
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2010

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number: 1-13277

CNA SURETY CORPORATION

(Exact name of Registrant as specified in its Charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

36-4144905
(I.R.S. Employer
Identification No.)

333 S. WABASH AVE., CHICAGO, ILLINOIS
(Address of principal executive offices)

60604
(Zip Code)

(312) 822-5000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company
(Do not check if a smaller reporting company)

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

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY
PROCEEDINGS DURING THE PRECEDING FIVE YEARS:**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

44,303,248 shares of Common Stock, \$.01 par value as of April 23, 2010.

CNA SURETY CORPORATION AND SUBSIDIARIES

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CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	<u>March 31,</u> <u>2010</u>	<u>December 31,</u> <u>2009</u>
	<small>(Amounts in thousands, except per share data)</small>	
Assets		
Invested assets:		
Fixed income securities, at fair value (amortized cost: \$1,258,775 and \$1,219,270)	\$ 1,308,297	\$ 1,266,223
Equity securities, at fair value (cost: \$1,650 and \$1,429)	1,852	1,610
Short-term investments, at amortized cost (approximates fair value)	<u>39,970</u>	<u>48,999</u>
Total invested assets	1,350,119	1,316,832
Cash	2,018	5,822
Deferred policy acquisition costs	102,660	99,836
Insurance receivables:		
Premiums, including \$9,215 and \$9,753 from affiliates, (net of allowance for doubtful accounts: \$1,112 and \$1,110)	43,089	33,392
Reinsurance	49,144	48,645
Deposit with affiliated ceding company	26,904	26,878
Goodwill and other intangible assets (net of accumulated amortization: \$25,523 and \$25,523)	138,785	138,785
Property and equipment, at cost (less accumulated depreciation and amortization: \$38,603 and \$37,514)	18,936	19,681
Prepaid reinsurance premiums	197	210
Accrued investment income	14,724	15,832
Other assets	<u>2,548</u>	<u>3,122</u>
Total assets	<u>\$ 1,749,124</u>	<u>\$ 1,709,035</u>
Liabilities		
Reserves:		
Unpaid losses and loss adjustment expenses	\$ 426,458	\$ 406,123
Unearned premiums	<u>256,171</u>	<u>247,776</u>
Total reserves	682,629	653,899
Long-term debt	30,930	30,930
Deferred income taxes, net	29,663	28,065
Reinsurance and other payables to affiliates	676	548
Accrued expenses	12,169	18,586
Liability for postretirement benefits	10,911	10,718
Payable for securities purchased	3,426	1,356
Income tax payable	7,781	13,389
Other liabilities	<u>24,580</u>	<u>28,460</u>
Total liabilities	802,765	785,951
Commitments and contingencies (See Notes 3, 5, & 8)		
Stockholders' Equity		
Common stock, par value \$.01 per share, 100,000 shares authorized; 45,659 shares issued and 44,298 shares outstanding at March 31, 2010 and 45,635 shares issued and 44,268 shares outstanding at December 31, 2009	457	456
Additional paid-in capital	280,126	279,388
Retained earnings	648,310	627,505
Accumulated other comprehensive income	32,072	30,406
Treasury stock, 1,361 and 1,367 shares, at cost	<u>(14,606)</u>	<u>(14,671)</u>
Total stockholders' equity	<u>946,359</u>	<u>923,084</u>
Total liabilities and stockholders' equity	<u>\$ 1,749,124</u>	<u>\$ 1,709,035</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	Three Months Ended	
	March 31,	
	2010	2009
	(Amounts in thousands, except per share data)	
Revenues:		
Net earned premium	\$ 98,252	\$ 101,151
Net investment income	13,377	12,246
Net realized investment gains (losses):		
Other-than-temporary impairment losses	—	(46)
Portion of other-than-temporary impairment losses recognized in other comprehensive income (before taxes)	(94)	—
Net impairment losses recognized in earnings	(94)	(46)
Net realized investment gains (losses), excluding impairment losses on available-for-sale securities	417	(20)
Total net realized investment gains (losses)	323	(66)
Total revenues	<u>111,952</u>	<u>113,331</u>
Expenses:		
Net losses and loss adjustment expenses	28,581	29,588
Net commissions, brokerage and other underwriting expenses	52,788	54,278
Interest expense	281	418
Total expenses	<u>81,650</u>	<u>84,284</u>
Income before income taxes	30,302	29,047
Income tax expense	9,497	8,183
Net income	<u>\$ 20,805</u>	<u>\$ 20,864</u>
Earnings per common share	<u>\$ 0.47</u>	<u>\$ 0.47</u>
Earnings per common share, assuming dilution	<u>\$ 0.47</u>	<u>\$ 0.47</u>
Weighted average shares outstanding	<u>44,280</u>	<u>44,206</u>
Weighted average shares outstanding, assuming dilution	<u>44,421</u>	<u>44,376</u>

The accompanying notes are an integral part of these condensed consolidated financial statements.

CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(UNAUDITED)

	Common Stock Shares Outstanding	Common Stock	Additional Paid-in Capital	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock At Cost	Total Stockholders' Equity
	(Amounts in thousands)							
Balance, January 1, 2009	44,168	\$ 455	\$ 276,255		\$ 509,644	\$ (4,286)	\$ (14,773)	\$ 767,295
Comprehensive income:								
Net income	—	\$ —	\$ —	\$ 20,864	\$ 20,864	\$ —	\$ —	\$ 20,864
Other comprehensive income:								
Change in unrealized gains on securities, after income tax expense of \$4,455 (net of reclassification adjustment of \$0, after income tax benefit of \$0)	—	—	—	8,272	—	8,272	—	8,272
Net change related to postretirement benefits, after income tax benefit of \$12	—	—	—	(28)	—	(28)	—	(28)
Total comprehensive income	—	—	—	\$ 29,108	—	—	—	—
Stock-based compensation	—	—	578	—	—	—	—	578
Stock options exercised and other	72	1	886	—	—	—	41	928
Balance, March 31, 2009	44,240	\$ 456	\$ 277,719		\$ 530,508	\$ 3,958	\$ (14,732)	\$ 797,909
Balance, January 1, 2010	44,268	\$ 456	\$ 279,388		\$ 627,505	\$ 30,406	\$ (14,671)	\$ 923,084
Comprehensive income:								
Net income	—	\$ —	\$ —	\$ 20,805	\$ 20,805	\$ —	\$ —	\$ 20,805
Other comprehensive income:								
Change in unrealized gains on securities, after income tax expense of \$865 (net of reclassification adjustment of \$228, after income tax expense of \$123)	—	—	—	1,607	—	1,607	—	1,607
Other-than-temporary impairment losses not recognized in the Condensed Consolidated Statements of Income, after income tax expense of \$41 (net of reclassification adjustment of (\$353), after income tax benefit of \$190)	—	—	—	77	—	77	—	77
Net change related to postretirement benefits, after income tax benefit of \$9	—	—	—	(18)	—	(18)	—	(18)
Total comprehensive income	—	—	—	\$ 22,471	—	—	—	—
Stock-based compensation	—	—	441	—	—	—	—	441
Stock options exercised and other	30	1	297	—	—	—	65	363
Balance, March 31, 2010	44,298	\$ 457	\$ 280,126		\$ 648,310	\$ 32,072	\$ (14,606)	\$ 946,359

The accompanying notes are an integral part of these condensed consolidated financial statements.

CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three Months Ended	
	March 31,	
	2010	2009
	(Amounts in thousands)	
Cash Flows from Operating Activities:		
Net income	\$ 20,805	\$ 20,864
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts	95	(48)
Depreciation and amortization	1,476	1,524
Amortization of bond premium, net	1,492	1,126
Gain on disposal of property and equipment	(49)	(3)
Net realized investment (gains) losses	(323)	66
Stock-based compensation	441	578
Deferred income tax expense	661	38
Changes in:		
Insurance receivables	(10,291)	(8,273)
Reserve for unearned premiums	8,395	2,908
Reserve for unpaid losses and loss adjustment expenses	20,335	25,000
Deposit with affiliated ceding company	(26)	2,382
Deferred policy acquisition costs	(2,824)	(1,964)
Reinsurance and other payables to affiliates	128	(1,609)
Prepaid reinsurance premiums	13	(40)
Accrued expenses	(6,417)	(8,439)
Other assets and liabilities	(7,599)	(458)
Net cash provided by operating activities	<u>26,312</u>	<u>33,652</u>
Cash Flows from Investing Activities:		
Fixed income securities:		
Purchases	(63,950)	(68,727)
Maturities	14,834	21,787
Sales	8,422	—
Purchases of equity securities	(274)	(473)
Proceeds from the sale of equity securities	65	336
Changes in short-term investments	9,036	24,689
Purchases of property and equipment, net	(682)	(1,592)
Changes in payables for securities purchased	2,070	(8,398)
Net cash (used in) investing activities	<u>(30,479)</u>	<u>(32,378)</u>
Cash Flows from Financing Activities:		
Employee stock option exercises and other	363	928
Net cash provided by financing activities	<u>363</u>	<u>928</u>
(Decrease) increase in cash	(3,804)	2,202
Cash at beginning of period	5,822	9,596
Cash at end of period	<u>\$ 2,018</u>	<u>\$ 11,798</u>
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the period for:		
Interest	\$ 288	\$ 437
Income taxes	\$ 14,404	\$ 2,312

The accompanying notes are an integral part of these condensed consolidated financial statements.

CNA SURETY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS MARCH 31, 2010 (UNAUDITED)

1. Significant Accounting Policies

Formation of CNA Surety Corporation and Merger

In December 1996, CNA Financial Corporation (“CNAF”) and Capsure Holdings Corp. (“Capsure”) agreed to merge (the “Merger”) the surety business of CNAF with Capsure’s insurance subsidiaries, Western Surety Company (“Western Surety”), Surety Bonding Company of America (“Surety Bonding”) and Universal Surety of America (“Universal Surety”), into CNA Surety Corporation (“CNA Surety” or the “Company”). CNAF, through its operating subsidiaries, writes multiple lines of property and casualty insurance, including surety business that is reinsured by Western Surety. The principal operating subsidiaries of CNAF that wrote the surety line of business for their own account prior to the Merger were Continental Casualty Company and its property and casualty affiliates (collectively, “CCC”) and The Continental Insurance Company and its property and casualty affiliates (collectively, “CIC”). Through its insurance subsidiaries, CNAF owns approximately 62% of the outstanding common stock of CNA Surety. Loews Corporation owns approximately 90% of the outstanding common stock of CNAF.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of CNA Surety and all majority-owned subsidiaries.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles (“GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Presentation

These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company’s 2009 Form 10-K. Certain financial information that is included in annual financial statements prepared in accordance with GAAP is not required for interim reporting and has been condensed or omitted. The accompanying unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all adjustments necessary for a fair presentation of the interim financial statements. All such adjustments are of a normal and recurring nature. The financial results for interim periods may not be indicative of financial results for a full year.

Earnings Per Share

Basic earnings per common share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per common share is computed based on the weighted average number of shares outstanding plus the dilutive effect of common stock equivalents which is computed using the treasury stock method.

The computation of earnings per common share is as follows (amounts in thousands, except for per share data):

	Three Months Ended	
	March 31,	
	2010	2009
Net income	<u>\$ 20,805</u>	<u>\$ 20,864</u>
Shares:		
Weighted average shares outstanding	44,268	44,168
Weighted average shares of options exercised and additional stock issuance	<u>12</u>	<u>38</u>
Total weighted average shares outstanding	44,280	44,206
Effect of dilutive options	<u>141</u>	<u>170</u>
Total weighted average shares outstanding, assuming dilution	<u>44,421</u>	<u>44,376</u>
Earnings per share	<u>\$ 0.47</u>	<u>\$ 0.47</u>
Earnings per share, assuming dilution	<u>\$ 0.47</u>	<u>\$ 0.47</u>

No adjustments were made to reported net income in the computation of earnings per share. Options to purchase shares of common stock of 0.7 million and 0.8 million were excluded from the calculation of diluted earnings per share for the three months ended March 31, 2010 and 2009, respectively, because the exercise price of these options was greater than the average market price of CNA Surety's common stock.

Adopted Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2009-16, "Transfers and Servicing (Topic 860) – Accounting for Transfers of Financial Assets". This guidance removed the concept of a qualifying special-purpose entity and eliminated it from exceptions under the guidance for consolidation of variable interest entities. It also modified the de-recognition conditions related to legal isolation and effective control and added additional disclosure requirements for transfers of financial assets. This guidance was effective for annual reporting periods beginning after November 15, 2009. The adoption of this guidance did not have an impact on the Company's financial condition or results of operations.

