079
2001	2021	404,748
2002	2022	38,885
2003	2023	211,668
2004	2024	399,689
2005	2025	177,705
2006	2026	170,039
		<u>\$ 1,581,813</u>

There were no income taxes incurred in the current and prior year that will be available for recoupment in the event of future net losses.

Tax returns for the years through 2002 are closed for Internal Revenue Service (IRS) examination. The Company is not currently under examination by the IRS for any open tax years.

The Company files as part of a consolidated federal income tax return which includes the Company as the common parent corporation and includes or included the following affiliated entities: AMICO, AMICO Realty Corporation, American Underwriting Corporation, Kemper Casualty Insurance Company, Kemper International Corporation, Kemper Lloyds Insurance Company, Kemper Realty Corporation, Kemper Technology Services, Inc., LGA-2, Inc., LGA-3, Inc., LGA-17, Inc., Lou Jones & Associates, Nereus Holdings, Inc., Point & Quote Insurance Services, Inc., Specialty Surplus Insurance Company, Universal Bonding Holding Company, and UBIC.

**(7) Transactions with Affiliates and Related Parties**

The Company charges certain affiliated companies for utilizing the services of the employees and the office facilities of the Company. Charges for services for other affiliated companies are based on actual expenses incurred in accordance with their use of the services and facilities.

**Affiliate Support for D&O Insurance**

In connection with a portion of the Company's and its affiliates' corporate insurance program, a wholly owned subsidiary of the Company, SSIC, entered into a reinsurance agreement, effective January 1, 2005 for a three-year period ending December 31, 2007, facultatively reinsuring a corresponding three-year management liability policy issued by an unaffiliated third party to the Company and AMM. In 2005, SSIC deposited the \$15.0 million reinsurance premium it received into trust for the benefit of the third party insurer to collateralize the reinsurance obligation.

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

### (8) Employee Benefit Plans

#### *Pension Plan*

The Company no longer maintains a retirement plan for its employees. In late 2004, the Pension Benefit Guaranty Corporation (PBGC), as the federal corporation responsible for guaranteeing payment of pension benefits, took control of the Company's defined benefit pension plans. The then vested benefits under the pension plans were insured through the PBGC; the benefit levels for the majority of the approximately twelve thousand plan participants were not significantly affected by the PBGC action; and payments to retirees have continued uninterrupted at the insured levels. Future retirees will receive their vested insured pension benefits from the PBGC when they are eligible to retire. Since 2004, the Company does not provide post retirement benefits for its employees or retirees.

#### *Profit Sharing Plan*

Beginning in 2005, the Company ceased matching contributions to the Company's 401(k) plan.

#### *Retention Plans*

The Company's workforce decreased to 274 employees at December 31, 2006, from 284 employees at December 31, 2005 and 340 at December 31, 2004. To help stabilize the workforce, the Company maintains a retention plan providing for scheduled quarterly payments. The retention payments for 2006 and 2005 totaled \$4.7 million and \$5.3 million, respectively. Payments under this retention plan satisfied a portion of the Company's obligations to pay in February 2006 otherwise guaranteed annual bonuses under certain employment agreements with approximately 8 employees; all remaining guaranteed annual bonus payments to those employees totaled \$262 thousand and were paid in February 2006.

As an additional retention plan, the Company maintains an employee severance program which provides a maximum benefit of up to one year of salary depending on the employee's level and service time with the Company. Severance liabilities are not reflected on the Company's balance sheets until a decision is reached that a specific employee or group of employees is to be terminated without cause. Severance payments in 2006 and 2005 totaled \$0.8 million and \$2.4 million, respectively, and severance liabilities recorded at December 31, 2006 and 2005 totaled \$0.5 million and \$0.4 million, respectively. In 2006, with the approval of the Division of Insurance, the Company made a one-time deposit of \$4.75 million into a long-term retention trust to secure funds for future severance obligations.

#### *Incentive Plans*

The Company has maintained since 2004 an annual incentive plan linked to successfully achieving or exceeding certain targets as anticipated from time to time in the Company's run-off plan (the "Short-Term Plan). The Short-Term Plan payments totaled \$3.6 million in 2006 and \$2.7 million in 2005. In addition to the Short-Term Plan, the Company, with final approval from the Division in 2006, established a long-term incentive plan linked to the successful maintenance of the commercial run-off as anticipated in the Company's run-off plan. At December 31, 2006, the Company has accrued approximately \$6.2 million under the incentive plans for payments to be made in 2007.

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

### *Deferred Compensation*

The Company carried deferred compensation liabilities of approximately \$1.3 million at December 31, 2006 and \$1.2 million at December 31, 2005.

### *Other Benefit Plans*

The Kemper Benefit Plan (the Plan) consists of the health, dental, life, long-term disability, and accident benefits. The Plan is sponsored by the Company and provides benefits covering eligible employees, and eligible dependents of employees of the Company. The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

Certain coverages of the Plan require both employer and employee contributions, while others require either an employer or employee contribution. The Company and its employees make specified monthly contributions for the coverages selected. The contribution rates for both the employer and employee are determined annually by the Company. In accordance with provisions of the Plan, eligible employees, and eligible dependents of employees of the Company who incur claims are entitled to receive benefits under the Plan.

Employer and employee contributions for 2006 were \$2.2 million and \$1.2 million, respectively, while 2005 employer and employee contributions were \$5 million and \$1.9 million, respectively. For 2006 and 2005, total benefit payments under the Plan were \$3.4 million and \$6.8 million, respectively.

### **(9) Risk-based Capital**

The NAIC utilizes a RBC formula intended for regulatory monitoring of property-casualty insurers. Under RBC rules in Illinois, state regulators may mandate remedial action for inadequately capitalized companies. The focus of the capital rules is a risk-based formula that applies prescribed factors to various risk elements in an insurer's business and investments to develop a minimum capital requirement designed to be proportional to the amount of risk assumed by the insurer. For the last three years (and for 2006 excluding the benefit of prescribed accounting practices), the Company's level of surplus has been at the "mandatory control level" under the RBC rules. At this level, the Division of Insurance has substantial authority to exercise control over the Company and its affiliates. The Division of Insurance is mandated to place a company at this level under its control, except where, as is the case with the Company, such company is a property and casualty insurance company that is no longer writing new business and is running off its existing business, in which case the Director has discretion to allow the continued run-off.

