# 2006

LawPRO® Annual Report

# Contents



## About LAWPRO®

Lawyers' Professional Indemnity Company (LAWPRO) is licensed to provide professional liability insurance and title insurance in numerous jurisdictions across Canada.

In 2006, LAWPRO provided liability insurance to about 20,700 members of the Law Society of Upper Canada. Through our TitlePLUS® operation, LAWPRO also provides comprehensive title insurance and legal services coverage for residential and commercial purchase and mortgage-only/refinance transactions handled by lawyers.

## Our mission

To be an innovative provider of insurance products and services that enhance the viability and competitive position of the legal profession.

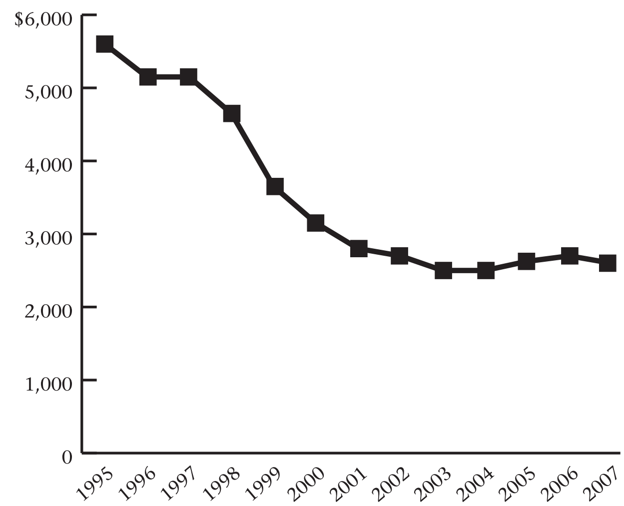
# Remarks of the Chairman

Solid financial results that ensure a viable, sustainable and innovative insurance program have become the norm for LAWPRO: 2006 was no exception.

The company posted net income of $9.4 million, up from $7.3 million in 2005. Strong investment gains, a robust housing market that led to strong transaction levy revenues, and record TitlePLUS sales that included substantial growth in western Canada contributed to this profitable result. We have assets of $456 million and equity of just over $119 million – a strong financial position confirmed by consistent A ratings from A.M. Best, a leading rating agency.

Positive results contribute to premium stability. For six years, our Board has maintained practice insurance premiums in the $2,500 to $2,700 range. For 2007, insurance premiums have been reduced by $100 to $2,600 per lawyer, despite increased claims costs, and despite indications that claims frequency and severity are on the rise. Fraud claims now cost our program about $7 million annually; as well, the LAWPRO program is faced with many more large claims in the $500,000+ range than ever before. A profitable bottom line provides the flexibility to judiciously manage these trends against the goal of providing the bar with an innovative, affordable insurance program.

Strong financial results also enable us to innovate.




Insurance premiums for lawyers have been held in the $2,500 to $2,700 range for six consecutive years.

Now in its 10th year, practicePRO offers Ontario lawyers a wealth of risk management and education resources. Through practicePRO, LAWPRO in 2006 helped shape the Sedona E-Discovery principles. The practicePRO CLE premium credit has made risk management information an integral part of CLE programming. Last year, for example, 130 CLE programs included sufficient risk management content to be accredited; the 17,500 lawyers attending those programs were eligible for a reduction of up to $100 on their insurance premiums. Our practicePRO's many publications, articles, and columns are frequently cited, excerpted or reproduced in jurisdictions from the U.S. to Malaysia.

Our TitlePLUS program is a unique example of risk management in action. Since its launch in 1997, LAWPRO's TitlePLUS program has established itself as the Canadian Bar-related® title insurer, committed to enhancing the vital role of lawyers in real estate conveyancing and supporting education for all stakeholders in the real estate market. Its advanced, technology-based application process ensures stringent underwriting, enabling lawyers to provide superior service to clients while also mitigating the risk inherent in conveyancing.

This unique position as the quality, lawyer-focused title insurer is striking a chord in the bar. An increase in TitlePLUS market share in Ontario, and major growth in our business in markets in eastern and western Canada bode well for the future of the TitlePLUS program on the eve of its 10th anniversary. Our view that TitlePLUS title insurance is the best available is being echoed from coast to coast.

LAWPRO's stability and expertise also serves the bar beyond the boundaries of the insurance program.

Through mining our extensive databases, we have helped educate leaders of the bar on emerging issues and trends: The changing demographics of the bar and the related need to support sole and small practice lawyers are a good example. LAWPRO has responded with initiatives such as the Excess insurance program, which aims to put additional layers of insurance within the reach of sole and small firm practitioners; and the *Real Simple Real Estate Guide*, a new TitlePLUS web-based tool launched in 2006 to help real estate lawyers (the majority of whom practise solo) better serve their clients.

Behind the scenes, we strategically represent the long-term interests of the bar in the important legislative arena. In 2006, our representations on Bill 14 (with respect to paralegal legislation) helped ensure that the legislation affirms the primary role of lawyers as providers of legal services. We also provided input into discussions on an insurance framework for paralegals that would mesh with the protection afforded lawyers under the LAWPRO program. On Bill 152, the Ontario government's new anti-fraud legislation, we again contributed evidence on the need to balance consumer protection with the need for all parties in conveyancing to be appropriately liable in cases of fraud. Our experience in litigation provided those considering civil justice reform with a unique perspective on how the system could be restructured to be more efficient.

The risk management approach that LAWPRO practises applies equally to this Board's governance of the company. Premium strategies are carefully weighed against claims trends, profits and predictions of risk; we consider the need for premium stability against the need to provide the company with the flexibility to respond to unexpected claims. We apply a best practices approach to the Board's work, from evaluation processes for the LAWPRO management and Board members to the controls and processes in all areas of LAWPRO operations. While we carry the risk for the primary program within the company – a reflection of our strong capital position – we reinsure the Excess program where a loss could have a more significant effect.