In June 2009, the FASB issued ASU No. 2009-17, "Consolidations (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities". This guidance amended existing consolidation guidance applicable for variable interest entities as well as requirements for determination of the primary beneficiary of a variable interest entity, required an ongoing assessment of whether an entity is the primary beneficiary and required enhanced disclosures that will provide users of financial statements information regarding an enterprise's involvement in a variable interest entity. This guidance was effective for annual reporting periods beginning after November 15, 2009. The Company evaluated its trust preferred security arrangement discussed further in Note 6., Debt, to these Condensed Consolidated Financial Statements and determined the issuer trust should remain unconsolidated under this guidance. As such, the adoption of this guidance did not have an impact on the Company's financial condition or results of operations.

In April 2009, the FASB issued updated accounting guidance, which amended the other-than-temporary impairment ("OTTI") loss model for fixed income securities. A fixed income security is impaired if the fair value of the security is less than its amortized cost basis, which is its cost adjusted for accretion, amortization and previously recorded OTTI losses. The updated accounting guidance requires an OTTI loss equal to the difference between fair value and amortized cost to be recognized in earnings if the Company intends to sell the fixed income security or if it is more likely than not the Company will be required to sell the fixed income security before recovery of its amortized cost basis.

The remaining fixed income securities in an unrealized loss position are evaluated to determine if a credit loss exists. If the Company does not expect to recover the entire amortized cost basis of a fixed income security, the security is deemed to be other-than-temporarily impaired for credit reasons. For these securities, the bifurcation of OTTI losses into a credit component and a non-credit component is required by the updated accounting guidance. The credit component is recognized in earnings and represents the difference between the present value of the future cash flows that the Company expects to collect and a fixed income security's amortized cost basis. The non-credit component is recognized in other comprehensive income and represents the difference between fair value and the present value of the future cash flows that the Company expects to collect.

Prior to the adoption of the updated accounting guidance, OTTI losses were not bifurcated between credit and non-credit components. The difference between fair value and amortized cost was recognized in earnings for all securities for which the Company did not expect to recover the amortized cost basis, or for which the Company did not have the ability and intent to hold until recovery of fair value to amortized cost.

2. Investments

Major categories of net investment income were as follows (dollars in thousands):

	Three Months Ended March 31,	
	2010	2009
Investment income:		
Fixed income securities	\$ 13,666	\$ 12,303
Equity securities	8	9
Short-term investments	15	48
Other	<u>13</u>	<u>19</u>
Total investment income on available-for-sale securities	13,702	12,379
Investment income on deposit with affiliated ceding company	26	157
Investment expenses	<u>351</u>	<u>290</u>
Net investment income	<u>13,377</u>	<u>12,246</u>

Net realized investment gains and losses and the net change in unrealized gains and losses of available-for-sale securities were as follows (dollars in thousands):

	Three Months Ended March 31,	
	2010	2009
Net realized investment gains (losses):		
Fixed income securities:		
Gross realized investment gains	\$ 425	\$ —
Gross realized investment losses:		
Other-than-temporary impairment losses	(94)	—
Realized losses from sales	<u>(19)</u>	<u>—</u>
Total gross realized investment losses	(113)	—
Net realized investment gains on fixed income securities	<u>312</u>	<u>—</u>
Equity securities:		
Gross realized investment gains	11	—
Gross realized investment losses:		
Other-than-temporary impairment losses	—	(46)
Realized losses from sales	<u>—</u>	<u>(20)</u>
Total gross realized investment losses	—	(66)
Net realized investment gains (losses) on equity securities	<u>11</u>	<u>(66)</u>
Other	<u>—</u>	<u>—</u>
Net realized investment gains (losses)	<u>323</u>	<u>(66)</u>
Net change in unrealized gains (losses)		
Fixed income securities	\$ 2,569	\$ (12,727)
Equity securities	<u>21</u>	<u>—</u>
Total net change in unrealized gains (losses)	<u>\$ 2,590</u>	<u>\$ (12,727)</u>
Net realized gains (losses) and change in unrealized gains (losses)	<u>\$ 2,913</u>	<u>\$ (12,793)</u>

The amortized cost, gross unrealized gains, gross unrealized losses, estimated fair value and OTTI of fixed income securities and the cost, gross unrealized gains, gross unrealized losses and estimated fair value of equity securities held by CNA Surety at March 31, 2010, by investment category, were as follows (dollars in thousands):

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses		Estimated Fair Value	Unrealized OTTI Losses(a)
			Less Than 12 Months	More Than 12 Months		
March 31, 2010						
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. Government and agencies:						
U.S. Treasury	\$ 18,085	\$ 977	\$ —	\$ —	\$ 19,062	\$ —
U.S. Agencies	6,528	315	—	—	6,843	—
Collateralized mortgage obligations — residential	29,832	1,715	—	—	31,547	—
Mortgage pass-through securities — residential	87,012	2,638	(45)	—	89,605	—
Obligations of states and political subdivisions	699,069	33,738	(866)	(2,505)	729,436	—
Corporate bonds	382,765	13,572	(714)	(150)	395,473	—
Collateralized mortgage obligations — commercial	10,022	163	—	—	10,185	—
Other asset-backed securities:						
Second mortgages/home equity loans — residential	4,989	—	—	(553)	4,436	(1,207)
Consumer credit receivables	10,767	482	—	—	11,249	—
Other	9,706	755	—	—	10,461	—
Total fixed income securities	1,258,775	54,355	(1,625)	(3,208)	1,308,297	\$ (1,207)
Equity securities	1,650	202	—	—	1,852	—
Total	<u>\$ 1,260,425</u>	<u>\$ 54,557</u>	<u>\$ (1,625)</u>	<u>\$ (3,208)</u>	<u>\$ 1,310,149</u>	

(a) The unrealized loss position of this security was \$0.4 million at March 31, 2010.

The amortized cost, gross unrealized gains, gross unrealized losses, estimated fair value and OTTI of fixed income securities and the cost, gross unrealized gains, gross unrealized losses and estimated fair value of equity securities held by CNA Surety at December 31, 2009, by investment category, were as follows (dollars in thousands):

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses		Estimated Fair Value	Unrealized OTTI Losses(a)
			Less Than 12 Months	More Than 12 Months		
December 31, 2009						
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. Government and agencies:						
U.S. Treasury	\$ 17,378	\$ 970	\$ —	\$ —	\$ 18,348	\$ —
U.S. Agencies	9,794	337	—	—	10,131	—
Collateralized mortgage obligations — residential	30,709	1,383	—	—	32,092	—
Mortgage pass-through securities — residential	94,453	2,336	(232)	—	96,557	—
Obligations of states and political subdivisions	696,505	35,847	(882)	(2,902)	728,568	—
Corporate bonds	334,136	11,478	(1,248)	(257)	344,109	—
Collateralized mortgage obligations — commercial	10,024	—	—	(351)	9,673	—
Other asset-backed securities:						
Second mortgages/home equity loans — residential	5,501	—	—	(740)	4,761	(1,399)
Consumer credit receivables	11,055	528	—	—	11,583	—
Other	9,715	686	—	—	10,401	—
Total fixed income securities	1,219,270	53,565	(2,362)	(4,250)	1,266,223	\$ (1,399)
Equity securities	1,429	181	—	—	1,610	—
Total	<u>\$ 1,220,699</u>	<u>\$ 53,746</u>	<u>\$ (2,362)</u>	<u>\$ (4,250)</u>	<u>\$ 1,267,833</u>	

(a) The unrealized loss position of this security was \$0.5 million at December 31, 2009.

A security is in an unrealized loss position, or impaired, if the fair value of the security is less than its amortized cost or cost, which includes adjustments for accretion, amortization and previously recorded other-than-temporary impairment losses. When a security is impaired, the impairment is evaluated to determine whether it is temporary or other-than-temporary.

A significant judgment in the valuation of investments is the determination of when an other-than-temporary decline in value has occurred. The Company follows a consistent and systematic process for identifying securities that sustain other-than-temporary declines in value. The Company has established a watch list that is reviewed by the Chief Financial Officer and one other executive officer on at least a quarterly basis. The watch list includes individual securities that fall below certain thresholds or that exhibit evidence of impairment indicators including, but not limited to, a significant adverse change in the financial condition and near-term prospects of the investment or a significant adverse change in legal factors, the business climate or credit ratings.

When a security is placed on the watch list, it is monitored for further market value changes and additional news related to the issuer's financial condition. The focus is on objective evidence that may influence the evaluation of impairment factors. The decision to record an other-than-temporary impairment loss incorporates both quantitative criteria and qualitative information.

In determining whether an equity security is other-than-temporarily impaired, the Company considers a number of factors including, but not limited to: (a) the length of time and the extent to which the market value has been less than book value, (b) the financial condition and near-term prospects of the issuer, (c) the intent and ability of the Company to retain its investment for a period of time sufficient to allow for any anticipated recovery in value and (d) general market conditions and industry or sector specific factors. Currently, the Company's equity portfolio is comprised solely of mutual funds related to the Company's deferred compensation plan, which is an unfunded, nonqualified deferred compensation plan for a select group of management or highly compensated employees. Due to the nature of the plan, the Company does not assert the ability to hold these securities until their recovery in value. As such, if any of these securities are in an unrealized loss position, they are considered to be other-than-temporarily impaired.

For equity securities for which an other-than-temporary impairment loss has been identified, the security is written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

Fixed income securities in an unrealized loss position that the Company intends to sell, or it more likely than not will be required to sell before recovery of amortized cost, are considered to be other-than-temporarily impaired. These securities are written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

The remaining fixed income securities in an unrealized loss position are evaluated to determine if a credit loss exists. To determine if a credit loss exists, the Company considers a number of factors including, but not limited to: (a) the financial condition and near-term prospects of the issuer, (b) credit ratings of the securities, (c) whether the debtor is current on interest and principal payments, (d) the length of time and the extent to which the market value has been less than book value and (e) general market conditions and industry or sector specific factors.

In addition to these factors, the Company considers the results of discounted cash flow modeling using assumptions representative of current market conditions as well as those specific to the Company's particular security holdings. For asset-backed and mortgage-backed securities, the focus of this analysis is on assessing the sufficiency and quality of underlying collateral and timing of cash flows. Significant assumptions considered by the Company in its cash flow projections include delinquency rates, probable risk of default, over collateralization and credit support from lower level tranches. If the discounted expected cash flows for a security equal or exceed the amortized cost of that security, no credit loss exists and the security is deemed to be temporarily impaired.

Fixed income securities in an unrealized loss position for which management believes a credit loss exists are considered to be other-than-temporarily impaired. For these fixed income securities, the Company bifurcates OTTI losses into a credit component and a non-credit component. The credit component, which represents the difference between the discounted expected cash flows and the fixed income security's amortized cost, is recognized in earnings. The non-credit component is recognized in other comprehensive income and represents the difference between fair value and the discounted cash flows that the Company expects to collect.

Based on the Company's evaluation of this quantitative criteria and qualitative information during the first quarter of 2010, the Company recorded additional credit-related OTTI losses of \$0.1 million in earnings. The Company initially recorded credit-related OTTI losses on this security in the second quarter of 2009. This security is rated below investment grade by Standard & Poor's ("S&P") and collateralized by sub-prime home loans.

The following table presents a roll-forward of the Company's cumulative credit losses recognized in net realized gains (losses) on the Condensed Consolidated Statements of Income on fixed income securities held as of March 31, 2010 (in thousands of dollars):

Beginning balance at January 1, 2010	\$ 116
Credit losses for which an OTTI loss was not previously recognized	—
Credit losses for which an OTTI loss was previously recognized	<u>94</u>
Ending balance at March 31, 2010	<u>\$ 210</u>

For the three months ended March 31, 2010, the Company has recorded no OTTI losses on equity securities. For the three months ended March 31, 2009, the Company recorded OTTI losses of less than \$0.1 million on the equity securities that are related to the Company's nonqualified deferred compensation plan.