Having entered into voluntary run-off in the first half of 2003, the Company has been operating under guidance provided within certain agreed to Corrective Orders with the Division of Insurance, pursuant to which the Company has ceased to write virtually all insurance business and is settling its liabilities under the administrative supervision of the Division of Insurance. As required by the Division of Insurance, the Company is operating under a confidential RBC plan (the run-off plan) to address its RBC level. The run-off plan is designed to help the Company meet its goal of resolving, to the maximum extent possible, all valid policyholder claims. The Company updates the run-off plan based on current information from time to time. Details of the plan are confidential pursuant to the state's RBC statute.

Risks and uncertainties involved in implementing the run-off plan include the need to achieve significant policy buybacks and novations (the volume of which has declined in each of the last two years as overall

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

liabilities also declined); to conclude other surplus-enhancing transactions; to commute certain reinsurance agreements; to conclude other liquidity-enhancing transactions; to hire and retain the staff and resources necessary to implement the plan; to further reduce expenses; and to consummate agreements with regulators and other third parties. Achieving the surplus and liquidity projections in the run-off plan requires the consummation of agreements with insureds for policy buybacks and novations; the timely performance of payment and other contractual obligations owed to the Company by various third parties, including reinsurers as well as insureds and agents; agreements with regulators in various jurisdictions; and the absence of significant additional disputes not only with reinsurers but also with creditors, including insureds and certain states, which could involve judicial or other actions to seek either to force the Company to collateralize its unsecured obligations or to not timely release collateral back to the Company. Therefore, no assurance can be given that the run-off plan will continue to be successfully implemented.

The Division of Insurance continues to closely monitor the Company's progress in achieving the objectives of the run-off plan. As has been the case for four years, the Division of Insurance retains the discretion at any time to seek to place the Company in a formal insolvency proceeding (conservatorship or receivership, rehabilitation or liquidation). The risk of a proceeding would be exacerbated if the Company fails to have sufficient liquid assets to meet its current obligations, or if the Company's reported liabilities at any time exceed its reported assets, or if the Company fails to meet the surplus and liquidity projections set forth in the run-off plan.

The Company has also entered into consent agreements with certain other states under which the Company agreed to cease writing business in those jurisdictions. In addition, as of December 31, 2006, the Company agreed to its licenses being suspended in Florida in 2004 and Tennessee in 2005, with the Company permitted to maintain its licenses but not permitted to write any new business. The Company has appealed its 2006 license suspension in the state of North Carolina as not being in the best interests of the Company's policyholders or claimants.

#### **(10) Commitments, Contingent Liabilities, Liquidity, and Other Contingencies**

##### *Ratings*

In early 2005, the Company requested that A.M. Best cease rating the Company. As of December 31, 2004, A.M. Best had assigned the Company a D (poor) rating. In June and July 2003, respectively, Moody's Investor Services and Standard & Poors last downgraded the Company's financial strength ratings to Caa3 (very poor) and CCC (very weak), respectively, when, at the Company's request, they ceased rating the Company.

The downgrades to below A- effectively ended the Company's and its affiliates' ability to write most new commercial lines of business or retain existing policyholders. In the first half of 2003, as a result of a combination of various business factors including the ratings downgrades and the Company's deteriorating statutory surplus, the Company substantially ceased underwriting activities other than as required by contract or law. Since then, the Company and most of its affiliates have been subject to Corrective Orders by the Division of Insurance not to write any new or renewal business except as necessary to comply with contractual commitments or as expressly permitted by the Division of Insurance.

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

### *Liquidity*

As a run-off company, the Company's cash outflows exceed its cash inflows. There are a number of factors that could adversely affect the Company's liquidity position and its adequacy. Accelerated claim payments or imposition of requirements to secure future maturing obligations by court order or otherwise, deterioration of reinsurance collections, increases in operating expenses, and other unanticipated strains on liquidity could cause the Company to have insufficient liquid and unencumbered assets to continue to pay obligations as they mature. As liquidity declines, there can be no assurance that formal proceedings would not be initiated by the Division of Insurance significantly before the Company's projected liquidity would reach zero. The Company's reported approximately \$737 million of unencumbered assets at December 31, 2006 shown in the table under *Securities on Deposit and Encumbered Assets* below in this note includes approximately \$159 million that, although unencumbered, are not necessarily immediately available funds, as this amount consists of such items as assets held in subsidiaries and working capital requirements.

The Company is addressing potential future liquidity challenges by taking a number of actions, including, but not limited to, seeking the release of what the Company believes is excess collateral held by various governmental agencies, merging or dissolving subsidiaries, converting illiquid assets to liquid assets, negotiating liquidity-enhancing novations, continuing to collect on its reinsurance, and evaluating the possibility of reinsurance commutations. The Company's run-off plan anticipates that portions of state deposits will continue to be released as excess collateral as claims are paid and the remaining reserves are reduced. There are significant uncertainties with respect to the legal and regulatory issues related to releases of encumbered assets.

Also to supplement liquidity, the Company during 2006 merged or dissolved three insurance company subsidiaries and during 2005 dissolved 20 other noninsurance company subsidiaries (see note 3). The liquidity benefits from these actions include minor reductions in expenses from not needing to maintain corporate entities and, following regulatory approvals, allowed certain dividends from subsidiaries to the Company.

Prompt collection of reinsurance recoverables is a primary driver of the Company's liquidity at all times. Reinsurance provided approximately \$800 million of liquidity to the Kemper Insurance Companies during 2006 and approximately \$900 million during 2005. The Company's gross reinsurance recoverables totaled \$1.6 billion at December 31, 2006, down from \$2.3 billion at December 31, 2005.

The Company recognizes the general principle that commutations of ceded reinsurance, if executed, could substantially increase liquidity. Reinsurance commutations, however, would also be anticipated both to decrease surplus, since commutations involve present value or other discounting in return for cash, and to increase the risks of any future adverse development, since the reinsurers would no longer share in such developments. Management remains focused on managing liquidity, surplus, and the balance between them.