The experience and expertise of our Board members, who represent insurance, legal, and financial services sectors, are a tremendous asset in this regard. I thank them for their continued support and guidance. As well, I commend President and CEO Michelle Strom, her management team and all employees of the company for their commitment to making this organization one in which all members of the bar can take pride. They continue to set a standard that consistently earns LAWPRO kudos in insurance circles across North America.

Kim A. Carpenter-Gunn
Chairman

# Remarks of the President and CEO

The Ontario bar today expects more than insurance from LawPRO: We are a resource to and a partner with the bar, as it adapts to evolving demographic, legislative, environmental and practice pressures.

We are expected to provide: affordable insurance; expert, principled claims management; quality customer service; vision and advocacy. In summary, an innovative, profitable program that adapts to the bar's short and long-term needs.

As our 2006 results illustrate, we are more than capable of delivering.

Although we saw more claims and more costly claims than in previous years, we were able to reduce premiums by $100 per lawyer for 2007. We maintained our enviable trial record, winning the majority of all matters that escalated beyond the boardroom. Our TitlePLUS business established itself as a force on the national stage, recording not only steady growth but also acknowledgement from across the country as the lawyers' title insurer. We adapted both our primary and Excess programs to reflect changing needs, and expect about a 10 per cent growth in our Excess premium revenue for 2007. Innovative use of technology made it easier for lawyers to get detailed information on their specific insurance coverage and account information via our website. Our mission to educate the bar about its exposures to risk succeeded: Record numbers of lawyers customized their protection with optional insurance coverages, or bought up their coverage limits, or applied for our CLE premium credit.

### Insuring lawyers

The number of lawyers insured under the LawPRO program continues to increase an average of about 1.5 per cent annually. To date in 2007, about 21,000 lawyers have practice coverage compared to 20,700 in 2006 and 20,400 in 2005.

To ensure we deliver on our commitment to excellence in customer service while holding the line on expenses, we depend increasingly on the advantages of online technology: A simplified online application process prompted more than 90 per cent of the bar to web-file for insurance coverage in 2007.

Similarly we revamped our website to ensure it is a comprehensive resource to lawyers: Detailed insurance information is now easier to access; an expanded Frequently Asked Questions (FAQ) section addresses the most common questions of lawyers; and a new feature enables individual lawyers to access detailed information on their specific coverage, payment schedule and account status. Traffic to our site is up eight per cent, while the number of calls into our Customer Service department is down just under five per cent – evidence of our success in cost-effectively serving lawyer insureds.

Equally important is the need to adapt the program to the bar's evolving needs. As the chart illustrates, many lawyers customize the program to their specific situation.

For 2007, we modified the program to provide exemption for those acting as estate trustee, trustee for *inter vivos* trust or power of attorney. We also offer optional coverage at an additional premium for this exposure.

We also expanded the scope of our Excess insurance program. Launched in 1998 to ensure sole and small practice lawyers have access to competitively priced excess insurance, this program was expanded for 2007 to address the needs of firms of up to 50 lawyers. To respond to the need for higher limits for this new target group, we introduced a $9 million limit option. Market response has been very positive: 42 firms opted for this higher level Excess coverage; and 96 per cent of firms renewed their Excess coverage with us for 2007. Another 98 firms opted to buy our Excess coverage for

| Coverage option | Feature | No of lawyers participating (as of Jan. 31, 2007) |
|---|---|---|
| New call discount | 10-40% base premium discount for those called 1-4 years | 3,467 |
| Part-time practice | 40% base premium discount for eligible lawyers | 1,282 |
| Restricted area of practice option | 40% base premium discount for immigration/criminal law practitioners | 1,144 |
| Innocent Party Buy-Up | Increase in Innocent Party limits up to $1 million per claim/$1 million aggregate | 3,601 (based on $249/lawyer) |
| Run-Off Buy Up | Increase limits for past services from $250,000 per claim/ aggregate up to $1 million per claim/$2 million aggregate | 714 |
| Excess Insurance | Add additional layer of protection of up to $9 million above primary limits of $1 million per claim/ $2 million in the aggregate | 3,507 lawyers (1,306 firms) |

the first time – 86 of which had no excess coverage in the past. These results confirm the success of our efforts to educate the bar about their exposure and provide a competitive program through LAWPRO.

### Defending lawyers: Claims management

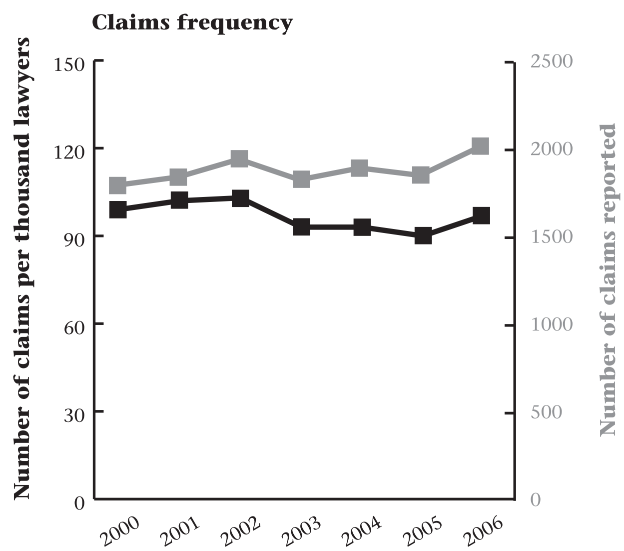
On all counts, our claims portfolio continues to be challenging – a reflection of an increasingly complex practice climate.

Claims frequency, claims severity and claims costs all indicate an upward trend in 2006:

- The number of newly reported claims increased eight per cent to 2,020 up from 1,855 the previous year. As the accompanying graph illustrates, claims frequency (claims per 1,000 lawyers) also increased in 2006.

- We estimate that the average cost per claim will also increase – the result of more large claims of $100,000 or more. These claims run the gamut from real estate to complex commercial in origin.