The amortized cost and estimated fair value of fixed income securities, by contractual maturity, at March 31, 2010 and December 31, 2009 are shown below. Actual maturities may differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (dollars in thousands):

	March 31, 2010		December 31, 2009	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Fixed income securities:				
Due within one year	\$ 33,239	\$ 34,664	\$ 13,006	\$ 13,224
Due after one year but within five years	337,092	352,962	304,654	321,144
Due after five years but within ten years	450,617	473,081	447,485	468,254
Due after ten years	285,499	290,107	292,668	298,534
	<u>1,106,447</u>	<u>1,150,814</u>	<u>1,057,813</u>	<u>1,101,156</u>
Mortgage pass-through securities, collateralized mortgage obligations and asset-backed securities	152,328	157,483	161,457	165,067
	<u>\$ 1,258,775</u>	<u>\$ 1,308,297</u>	<u>\$ 1,219,270</u>	<u>\$ 1,266,223</u>

The following table provides the composition of fixed income securities with an unrealized loss at March 31, 2010 in relation to the total of all fixed income securities in an unrealized loss position by contractual maturities:

Contractual Maturity	% of Estimated Fair Value	% of Unrealized Loss
Due after one year through five years	20%	6%
Due after five years through ten years	33	19
Due after ten years	39	63
Asset-backed securities	8	12
Total	<u>100%</u>	<u>100%</u>

The following table summarizes for fixed income securities in an unrealized loss position at March 31, 2010 and December 31, 2009, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position (dollars in thousands):

Unrealized Loss Aging	March 31, 2010		December 31, 2009	
	Estimated Fair Value	Gross Unrealized Loss	Estimated Fair Value	Gross Unrealized Loss
Fixed income securities:				
Investment grade (a):				
0-6 months	\$ 143,354	\$ 1,625	\$ 162,087	\$ 2,362
7-12 months	—	—	—	—
13-24 months	—	—	11,176	469
Greater than 24 months	34,695	1,656	32,932	2,065
Total investment grade	<u>178,049</u>	<u>3,281</u>	<u>206,195</u>	<u>4,896</u>
Non-investment grade:				
Greater than 24 months	17,205	1,552	17,346	1,716
Total	<u>\$ 195,254</u>	<u>\$ 4,833</u>	<u>\$ 223,541</u>	<u>\$ 6,612</u>

(a) Investment grade is determined by using the S&P rating. If a security is not rated by S&P, the Moody's Investor Services ("Moody's") rating is used. As of March 31, 2010 and December 31, 2009, all of the Company's fixed income securities were rated by S&P or Moody's.

At March 31, 2010, the Company holds 271 fixed income securities in an unrealized gain position with a total estimated fair value of \$1,113.0 million and an aggregate gross unrealized gain of \$54.4 million.

The following table summarizes securities in a gross unrealized loss position by investment category and by credit rating. The table also discloses the corresponding count of securities in an unrealized loss position and estimated fair value by category (in thousands of dollars):

March 31, 2010	Gross Unrealized Losses				Total	Count	Estimated Fair Value
	AAA	AA	A	BBB			
Fixed income securities:							
Investment grade(a):							
U.S. Treasury securities and obligations of U. S. Government and agencies:							
Mortgage pass-through securities — residential	\$ 45	\$ —	\$ —	\$ —	\$ 45	1	\$ 10,529
Obligations of states and political subdivisions	457	997	791	—	2,245	16	82,271
Corporate bonds	10	181	394	279	864	19	82,955
Other asset-backed securities:							
Second mortgages/home equity loans — residential	127	—	—	—	127	1	2,294
Total investment grade	639	1,178	1,185	279	3,281	37	178,049
Non-investment grade:							
Obligations of states and political subdivisions	—	—	—	—	1,126	2	15,063
Other asset-backed securities:							
Second mortgages/home equity loans — residential	—	—	—	—	426	1	2,142
Total non-investment grade	—	—	—	—	1,552	3	17,205
Total	\$ 639	\$ 1,178	\$ 1,185	\$ 279	\$ 4,833	40	\$ 195,254

(a) Securities are categorized using the S&P rating. If a security is not rated by S&P, the Moody's rating is used. At March 31, 2010, all of the Company's fixed income securities were rated by S&P or Moody's.

As of March 31, 2010, the Company's fixed income securities included one U.S. Government agency collateralized mortgage obligation backed by residential mortgages in a nominal unrealized loss position. The Company has no current intent to sell this security, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. The Company does not believe this unrealized loss is indicative of a credit loss and, as such, has not recorded an OTTI loss on this security at March 31, 2010.

The unrealized losses on the Company's investments in obligations of states and political subdivisions are due to changes in credit spreads and rising interest rates. Of the sixteen investment grade obligations of states and political subdivisions that were in an unrealized loss position at March 31, 2010, only one was in an unrealized loss position exceeding 5% of the security's amortized cost. This security, issued by a governmental utility authority, had an unrealized loss of \$0.6 million, which was 10.6% of the security's amortized cost. Although the unrealized loss on this security remained flat compared to December 31, 2009, improving market conditions resulted in an improvement of \$0.3 million in the unrealized losses on the Company's other investment grade obligations of states and political subdivisions at March 31, 2010. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. The Company does not believe the unrealized losses on these securities are indicative of credit losses and, as such, has not recorded an OTTI loss on these securities at March 31, 2010.

The Company's investments in two other obligations of states and political subdivisions, issued by governmental utility authorities, are below investment grade. At March 31, 2010, one of these securities had an unrealized loss of \$0.2 million, or 4.7% of its amortized cost, and the other had an unrealized loss of \$0.9 million, or 8.1% of its amortized cost. The unrealized loss position of each of these securities improved slightly at March 31, 2010 compared to December 31, 2009. Based on the underlying fundamentals of these securities, the Company continues to believe that all interest and principal will be paid according to their contractual terms. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. As such, the Company has not recorded an OTTI loss on these securities at March 31, 2010.

Only one of the nineteen corporate bond investments in an unrealized loss position at March 31, 2010 had an unrealized loss of 5% or more. This security, which was issued by a large student loan provider, had an unrealized loss of \$0.2 million, or 5.0% of its amortized cost. The unrealized loss position of this security was 8.5% (\$0.3 million) of amortized cost at December 31, 2009. Further, the overall unrealized loss position on the Company's corporate bond holdings improved \$0.6 million compared to December 31, 2009. The unrealized losses on the Company's corporate bond investments are primarily attributable to increases in interest rates beginning in the fourth quarter of 2009. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. The Company does not believe the unrealized losses on these securities are indicative of credit losses and, as such, has not recorded any OTTI losses on these securities at March 31, 2010.

At March 31, 2010 the Company's exposure to sub-prime home loans is limited to two asset-backed securities collateralized by sub-prime home loans originated prior to 2005. Both of these securities are in an unrealized loss position. One of these securities, which is rated investment grade, has an estimated fair value of \$2.3 million and is in an unrealized loss position of \$0.1 million, or 5.3% of its amortized cost, at March 31, 2010. The Company believes the unrealized loss on this security is primarily attributable to

broader economic conditions and liquidity concerns and is not indicative of the quality of the underlying collateral. The Company has no current intent to sell this security, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost.

The other security with sub-prime exposure is rated below investment grade. During 2010, the Company received repayments on this security of \$0.2 million, or approximately 6% of the par value outstanding at December 31, 2009. As discussed previously, this security was determined to have an additional credit loss of \$0.1 million during the three months ended March 31, 2010. The non-credit component of this security's OTTI recognized in accumulated other comprehensive income at March 31, 2010 was \$0.4 million. The Company believes the unrealized loss on this security is primarily attributable to broader economic conditions and liquidity concerns and is not indicative of the quality of the underlying collateral. The unrealized loss on this security at December 31, 2009 was \$0.5 million. The Company also recognized a credit-related loss of \$0.1 million on this security in the second quarter of 2009. The Company has no current intent to sell this security, nor is it more likely than not that it will be required to sell prior to recovery of the adjusted amortized cost.

Based on the current facts and circumstances discussed above for the Company's securities in an unrealized loss position, the Company has determined that no additional OTTI losses related to the securities in an unrealized loss position are required to be recorded at March 31, 2010.

Invested assets are exposed to various risks, such as interest rate, market and credit risks. Due to the level of risk associated with certain of these invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may significantly affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

3. Reinsurance

The effect of reinsurance on the Company's written and earned premium was as follows (dollars in thousands):

	Three Months Ended March 31,			
	2010		2009	
	Written	Earned	Written	Earned
Direct	\$ 91,963	\$ 81,879	\$ 89,128	\$ 83,341
Assumed	20,564	22,253	21,997	24,876
Ceded	<u>(5,867)</u>	<u>(5,880)</u>	<u>(7,106)</u>	<u>(7,066)</u>
Net premiums	<u>\$ 106,660</u>	<u>\$ 98,252</u>	<u>\$ 104,019</u>	<u>\$ 101,151</u>

Assumed premiums primarily include surety business written or renewed, net of reinsurance, by CCC and CIC after September 30, 1997 that is reinsured by Western Surety pursuant to reinsurance and related agreements. Because of certain regulatory restrictions that limit Western Surety's ability to write certain business on a direct basis, the Company utilizes the underwriting capacity available through these agreements while retaining control of the underwriting and claim management of this assumed business.

Assumed premium also includes surety business written by another affiliate, First Insurance Company of Hawaii, Ltd. and its subsidiaries First Indemnity Insurance of Hawaii, Inc., First Fire and Casualty Insurance of Hawaii, Inc. and First Security Insurance of Hawaii, Inc. (collectively, "FICOH"). Through its insurance subsidiaries, CNAF owns approximately 50% of the outstanding common stock of First Insurance Company of Hawaii, Ltd. Under the terms of this excess of loss agreement that covers certain contract surety business, FICOH retains losses of \$2 million per principal and Western Surety assumes 80% of \$5 million per principal in excess of \$2 million subject to an aggregate annual limit of \$8 million. Premiums assumed by Western Surety under this agreement were less than \$0.1 million for both the three months ended March 31, 2010 and 2009.

CNA Surety also assumes premium on contract and commercial surety bonds for international risks. Such premiums are assumed pursuant to the terms of reinsurance treaties or as a result of specific international bond requirements of domestic customers. For the three month periods ended March 31, 2010 and 2009, premiums assumed under such arrangements were \$1.3 million and \$0.5 million, respectively.

The effect of reinsurance on the Company's provision for loss and loss adjustment expenses and the corresponding ratio to earned premium was as follows (dollars in thousands):

	Three Months Ended March 31,			
	2010		2009	
	\$	Ratio	\$	Ratio
Gross losses and loss adjustment expenses	\$ 27,815	26.7%	\$ 31,308	28.9%
Ceded amounts	766	(13.0)%	(1,720)	24.3%
Net losses and loss adjustment expenses	<u>\$ 28,581</u>	29.1%	<u>\$ 29,588</u>	29.3%

The unusual impact of ceded amounts as an increase in net loss and loss adjustment expenses for the three months ended March 31, 2010 resulted from large indemnification recoveries on claims subject to excess of loss reinsurance contracts.

Excess of Loss Reinsurance

The Company's ceded reinsurance program is predominantly comprised of excess of loss reinsurance contracts that limit the Company's retention on a per principal basis. The Company's reinsurance coverage is provided by third party reinsurers and related parties. Due to the terms of these excess of loss treaties, reinsurers may cover some principals in one year but then exclude these same principals in subsequent years. As a result, the Company may have exposures to these principals that have limited or no reinsurance coverage. Only the large national contractor discussed below was excluded from the third party reinsurance agreements effective for the treaty periods discussed; however, as discussed below, the Company has no further exposure to this principal.

2009 Third Party Reinsurance

Effective January 1, 2009, CNA Surety entered into an excess of loss treaty ("2009 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the excess of loss treaty effective in 2008. Under the 2009 Excess of Loss Treaty, the Company's net retention per principal was \$15 million with a 5% co-participation in the \$90 million layer of third party reinsurance coverage above the Company's retention. The contract provided aggregate coverage of \$185 million and included an optional extended discovery period, which was not exercised. The contract also included a provision for additional premiums of up to \$13.8 million based on losses ceded under the contract. The actual ceded premiums for the 2009 Excess of Loss Treaty were \$26.6 million.

2010 Third Party Reinsurance

Effective January 1, 2010, CNA Surety entered into an excess of loss treaty ("2010 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the 2009 Excess of Loss Treaty. Under the 2010 Excess of Loss Treaty, the Company's net retention per principal remains at \$15 million with a 5% co-participation in the \$90 million layer of third party reinsurance coverage above the Company's retention. The contract provides aggregate coverage of \$185 million and includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2010 on bonds that were in force during 2010. The contract also includes a provision for additional premiums of up to \$12.3 million based on losses ceded under the contract. The base annual premium for the 2010 Excess of Loss Treaty is \$24.6 million.

Related Party Reinsurance

Reinsurance agreements together with the Services and Indemnity Agreement described below provide for the transfer of the surety business written by CCC and CIC to Western Surety. Many of these agreements originally were entered into on September 30, 1997 (the "Merger Date") and include: (i) the Surety Quota Share Treaty (the "Quota Share Treaty"); (ii) the Aggregate Stop Loss Reinsurance Contract (the "Stop Loss Contract") and (iii) the Surety Excess of Loss Reinsurance Contract. Although the contracts entered on the Merger Date have expired, some have been renewed on different terms as described below.