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

### *Securities on Deposit and Encumbered Assets*

Approximately \$909 million of the Company's cash and invested assets at December 31, 2006 were encumbered by being on deposit or held in trust or escrow arrangements, compared with \$1.1 billion one year earlier, as shown in the following table:

	<b>2006</b>	<b>2005</b>
	(In millions)	
Special deposits/encumbered assets:		
California state deposit	\$ 430	538
Other state deposits	130	155
NICO cut-through collateral	247	269
NICO appeal bond collateral	26	43
Canada deposits	45	42
All other	31	26
	909	1,073
Unencumbered assets:		
Cash, bonds, and stocks	704	881
Receivables for securities	—	32
Other assets	33	34
	737	947
Cash and invested assets	\$ 1,646	2,020

The majority of the encumbrances are deposits with state insurance departments, with California accounting for the majority of that amount, as shown in the preceding table. The Company received releases of encumbered assets from states totaling approximately \$133 million and \$303 million during 2006 and 2005, respectively, including approximately \$108 million and \$285 million, respectively, from California. Releases reflect lower levels of liabilities of the Company that the state deposits have historically secured. There can be no assurance that there will be additional releases.

Where required to post court bonds, including supersedeas or appeal bonds, or when using surety bonds to satisfy state deposit requirements, the Company, due to its financial condition, has had to post cash or other security totaling 100% of the bond. At December 31, 2006 and 2005, the Company had pledged invested and other assets of \$27.5 million and \$44.1 million, respectively, for such bonds, most of which are issued by NICO. (See note 5.)

Approximately \$247 million of the Company's invested assets at December 31, 2006 provide collateral for Berkshire affiliates related to the NICO cut-through agreements. (See note 5.) This amount reflects a \$22.4 million reduction from a year earlier. Of the cut-through encumbered assets at December 31, 2006, \$146.9 million are subject to release to the Company annually as claim payments are made on policies to which the NICO cut-through agreements are attached so long as NICO is not required to pay any amounts on Kemper policies that have the benefit of cut-through agreements.

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

Approximately \$5.2 million and \$4.9 million of the Company's invested assets at December 31, 2006 and 2005, respectively, are in a collateral trust for the benefit of SeaBright Insurance Company related to a reinsurance agreement.

The Company is contingently liable to provide up to an estimated additional \$27.7 million in collateral due to ratings triggers in reinsurance agreements where it is a reinsurer. Of this amount, \$4.7 million has been funded with assets of an unrelated third party, Alea Bermuda Ltd. (Alea), for business where the Company from late 1999 to year-end 2001 fronted assumed reinsurance contracts in the U.S. for Alea. Alea's insurance ratings fell to below the "A" level in 2005, and Alea and its affiliates subsequently went into run-off status and have been undergoing related operational changes. Alea's reinsurance obligations to the Company for the fronted liabilities are secured by collateral trust assets of Alea in the amount of \$129.8 million at December 31, 2006. The amount of trust assets was reduced in early 2007 in accordance with existing agreements by \$11.3 million, reflecting reductions in liabilities retroceded to Alea. Alea also has handled claims on behalf of the Company since 1999 on both the fronted liabilities and, at December 31, 2006, \$75.6 million of other assumed reinsurance liabilities written by the Company from 1997 through 1999.

In addition to the encumbrances applicable to the Company's cash and invested assets which are reflected in the preceding table, the Company has certain reinsurance related assets which have been pledged or otherwise encumbered. Such encumbered assets include funds held by or deposited with reinsured companies (\$12.7 million at December 31, 2006), certain reinsurance recoverables that serve as additional security for the NICO cut-through (see note 5), and reinsurance recoverables for claims paid and to be paid by certain Markel Corporation subsidiaries related to business written by companies that the Company acquired from Markel in 1998 and 1999 (\$4.6 million at December 31, 2006). In addition, one of the Company's wholly owned subsidiaries, SSIC, which was a Markel subsidiary until January 2000, has granted to a Markel entity a security interest in SSIC's reinsurance recoverables related to claims from before 2000 that Markel is responsible for handling and paying; SSIC's related encumbered reinsurance assets totaled \$126.7 million at December 31, 2006.

#### *Structured Settlements*

To discharge certain insurance claim liabilities, the Company has purchased structured settlement annuities with the claimant as payee. The aggregate December 31, 2006 and 2005 value of loss liabilities eliminated by the purchase of these annuities was approximately \$388 million and \$139 million, respectively. The Company remains contingently liable should the issuers of the annuities fail to perform.

## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

The total value of annuities due from a life insurer in excess of 1% of the Company's surplus is shown in the table below.

Carrier	Location	LMC Reportable amounts
Genworth Life and Annuity Company	Lynchburg, VA	\$ 61,861,449
Western National Life	Houston, TX	40,930,942
Symetra Life Insurance Company	Redmond, VA	33,803,125
Aurora National Life Assurance Company	Valencia, CA	32,304,952
Manufacturers Life Insurance Company (U.S.A.)	Boston, MA	18,707,166
Metropolitan Life Insurance Company	New York, NY	17,927,317
Aviva Life Insurance Company	Wilmington, DE	16,940,723
Fidelity Life Association	Oak Brook, IL	16,847,797
Federal Home Life Insurance Company	Lynchburg, VA	14,281,725
Security Benefit Life Insurance Company	Topeka, KS	13,903,893
Life Insurance Company of North America	Philadelphia, PA	11,115,580
AEGON USA Inc.	Louisville, KY	9,992,038
Midland National Life Insurance Company	Sioux Falls, SD	9,590,363
Presidential Life Insurance Company	Nyack, NY	9,361,633
Transamerica Life Insurance Company	Cedar Rapids, IA	8,971,159
Prudential Insurance Company of America	Newark, NJ	8,927,387
Allstate Life Insurance Company	Northbrook, IL	8,840,895
Chase Insurance Life and Annuity Company	Elgin, IL	6,702,288
Lincoln Financial Group	Greensboro, NC	4,851,975
William Penn Life Insurance Company of New York	Garden City, NY	3,984,005
Metlife Insurance Company of Connecticut	Hartford, CT	3,561,170
Pacific Life Insurance Company	Newport Beach, CA	2,619,307
Mutual of Omaha	Omaha, NE	2,498,181
AXA Equitable Life	New York, NY	2,379,675
New York Life Insurance Company	New York, NY	2,349,312
Monarch Life Insurance Company	Springfield, MA	2,150,902
AIG Life Insurance Company	Wilmington, DE	1,830,374
American General Life and Accident Insurance Company	Nashville, TN	1,758,046