- Fraud continues to be a significant problem, accounting for close to $7 million in costs in 2006. This trend is reflected in increased costs associated with real estate claims, which now account for about




An increase in the number of claims reported can be partly attributed to continued growth in the number of lawyers in practice in 2006. However, in 2006 claims frequency (number of claims per 1,000 lawyers) trended upward for the first time in several years – a trend that we will be watching carefully.

40 per cent of claims costs. We continue to proactively educate the bar about the risk of fraud through our publication, LAWPRO Magazine, and through conferences and seminars on the subject. In November 2006, members of our TitlePLUS team organized and chaired the Ontario Bar Association's program "*A Viper in the House: Real Estate Fraud and You*."

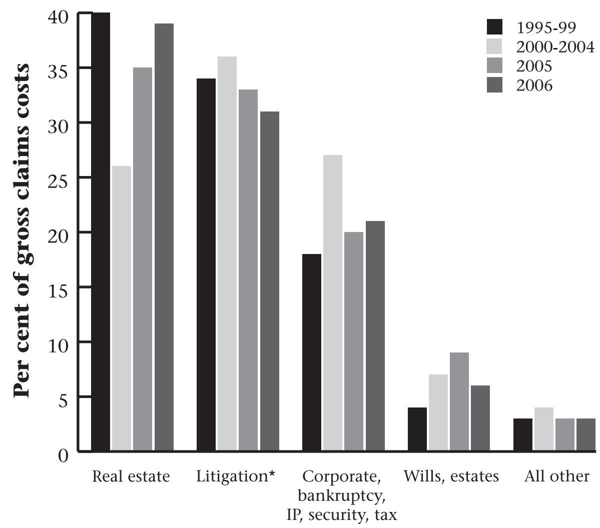
In this type of environment, expertise and experience are critical. Of claims closed in 2006, 84 per cent had no indemnity payment, and almost half had no defence or indemnity payment.

These results speak to our principled claims management strategy: We attempt to resolve quickly those matters in which liability is clear. We will not, however, make economic settlements: Claims without merit are defended vigorously, even to trial if required. Our enviable track record in this regard is intact: We won 11 of 14 matters at trial (one is under reserve); we were successful in five of seven Court of Appeal matters and on 10 of 11 summary judgment applications.

## Educating lawyers: practicePRO

In today's complex practice climate, the need to educate lawyers about their exposure to risk – and how to prevent a claim – is a vital service to the profession. In 2006, our practicePRO staff delivered more than 40 presentations at conferences, seminars and to individual

**Distribution of claims by area of practice**




**Includes defence and plaintiff litigation, family law and criminal law.*

Real estate claims accounted for close to 40 per cent of LAWPRO's gross claims costs in 2006, and are at levels last seen in the mid– to late–1990s. A small increase in claims attributed to corporate, bankruptcy, securities and tax practices reflects the higher average cost of many of these more complex claims files.

law firms across Ontario. Building on our lead role in educating the bar about electronic discovery, in 2006 we helped shape the E-Discovery principles that will guide lawyers. Through our leadership on committees of legal associations such as the Ontario Bar Association and Canadian Bar Association, we ensure our risk management message gets heard at these levels – and that programming reflects this emphasis.

Our principal risk management publication – LAWPRO Magazine – provided lawyers with in-depth discussions on client service and wellness issues; the eighth in our series of booklets on law office management focused on *managing a better professional services firm*.

We also get our risk management message out by providing legal publications with tailor-made content on risk and practice trends. Our success at helping lawyers integrate technology into law practice has been recognized across North America.

### Charting the future: TitlePLUS title insurance

As it heads into its 10th year of operation, our TitlePLUS program has become a recognized force on the national title insurance stage. Our increased market share in Ontario, and significant growth outside Ontario, are a clear indication that the real estate bar has bought into the TitlePLUS vision: A conveyancing system that enhances the role of lawyers and TitlePLUS title insurance, thus providing consumers and lenders alike with superior service and protection.

To this end, we launched a major education/public relations campaign in 2006. Radio and print advertising focused on how a lawyer and TitlePLUS insurance protect homebuyers against common pitfalls, such as zoning and building permit issues.

Central to this campaign was a new web-based tool: The TitlePLUS *Real Simple Real Estate Guide*. This is a consumer-oriented website that includes many tools, "to do" checklists, and information on the role of a lawyer and the merits of TitlePLUS insurance. By year end, the site had recorded more than 60,000 hits; as well, thousands of visitors used the online lawyer locator function on our TitlePLUS site to find a local TitlePLUS lawyer.

A complementary media campaign provided tips and insights into what homebuyers could expect their lawyer to do for them. This generated extensive coverage in major Canadian print and broadcast media. We estimate that we reached more than nine million consumers across Canada through these articles and interviews. A similar campaign will be conducted in 2007.

Technology also continued to figure prominently in the TitlePLUS advantage. Lawyers across Canada can now use the web to apply online for our TitlePLUS products – from our purchase program to our OwnerEXPRESS® program for current property owners and our mortgage-only product.

Education about good real estate practices that benefit both the lender and consumer is also a TitlePLUS focus. Through more than 50 "lunch and learn" seminars in communities across Canada, we demonstrated to lenders and lawyers how the TitlePLUS program not only streamlines transactions but also better protects all parties in conveyancing. Seventeen new lenders joined our roster of confirmed lenders in 2006.

Year-end results for TitlePLUS sales demonstrate that this is a program on the move. Overall we grew the business by more than five percent and our subscriber base by more than 15 per cent to more than 3,700 lawyers nationally. Many of the 580 lawyers using TitlePLUS products for the first time in 2006 were from outside Ontario – in markets where TitlePLUS insurance is posting double digit growth. These results bode well for the future.

### TitlePLUS claims

As in the past, municipal issues such as realty tax arrears, building deficiency work orders, and building code violations account for most claims. TitlePLUS claims are settled for an average of $3,500 per claim; more than 90 per cent are closed for under $5,000 per claim.