Through the Quota Share Treaty, CCC and CIC transfer to Western Surety surety business written or renewed by CCC and CIC after the Merger Date. The Quota Share Treaty was renewed on January 1, 2010 and expires on December 31, 2010 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC's and CIC's net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to \$50,000 plus 25% of net written premiums written on all such business. For 2009 this resulted in an override commission on their actual direct acquisition costs of 4.8% to CCC and CIC.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of the Merger Date by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from the Merger Date through March 31, 2010.

Through the Stop Loss Contract, the Company's insurance subsidiaries were protected from adverse loss development on certain business underwritten after the Merger Date. The Stop Loss Contract between the Company's insurance subsidiaries and CCC limited the insurance subsidiaries' prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries' accident year net loss ratio exceeds 24% in any of the accident years 1997 through 2000 on certain insured accounts (the "Loss Ratio Cap"), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which the Company's actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. In consideration for the coverage provided by the Stop Loss Contract, the Company's insurance subsidiaries paid CCC an annual premium of \$20,000. The CNA Surety insurance subsidiaries have paid CCC all required annual premiums. Through March 31, 2010 and December 31, 2009, losses incurred under the Stop Loss Contract were \$47.2 million and \$49.1 million, respectively. The decrease is a result of favorable development on claims subject to the Stop Loss Contract during the first quarter of 2010. As a result of this favorable development, the Company paid CCC \$1.9 million under the Stop Loss Contract. At March 31, 2010, the amount received under the Stop Loss Contract included \$2.8 million held by the Company for losses covered under this contract that were incurred but not paid.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the surety business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of \$50,000. In 2009, this agreement was amended so that the Company's authority to conduct administrative, management, underwriting and claim functions for bonds written for the large national contractor discussed below shall continue until CCC's bonds for such contractor have expired and claims have been settled or closed. This agreement was renewed on January 1, 2010 and expires on December 31, 2010 and is annually renewable thereafter. As of March 31, 2010 there were no amounts due to the CNA Surety insurance subsidiaries under this agreement.

From January 1, 2005 to June 30, 2009, the Company and CCC were parties to an excess of loss contract, and extensions to that contract, that provided unlimited reinsurance coverage in excess of \$60 million retention for the life of bonds either in force or written during the contract periods exclusively for the one large national contractor excluded from the Company's third party reinsurance. Premiums for these contracts totaled \$8.6 million and included an initial premium of \$7.0 million and premiums of \$1.6 million based on the level of premiums written on bonds for the large national contractor.

In 2009, the Company and CCC terminated the excess of loss contract discussed in the preceding paragraph. Related to the termination of this contract, the Company and CCC also commuted the Quota Share Treaty as regards the premium and losses for the large national contractor. The impact of this commutation was a decrease of gross loss reserves of \$51.8 million. Under the terms of the agreements effecting this commutation, the Company paid CCC \$1.8 million. This settlement reflected the difference between the Company's \$60.0 million retention under the excess of loss contract and the \$58.2 million paid by the Company for losses of the large national contractor through 2009.

On January 1, 2010, the Company and CCC entered into separate agreements that provide for the transfer of the Canadian surety business of CCC to Western Surety. These agreements, which include a quota share treaty (the "Canadian Quota Share Treaty") and a services and indemnity agreement (the "Canadian Services and Indemnity Agreement"), are substantially similar to the Quota Share Treaty and the Services and Indemnity Agreement discussed above. The Canadian Services and Indemnity Agreement provides Western Surety with the authority to supervise various administrative, underwriting and claim functions associated with the surety business written by CCC, through its Canadian branch, on behalf of the Company. Through the Canadian Quota Share Treaty, this Canadian surety business is transferred to Western Surety. Pursuant to these agreements, CCC will transfer the subject premium and related liabilities of such business and pay to Western Surety an amount equal to CCC's net written premiums on all such business, minus a ceding commission of 33.5% of net written premiums. Further, Western Surety will pay an additional ceding commission to CCC in the amount of actual direct expense in producing such premium. These agreements expire on December 31, 2010 and are annually renewable thereafter.

As of March 31, 2010 and December 31, 2009, CNA Surety had an insurance receivable balance from CCC and CIC of \$9.2 million and \$9.8 million, respectively, comprised of premiums receivable.

The Company's Condensed Consolidated Balance Sheets also include a "Deposit with affiliated ceding company" of \$26.9 million at both March 31, 2010 and December 31, 2009. In 2005, pursuant to an agreement with the claimant on a bond regarding certain aspects of the claim resolution, the Company deposited \$32.7 million with an affiliate to enable the affiliate to establish a trust to fund future payments under the bond. The bond was written by the affiliate and assumed by one of the Company's insurance subsidiaries pursuant to the Quota Share Treaty. The Company is entitled to the interest income earned by the trust. Prior to the establishment of the trust, the Company had fully reserved its obligation under the bond and the claim remains fully reserved.

4. Fair Value of Financial Instruments

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Company uses the following fair value hierarchy in selecting inputs, with the highest priority given to Level 1, as these are the most transparent or reliable:

- Level 1 — Quoted prices for identical instruments in active markets.
- Level 2 — Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs are observable in active markets.
- Level 3 — Valuations derived from valuation techniques in which one or more significant inputs are unobservable.

The Company utilizes a pricing service for the valuation of the majority of securities held. This pricing service is an independent, third party vendor recognized to be an industry leader with access to market information who obtains or computes fair market values from quoted market prices, pricing for similar securities, recently executed transactions, cash flow models with yield curves and other pricing models. For valuations obtained from the pricing service, the Company performs due diligence to understand how the valuation was calculated or derived, focusing on the valuation technique used and the nature of the inputs.

The following section describes the valuation methodologies used to measure different financial instruments at fair value, including an indication of the level in the fair value hierarchy in which the instrument is generally classified.

Fixed Income Securities

Securities valued using Level 1 inputs include highly liquid government bonds for which quoted market prices are available. Securities using Level 2 inputs are valued using pricing for similar securities, recently executed transactions, cash flow models with yield curves and other pricing models utilizing observable inputs. Most fixed income securities are valued using Level 2 inputs. Level 2 includes corporate bonds, municipal bonds, asset-backed securities and mortgage pass-through securities.

Equity Securities

Level 1 includes publicly traded securities valued using quoted market prices.

Short-Term Investments

The valuation of securities that are actively traded or have quoted prices are classified as Level 1. These securities include money market funds and U.S. Treasury bills. Level 2 includes securities for which all significant inputs are observable, such as commercial paper and discount notes.

Assets measured at fair value on a recurring basis as of March 31, 2010 and December 31, 2009 are summarized below (amounts in thousands):

	March 31, 2010			Assets at Fair Value
	Fair Value Measurement Using			
	Level 1	Level 2	Level 3	
Assets:				
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. Government and agencies:				
U.S. Treasury	\$ 19,062	\$ —	\$ —	\$ 19,062
U.S. Agencies	—	6,843	—	6,843
Collateralized mortgage obligations — residential	—	31,547	—	31,547
Mortgage pass-through securities — residential	—	89,605	—	89,605
Obligations of states and political subdivisions	—	729,436	—	729,436
Corporate bonds	—	395,473	—	395,473
Collateralized mortgage obligations — commercial	—	10,185	—	10,185
Other asset-backed securities:				
Second mortgages/home equity loans — residential	—	4,436	—	4,436
Consumer credit receivables	—	11,249	—	11,249
Other	—	10,461	—	10,461
Total fixed income securities	19,062	1,289,235	—	1,308,297
Equity securities at fair value	1,852	—	—	1,852
Short-term investments at fair value (a)	34,900	5,070	—	39,970
Total assets	<u>\$ 55,814</u>	<u>\$ 1,294,305</u>	<u>\$ —</u>	<u>\$ 1,350,119</u>

(a) Includes commercial paper, U.S. Government agency discount notes and money market funds.

	December 31, 2009			Assets at Fair Value
	Fair Value Measurement Using			
	Level 1	Level 2	Level 3	
Assets:				
Fixed income securities:				
U.S. Treasury securities and obligations of U.S. Government and agencies:				
U.S. Treasury	\$ 18,348	\$ —	\$ —	\$ 18,348
U.S. Agencies	—	10,131	—	10,131
Collateralized mortgage obligations — residential	—	32,092	—	32,092
Mortgage pass -through securities — residential	—	96,557	—	96,557
Obligations of states and political subdivisions	—	728,568	—	728,568
Corporate bonds	—	344,109	—	344,109
Collateralized mortgage obligations — commercial	—	9,673	—	9,673
Other asset-backed securities:				
Second mortgages/home equity loans — residential	—	4,761	—	4,761
Consumer credit receivables	—	11,583	—	11,583
Other	—	10,401	—	10,401
Total fixed income securities	18,348	1,247,875	—	1,266,223
Equity securities at fair value	1,610	—	—	1,610
Short-term investments at fair value (a)	15,412	33,587	—	48,999
Total assets	<u>\$ 35,370</u>	<u>\$ 1,281,462</u>	<u>\$ —</u>	<u>\$ 1,316,832</u>

(a) Includes commercial paper, U.S. Government agency discount notes and money market funds.

The Company had no transfers between levels in the fair value hierarchy requiring additional disclosure.

5. Reserves for Losses and Loss Adjustment Expenses

Activity in the reserves for unpaid losses and loss adjustment expenses was as follows (dollars in thousands):

	Three Months Ended	
	March 31,	
	2010	2009
Reserves at beginning of period:		
Gross	\$ 406,123	\$ 428,724
Ceded reinsurance	50,968	83,691
Net reserves at beginning of period	355,155	345,033
Net incurred loss and loss adjustment expenses:		
Provision for insured events of current year	28,581	29,637
(Decrease) increase in provision for insured events of prior years	—	(49)
Total net incurred	28,581	29,588
Net payments attributable to:		
Current year events	690	781
Prior year events	8,092	11,775
Total net payments	8,782	12,556
Foreign currency transaction adjustments	74	—
Net reserves at end of period	375,028	362,065
Ceded reinsurance at end of period	51,430	91,659
Gross reserves at end of period	<u>\$ 426,458</u>	<u>\$ 453,724</u>

6. Debt

In May 2004, the Company, through a wholly-owned trust, privately issued \$30.0 million of preferred securities through two pooled transactions. These securities, issued by CNA Surety Capital Trust I (the "Issuer Trust"), bear interest at the London Interbank Offered Rate ("LIBOR") plus 337.5 basis points with a 30-year term. Beginning in May 2009, these securities may be redeemed, in whole or in part, at par value at any scheduled quarterly interest payment date. As of March 31, 2010, none of these preferred securities have been redeemed.

The Company's investment of \$0.9 million in the Issuer Trust is carried at cost in "Other assets" in the Company's Condensed Consolidated Balance Sheets. The sole asset of the Issuer Trust consists of a \$30.9 million junior subordinated debenture issued by the

Company to the Issuer Trust. Due to the underlying characteristics of this debt, the carrying value of the debenture approximates its estimated fair value.

The Company has also guaranteed the dividend payments and redemption of the preferred securities issued by the Issuer Trust. The maximum amount of undiscounted future payments the Company could make under the guarantee is approximately \$56.3 million, consisting of annual dividend payments of approximately \$1.1 million until maturity and the redemption value of the preferred securities of \$30.0 million. Because payment under the guarantee would only be required if the Company does not fulfill its obligations under the debentures held by the Issuer Trust, the Company has not recorded any additional liabilities related to this guarantee.

The junior subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April 2034. As of March 31, 2010 and 2009, the interest rate on the junior subordinated debenture was 3.625% and 4.613%, respectively.

7. Employee Benefits

Western Surety sponsors two postretirement benefit plans covering certain employees. One plan provides medical benefits and the other plan provides sick leave termination payments. The medical benefit plan provides coverage for employees, and their eligible dependents, hired by Western Surety before November 1, 1992 and who retire at age 55 or later with at least 15 years of service. Only employees hired by Western Surety prior to 1988 are eligible for the sick leave plan. Further, benefits for the sick leave plan are based on unused accrued sick leave as of December 31, 2003, the date the accruals were frozen. The postretirement medical benefit plan is contributory and the sick leave plan is non-contributory. Western Surety uses a December 31 measurement date for both of its postretirement benefit plans. There were no plan assets for either of the postretirement benefit plans.

The postretirement benefit plan that provides medical benefits has been determined to be actuarially equivalent to Medicare Part D on an estimated basis under the rules provided in final regulations issued in 2005. As such, the federal subsidy to plan sponsors under the Medicare Modernization Act (“MMA”) has been recognized in the accounting for that plan. Also, as further described in Note 9., Income Taxes, to these Condensed Consolidated Financial Statements, enactment of the Patient Protection and Affordable Care Act (the “Act”) and the Healthcare and Education Affordability Reconciliation Act (the “Reconciliation Measure”), which modifies certain provisions of the Act, repeal the current rule permitting deduction, for tax purposes, of the entire cost of providing prescription drug benefits even though a portion is offset by the federal subsidy. As of March 31, 2010, the impact of these provisions has been recognized in the accounting for this postretirement benefit plan.