### *Litigation*

In 1996 and 1997, the Company issued surplus notes in the aggregate principal amount of \$700.0 million (see note 11). The Company is required to seek the approval of the Director to make each and any semi-annual payments of interest on the surplus notes. Beginning in 2003, the Director has denied the Company's requests for payment of interest on the surplus notes. Following the nonpayment of interest in 2003, several lawsuits were filed in the Circuit Court of Cook County, Illinois by certain holders of surplus notes aggregating approximately \$368 million and naming, as defendants, the Company, various directors or former directors of the Company, and Kemper Commercial Insurance Company, a now dissolved subsidiary of the Company. One case was voluntarily dismissed by the plaintiff, and the other two were consolidated in 2004. The Company was not served with the consolidated amended complaint. This



## LUMBERMENS MUTUAL CASUALTY COMPANY

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

complaint alleged that the Company breached the agreements relating to the surplus notes by adopting a divestiture plan to sell all or substantially all of the Company's assets and ongoing businesses without requiring the acquiring entities to assume the Company's surplus notes or obtaining the consent of a majority of the holders of the surplus notes. The complaint further alleged that the directors breached their fiduciary duties and committed corporate waste, and that the Company and Kemper Commercial Insurance Company engaged in a fraudulent conveyance. The complaint, among other things, sought a declaratory judgment of the parties' rights, an injunction against further asset sales, and monetary damages. In May 2006, the Circuit Court entered a stipulation and order whereby the lawsuit was dismissed without prejudice with leave to reinstate no earlier than October 2008.

In addition to the above, in the ordinary course of business, the Company is involved in various legal actions for which it establishes liabilities where appropriate. In the opinion of the Company's management, based upon the advice of legal counsel, contingent liabilities arising from litigation, tax, and compliance matters are not expected to have a material adverse effect on the Company's statutory balance sheets due to established liabilities and anticipated insurance and reinsurance recoverables, but there can be no assurance that such matters will not become material due to future developments, including any changes with respect to the financial condition of the Company.

### *Other Items*

#### **Lease Commitments**

The Company leases office space and equipment under various noncancelable operating lease agreements.

At December 31, 2006, the total aggregate minimum rental payments on operating leases is \$11.9 million and future minimum rental payments are as follows:

	<b>Minimum payments</b>
	(In thousands)
Year ending December 31:	
2007	\$ 4,346
2008	4,072
2009	2,860
2010	615
2011 and thereafter	—
	<b>\$ 11,893</b>

Certain rental commitments have renewal options extending through the year 2010. Some of these renewals are subject to adjustments in future periods.

#### **Assessments**

The Company is liable for guaranty fund assessments related to certain unaffiliated companies that have become insolvent during the years 2006 and prior. The Company's balance sheets includes provisions for all known assessments that are expected to be levied against the Company as well as an estimate of

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

amounts (net of estimated future premium tax recoveries) that the Company believes it will be assessed in the future for which the insurance industry has estimated the cost to cover losses to policyholders. The Company is also contingently liable for any future guaranty fund assessments related to insolvencies of unaffiliated insurance companies for which the insurance industry has been unable to estimate the cost to cover losses to policyholders. No specific amount can be reasonably estimated for such insolvencies as of December 31, 2006. The Company has accrued a liability of approximately \$3.2 million for guaranty fund assessments as of December 31, 2006, compared with \$4.5 million at December 31, 2005. In addition, the Company has accrued a liability for premium and loss based assessments of approximately \$39.0 million as of December 31, 2006, compared with \$43.0 million at December 31, 2005.

#### **Kemper Corporation**

Kemper Corporation (KC) was a former affiliate of the Company acquired by Zurich Insurance Company (Zurich) in 1996. Dating from before that acquisition, there were certain contractual tax indemnification obligations between the Company and KC related to an earlier corporate transaction and a corporate insurance indemnification owed by KC to the Company for certain reinsurance arrangements dating from decades ago. The Company and Zurich/KC fully settled those former obligations in 2005; the settlement resulted in an increase in surplus of \$16.8 million in 2005.

#### **GE Reinsurance Company**

In 1998, the Company sold to GE Insurance Solutions (GEIS) the Company's professional reinsurance subsidiary, Kemper Reinsurance Company, and that former Company affiliate was then renamed GE Reinsurance Company (GE Re). Dating from before that sale, there were and are intercompany obligations between the Company and the renamed GE Re, including numerous reinsurance arrangements. Under one of those reinsurance arrangements, GE Re reinsured certain aviation pool exposures in the U.S. and Canada. In addition, the 1998 sale created certain tax indemnification obligations between the parties. In 2005, the Company and GE Re commuted the aviation reinsurance and settled all open matters relating to the tax indemnification obligations. As a result, the Company recorded an increase in surplus of \$3.8 million in 2005. In 2006, GE Re was acquired by the Swiss Reinsurance Company and its affiliates (Swiss Re). The Company's reinsurance recoverables from GE Re at December 31, 2005 totaled \$238 million and from Swiss Re at December 31, 2006 (now including those owed by GE Re) totaled \$277 million.

#### **SeaBright Insurance Company**

Following the 2003 sale by the Company of 100% of the capital stock of Kemper Employers Insurance Company (KEIC) to SeaBright Insurance Holdings, Inc., the purchaser renamed KEIC as SeaBright Insurance Company. As part of the 2003 sale transaction, the Company provided a stop loss reinsurance agreement to KEIC, now SeaBright, and collateralized that reinsurance with a collateral trust. The Company's assets in that collateral trust totaled approximately \$5.2 million and \$4.9 million at December 31, 2006 and 2005, respectively; the increase in 2006 was due to investment income on the trust assets. In early 2007, \$1.8 million of trust assets were released back to the Company, in accordance with existing agreements. Also in connection with the 2003 sale, the Company had established for the benefit of the purchaser an escrow in the amount of \$4.0 million. In 2005, \$3.8 million of the escrowed assets were released back to the Company, and the remainder was released in 2006. SeaBright also provides for agreed fees for certain claim handling services with respect to approximately 700 claims (accounting for

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

approximately \$30.0 million of net liabilities at December 31, 2006) under policies issued by the Company's Eagle insurance operations prior to the 2003 sale of KEIC.