Stringent underwriting and other control measures have helped address the growing problem of fraud in our TitlePLUS portfolio. Fraud typically accounts for less than 3 per cent of all claims reported, but 40 per cent of indemnity payments made on the TitlePLUS program – an indication of the significant cost of a very small number of these types of claims.

On all fronts, we have had an enviable year of accomplishments. You, as the expression goes, be the judge.

Michelle L. M. Strom
President & CEO

# 2006
# Financial Report

# Management Discussion and Analysis

## Income Statement

In 2006, the Company generated net income of $9.4 million, an increase of $2.1 million over 2005. Income before taxes increased by $3.6 million to $14.5 million. Underwriting loss decreased by $5.2 million, offset by a decrease of $1.6 million in investment income.

### Net Premiums earned

Premiums earned, net of reinsurance ceded, increased by $9.3 million to $82.1 million in 2006. Effective January 1, 2005, the Company ceased underwriting of the Law Society of Newfoundland's insurance program. While both the optional Excess and title insurance programs experienced growth in the year, premiums from the mandatory Ontario professional liability insurance program remained overall in line with expectations.

### Net claims and adjustment expenses

Incurred claims and adjustment expenses, net of reinsurance recoveries increased by $2.6 million. During 2006, there was favourable development of prior years' claims in the amount of $11.9 million which partly offset the higher claims incurred in respect of the current year as compared to 2005.

### Reinsurance

The Company has purchased excess of loss clash reinsurance coverage for 2006, which limits its exposure to large aggregation of multiple claims arising from the same proximate cause. The optional Excess program continues to be fully reinsured, removing exposure to the Company from claims in this program.

Prior to January 1, 2003, the Company had quota share reinsurance arrangements on the mandatory Ontario professional liability insurance program.

### General expenses

The general expenses in 2006 are as anticipated, with the increase of $1.7 million primarily attributable to the insurance program's ongoing costs, including risk management initiatives.

### Reinsurance commissions earned

The Company earns commissions on premium ceded in respect of reinsurance of its optional Excess insurance program. In addition, the Company also earns commissions for profitable results on the quota share reinsurance arrangements that it had prior to January 1, 2003. The increase in commissions of $0.5 million in 2006 primarily relates to increased profit commissions arising on prior years' reinsurance arrangements.

### Investment income

Income generated from investments decreased by $1.6 million in 2006. Investment income includes net capital gains of $3.8 million realized on disposition of assets ($6.3 million in 2005). At December 31, 2006 the market value of the investment portfolio exceeded book value by $16.7 million (2005: $14 million).

## Balance Sheet

Shareholder's equity increased by $9.4 million, the net income earned during the year.

### Investments

Investment assets, inclusive of cash and cash equivalents, increased by $24.5 million to $368.1 million at December 31, 2006. The increase was primarily the result of cash provided by operations and investment income generated by the portfolio. The investment portfolio is managed in accordance with investment policy approved by the Company's Board of Directors in diversified, high quality assets. A portion of the investment portfolio, comprised primarily of fixed income securities, is invested in a manner that is expected to substantially match in maturity to the payment of claims liabilities in future.

The portion of the Company's investment portfolio, which is considered surplus to the requirements of settling claims liabilities, is managed separately and includes fixed income securities and equity investments in publicly traded companies, the values of which are subject to market volatility.

### Provision for unpaid claims and adjustment expenses and reinsurers' share thereof

The provision for unpaid claims represents the amount required to satisfy all of the Company's obligations to claimants prior to reinsurance recoveries. This has increased by $6.2 million. Reinsurance recoveries have declined by $13.6 million and accordingly the net increase in the provision is $19.8 million. This increase is primarily attributable to the impact of changes in reinsurance arrangements made since 2002, as the percentage ceded under quota share reinsurance in respect of the Ontario mandatory professional liability insurance program declined from 57% in 1995 to nil effective January 1, 2003.

The determination of the provision of unpaid claims and adjustment expenses involves significant estimation. The process of determination of the provision is based on known facts currently available, interpretations and judgments, and is influenced by factors that are inherently variable.

# Management Statement on Responsibility for Financial Information

The preparation of the annual financial statements, Management's Discussion and Analysis (MD&A) and all other information in the Company's Annual Report is the responsibility of the Company's management and has been approved by the Board of Directors.

The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. Financial statements, by their very nature, include amounts and disclosures based on estimates and judgments. Where alternative methods or interpretations exist, management has chosen those it deems most appropriate in the circumstances, including appropriate consideration to relevance and materiality. Actual results in the future may differ materially from management's current assessment given the inherent variability of future events and circumstances. Financial information appearing elsewhere in the Company's Annual Report is consistent with the financial statements.

Management maintains the necessary system of internal controls over financial reporting to meet its responsibility for the reliability of the financial statements. These controls are designed to provide management with reasonable assurance that the financial records are reliable for preparing financial statements and other financial information, assets are safeguarded against unauthorized use or disposition and liabilities are recognized.

The Board of Directors is responsible for ensuring that management fulfils its responsibilities for financial reporting and is ultimately responsible for reviewing and approving the financial statements. The Board carries out its responsibility, primarily through its Audit Committee, which is independent of management. The Audit Committee reviews the financial statements and recommends them to the Board for approval. The Audit Committee also reviews and monitors the Company's system of internal controls over financial reporting in the context of reports made by management or the external auditors.

## Role of the Auditor

The external auditors, Deloitte and Touche LLP, have been appointed by the shareholder. Their responsibility is to conduct an independent and objective audit of the financial statements in accordance with Canadian generally accepted auditing standards and to report thereon to the Company's shareholder. In carrying out their audit, the auditors consider the work of the appointed actuary and their report on the policy liabilities of the Company. The external auditors have full and unrestricted access to the Audit Committee and the Board of Directors to discuss audit, financial reporting and related findings. The auditors' report outlines the scope of their audit and their opinion.