The plans’ combined net periodic postretirement benefit cost included the following components (amounts in thousands):

	Three Months Ended	
	March 31,	
	2010	2009
Net periodic benefit cost:		
Service cost	\$ 61	\$ 53
Interest cost	158	134
Amortization of prior service cost	(28)	(40)
Net amortization of actuarial loss	1	—
Net periodic benefit cost	<u>\$ 192</u>	<u>\$ 147</u>

The Company expects to contribute \$0.2 million to the postretirement benefit plans to pay benefits in 2010. As of March 31, 2010, less than \$0.1 million of contributions have been made to the postretirement benefit plans.

8. Commitments and Contingencies

The Company is party to various lawsuits arising in the normal course of business. The Company believes the resolution of these lawsuits will not have a material adverse effect on its financial condition or its results of operations.

9. Income Taxes

As previously discussed, the enactment of the Act and the related Reconciliation Measure repealed the rule permitting deduction, for tax purposes, of the entire cost of providing prescription drug benefits even though a portion is offset by a federal subsidy. The Company's postretirement benefit plan that provides medical benefits includes such prescription drug coverage. Under the Act and the Reconciliation Measure, the subsidy remains tax-free through 2012. As of March 31, 2010, the impact of these provisions has been recognized in the accounting for this postretirement benefit plan. As a result, the Company recognized additional income tax expense of \$0.5 million for the quarter ended March 31, 2010.

The Company is subject to taxation in the United States and various state jurisdictions. In 2009, the Internal Revenue Service notified the Company that the examination of the Company's tax return for the year 2006 was completed and no changes were made to the Company's reported income taxes. However, the Company's tax year 2006, as well as tax years 2007 through 2009, remain open as to the applicable statute of limitations and are subject to examination by the Internal Revenue Service.

The Company has not recognized any liabilities for uncertain income taxes as of March 31, 2010 or December 31, 2009, respectively. Also, the Company does not anticipate any material change in the total amount of unrecognized tax benefits to occur within the next twelve months.

10. Stockholders Equity

The compensation expense recorded for the Company's stock-based compensation plans was \$0.4 million and \$0.6 million for the three months ended March 31, 2010 and 2009, respectively. The total income tax benefit recognized in the Condensed Consolidated Statements of Income for stock-based compensation arrangements was \$0.2 million for both the three months ended March 31, 2010 and 2009. The amount of cash received from the exercise of stock options was \$0.3 million and \$0.9 million for the three months ended March 31, 2010 and 2009, respectively.

Equity Compensation Plans

The Company reserved shares of its common stock for issuance to directors, officers, employees and certain advisors of the Company through incentive stock options, nonqualified stock options, restricted stock, bonus shares or stock appreciation rights to be granted under the CNA Surety 2006 Long-Term Equity Compensation Plan (the "2006 Plan"), approved by shareholders on April 25, 2006. The aggregate number of shares initially available for which options may be granted under the 2006 Plan was 3,000,000. Option exercises under the 2006 Plan are settled in newly issued common shares.

The 2006 Plan is administered by the compensation committee of the Board of Directors (the "Committee"), consisting of two or more directors of the Company. Subject to the provisions set forth in the 2006 Plan, all of the members of the Committee shall be independent members of the Board of Directors. The Committee determines the option exercise prices. Exercise prices may not be less than the fair market value of the Company's common stock on the date of grant for incentive stock options and may not be less than the par value of the Company's common stock for nonqualified stock options.

The 2006 Plan provides for the granting of incentive stock options as defined under Section 409A of the Internal Revenue Code of 1986, as amended. All nonqualified stock options and incentive stock options granted under the 2006 Plan expire ten years after the date of grant and vest ratably over the four-year period following the date of grant.

On February 5, 2010, 281,260 options were granted under the 2006 Plan. The fair market value (at grant date) per option granted was \$7.25 for these options. The fair value of these options was estimated at the grant date using a Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 2.32%; dividend yield of 0.0%; expected option life of 5.3 years and volatility of 55.5%, which was based on historical volatility. The Company estimated the expected option life of the 2010 grant based on its analysis of past exercise patterns for similar options. As of March 31, 2010, the number of shares available for granting of options under the 2006 Plan was 1,980,165.

On February 6, 2009, 217,960 options were granted under the 2006 Plan. The fair market value (at grant date) per option granted was \$8.95 for these options. The fair value of these options was estimated at the grant date using a Black-Scholes option pricing model with the following weighted average assumptions: risk free interest rate of 1.95%; dividend yield of 0.0%; expected option life of 5.3 years and volatility of 51.8%, which was based on historical volatility. The Company estimated the expected option life of the 2009 grant based on its analysis of past exercise patterns for similar options. As of March 31, 2009, the number of shares available for granting of options under the 2006 Plan was 2,234,795.

A summary of option activity for the three months ended March 31, 2010 and 2009 is presented below:

	Shares Subject To Option	Weighted Average Exercise Price Per Share
Outstanding options at January 1, 2009	1,221,118	\$ 14.93
Options granted	217,960	\$ 18.85
Options forfeited	(570)	\$ 16.35
Options expired	(1,090)	\$ 13.09
Options exercised	<u>(68,305)</u>	\$ 11.50
Outstanding options at March 31, 2009	<u>1,369,113</u>	\$ 15.72
Outstanding options at January 1, 2010	1,318,288	\$ 15.78
Options granted	281,260	\$ 14.32
Options forfeited	(6,685)	\$ 18.01
Options expired	(1,445)	\$ 19.76
Options exercised	<u>(23,775)</u>	\$ 12.23
Outstanding options at March 31, 2010	<u>1,567,643</u>	\$ 15.56

A summary of the status of the Company's non-vested options as of March 31, 2010 and 2009 and changes during the three months then ended is presented below:

	Shares Subject To Option	Weighted Average Grant Date Fair Value
Non-vested options at January 1, 2009	545,095	\$ 7.29
Options granted	217,960	\$ 8.95
Options vested	(136,849)	\$ 7.82
Options forfeited	<u>(570)</u>	\$ 6.32
Non-vested options at March 31, 2009	<u>625,636</u>	\$ 7.76
Non-vested options at January 1, 2010	539,396	\$ 8.10
Options granted	281,260	\$ 7.25
Options vested	(185,202)	\$ 8.14
Options forfeited	<u>(6,685)</u>	\$ 7.97
Non-vested options at March 31, 2010	<u>628,769</u>	\$ 7.71

A summary of the options vested or expected to vest and options exercisable as of March 31, 2010 is presented below:

	Options Vested or Expected to Vest		
	Weighted Average Number	Weighted Average Exercise Price	Aggregate Intrinsic Value
March 31, 2010	1,490,357	\$ 15.50	\$ 4,430,612
			6.9 years
			Options Exercisable
	Weighted Average Number	Weighted Average Exercise Price	Aggregate Intrinsic Value
March 31, 2010	938,874	\$ 14.88	\$ 3,427,235
			5.7 years

The total intrinsic value of options exercised was \$0.1 million and \$0.4 million for the three months ended March 31, 2010 and 2009, respectively. The tax benefits recognized by the Company for these exercises were less than \$0.1 million and \$0.1 million for the three months ended March 31, 2010 and 2009, respectively.

As of March 31, 2010, there was \$2.7 million of total unrecognized compensation cost related to non-vested stock-based compensation arrangements granted under the Company's equity compensation plans. That cost is expected to be recognized as follows: 2010 — \$1.3 million; 2011 — \$0.9 million; 2012 — \$0.4 million and 2013 — \$0.1 million.

CNA SURETY CORPORATION AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

The following is a discussion and analysis of CNA Surety Corporation and its subsidiaries' (collectively, "CNA Surety" or the "Company") operating results, liquidity and capital resources, and financial condition. This discussion should be read in conjunction with the Condensed Consolidated Financial Statements in Item 1 of Part 1 of this Quarterly Report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Critical Accounting Policies

The Company's accounting policies related to reserves and disclosures for unpaid losses and loss adjustment expenses and related estimates of reinsurance recoverables are particularly critical to an assessment of the Company's financial results. Given the nature of the surety business, the determination of these balances is inherently a highly subjective exercise which requires management to analyze, weigh and balance numerous macroeconomic, customer specific and claim specific factors and trends, most of which, in and of themselves, are inherently uncertain and difficult to predict. In addition, management believes the other most critical accounting policies and related disclosures for purposes of understanding the Company's results of operations and financial condition pertain to investments, goodwill and other intangible assets, recognition of premium revenue and the related unearned premium liability and deferred policy acquisition costs.

Reserves for Unpaid Losses and Loss Adjustment Expenses and Reinsurance

CNA Surety accrues liabilities for unpaid losses and loss adjustment expenses ("LAE") under its surety and property and casualty insurance contracts based upon estimates of the ultimate amounts payable under the contracts related to losses occurring on or before the balance sheet date.

Reported claims are in various stages of the settlement process. Due to the nature of surety, which is the relationship among three parties whereby the surety guarantees the performance of the principal to a third party (the obligee), the investigation of claims and the establishment of case estimates on claim files can be a complex process that can occur over a period of time depending on the type of bond(s) and the facts and circumstances involving the particular bond(s), the claim(s) and the principal. Case reserves are typically established after a claim is filed and an investigation and analysis has been conducted as to the validity of the claim, the principal's response to the claim and the principal's financial viability. To the extent it is determined that there are no bona fide defenses to the claim and the principal is unwilling or financially unable to resolve the claim, a case reserve is established on the claim file for the amount the Company estimates it will have to pay to honor its obligations under the provisions of the bond(s).

While the Company intends to establish initial case reserve estimates that are sufficient to cover the ultimate anticipated loss on a claim file, some estimates need to be adjusted during the life cycle of the claim file as matters continue to develop. Factors that can necessitate case reserve increases or decreases are the complexity of the bond(s) and/or underlying contract(s), if additional and/or unexpected claims are filed, if the financial condition of the principal or obligee changes or as claims develop and more information is discovered that was unknown and/or unexpected at the time the initial case reserve estimate was established. Ultimately, claims are resolved through payment and/or a determination that, based on the information available, a case reserve is no longer required.

As of any balance sheet date, not all claims have been reported and some claims may not be reported for many years. As a result, the liability for unpaid losses includes significant estimates for incurred-but-not-reported ("IBNR") claims. The IBNR reserves also include provisions for losses in excess of the current case reserve for previously reported claims and for claims that may be reopened. The IBNR reserves also include offsets for anticipated indemnity recoveries.

The following table shows the estimated liability as of March 31, 2010 for unpaid claims applicable to reported claims and to IBNR for each sub-line of business (dollars in thousands):

	<u>Gross Case Loss and LAE Reserves</u>	<u>Gross IBNR Loss and LAE Reserves</u>	<u>Total Gross Reserves</u>
Contract	\$ 58,973	\$ 246,042	\$ 305,015
Commercial	56,677	53,175	109,852
Fidelity and other	<u>3,550</u>	<u>8,041</u>	<u>11,591</u>
Total	<u>\$ 119,200</u>	<u>\$ 307,258</u>	<u>\$ 426,458</u>

Periodic actuarial analyses of the Company's loss reserves are performed. These analyses have typically included a comprehensive review performed in the third quarter based on data as of June 30 and an update of the comprehensive review performed in January based on data as of December 31. In 2009, the Company changed the timing of the comprehensive review to occur in the fourth quarter using data as of September 30. In between these analyses, management monitors claim activity against benchmarks of expected claim activity prepared in connection with the comprehensive review and records adjustments as necessary.

The actuarial analysis is the primary tool that management utilizes in determining its best estimate of loss reserves. However, the carried reserve may differ from the actuarial point estimate as a result of management's consideration of the impact of factors such as the following, especially as they relate to the current accident year:

- Current claim activity, including the frequency and severity of current claims;
- Changes in underwriting standards and business mix such as the Company's efforts to reduce exposures to large commercial bonds;
- Changes in the claims handling process;
- Potential changes in the Company's reinsurance program; and
- Current economic conditions, especially corporate default rates and the condition of the construction economy.

Management believes that the impact of the factors listed above, and others, may not be fully quantifiable through actuarial analysis. Accordingly, management applies its judgment of the impact of these factors, and others, to its selection of the recorded loss reserves.

Receivables recorded with respect to insurance losses ceded to reinsurers under reinsurance contracts are estimated in a manner similar to liabilities for insurance losses and, therefore, are also subject to uncertainty. In addition to the factors cited above, assumptions are made regarding the impact of reinsurance programs to be in place in future periods. Estimates of reinsurance recoveries may prove uncollectible if the reinsurer is unable to perform under the contract. Reinsurance contracts do not relieve the ceding company of its obligations to indemnify its own policyholders.