#### **Broadspire**

In July 2003, the Company sold its NATLSCO, Inc. subsidiary and related claim service operations (together subsequently renamed "Broadspire). Based on purchase price adjustment provisions in the sale contract, the Company initially asserted a claim against Broadspire for \$22.9 million. In June 2005, a binding arbitration ruling awarded the Company \$23.2 million on its claim that was carried at \$17.9 million at December 31, 2004. The Company's surplus at December 31, 2005 reflected a benefit of \$5.3 million due to the ruling. Broadspire in 2005 paid \$19.0 million in cash and asserted an offset right to the remaining \$4.2 million. The Company disputed owing the liability upon which Broadspire asserted an offset right, and the Company recovered the disputed amount by offsetting other monies otherwise owed to Broadspire. Broadspire subsequently prevailed in an arbitration dealing with the claim upon which Broadspire had asserted the offset right, which resulted in a \$3.7 million adverse impact to the Company's surplus in 2006.

The 2003 sales agreement with Broadspire also provided for certain contingent consideration (earn-out) based on the revenue and net income of the sold business for a four-year period beginning January 1, 2004 (the Earn-out Period). The sales agreement required the acceleration and payment of remaining earn-out if Broadspire sold assets of NATLSCO during the Earn-out Period. In 2006, Broadspire paid the Company \$354 thousand as an adjustment to the 2004 earn-out. In another arbitration proceeding, the Company is disputing the accuracy of the amounts paid by Broadspire for the earn-out in both years. In addition, in a series of three transactions between December 2004 and November 2006, Broadspire disposed of NATLSCO and certain of its assets. In 2006, Broadspire paid \$3.6 million as a buy-out of the remaining earn-out (due to the asset dispositions) that Broadspire admits is due under the sales agreement. The Company is disputing the accuracy of Broadspire's calculations. The Company has recorded the payments received to date (benefiting the Company's surplus and liquidity to that extent in 2006). In accordance with the Manual, the Company is not carrying an admitted asset for any future recoveries from Broadspire.

Also in connection with the 2003 transaction, the Company entered into a long-term claim administration agreement with Broadspire for the servicing of most of the Company's existing workers' compensation, general liability, and employer liability claims. The Company paid approximately \$95.3 million in advance for the future servicing of such claims, of which \$56.8 million was placed in trust by Broadspire to be drawn down monthly over a four-year period commencing January 1, 2004. The Company is not obligated to add any assets to the trust. The Company receives the interest on Broadspire's trust assets. In accordance with a prescribed accounting practice more fully described in note 2, the Company reflects as an admitted asset the remaining prepaid amount for claim handling services; that amount has declined to approximately \$23 million as of December 31, 2006 and \$33 million as of December 31, 2005.

#### **Kemper Auto & Home: Renewal Rights and Cut-Through**

Following the sale in 2002 of the Company's and its affiliates' U.S. personal lines business to Unitrin, Inc. (Unitrin) and its subsidiaries including Trinity Universal Insurance Company (Trinity), Unitrin operates this business under the name Kemper Auto & Home. Unitrin has a 100-year license to use the Kemper name in the acquired personal lines businesses. Unitrin did not acquire then in-force or previously issued policies nor renewal rights to policies issued in Alaska, Michigan, Delaware, or Arkansas or to policies

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

produced by independent agents whose authority to write new business had been terminated prior to April 19, 2002. Pursuant to the 2002 sale agreement, Unitrin continues to monitor and service the Company's run-off of its retained personal lines policies. Through early 2005, the Company and certain of its affiliates fronted for Trinity, at Trinity's expense, personal lines policies in states where Trinity (or an affiliate) was seeking licenses and making form and rate filings necessary for the issuance of policies in place of renewals of policies originally issued by the Company or its affiliates. As of December 31, 2006 and 2005, respectively, approximately \$26 million and \$49 million of the Company's gross liabilities were from fronted policies that are 100% reinsured by (ceded to) Unitrin. Not only are these reinsured policies fully administered (including claims handled) by Unitrin subsidiaries, such policies are covered by a cut-through provision allowing the insureds to seek direct recourse to a Unitrin subsidiary in the event of any insolvency of the Company.

#### (11) Surplus

##### *Surplus Notes*

The Company had the following surplus notes issued and outstanding as of December 31, 2006:

<u>Description</u>	<u>Interest rate</u>	<u>Maturity date</u>	<u>Par or face value</u>	<u>Carrying value</u>	<u>Interest paid in 2006 and 2005</u>	<u>Inception to-date interest paid</u>	<u>Accrued interest at December 31, 2006</u>
					(In thousands)		
30-Year Notes	9.15%	07/01/2026	\$ 400,000	399,123	—	238,612	—
40-Year Notes	8.30	12/01/2037	200,000	199,507	—	83,461	—
100-Year Notes	8.45	12/01/2097	100,000	99,726	—	42,485	—
			<u>\$ 700,000</u>	<u>698,356</u>	<u>—</u>	<u>364,558</u>	<u>—</u>

The unamortized discount at issuance has been charged directly against surplus. The unamortized discount amounted to \$1.6 million at December 31, 2006 and 2005.

All surplus notes were issued pursuant to Rule 144A of the Securities Act of 1933. All surplus notes are unsecured and subordinated to all present and future indebtedness, policy claims, and prior claims of the Company. The surplus notes are not entitled to a sinking fund. As it relates to the surplus notes, the Company is not restricted from incurring any future indebtedness, policy claims, or prior claims. Under statutory accounting, the surplus notes are part of surplus for financial statement purposes. The 30-year notes and the 40-year notes may not be redeemed at the option of the Company or any holder of the notes prior to maturity. Upon the occurrence and during the continuation of certain events, as described in the Offering Circular, the Company has the right, if certain conditions are met, to shorten the maturity of the 100-year notes, or subject to the prior written approval of the Director, to redeem them in whole but not in part.

Each payment of interest on and/or repayment of principal of the surplus notes may be made only with the prior approval of the Director, which approval will only be granted if, in the judgment of the Director, the financial condition of the Company warrants the making of such payments and the Company's surplus reflects sufficient funds to cover the amount of such payment. The Director has denied the Company's 2006 and 2005 requests for payment of interest on the surplus notes due on June 1 and July 1, and on

## LUMBERMENS MUTUAL CASUALTY COMPANY

### Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

December 1, and January 1. All payments of interest scheduled since January 1, 2003 have not been paid due to disapprovals by the Director based on the Company's financial condition. The cumulative amount of interest that was scheduled to be paid but is unpaid, plus the amount otherwise accruing in 2006 for which scheduled interest payment dates have not yet arrived, totaled \$248.7 million as of December 31, 2006. In accordance with statutory accounting principles, this total amount is not reflected as a liability on the Company's statutory balance sheet as of December 31, 2006.