## Role of the Appointed Actuary

The actuary is appointed by the Board of Directors of the Company. With respect to the preparation of these financial statements, the appointed actuary is required to carry out a valuation of the policy liabilities and to report thereon to the Company's shareholder. The valuation is carried out in accordance with accepted actuarial practice and regulatory requirements. The scope of the valuation encompasses the policy liabilities as well as any other matter specified in any direction that may be made by the regulators. The policy liabilities consist of a provision for unpaid claims and adjustment expenses on the expired portion of policies, a provision for future obligations on the unexpired portion of policies, and other policy liabilities that may be applicable to the specific circumstances of the Company.

In performing the valuation of the policy liabilities, which are by their very nature inherently variable, the appointed actuary makes assumptions as to the future rates of claims severity, inflation, reinsurance recoveries, expenses and other matters, taking into consideration the circumstances of the Company and the nature of the insurance coverage being offered. The valuation is necessarily based on estimates; consequently, the final values may vary significantly from those estimates. The appointed actuary also makes use of management information provided by the Company, and uses the work of the auditor with respect to the verification of the underlying data used in the valuation.

Toronto, Ontario
February 9, 2007

Michelle Strom
President and CEO

Akhil J. Wagh
Vice-President, Finance and Treasurer

# Auditors' Report

**Deloitte.**

To the Shareholder of Lawyers' Professional Indemnity Company

We have audited the balance sheet of Lawyers' Professional Indemnity Company as at December 31, 2006 and the statements of income and retained earnings and of cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2006 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

Toronto, Ontario
February 9, 2007

Chartered Accountants

# Appointed Actuary's Report

**Eckler Ltd.**
*Consultants and Actuaries*

To the Shareholder of Lawyers' Professional Indemnity Company

I have valued the policy liabilities of the Lawyers' Professional Indemnity Company for its balance sheet as at 31 December 2006, and their changes in its statement of income and retained earnings for the year then ended, in accordance with accepted actuarial practice, including selection of appropriate assumptions and methods.

In my opinion, the amount of the policy liabilities makes appropriate provision for all policyholder obligations, and the financial statements fairly present the results of the valuation.

Toronto, Ontario
February 9, 2007

Brian G. Pelly
Fellow, Canadian Institute of Actuaries

# Balance Sheet

| Stated in thousands of Canadian dollars<br>**As at December 31** | **2006** | **2005** |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | 1,634 | 1,820 |
| Investments (note 2) | 366,513 | 341,812 |
| Investment income due and accrued | 2,637 | 3,056 |
| Due from reinsurers | 7,224 | 7,695 |
| Due from insureds | 2,312 | 2,222 |
| Due from the Law Society of Upper Canada (note 5) | 731 | - |
| Reinsurers' share of provisions for: | | |
| Unpaid claims and adjustment expenses (note 4) | 66,008 | 79,650 |
| Other receivable | 665 | 1,032 |
| Other assets | 343 | 307 |
| Capital assets (note 3) | 432 | 589 |
| Future income taxes (note 7) | 7,750 | 6,177 |
| **Total assets** | **456,249** | **444,360** |
| **Liabilities** | | |
| Provision for unpaid claims and adjustment expenses (note 4) | 327,911 | 321,689 |
| Due to reinsurers | 495 | 754 |
| Due to insureds | 1,637 | 1,467 |
| Due to the Law Society of Upper Canada (note 5) | - | 5,708 |
| Expenses due and accrued | 2,735 | 3,439 |
| Income taxes due and accrued | 2,587 | 64 |
| Other taxes payable | 1,078 | 954 |
| Unearned premiums | 787 | 664 |
| | 337,230 | 334,739 |
| **Shareholder's Equity (note 8)** | | |
| Capital stock issued and paid | 5,000 | 5,000 |
| Contributed surplus | 30,645 | 30,645 |
| Retained earnings | 83,374 | 73,976 |
| | 119,019 | 109,621 |
| **Total liabilities and shareholder's equity** | **456,249** | **444,360** |

*See accompanying notes to financial statements*

On behalf of the Board

Kim A. Carpenter-Gunn
Director

Michelle L. M. Strom
Director

# Statement of Income and Retained Earnings

Stated in thousands of Canadian dollars

| **Year ended December 31** | **2006** | **2005** |
|---|---|---|
| Premiums earned – gross | 86,972 | 77,388 |
| Premiums earned – ceded | (4,886) | (4,632) |
| **Net premiums earned** | **82,086** | **72,756** |
| | | |
| Net claims and adjustment expenses (note 4) | 72,319 | 69,686 |
| Premium taxes | 2,610 | 2,325 |
| General expenses | 15,182 | 13,446 |
| Reinsurance commissions earned | (3,727) | (3,205) |
| | **86,384** | **82,252** |
| | | |
| **Underwriting loss** | **(4,298)** | **(9,496)** |
| Investment and other income | 18,834 | 20,388 |
| **Income before income taxes** | **14,536** | **10,892** |
| | | |
| Income tax expense/(recovery) (note 7) | | |
| Current | 6,711 | 4,239 |
| Future | (1,573) | (682) |
| **Net income for the year** | **9,398** | **7,335** |
| | | |
| Retained earnings, beginning of year | 73,976 | 66,641 |
| **Retained earnings, end of year** | **83,374** | **73,976** |