Casualty insurance loss reserves are subject to a significant amount of uncertainty. Given the nature of surety losses with its low frequency, high severity characteristics, this is particularly true for surety loss reserves. As a result, the range of reasonable loss reserve estimates may be broader than that associated with traditional property/casualty insurance products. While the loss reserve estimates represent the best professional judgments, arrived at after careful actuarial analysis of the available data, it is important to note that variation from the estimates is not only possible but, in fact, probable. The sources of this inherent variability are numerous — future economic conditions, court decisions, legislative actions and individual large claim impacts, for example.

Due to the inherent uncertainties in the process of establishing the liabilities for unpaid losses and loss adjustment expenses, the actual ultimate claims amounts will differ from the currently recorded amounts. This difference could have a material effect on reported earnings and financial condition. Future effects from changes in these estimates will be recorded in the period such changes are determined to be needed.

Investments

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements, or other similar factors. As a result, the Company considers all of its fixed income securities (bonds) and equity securities as available-for-sale. These securities are reported at fair value, with unrealized gains and losses, net of deferred income taxes, reported in stockholders' equity as a separate component of accumulated other comprehensive income.

Fixed income securities in an unrealized loss position that the Company intends to sell, or it more likely than not will be required to sell before recovery of amortized cost, are considered to be other-than-temporarily impaired (“OTTI”). These securities are written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income. Fixed income securities in an unrealized loss position for which management believes a credit loss exists are also considered to be other-than-temporarily impaired. For those securities, the Company bifurcates the impairment into a credit component and a non-credit component. The credit component, which represents the difference between discounted cash flows and the fixed income security’s amortized cost, is recognized in earnings and the non-credit component is recognized in other comprehensive income. Cash flows from purchases, sales and maturities of fixed income and equity securities are reported gross in the investing activities section of the Condensed Consolidated Statements of Cash Flows.

The amortized cost of fixed income securities is determined based on cost, adjustments for previously recorded other-than-temporary impairment losses and the cumulative effect of amortization of premiums and accretion of discounts using the interest method. Such amortization and accretion are included in investment income. For mortgage-backed and asset-backed securities, the Company considers estimates of future prepayments in the calculation of the effective yield used to apply the interest method. If a difference arises between the anticipated prepayments and the actual prepayments, the Company recalculates the effective yield based on actual prepayments and the currently anticipated future prepayments. The amortized costs of such securities are adjusted to the amount that would have resulted had the recalculated effective yields been applied since the acquisition of the securities with a corresponding charge or credit to investment income. Prepayment estimates are based on the structural elements of specific securities, interest rates and generally recognized prepayment speed indices.

Short-term investments, that generally include U.S. Treasury bills, corporate notes, money market funds and investment grade commercial paper equivalents, are carried at amortized cost, which approximates fair value.

Invested assets are exposed to various risks, such as interest rate risk, market risk and credit risk. Due to the level of risk associated with invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may materially affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

Goodwill and Other Intangible Assets

CNA Surety’s Condensed Consolidated Balance Sheets as of March 31, 2010 and December 31, 2009 include goodwill and intangible assets of approximately \$138.8 million. This amount primarily represents goodwill and identified intangibles with indefinite useful lives arising from the acquisition of Capsure Holdings Corp. (“Capsure”).

A significant amount of judgment is required in performing intangible assets impairment tests. Such tests include periodically determining or reviewing the estimated fair value of CNA Surety’s reporting units. Under the relevant standard, fair value of a reporting unit refers to the price that would be received to sell the reporting unit as a whole in an orderly transaction between market participants. There are several methods of estimating fair value, including market quotations, asset and liability fair values and other valuation techniques, such as discounted cash flows and multiples of earnings or revenues. The Company uses a valuation technique based on discounted cash flows. Significant inputs to the Company’s discounted cash flow model include estimated capital requirements to support the business, expected cash flows from underwriting activity, required capital reinvestment to support growth and the selected discount rates. If the carrying amount of a reporting unit, including goodwill, exceeds the estimated fair value, then individual assets, including identifiable intangible assets, and liabilities of the reporting unit are estimated at fair value. The excess of the estimated fair value of the reporting unit over the estimated fair value of net assets would establish the implied value of intangible assets. The excess of the recorded amount of intangible assets over the implied value of intangible assets is recorded as an impairment loss.

Insurance Premiums

Insurance premiums are recognized as revenue ratably over the term of the related policies in proportion to the insurance protection provided. Contract bonds provide coverage for the length of the bonded project and not a fixed time period. As such, the Company uses estimates of the contract length as the basis for recognizing premium revenue on these bonds. Premium revenues are net of amounts ceded to reinsurers. Unearned premiums represent the portion of premiums written, before ceded reinsurance which is shown as an asset, applicable to the unexpired terms of policies in force determined on a pro rata basis.

Insurance premium receivables are presented net of an estimated allowance for doubtful accounts, which is based on a periodic evaluation of the aging and collectability of premium receivables.

Deferred Policy Acquisitions Costs

Policy acquisition costs, consisting of commissions, premium taxes and other underwriting expenses which vary with, and are primarily related to, the production of business, net of reinsurance commissions, are deferred and amortized as a charge to income as the related premiums are earned. The Company periodically tests that deferred policy acquisition costs are recoverable based on the expected profitability embedded in the reserve for unearned premium. If the expected profitability is less than the balance of deferred policy acquisition costs, a charge to net income is taken and the deferred policy acquisition cost balance is reduced to the amount determined to be recoverable. Anticipated investment income is considered in the determination of the recoverability of deferred policy acquisition costs.

Results of Operations

Financial Measures

The Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") discusses certain accounting principles generally accepted in the United States of America ("GAAP") and non-GAAP financial measures in order to provide information used by management to monitor the Company's operating performance. Management utilizes various financial measures to monitor the Company's insurance operations and investment portfolio. Underwriting results, which are derived from certain income statement amounts, are considered a non-GAAP financial measure and are used by management to monitor performance of the Company's insurance operations.

Underwriting results are computed as net earned premiums less net losses and loss adjustment expenses and net commissions, brokerage and other underwriting expenses. Management uses underwriting results to monitor its insurance operations' results without the impact of certain factors, including net investment income, net realized investment gains (losses) and interest expense. Management excludes these factors in order to analyze the direct relationship between net earned premiums and the related net losses and loss adjustment expenses along with net commissions, brokerage and other underwriting expenses.

Operating ratios are calculated using insurance results and are widely used by the insurance industry and regulators such as state departments of insurance and the National Association of Insurance Commissioners for financial regulation and as a basis of comparison among companies. The ratios discussed in the Company's MD&A are calculated using GAAP financial results and include the net loss and loss adjustment expense ratio ("loss ratio") as well as the net commissions, brokerage and other underwriting expense ratio ("expense ratio") and combined ratio. The loss ratio is the percentage of net incurred losses and loss adjustment expenses to net earned premiums. The expense ratio is the percentage of net commissions, brokerage and other underwriting expenses, including the amortization of deferred policy acquisition costs, to net earned premiums. The combined ratio is the sum of the loss ratio and expense ratio.

While management uses various GAAP and non-GAAP financial measures to monitor various aspects of the Company's performance, net income is the most directly comparable GAAP measure and represents a more comprehensive measure of operating performance. Management believes that its process of evaluating performance through the use of these non-GAAP financial measures provides a basis for enhanced understanding of the operating performance and the impact to net income as a whole. Management also believes that investors may find these widely used financial measures described above useful in interpreting the underlying trends and performance, as well as to provide visibility into the significant components of net income.

Comparison of CNA Surety Actual Results for the Three Months Ended March 31, 2010 and 2009

Analysis of Net Income

Net income for the three months ended March 31, 2010 was \$20.8 million, or \$0.47 per diluted share, compared to \$20.9 million, or \$0.47 per diluted share, for the same period in 2009. The current quarter results include an income tax charge of \$0.5 million related to tax code changes contained within the recently enacted health care reform legislation.

The components of net income are discussed in the following sections.

Results of Insurance Operations

Underwriting components for the Company for the three months ended March 31, 2010 and 2009 are summarized in the following table (dollars in thousands):

	Three Months Ended March 31,	
	2010	2009
Gross written premiums	<u>\$ 112,527</u>	<u>\$ 111,125</u>
Net written premiums	<u>\$ 106,660</u>	<u>\$ 104,019</u>
Net earned premiums	<u>\$ 98,252</u>	<u>\$ 101,151</u>
Net losses and loss adjustment expenses	<u>\$ 28,581</u>	<u>\$ 29,588</u>
Net commissions, brokerage and other underwriting expenses	<u>\$ 52,788</u>	<u>\$ 54,278</u>
Loss ratio	29.1%	29.3%
Expense ratio	<u>53.7</u>	<u>53.7</u>
Combined ratio	<u>82.8%</u>	<u>83.0%</u>

Premiums Written/Earned

CNA Surety primarily markets contract and commercial surety bonds. Contract surety bonds generally secure a contractor's performance and/or payment obligation with respect to a construction project. Contract surety bonds are generally required by federal, state and local governments for public works projects. The most common types include bid, performance and payment bonds. Commercial surety bonds include all surety bonds other than contract and cover obligations typically required by law or regulation. The commercial surety market includes numerous types of bonds categorized as court judicial, court fiduciary, public official, license and permit and many miscellaneous bonds that include guarantees of financial performance. The Company also writes fidelity bonds that cover losses arising from employee dishonesty and other insurance products that are generally companion products to certain surety bonds. For example, the Company writes surety bonds for notaries and also offers related errors and omissions insurance coverage.

Through one of its insurance subsidiaries, Western Surety Company ("Western Surety"), the Company assumes significant amounts of premiums primarily from affiliates. This includes surety business written or renewed, net of reinsurance, by Continental Casualty Company ("CCC") and The Continental Insurance Company ("CIC"), and their affiliates, after September 30, 1997 that is reinsured by Western Surety pursuant to reinsurance and related agreements. Because of certain regulatory restrictions that limit the Company's ability to write certain business on a direct basis, the Company continues to utilize the underwriting capacity available through these agreements. The Company is in full control of all aspects of the underwriting and claim management of the assumed business from CCC and CIC.

CNA Surety also assumes premium on contract and commercial surety bonds for international risks. Such premiums are assumed pursuant to the terms of reinsurance treaties or as a result of specific international bond requirements of domestic customers. For the three month periods ended March 31, 2010 and 2009, premiums assumed under such arrangements were \$1.3 million and \$0.5 million, respectively.

Gross written premium, which is the aggregate of direct written premiums and assumed written premiums, for the three months ended March 31, 2010 and 2009 is shown in the table below (dollars in thousands) for each sub-line of business:

	Three Months Ended March 31,	
	2010	2009
Contract	\$ 68,457	\$ 67,355
Commercial	35,221	34,978
Fidelity and other	<u>8,849</u>	<u>8,792</u>
Total	<u>\$ 112,527</u>	<u>\$ 111,125</u>

For the three months ended March 31, 2010, gross written premiums increased 1.3% to \$112.5 million compared to \$111.1 million for the three months ended March 31, 2009. Contract surety gross written premiums increased 1.6% to \$68.5 million due to an increase in non-construction performance bonds as well as premiums assumed under international reinsurance contracts. Commercial surety gross written premiums increased 0.7% to \$35.2 million, reflecting more stable general economic conditions, which also impacted fidelity and other premiums related to the Company's small commercial surety business.

The Company's insurance subsidiaries purchase reinsurance from other insurance companies and affiliates. Reinsurance arrangements are used to limit maximum loss, provide greater diversification of risk and minimize exposure on larger risks. The cost of this reinsurance is recorded as ceded written premium. Ceded written premium decreased from \$7.1 million for the three months ended March 31, 2009 to \$5.9 million for the three months ended March 31, 2010 due to the lower cost of the Company's 2010 third party excess of loss reinsurance treaty.

Net written premium, which is gross written premiums less ceded written premiums, for the three months ended March 31, 2010 and 2009 are shown in the table below (dollars in thousands) for each sub-line of business:

	Three Months Ended March 31,	
	2010	2009
Contract	\$ 63,313	\$ 61,025
Commercial	34,498	34,202
Fidelity and other	8,849	8,792
Total	<u>\$ 106,660</u>	<u>\$ 104,019</u>

Net written premiums increased 2.5% to \$106.6 million for the three months ended March 31, 2010 compared to the same period of 2009 due to the increase in gross written premium and the reduction in ceded written premium discussed above.