#### (12) Fair Value of Financial Instruments

Fair value estimates are made at specific points in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Fair value estimates for financial instruments are generally determined using discounted cash flow models and assumptions that are based on judgments regarding current and future economic conditions and the risk characteristics of the investments. Although fair value estimates are calculated using assumptions that management believes are appropriate, changes in assumptions could significantly affect the estimates and such estimates should be used with care.

Fair value estimates are determined for existing on- and off- balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and certain liabilities that are not considered financial instruments. Accordingly, the aggregate fair value estimates presented do not represent the underlying value of the Company. For example, the Company's subsidiaries are not considered financial instruments, and their value has not been incorporated into the fair value estimates. In addition, tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

The following methods and assumptions were used by the Company in estimating the fair value of its financial instruments:

Cash equivalents, short-term investments, bonds, and unaffiliated stocks: Fair values for cash equivalents, short-term investments, bonds, and unaffiliated stocks have been determined using prices provided by the SVO, or when such values are not available from the SVO, using prices from independent pricing services that use market quotations, prices provided by brokers, or estimates of fair values obtained from yield data relating to instruments or securities with similar characteristics, or prices determined in good faith by the Company's engaged portfolio manager.

Cash and receivables for securities sold: The statement values reported for these instruments approximate fair value.

Mortgage loans: The statement value reported for mortgage loans approximates its fair value. The estimates of fair value should be used with care given the inherent difficulty of estimating the fair value of mortgage loans due to the lack of a liquid quotable market.

The fair value of notes receivable is based upon fair values as determined in good faith by the Company's investment managers.

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Notes to Statutory Statements of Admitted Assets, Liabilities, and Surplus

December 31, 2006 and 2005

The statement values and estimated fair values of the Company's financial instruments at December 31, 2006 and 2005 were as follows:

	2006		2005	
	Statement value	Estimated fair value	Statement value	Estimated fair value
	(In thousands)			
Financial instruments recorded as assets:				
Bonds	\$ 1,394,364	1,350,119	1,551,962	1,500,553
Cash, cash equivalents, and short-term investments	130,979	130,953	308,271	307,844
Mortgage loans	—	—	804	804
Unaffiliated stocks	2,257	2,784	2,437	2,716
Notes receivable	840	1,857	840	840
Receivables for securities sold	—	—	32,476	32,476

**(13) Subsequent Event**

At December 31, 2006 and 2005, the Company owned certain Texas guaranty fund premium tax credits that previously had ceased to be carried on the Company's balance sheets after the Company had entered run-off status in 2003. In the first quarter of 2007, the Company and certain affiliates sold its off-balance-sheet premium tax credits in two sales transactions. Both transactions received regulatory approvals in both Texas and Illinois. Most of the credits were sold to two subsidiaries of Unitrin in February 2007. The Company also sold \$369,626 of its credits to four affiliates, who collectively paid the Company in February 2007, as follows: AMM, \$28,408; AMICO, \$119,715; KCIC, \$14,855; and Kemper Lloyds Insurance Company, \$206,648. The sales together added approximately \$4.6 million to the Company's 2007 surplus and liquidity.

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Investments

December 31, 2006

The following is a summary of certain financial data as of December 31, 2006 and for the year then ended for purposes of complying with the National Association of Insurance Commissioners' Accounting Practices and Procedures Manual. Such data is included in the Company's 2006 Annual Statement as filed with the Division of Insurance.

Investment categories	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	Percentage	Amount	Percentage
Bonds:				
U.S. Treasury securities	\$ 454,888,479	27.793%	\$ 454,888,479	27.633%
U.S. Government agency obligations (excluding mortgage-backed securities):				
Issued by U.S. Government sponsored agencies	47,527,009	2.904	47,527,009	2.887%
Foreign government (including Canada, excluding mortgage- backed securities)	2,312,099	0.141	2,312,099	0.140
Securities issued by states, territories, and possessions and political subdivisions in the U.S.:				
States, territories and possessions general obligations	20,649,383	1.262	20,649,383	1.254
Revenue and assessment obligations	31,932,287	1.951	31,932,287	1.940
Mortgage-backed securities (includes residential and commercial MBS):				
Pass-through securities:				
Issued or guaranteed by GNMA	12,844	0.001	12,844	0.001
Issued or guaranteed by FNMA and FHLMC	17,260,971	1.055	17,260,971	1.049
CMOs and REMICs:				
Issued or guaranteed by GNMA, FNMA, FHLMC, or VA	80,922,905	4.944	80,922,905	4.916
All other	66,159,171	4.042	66,159,171	4.019
Other debt and other fixed income securities (excluding short-term):				
Unaffiliated domestic securities (includes credit tenant loans rated by the SVO)	648,374,093	39.614	648,374,093	39.386
Unaffiliated foreign securities	25,164,472	1.537	25,164,472	1.529

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Investments

December 31, 2006

Investment categories	Gross investment holdings		Admitted assets as reported in the annual statement	
	Amount	Percentage	Amount	Percentage
Equity interests:				
Publicly traded equity securities (excluding preferred stocks):				
Unaffiliated	\$ 90,181	0.006%	\$ 90,181	0.005%
Other equity securities:				
Affiliated (a)	76,055,977	4.647	85,535,429	5.196
Unaffiliated	2,166,375	0.132	2,166,375	0.132
Other equity interests including tangible personal property under lease:				
Affiliated	27,666,041	1.690	27,666,041	1.681
Unaffiliated	392,342	0.024	392,342	0.024
Real estate investments:				
Property held for sale	4,172,747	0.255	4,172,747	0.252
Cash, cash equivalents and short-term investments	130,978,945	8.002	130,978,945	7.956
Total invested assets	\$ 1,636,726,321	100.000%	\$ 1,646,205,773	100.000%

(a) Admitted assets differ from Manual basis due to an accounting allowance from the Division of Insurance. Please see note 1 to the 2006 audited statutory financial statements for further information.

See accompanying independent auditors' report.



## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Investments Risk Interrogatories

December 31, 2006

The following interrogatories as of December 31, 2006 and for the year then ended are for the purpose of complying with the National Association of Insurance Commissioners *Accounting Practices and Procedures Manual*.

Answer the following interrogatories by reporting the applicable U.S. dollar amounts and percentages of the reporting entity's total admitted assets held in that category of investments.