*See accompanying notes to financial statements*

# Statement of Cash Flows

Stated in thousands of Canadian dollars

| **Year ended December 31** | **2006** | **2005** |
|---|---|---|
| **Operating Activities** | | |
| Net income | 9,398 | 7,335 |
| Items not affecting cash: | | |
| Future income taxes | (1,573) | (682) |
| Amortization of capital assets | 311 | 469 |
| Realized gains | (3,779) | (6,282) |
| Amortization of premiums and discounts on bonds | (1,521) | (788) |
| | 2,836 | 52 |
| Change in other non-cash balances: | | |
| Other taxes payable | 124 | 476 |
| Income taxes due and accrued | 2,523 | 3,288 |
| Due to/from reinsurers and insureds | 292 | 4,448 |
| Provision for unpaid claims and adjustment expenses | 6,222 | 5,844 |
| Reinsurers' share of provisions | 13,642 | 18,013 |
| Unearned premiums | 123 | 75 |
| Expenses due and accrued | (704) | (390) |
| Investment income due and accrued | 419 | (1,275) |
| Other receivable | 367 | (150) |
| Other assets | (36) | 79 |
| Due to/from the Law Society of Upper Canada | (6,439) | (268) |
| **Net cash inflow from operating activities** | **19,369** | **30,192** |
| **Investing Activities** | | |
| Purchase of capital assets | (154) | (329) |
| Purchases of investments | (231,398) | (129,010) |
| Proceeds from sale of investments | 211,997 | 73,246 |
| **Net cash outflow from investing activities** | **(19,555)** | **(56,093)** |
| Increase/(decrease) in cash and cash equivalents during the year | (186) | (25,901) |
| Cash and cash equivalents, beginning of year | 1,820 | 27,721 |
| **Cash and cash equivalents, end of year** | **1,634** | **1,820** |
| **Cash and cash equivalents at end of year consists of:** | | |
| Cash | 1,381 | 676 |
| Cash equivalents | 253 | 1,144 |
| | **1,634** | **1,820** |

*See accompanying notes to financial statements*

# Notes to Financial Statements

As at December 31, 2006

Amounts stated in thousands of Canadian dollars (except per share amounts)

Lawyers’ Professional Indemnity Company (the “Company”) is an insurance company, incorporated in Ontario and licensed to provide lawyers' professional liability insurance and title insurance. The Company is a wholly-owned subsidiary of the Law Society of Upper Canada (“LSUC”), which is the governing body of lawyers in Ontario.

## 1. Significant accounting policies

These financial statements have been prepared under the *Insurance Act of Ontario* (the “Act”) and related regulations which require that except as otherwise specified by the Company’s regulator, the Financial Services Commission of Ontario (“FSCO”), the financial statements of the Company are to be prepared in accordance with Canadian generally accepted accounting principles. The significant accounting policies used in the preparation of these financial statements are summarized below. These accounting policies conform, in all material respects, to Canadian generally accepted accounting principles.

### Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, balances with banks, and short-term investments with maturities of three months or less at the time of acquisition. The fair value of cash and cash equivalents approximates the amounts shown in the financial statements.

### Investments

The Company carries its investments in debt securities at amortized cost. Investments in common and preferred shares are carried at cost. Premiums and discounts on the par value of debt securities are amortized on a straight-line basis over the term to maturity. Realized gains and losses on investments are calculated using the carrying value of securities sold.

Investment income includes interest income and dividends earned, amortization of premiums and discounts on debt securities and realized gains and losses. Any loss in value of an investment, which is considered other than temporary in nature, is also recognized in income.

### Capital assets

Capital assets are carried at amortized cost. Amortization is charged to expense on a straight-line basis over the estimated useful lives of the assets as follows:

| | |
|---|---|
| Leasehold improvements | Term of lease |
| Furniture and fixtures | 3 to 5 years |
| Computer equipment and software | 1 to 3 years |

### Premium related balances

Insurance policies under the professional liability insurance program are effective on a calendar year basis. Professional liability insurance premium income is earned on a *pro rata* basis over the term of coverage of the underlying insurance policies; generally one year, except for policies for retired lawyers, which have terms of up to five years. The portion of premiums related to the unexpired term of coverage at the balance sheet date is recorded as unearned premiums.

Title insurance premiums are earned at the inception date of policies.

Premiums receivable are recorded as amounts due from insureds in the balance sheet, net of any required provision for doubtful amounts. Premiums received from insureds in advance of the effective date of the insurance policy are recorded as amounts due to insureds in the balance sheet.

The Company defers policy acquisition costs, primarily premium taxes on its written professional liability insurance premiums to the extent these costs are considered recoverable. These costs are expensed on the same basis that the related premiums are earned. The method to determine recoverability of deferred policy acquisition costs takes into consideration future claims and adjustment expenses to be incurred as premiums are earned and anticipated investment income. Deferred policy acquisition costs are not material at year-end.

### Other income

Other income is miscellaneous income other than premium income or investment income and is recognized when it is earned.

### Claims related balances

***a) Provision for unpaid claims and adjustment expenses***

The provision for unpaid claims and adjustment expenses is an estimate of the ultimate cost of all insurance claims not paid as at the balance sheet date and is determined using case-basis evaluations and an amount for the expected future development of claims incurred as at the balance sheet date. The provision takes into account the time value of money.

***b) Deductibles***

The professional liability insurance policy requires insureds to pay deductibles to the maximum extent of $25 each on individual claims. Expected deductible recoveries on paid and unpaid claims are recognized net of any required provision for uncollectible accounts at the same time as the related claims liability.

### Reinsurance

Net premiums earned and claims incurred are recorded net of amounts ceded to, and recoverable from, reinsurers in the statement of income.

# Notes to Financial Statements

As at December 31, 2006

Amounts stated in thousands of Canadian dollars (except per share amounts)

Amounts relating to reinsurance in respect of the premiums and claims related balances in the balance sheet are recorded separately. Amounts recoverable from reinsurers are estimated and recognized in a manner consistent with the Company's method of determining the related policy liability associated with the reinsurance policy.

### Employee future benefits

The Company maintains a defined contribution pension plan for its employees as well as a supplemental defined benefit pension plan for certain designated employees, which provides benefits to those employees in excess of the benefits provided by the Company's defined contribution pension plan. The benefit liability under the supplemental defined benefit pension plan is actuarially determined using the projected benefit method pro-rated on service and management's assumptions about discount rates, expected plan assets' performance, salary growth and retirement ages of employees. The discount rate is determined on the basis of market conditions at year-end and other assumptions are based on long-term expectations.

Adjustments for plan amendments are recognized fully into income in the year to which they relate. Changes in assumptions and actuarial gains and losses are recognized into income in the year following the actuarial valuation of the benefit liability to which they relate.