Net written premiums are recognized as revenue over the policy term as net earned premiums. Net earned premiums for the three months ended March 31, 2010 and 2009 are shown in the table below (dollars in thousands) for each sub-line of business:

	Three Months Ended March 31,	
	2010	2009
Contract	\$ 58,526	\$ 61,292
Commercial	32,276	32,217
Fidelity and other	7,450	7,642
	<u>\$ 98,252</u>	<u>\$ 101,151</u>

For the three months ended March 31, 2010, net earned premiums decreased by \$2.9 million to \$98.3 million as compared to the same period of 2009 reflecting the impact of adverse economic conditions on gross written premiums in prior periods, partially offset by the decrease in ceded written premiums discussed above. Ceded earned premiums decreased \$1.2 million to \$5.9 million for the three months ended March 31, 2010 compared to the three months ended March 31, 2009. Net earned premiums for contract surety business decreased 4.5% to \$58.5 million for the three months ended March 31, 2010 compared to the three months ended March 31, 2009. Net earned premiums for commercial surety increased slightly while earned premium for fidelity and other premiums decreased 2.5% to \$7.5 million for the three months ended March 31, 2010 compared to the three months ended March 31, 2009.

Net Loss Ratio

The loss ratios for the three months ended March 31, 2010 and 2009 were 29.1% and 29.3%, respectively. The slight decrease reflects the lower ceded written premium discussed previously. These loss ratios typically include re-estimates of prior accident year reserves, known as reserve development. There were no revisions of prior year reserves for the three months ended March 31, 2010. Nominal revisions of prior year reserves in the three months ended March 31, 2009 had no effect on the loss ratio.

Expense Ratio

The expense ratio was 53.7% for both the three months ended March 31, 2010 and 2009. Expected upward pressure on the expense ratio resulting from the impact on earned premiums of lower written premiums in prior periods was offset by the impact of lower ceded written premium and the Company's continued expense management.

Investment Income and Realized Investment Gains/Losses

Net investment income was \$13.4 million for the three months ended March 31, 2010 compared to \$12.2 million for the three months ended March 31, 2009. This increase is due to an increase in invested assets. The annualized pre-tax yield was 4.2% and 4.3% for the three months ended March 31, 2010 and 2009, respectively. The annualized after-tax yield was 3.4% and 3.6% for the three months ended March 31, 2010 and 2009, respectively.

Net realized investment gains and losses and the net change in unrealized gains and losses of available-for-sale securities were as follows (dollars in thousands):

	Three Months Ended	
	March 31,	
	2010	2009
Net realized investment gains (losses):		
Fixed income securities:		
Gross realized investment gains	\$ 425	\$ —
Gross realized investment losses:		
Other-than-temporary impairment losses	(94)	—
Realized losses from sales	(19)	—
Total gross realized investment losses	(113)	—
Net realized investment gains on fixed income securities	312	—
Equity securities:		
Gross realized investment gains	11	—
Gross realized investment losses:		
Other-than-temporary impairment losses	—	(46)
Realized losses from sales	—	(20)
Total gross realized investment losses	—	(66)
Net realized investment gains (losses) on equity securities	11	(66)
Other	—	—
Net realized investment gains (losses)	323	(66)
Net change in unrealized gains (losses) Fixed income securities	\$ 2,569	\$ (12,727)
Equity securities	21	—
Total net change in unrealized gains (losses)	<u>\$ 2,590</u>	<u>\$ (12,727)</u>
Net realized gains (losses) and change in unrealized gains (losses)	<u>\$ 2,913</u>	<u>\$ (12,793)</u>

The Company's investment portfolio is generally managed to maximize after-tax investment return, while minimizing credit risk with investments concentrated in high quality fixed income securities. CNA Surety's portfolio is managed to provide diversification by limiting exposures to any one industry, issue or issuer, and to provide liquidity by investing in the public securities markets. The portfolio is structured to support CNA Surety's insurance underwriting operations and to consider the expected duration of liabilities and short-term cash needs. In achieving these goals, assets may be sold to take advantage of market conditions or other investment opportunities or regulatory, credit and tax considerations. These activities will produce realized gains and losses.

Interest Expense

The benchmark interest rate for the Company's variable interest rate debt is the London Interbank Offered Rate ("LIBOR"). Due to lower three-month LIBOR rates, interest expense decreased \$0.1 million, or 32.8%, for the three months ended March 31, 2010 compared to the same period in 2009. The weighted average interest rate for the three months ended March 31, 2010 was 3.6% as compared with 5.1% for the same period in 2009. Weighted average debt outstanding was \$30.9 million for each of these periods.

Income Taxes

The Company's income tax expense for the three months ended March 31, 2010 was \$9.5 million compared to \$8.2 million for the three months ended March 31, 2009. The effective income tax rates for these periods were 31.3% and 28.2%, respectively. The Company's effective tax rate differs from the statutory tax rate due primarily to tax-exempt investment income. Tax-exempt investment income was \$6.3 million and \$6.6 million for the three months ended March 31, 2010 and 2009, respectively.

As previously discussed, the Company also recorded additional income tax expense of \$0.5 million for the three months ended March 31, 2010 as the result of the recently enacted health care reform legislation. The Patient Protection and Affordable Care Act (the "Act") and the Healthcare and Education Affordability Reconciliation Act (the "Reconciliation Measure") repealed the rule permitting deduction, for tax purposes, of the entire cost of providing prescription drug benefits even though a portion is offset by a federal subsidy. The Company's postretirement benefit plan that provides medical benefits includes such prescription drug coverage.

Under the Act and the Reconciliation Measure, the subsidy remains tax-free through 2012. As of March 31, 2010, the impact of these provisions has been recognized in the accounting for this postretirement benefit plan.

Exposure Management

The Company's business is subject to certain risks and uncertainties associated with the current economic environment and corporate credit conditions. In response to these risks and uncertainties, the Company has enacted various exposure management initiatives. With respect to risks on large commercial accounts, the Company generally limits its exposure to \$25.0 million per account, but will selectively accept higher exposures.

With respect to contract surety, the Company's portfolio is predominantly comprised of contractors with bonded backlog of less than \$30.0 million. Bonded backlog is an estimate of the Company's exposure in the event of default before indemnification. The Company does have accounts with bonded backlogs greater than \$30.0 million.

The Company manages its exposure to any one contract credit and aggressively looks for co-surety, shared accounts and other means to support or reduce larger exposures. Reinsurance and indemnification rights, including rights to contract proceeds on construction projects in the event of default, exist that substantially reduce CNA Surety's exposure to loss.

Excess of Loss Reinsurance

The Company's ceded reinsurance program is predominantly comprised of excess of loss reinsurance contracts that limit the Company's retention on a per principal basis. The Company's reinsurance coverage is provided by third party reinsurers and related parties. Due to the terms of these excess of loss treaties, reinsurers may cover some principals in one year but then exclude these same principals in subsequent years. As a result, the Company may have exposures to these principals that have limited or no reinsurance coverage. Only the large national contractor discussed below was excluded from the third party reinsurance agreements effective for the treaty periods discussed; however, as discussed below, the Company has no further exposure to this principal.

2009 Third Party Reinsurance

Effective January 1, 2009, CNA Surety entered into an excess of loss treaty ("2009 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the excess of loss treaty effective in 2008. Under the 2009 Excess of Loss Treaty, the Company's net retention per principal was \$15 million with a 5% co-participation in the \$90 million layer of third party reinsurance coverage above the Company's retention. The contract provided aggregate coverage of \$185 million and included an optional extended discovery period, which was not exercised. The contract also included a provision for additional premiums of up to \$13.8 million based on losses ceded under the contract. The actual ceded premiums for the 2009 Excess of Loss Treaty were \$26.6 million.

2010 Third Party Reinsurance

Effective January 1, 2010, CNA Surety entered into an excess of loss treaty ("2010 Excess of Loss Treaty") with a group of third party reinsurers on terms similar to the 2009 Excess of Loss Treaty. Under the 2010 Excess of Loss Treaty, the Company's net retention per principal remains at \$15 million with a 5% co-participation in the \$90 million layer of third party reinsurance coverage above the Company's retention. The contract provides aggregate coverage of \$185 million and includes an optional extended discovery period, for an additional premium (a percentage of the original premium based on any unexhausted aggregate limit by layer), which will provide coverage for losses discovered beyond 2010 on bonds that were in force during 2010. The contract also includes a provision for additional premiums of up to \$12.3 million based on losses ceded under the contract. The base annual premium for the 2010 Excess of Loss Treaty is \$24.6 million.

Related Party Reinsurance

Reinsurance agreements together with the Services and Indemnity Agreement described below provide for the transfer of the surety business written by CCC and CIC to Western Surety. Many of these agreements originally were entered into on September 30, 1997 (the "Merger Date") and include: (i) the Surety Quota Share Treaty (the "Quota Share Treaty"); (ii) the Aggregate Stop Loss Reinsurance Contract (the "Stop Loss Contract") and (iii) the Surety Excess of Loss Reinsurance Contract. Although the contracts entered on the Merger Date have expired, some have been renewed on different terms as described below.

Through the Quota Share Treaty, CCC and CIC transfer to Western Surety surety business written or renewed by CCC and CIC after the Merger Date. The Quota Share Treaty was renewed on January 1, 2010 and expires on December 31, 2010 and is annually renewable thereafter. CCC and CIC transfer the related liabilities of such business and pay to Western Surety an amount in cash equal to CCC's and CIC's net written premiums written on all such business, minus a quarterly ceding commission to be retained by CCC and CIC equal to \$50,000 plus 25% of net written premiums written on all such business. For 2009 this resulted in an override commission on their actual direct acquisition costs of 4.8% to CCC and CIC.

Under the terms of the Quota Share Treaty, CCC has guaranteed the loss and loss adjustment expense reserves transferred to Western Surety as of the Merger Date by agreeing to pay Western Surety, within 30 days following the end of each calendar quarter, the amount of any adverse development on such reserves, as re-estimated as of the end of such calendar quarter. There was no adverse reserve development for the period from the Merger Date through March 31, 2010.

Through the Stop Loss Contract, the Company's insurance subsidiaries were protected from adverse loss development on certain business underwritten after the Merger Date. The Stop Loss Contract between the Company's insurance subsidiaries and CCC limited the insurance subsidiaries' prospective net loss ratios with respect to certain accounts and lines of insured business for three full accident years following the Merger Date. In the event the insurance subsidiaries' accident year net loss ratio exceeds 24% in any of the accident years 1997 through 2000 on certain insured accounts (the "Loss Ratio Cap"), the Stop Loss Contract requires CCC at the end of each calendar quarter following the Merger Date, to pay to the insurance subsidiaries a dollar amount equal to (i) the amount, if any, by which the Company's actual accident year net loss ratio exceeds the applicable Loss Ratio Cap, multiplied by (ii) the applicable net earned premiums. In consideration for the coverage provided by the Stop Loss Contract, the Company's insurance subsidiaries paid CCC an annual premium of \$20,000. The CNA Surety insurance subsidiaries have paid CCC all required annual premiums. Through March 31, 2010 and December 31, 2009, losses incurred under the Stop Loss Contract were \$47.2 million and \$49.1 million, respectively. The decrease is a result of favorable development on claims subject to the Stop Loss Contract during the first quarter of 2010. As a result of this favorable development, the Company paid CCC \$1.9 million under the Stop Loss Contract. At March 31, 2010, the amount received under the Stop Loss Contract included \$2.8 million held by the Company for losses covered under this contract that were incurred but not paid.

The Services and Indemnity Agreement provides the Company's insurance subsidiaries with the authority to perform various administrative, management, underwriting and claim functions in order to conduct the surety business of CCC and CIC and to be reimbursed by CCC for services rendered. In consideration for providing the foregoing services, CCC has agreed to pay Western Surety a quarterly fee of \$50,000. In 2009, this agreement was amended so that the Company's authority to conduct administrative, management, underwriting and claim functions for bonds written for the large national contractor discussed below shall continue until CCC's bonds for such contractor have expired and claims have been settled or closed. This agreement was renewed on January 1, 2010 and expires on December 31, 2010 and is annually renewable thereafter. As of March 31, 2010 there were no amounts due to the CNA Surety insurance subsidiaries under this agreement.

From January 1, 2005 to June 30, 2009, the Company and CCC were parties to an excess of loss contract, and extensions to that contract, that provided unlimited reinsurance coverage in excess of \$60 million retention for the life of bonds either in force or written during the contract periods exclusively for the one large national contractor excluded from the Company's third party reinsurance. Premiums for these contracts totaled \$8.6 million and included an initial premium of \$7.0 million and premiums of \$1.6 million based on the level of premiums written on bonds for the large national contractor.