- Reporting entity's total admitted assets as reported on page 2 of the annual statement: \$2,136,458,926.
- Ten largest exposures to a single issuer/borrower/investment.

Issuer	Description of exposure	Amount	Percentage of total admitted assets
1. Berkshire Hathaway, Inc.	Bond - Cat. 2.1	\$ 273,076,083	12.8%
2. JP Morgan Prime MMkt Fd - Inst	Class 1 MMF - Cat. 8	46,135,836	2.2
3. Canadian Government	ST Bond - Cat. 8 and Bond - Cat. 1.3	44,063,339	2.1
4. FNMA 2003-86OP & 83PB Mtg Multi-Class	Bond - Cat. 1.521	41,993,203	2.0
5. MSC 1998-WF1F & XL1A3 Mtg Multi-Class	Bond - Cat. 1.523	29,142,906	1.4
6. Kemper Casualty Ins Co.	Affiliate Common - Cat. 3.41	28,496,115	1.3
7. General Electric Cap Corp.	Bond - Cat. 2.1	27,010,193	1.3
8. American Motorists Ins Co.	Affiliate Common - Cat. 3.41	25,846,077	1.2
9. Dallas-Fort Worth TX Indl Arpt	Bond - Cat. 1.43	23,228,465	1.1
10. CHAIT 2005-A5 Asset-Backed	Bond - Cat. 2.1	22,345,443	1.0

- Amounts and percentages of the reporting entity's total admitted assets held in bonds and preferred stocks by NAIC rating.

Bonds	Amount	Percentage of total admitted assets	Preferred stocks	Amount	Percentage of total admitted assets
NAIC-1	\$ 1,527,247,264	71.5%	P/RP-1	\$ —	—%
NAIC-2	7,998,680	0.4	P/RP-2	—	—
NAIC-3	—	—	P/RP-3	—	—
NAIC-4	—	—	P/RP-4	—	—
NAIC-5	—	—	P/RP-5	—	—
NAIC-6	3,221,372	0.2	P/RP-6	—	—

**LUMBERMENS MUTUAL CASUALTY COMPANY**  
 Supplemental Schedule of Investments Risk Interrogatories  
 December 31, 2006

4. Assets held in foreign investments:
- |    |  |               |   |
|----|--|---------------|---|
| 1. | Are assets held in foreign investments less than 2.5% of the reporting entity's total admitted assets? |               | Yes <input checked="" type="checkbox"/> No <input type="checkbox"/> |
| 2. | Total admitted assets held in foreign investments  | \$ 15,430,830 | 0.7%  |
| 3. | Foreign-currency-denominated investments   | \$ —          | —%  |
| 4. | Insurance liabilities denominated in that same foreign currency  | \$ —          | —%  |

If response to 1. above is yes, responses are not required for interrogatories 5 – 10.

5. Aggregate foreign investment exposure categorized by NAIC sovereign rating:  
 Not applicable.
6. Two largest foreign investment exposures in a single country, categorized by NAIC sovereign rating:  
 Not applicable.
7. Aggregate unhedged foreign currency exposure:  
 Not applicable.
8. Aggregate unhedged foreign currency exposure categorized by the country's NAIC sovereign rating:  
 Not applicable.
9. Two largest unhedged foreign currency exposures to a single country, categorized by the country's NAIC sovereign rating:  
 Not applicable.
10. Ten largest nonsovereign (i.e. nongovernmental) foreign issues:  
 Not applicable.
11. Amounts and percentages of the reporting entity's total admitted assets held in Canadian investments and unhedged Canadian currency exposure.
- Are assets held in Canadian investments less than 2.5% of the reporting entity's total admitted assets?  
 Yes  No

If response is yes, detail is not required for the remainder of interrogatory 11.

## LUMBERMENS MUTUAL CASUALTY COMPANY

## Supplemental Schedule of Investments Risk Interrogatories

December 31, 2006

12. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments with contractual sales restrictions.

Are assets held in investments with contractual sales restrictions less than 2.5% of the reporting entity's total admitted assets? Yes  No

If response is yes, responses are not required for the remainder of interrogatory 12.

13. Amounts and percentages of admitted assets held in the ten largest equity interests.

Are assets held in equity interests less than 2.5% of the reporting entity's total admitted assets? Yes  No

If response is yes, responses are not required for the remainder of interrogatory 13.

Name of issuer	Amount	Percentage of total admitted assets
1. Kemper Casualty Insurance Co.	\$ 28,496,115	1.3%
2. American Motorists Insurance Co.	25,846,077	1.2
3. Kemper Lloyds Insurance Co.	22,350,820	1.0
4. Specialty Surplus Insurance Co.	21,713,785	1.0
5. Kemper International Corp.	7,553,401	0.4
6. Delta Wetlands Joint Venture	5,315,221	0.2
7. LGA-17 Inc.	1,926,051	0.1
8. Assurex Dev Corp.	1,438,585	0.1
9. Shorebank Corp.	727,791	—
10. Austin Ventures III-B LP	335,444	—

14. Amounts and percentages of the reporting entity's total admitted assets held in nonaffiliated, privately placed equities.

Are assets held in nonaffiliated, privately placed equities less than 2.5% of the reporting entity's total admitted assets? Yes  No

If response is yes, responses are not required for the remainder of interrogatory 14.

15. Amounts and percentages of the reporting entity's total admitted assets held in general partnership interests.

Are assets held in general partnership interests less than 2.5% of the reporting entity's total admitted assets? Yes  No

If response is yes, responses are not required for the remainder of interrogatory 15.

**LUMBERMENS MUTUAL CASUALTY COMPANY**  
Supplemental Schedule of Investments Risk Interrogatories  
December 31, 2006

16. Amounts and percentages of the reporting entity's total admitted assets held in mortgage loans.  
Are mortgage loans reported in Schedule B less than 2.5% of the reporting entity's total admitted assets?  
Yes  No   
If response is yes, responses are not required for the remainder of interrogatory 16 and interrogatory 17.
17. Not applicable.
18. Amounts and percentages of the reporting entity's total admitted assets held in each of the five largest investments in real estate.  
Are assets held in real estate reported in Schedule A less than 2.5% of the reporting entity's total admitted assets?  
Yes  No   
If response is yes, responses are not required for the remainder of interrogatory 18.
19. Report aggregate amounts and percentages of the reporting entity's total admitted assets held in investments in mezzanine real estate loans:  
Are assets held in investments in mezzanine real estate loans less than 2.5% of the reporting entity's total admitted assets?  
Yes  No   
If response is yes, responses are not required for the remainder of interrogatory 19.
20. Amounts and percentages of the reporting entity's total admitted assets subject to securities lending agreements, repurchase and reverse repurchase agreements, and dollar repurchase and dollar reverse repurchase agreements:  
None.
21. Amounts and percentages of the reporting entity's total admitted assets for warrants not attached to other financial instruments, options, caps, and floors:  
None.
22. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for collars, swaps, and forwards:  
None.
23. Amounts and percentages of the reporting entity's total admitted assets of potential exposure for futures contracts:  
None.