### Income taxes

The Company uses the asset and liability method of accounting for income taxes. Under this method of tax allocation, future income tax assets and liabilities are determined based on the differences between the financial reporting and tax basis of assets and liabilities, and are measured using the tax rates and laws that are expected to be in effect in the periods in which the future income tax assets or liabilities are expected to be settled or realized, where those tax rates and laws have been substantively enacted.

### Use of estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from these estimates and changes in estimates are recorded in the year in which they are determined. The most significant assets and liabilities which require estimation in their determination are the provision for unpaid claims and adjustments and reinsurers' share thereof (note 4).

## 2. Investments

The company holds a diversified portfolio consisting of equities and fixed income debt securities with investment grades of "BBB" or better.

### Estimated fair values and unrealized gains and losses

The carrying value, estimated fair values, yields and unrealized gains (losses) on investments at December 31 were as follows:

| 2006 | Carrying Value | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Debt Securities | $ 316,959 | 4,700 | (616) | 321,043 |
| Common Shares | 46,955 | 13,248 | (805) | 59,398 |
| Preferred Shares | 2,599 | 165 | – | 2,764 |
| | $ 366,513 | 18,113 | (1,421) | 383,205 |

| 2005 | Carrying Value | Unrealized Gains | Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Debt Securities | $ 293,913 | 7,611 | (773) | 300,751 |
| Common Shares | 45,300 | 9,376 | (2,362) | 52,314 |
| Preferred Shares | 2,599 | 129 | – | 2,728 |
| | $ 341,812 | 17,116 | (3,135) | 355,793 |

The effective yield on debt securities as at December 31, 2006 is 3.82% (2005: 4.21%).

The estimated fair values of debt securities, common and preferred shares are based on quoted market values.

### Liquidity and interest rate risk

The maturity profile of debt securities as at December 31, 2006 is as follows:

| | Within 1 Year | 1 to 5 Years | Over 5 Years | Carrying Value |
|---|---|---|---|---|
| Debt securities | $ 24,918 | 156,025 | 136,016 | 316,959 |
| Percent of total | 8% | 49% | 43% | |

# Notes to Financial Statements

As at December 31, 2006

Amounts stated in thousands of Canadian dollars (except per share amounts)

The weighted average duration of debt securities at December 31, 2006 is 5.18 years (2005: 5.18 years). The Company attempts to match the maturity of these investments to the expected maturity of claims obligations. Shares have no specific maturities.

## 3. Capital assets

| | 2006 | | | 2005 |
|---|---|---|---|---|
| | Cost | Accumulated Amortization | Carrying Value | Carrying Value |
| Furniture & Fixtures | $ 1,174 | (1,118) | 56 | 70 |
| Computer Equipment | 2,439 | (2,210) | 229 | 274 |
| Computer Software | 2,246 | (2,135) | 111 | 176 |
| Leasehold Improvements | 935 | (899) | 36 | 69 |
| Total | $ 6,794 | (6,362) | 432 | 589 |

## 4. Provision for unpaid claims and adjustment expenses

The determination of the provision of unpaid claims and adjustment expenses is a complex process based on known facts, interpretations and judgment and is influenced by a variety of factors. Consequently, the measurement of the ultimate settlement costs of claims made to date that underlies the provision for unpaid claims and adjustment expenses and any related recoveries for reinsurance and deductibles, involves estimates and measurement uncertainty. The amounts are based on estimates of future trends in claim severity and other factors, which could vary as claims are settled.

Variability can be caused by several factors including the emergence of additional information on claims, changes in judicial interpretation, and significant changes in severity or frequency of claims from historical trends. Ultimate costs incurred could vary from current estimates. Although it is not possible to measure the degree of variability inherent in such estimates, management believes that the methods of estimation that have been used will produce reasonable results given the current information. An actuary performs a valuation of claims liabilities at least annually. As adjustments to estimated claims liabilities become necessary, they are reflected in current operations.

To limit losses through the spreading of risks, the Company cedes reinsurance to other insurers. In the event that a reinsurer is unable to meet obligations assumed under reinsurance agreements, the Company is liable for such amounts. The Company has guidelines and a review process in place to ascertain the credit worthiness of the companies to which it cedes. Based on current information of the financial health of the reinsurers, no provision for doubtful debts has been made in the financial statements in respect of reinsurers.

Changes in provisions for unpaid claims and adjustment expenses recorded in the balance sheet comprise the following:

| | 2006 | 2005 |
|---|---|---|
| Provision for unpaid claims and adjustment expenses – beginning of year – net | $ 242,039 | 218,182 |
| Change in net provision for claims and adjustment expenses due to: | | |
| Prior years' incurred claims | (11,866) | (8,638) |
| Current year's incurred claims | 83,989 | 78,333 |
| Net claims and adjustment expenses paid in relation to: | | |
| Prior years | (45,534) | (39,933) |
| Current year | (6,921) | (5,796) |
| Impact of discounting | 196 | (109) |
| Provision for unpaid claims and adjustment expenses – end of year – net | 261,903 | 242,039 |
| Reinsurers' share of provisions for unpaid claims and adjustment expenses | 66,008 | 79,650 |
| Provision for unpaid claims and adjustment expenses – end of year – gross | $ 327,911 | 321,689 |

As the provision for unpaid claims and adjustment expenses is recorded on a discounted basis and reflects the time value of money, its carrying value is expected to provide a reasonable basis for the determination of fair value. However, determination of fair value also requires the practical context of a buyer and seller, both of whom are willing and able to enter into an arm's length transaction.

## 5. Related party transactions

Pursuant to a service agreement effective January 1, 1995, the Company administers the Errors and Omissions Insurance Fund (the "Fund") of the LSUC and provides all services directly related to the operations and general administration of the Fund in consideration

# Notes to Financial Statements

As at December 31, 2006

Amounts stated in thousands of Canadian dollars (except per share amounts)

for LSUC insuring its mandatory professional liability insurance program with the Company.