See accompanying independent auditors' report.

**LUMBERMENS MUTUAL CASUALTY COMPANY**

Supplemental Schedule of Reinsurance Risk Interrogatories

December 31, 2006

1. The reporting entity does have risks reinsured under quota share reinsurance contracts with other entities that include a provision that would limit the reinsurer's losses below the stated quota share percentage (e.g. a deductible, a loss ratio corridor, a loss cap, an aggregate limit or any similar provisions). The amount of reinsurance credit taken on the two contracts containing such provisions reflects the reduction in quota share coverage caused by the limiting provisions.
2. The reporting entity ceded risks under a reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates) for which during 2006: (i) it recorded a positive or negative underwriting result greater than 3% of prior year-end surplus as regards policyholders or it reported calendar year written premium ceded or year-end loss and loss expense reserves ceded greater than 3% of prior year-end surplus as regards policyholders; (ii) it accounted for that contract as reinsurance and not as a deposit; and (iii) the contracts contain one or more of the following features or other features that would have similar results:
  - a. A contract term longer than two years and the contract is noncancelable by the reporting entity during the contract term;
  - b. A limited or conditional cancellation provision under which cancellation triggers an obligation by the reporting entity, or an affiliate of the reporting entity, to enter into a new reinsurance contract with the reinsurer, or an affiliate of the reinsurer;
  - c. Aggregate stop loss reinsurance coverage;
  - d. An unconditional or unilateral right by either party to commute the reinsurance contract, except for such provisions which are only triggered by a decline in the credit status of the other party;
  - e. A provision permitting reporting of losses, or payment of losses, less frequently than on a quarterly basis (unless there is no activity during the period); or
  - f. Payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of the reimbursement to the ceding entity.

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3. The following information is provided for contracts meeting the provisions of paragraph 2. above:
- a. A summary of the reinsurance contract terms and management's principal objectives in entering into the reinsurance contracts is presented below:

Summary of Reinsurance Contract Terms	Related Management's Objectives
<p>Contract #1 – (IRA 4050, Ref No 1 ) – Workers' Compensation and/or Employers Liability Excess of Loss Reinsurance Agreement – This contract, with a term from March 1, 2001 to March 1, 2002, provides excess of loss coverage of \$750,000 xs \$250,000 per occurrence for workers' compensation business. The total premium is dependent on loss experience. The aggregate limit is the lesser of 8.0% of Subject Net Written Premium or \$60 million. This contract is being reported pursuant to paragraph 2.d. above.</p>	<p>Traditional reinsurance capacity was not available at a premium that management deemed acceptable. Rather than retaining this layer of exposure, the Company reinsured it under a finite risk reinsurance agreement that combined elements of risk retention and risk transfer. This agreement effectively serves as a transition layer between the Company's net retention and traditional reinsurance coverage.</p>
<p>Contract #2 – (IRA Code 4639, Ref No 1) – Kemper Financial Insurance Solutions Variable Quota Share Reinsurance Agreement – This contract, with a term from December 1, 1999 through December 31, 2002, provides variable quota share reinsurance coverage. This contract is being reported pursuant to paragraph 2.a. above.</p>	<p>The Company purchased this contract in order to lock into perceived favorable terms over a multiple year period.</p>
<p>Contract #3 – (IRA Code 6317, Ref No 1) – Certificate of Facultative Casualty Reinsurance – This contract, with a term from August 1, 1999 through May 1, 2000, provides facultative workers' compensation reinsurance coverage. Part (A) covers the \$900,000 xs \$100,000 per occurrence exposure; Part B covers the exposure of the first \$100,000 per occurrence on an aggregate excess of loss basis, with a limit of \$15 million xs \$60 million aggregate retention. This contract is being reported pursuant to paragraph 2.c. above.</p>	<p>This contract is similar to many other traditional casualty facultative reinsurance certificates, which the Company has purchased in the traditional markets, covering per occurrence losses above a self-insured retention to protect against large losses. The significant difference in this contract is the inclusion of a aggregate stop loss element to protect against loss frequency in addition to traditional per occurrence coverage.</p>

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- b. The aggregate financial statement impact gross of all such ceded reinsurance contracts on the statutory balance sheets is presented in the table below:

	<u>As reported</u>	<u>Reinsurance interrogatory effect</u> (In thousands)	<u>Restated without interrogatory reinsurance</u>
Year ended December 31, 2006:			
Assets	\$ 2,136,459	(68,846)	2,067,613
Liabilities	1,962,866	—	1,962,866
Capital and surplus	173,593	(68,846)	104,747

4. During 2006, the reporting entity did not cede any risk under any reinsurance contract (or under multiple contracts with the same reinsurer or its affiliates), excluding cessions to approved pooling arrangements or to captive insurance companies that are directly or indirectly controlling, controlled by, or under common control with (i) one or more unaffiliated policyholders of the reporting entity, or (ii) an association of which one or more unaffiliated policyholders of the reporting entity is a member, where:
- The written premium ceded to the reinsurer by the reporting entity or its affiliates represents fifty percent (50%) or more of the entire direct and assumed premium written by the reinsurer based on its most recently available financial statements; or
  - Twenty-five percent (25%) or more of the written premium ceded to the reinsurer has been retroceded back to the reporting entity or its affiliates.
5. The reporting entity did not cede any risk under any reinsurance contract (or multiple contracts with the same reinsurer or its affiliates) during 2006 that was either:
- Accounted for as reinsurance (either prospective or retrospective) under SSAP and as a deposit under GAAP; or
  - Accounted for as reinsurance under GAAP and as a deposit under SSAP.

See accompanying independent auditors' report