The insurance policy under the mandatory professional liability insurance program of the LSUC is written by the Company and is effective on a calendar year basis. The insurance policy is renewed effective January 1 each year subject to the LSUC's acceptance of the terms of renewal submitted by the Company.

For the year ended December 31, 2006, 88% of the premiums written related to mandatory insurance coverage provided to LSUC and its members. Under the insurance policy that was in force between July 1, 1990 and December 31, 1994, the Company was responsible for claims in excess of LSUC and member deductibles. The provision for unpaid claims and adjustment expenses is net of amounts relating to policies for years prior to 1995 that are payable by the LSUC.

Commencing January 1, 1995, there was no longer the LSUC deductible and 100% of the risk over the individual member deductible was insured through the Company. The annual policy limits for each of the years effective January 1, 1995 to December 31, 2006 are $1,000 per claim and $2,000 in aggregate per member.

For 2006, the Company has estimated a refund of $172 (2005: $7,027) in premiums to the Fund pursuant to the retrospective premium rating provisions of its insurance policy. This refund is payable to LSUC and forms part of the net inter-company balance due from LSUC of $731 (2005: $5,708 net balance due to LSUC).

## 6. Employee future benefits

The Company has a defined contribution pension plan which is available to all its employees upon meeting the eligibility requirements. Each employee is required to contribute 4.5% of yearly maximum pensionable earnings and 6% in excess thereof, of an employee's annual base earnings. Under the plan, the Company matches all employee contributions. The Company made payments of $421 in 2006 (2005: $385) and recorded pension expense of $424 (2005: $394).

The Company also has a supplemental defined benefit pension plan. Funding for the supplemental plan commenced in 2005. Funding requirements are reviewed annually with an actuarial valuation for funding purposes effective as at December 31. The most recent actuarial valuation for funding purposes was performed effective December 31, 2005. For reporting purposes, all assets and liabilities associated with pension benefits have been measured using values as at December 31, 2006.

**Defined benefit plan obligations**

| | 2006 | 2005 |
|---|---|---|
| Accrued benefit obligation | | |
| Balance, beginning of the year | $ 1,705 | 1,264 |
| Current service cost | 134 | 110 |
| Interest cost | 94 | 79 |
| Actuarial loss | 139 | 252 |
| Plan amendment | 92 | – |
| Balance, end of year | $ 2,164 | 1,705 |

**Defined benefit plan assets**

| | 2006 | 2005 |
|---|---|---|
| Fair value of plan assets | | |
| Market value of plan assets – beginning of year | $ 644 | – |
| Actual return on plan assets, net of expenses | 83 | 8 |
| Employer contribution | 833 | 636 |
| Market value of plan assets – end of year | $ 1,560 | 644 |

The defined benefit plan assets arise primarily from employer contributions that are originally allocated equally between deposits with the Government of Canada and investments in the units of a balanced pooled fund, representing a portfolio mix of equities and debt securities.

**Reconciliation of funded status surplus (deficit) of the benefit plans to the amounts recorded in the financial statements:**

| | 2006 | 2005 |
|---|---|---|
| Fair value of plan assets | $ 1,560 | 644 |
| Accrued benefit obligation | (2,164) | (1,705) |
| Funded status deficit | (604) | (1,061) |
| Unamortized net actuarial loss | 45 | 259 |
| Accrued benefit liability | $ (559) | (802) |

The accrued benefit liability is included in expenses due and accrued in the Company's balance sheet.

# Notes to Financial Statements

As at December 31, 2006

Amounts stated in thousands of Canadian dollars (except per share amounts)

**Components of defined benefit costs recognized in the year:**

| | 2006 | 2005 |
|---|---|---|
| Current service cost | $ 134 | 110 |
| Interest cost | 94 | 79 |
| Actual return on assets | (83) | (8) |
| Actuarial losses | 138 | 252 |
| Plan amendment | 92 | – |
| Difference between actual and recognized actuarial losses | 168 | (252) |
| Difference between actual and expected return on assets | 47 | (8) |
| Defined benefit costs recognized in the statement of income | $ 590 | 173 |

The significant assumptions used by the Company are as follows (weighted average):

| | 2006 | 2005 |
|---|---|---|
| Discount rate | 5.00% | 5.00% |
| Expected long term rate of return on plan assets | 6.00% | 6.00% |
| Rate of compensation increase | 3.50% | 3.50% |

## 7. Income taxes

The Company's effective tax rate does not differ significantly from the applicable Canadian statutory income tax rate of 36.12%.

The Company's future income tax asset is the result of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The sources of these temporary differences and the tax effects for each year are as follows:

| | 2006 | 2005 |
|---|---|---|
| Investments | $ 2,832 | 1,376 |
| Net provision for unpaid claims and adjustment expenses | 4,599 | 4,371 |
| Other | 319 | 430 |
| Total | $ 7,750 | 6,177 |

During the year the Company made payments of $4,144 and received refunds of $7 from tax authorities.

## 8. Shareholder's equity

Capital stock of the Company represents:

20,000 Common Shares of par value of $100 each – authorized, issued and paid.

30,000 6% non-cumulative, redeemable, non-voting Preferred Shares of par value of $100 each – authorized, issued and paid.

## 9. Statutory insurance information

The Company is the beneficiary of trust accounts in the amount of $7,423 (2005: $7,605) which are held as security for reinsurance ceded to unregistered reinsurers. This trust balance is not reflected in these financial statements but is considered in determining statutory capital requirements.

In accordance with licensing requirements, the Company has deposited securities with the regulatory authorities having a market value of $54 (2005: $57).

## 10. Operating lease rentals

The Company is committed to monthly lease payments in respect of the premises from which it operates. The lease expires on January 31, 2008. Lease payment obligations are as follows:

| | |
|---|---|
| 2007 | 1,362 |
| 2008 | 114 |

## 11. Fair value disclosure

The fair values of the Company's financial assets and liabilities other than investments (note 2) and the provision for unpaid claims and adjustment expenses (note 4) approximates their carrying value.

# Board of Directors

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