In 2009, the Company and CCC terminated the excess of loss contract discussed in the preceding paragraph. Related to the termination of this contract, the Company and CCC also commuted the Quota Share Treaty as regards the premium and losses for the large national contractor. The impact of this commutation was a decrease of gross loss reserves of \$51.8 million. Under the terms of the agreements effecting this commutation, the Company paid CCC \$1.8 million. This settlement reflected the difference between the Company's \$60.0 million retention under the excess of loss contract and the \$58.2 million paid by the Company for losses of the large national contractor through 2009.

On January 1, 2010, the Company and CCC entered into separate agreements that provide for the transfer of the Canadian surety business of CCC to Western Surety. These agreements, which include a quota share treaty (the "Canadian Quota Share Treaty") and a services and indemnity agreement (the "Canadian Services and Indemnity Agreement"), are substantially similar to the Quota Share Treaty and the Services and Indemnity Agreement discussed above. The Canadian Services and Indemnity Agreement provides Western Surety with the authority to supervise various administrative, underwriting and claim functions associated with the surety business written by CCC, through its Canadian branch, on behalf of the Company. Through the Canadian Quota Share Treaty, this Canadian surety business is transferred to Western Surety. Pursuant to these agreements, CCC will transfer the subject premium and related liabilities of such business and pay to Western Surety an amount equal to CCC's net written premiums on all such business, minus a ceding commission of 33.5% of net written premiums. Further, Western Surety will pay an additional ceding commission to CCC in the amount of actual direct expense in producing such premium. These agreements expire on December 31, 2010 and are annually renewable thereafter.

As of March 31, 2010 and December 31, 2009, CNA Surety had an insurance receivable balance from CCC and CIC of \$9.2 million and \$9.8 million, respectively, comprised of premiums receivable.

The Company's Condensed Consolidated Balance Sheets also include a "Deposit with affiliated ceding company" of \$26.9 million at both March 31, 2010 and December 31, 2009. In 2005, pursuant to an agreement with the claimant on a bond regarding certain aspects of the claim resolution, the Company deposited \$32.7 million with an affiliate to enable the affiliate to establish a trust to fund future payments under the bond. The bond was written by the affiliate and assumed by one of the Company's insurance subsidiaries pursuant to the Quota Share Treaty. The Company is entitled to the interest income earned by the trust. Prior to the establishment of the trust, the Company had fully reserved its obligation under the bond and the claim remains fully reserved.

Liquidity and Capital Resources

It is anticipated that the liquidity requirements of CNA Surety will be met primarily by funds generated from operations. The principal sources of operating cash flows are premiums, investment income and recoveries under reinsurance contracts. The primary cash flow uses are payments for claims, operating expenses, federal income taxes and debt service. In general, surety operations generate premium collections from customers in advance of cash outlays for claims. Premiums are invested until such time as funds are required to pay claims and claims adjusting expenses.

The Company believes that total invested assets, including cash and short-term investments, are sufficient in the aggregate and have suitably scheduled maturities to satisfy all policy claims and other operating liabilities, including dividend and income tax sharing payments of its insurance subsidiaries. If cash requirements unexpectedly exceed cash inflows, the Company may raise additional cash by liquidating fixed income securities ahead of their scheduled maturity. Depending on the interest rate environment at that time, the Company could generate realized gains or losses that would increase or decrease net income for the period. The extent of these gains or losses would depend on a number of factors such as the prevailing interest rates and credit spreads, the duration of the assets sold and the marketability of the assets. The need to liquidate fixed income securities would be expected to cause a reduction in future investment income.

At March 31, 2010, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$1,308.3 million of fixed income securities and \$32.8 million of short-term investments and cash. At December 31, 2009, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of \$1,266.2 million of fixed income securities and \$39.8 million of short-term investments and cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries, and to a lesser extent, investment income. The principal obligations at the parent company level are to service debt and pay operating expenses, including income taxes. At March 31, 2010, the parent company's invested assets consisted of \$1.9 million of equity securities and \$6.0 million of short-term investments and cash. At December 31, 2009, the parent company's invested assets consisted of \$1.6 million of equity securities and \$14.0 million of short-term investments and cash. At March 31, 2010 and December 31, 2009, parent company short-term investments and cash included \$5.4 million and \$11.1 million, respectively, of cash and short-term investments primarily related to premium receipt collections ultimately due to the Company's insurance subsidiaries.

The Company's consolidated net cash flow provided by operating activities was \$26.3 million for the three months ended March 31, 2010 compared to net cash flow provided by operating activities of \$33.7 million for the comparable period in 2009. The decrease in net cash flow provided by operating activities primarily relates to higher income tax payments, partially offset by lower net loss and loss adjustment expense payments resulting from indemnification recoveries.

In May 2004, the Company, through a wholly-owned trust, privately issued \$30.0 million of preferred securities through two pooled transactions. These securities, issued by CNA Surety Capital Trust I (the "Issuer Trust"), bear interest at LIBOR plus 337.5 basis points with a 30-year term. Beginning in May 2009, these securities may be redeemed, in whole or in part, at par value at any scheduled quarterly interest payment date. As of March 31, 2010, none of these preferred securities have been redeemed.

The Company's investment of \$0.9 million in the Issuer Trust is carried at cost in "Other assets" in the Company's Condensed Consolidated Balance Sheets. The sole asset of the Issuer Trust consists of a \$30.9 million junior subordinated debenture issued by the Company to the Issuer Trust. Due to the underlying characteristics of this debt, the carrying value of the debenture approximates its estimated fair value.

The Company has also guaranteed the dividend payments and redemption of the preferred securities issued by the Issuer Trust. The maximum amount of undiscounted future payments the Company could make under the guarantee is approximately \$56.3 million, consisting of annual dividend payments of approximately \$1.1 million until maturity and the redemption value of the preferred securities of \$30.0 million. Because payment under the guarantee would only be required if the Company does not fulfill its obligations under the debentures held by the Issuer Trust, the Company has not recorded any additional liabilities related to this guarantee.

The junior subordinated debenture bears interest at a rate of LIBOR plus 337.5 basis points and matures in April 2034. As of March 31, 2010 and 2009, the interest rate on the junior subordinated debenture was 3.625% and 4.613%, respectively.

The Company does not have any material off-balance sheet arrangements as defined by Item 303 of Regulation S-K under the Exchange Acts of 1933 and 1934.

A summary of the Company's commitments as of March 31, 2010 is presented in the following table (in millions):

Contractual Obligations as of March 31, 2010	2010	2011	2012	2013	2014	Thereafter	Total
Debt (a)	\$ 0.9	\$ 1.1	\$ 1.1	\$ 1.1	\$ 1.1	\$ 52.7	\$ 58.0
Operating leases	1.5	1.9	0.9	—	—	—	4.3
Loss and loss adjustment expense reserves	83.5	107.8	79.6	52.9	38.5	64.2	426.5
Other long-term liabilities (b)	0.3	1.3	1.0	0.5	0.4	10.2	13.7
Total	\$ 86.2	\$ 112.1	\$ 82.6	\$ 54.5	\$ 40.0	\$ 127.1	\$ 502.5

(a) Reflects expected principal and interest payments.

(b) Reflects unfunded postretirement benefit plans and long-term incentive plan payments to certain executives.

As an insurance holding company, CNA Surety is dependent upon dividends and other permitted payments from its insurance subsidiaries to pay operating expenses and meet debt service requirements, as well as to potentially pay cash dividends. The payment of dividends by the insurance subsidiaries is subject to varying degrees of supervision by the insurance regulatory authorities in the insurance subsidiaries' states of domicile. Western Surety, Surety Bonding Company of America ("Surety Bonding") and Universal Surety of America ("Universal Surety") are domiciled in South Dakota. In South Dakota, insurance companies may only pay dividends from earned surplus excluding surplus arising from unrealized capital gains or revaluation of assets. The insurance subsidiaries may pay dividends without obtaining prior regulatory approval only if such dividend or distribution (together with dividends or distributions made within the preceding 12-month period) is less than, as of the end of the immediately preceding year, the greater of (i) 10% of the insurer's surplus to policyholders or (ii) statutory net income. In South Dakota, net income includes net realized capital gains in an amount not to exceed 20% of net unrealized capital gains. All dividends must be reported to the South Dakota Division of Insurance prior to payment.

The dividends that may be paid without prior regulatory approval are determined by formulas established by the applicable insurance regulations, as described above. The formulas that determine dividend capacity in the current year are dependent on, among other items, the prior year's ending statutory surplus and statutory net income. Dividend capacity for 2010 is based on statutory surplus and income at and for the year ended December 31, 2009. Without prior regulatory approval in 2010, Western Surety may pay dividends of \$122.9 million to CNA Surety. CNA Surety received no dividends from its insurance subsidiaries or its non-insurance subsidiary during the first three months of 2010 or 2009.

Combined statutory surplus totaled \$699.8 million at March 31, 2010, resulting in a net written premium to statutory surplus ratio of to 0.6 to 1. Insurance regulations restrict Western Surety's maximum net retention on a single surety bond to 10 percent of statutory surplus. Under the 2010 Excess of Loss Treaty, the Company's net retention on new bonds would generally be \$15 million plus a 5% co-participation in the \$90 million layer of excess reinsurance above the Company's retention. Based on statutory surplus as of March 31, 2010, this regulation would limit Western Surety's largest gross risk to \$155.5 million. This surplus requirement may limit the amount of future dividends Western Surety could otherwise pay to CNA Surety.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the income tax of each subsidiary shall be determined based upon each subsidiary's separate return liability. Intercompany tax payments are made at such times when estimated tax payments would be required by the Internal Revenue Service. CNA Surety received tax sharing payments of \$14.0 million and \$1.8 million from its subsidiaries for the three months ended March 31, 2010 and 2009, respectively.

Western Surety and Surety Bonding each qualify as an acceptable surety for federal and other public works project bonds pursuant to U.S. Department of Treasury regulations. U.S. Treasury underwriting limitations, the maximum net retention on a single federal surety bond, are based on an insurer's statutory surplus. Effective July 1, 2009 through June 30, 2010, the underwriting limitations of Western Surety and Surety Bonding are \$54.7 million and \$0.7 million, respectively. Through the Quota Share Treaty previously discussed, CNA Surety has access to CCC and its affiliates' U.S. Department of Treasury underwriting limitations. Effective July 1, 2009 through June 30, 2010, the underwriting limitations of CCC and its affiliates utilized under the Quota Share Treaty total \$732.3 million. CNA Surety management believes that the foregoing U.S. Treasury underwriting limitations are sufficient for the conduct of its business.

CNA Surety management believes that the Company has sufficient available resources, including capital protection against large losses provided by the Company's excess of loss reinsurance arrangements, to meet its present capital needs.

Insurance Regulation and Supervision

CNA Surety's insurance subsidiaries are subject to periodic financial and market conduct examinations. These examinations are generally performed by the domiciliary state insurance regulatory authorities, however, they may be performed by any jurisdiction in which the insurer transacts business. During 2008, the South Dakota Division of Insurance began its financial examination of Western Surety, Surety Bonding and Universal Surety as of and for the period January 1, 2004 through December 31, 2008. The final financial examination report was filed with the South Dakota Division of Insurance on December 11, 2009. On January 13, 2010, the Company was notified that the final examination report was adopted by the Director of the South Dakota Division of Insurance as filed. No adverse findings were included in the final examination report.

Financial Condition

Investment Portfolio

The amortized cost, gross unrealized gains, gross unrealized losses, estimated fair value and OTTI of fixed income securities and the cost, gross unrealized gains, gross unrealized losses and estimated fair value of equity securities held by CNA Surety at March 31, 2010, by investment category, were as follows (dollars in thousands):

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses		Estimated Fair Value	Unrealized OTTI Losses(a)
			Less Than 12 Months	More Than 12 Months		
March 31, 2010						
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. Government and agencies:						
U.S. Treasury	\$ 18,085	\$ 977	\$ —	\$ —	\$ 19,062	\$ —
U.S. Agencies	6,528	315	—	—	6,843	—
Collateralized mortgage obligations — residential	29,832	1,715	—	—	31,547	—
Mortgage pass-through securities — residential	87,012	2,638	(45)	—	89,605	—
Obligations of states and political subdivisions	699,069	33,738	(866)	(2,505)	729,436	—
Corporate bonds	382,765	13,572	(714)	(150)	395,473	—
Collateralized mortgage obligations — commercial	10,022	163	—	—	10,185	—
Other asset-backed securities:						
Second mortgages/home equity loans — residential	4,989	—	—	(553)	4,436	(1,207)
Consumer credit receivables	10,767	482	—	—	11,249	—
Other	9,706	755	—	—	10,461	—
Total fixed income securities	1,258,775	54,355	(1,625)	(3,208)	1,308,297	\$ (1,207)
Equity securities	1,650	202	—	—	1,852	—
Total	\$ 1,260,425	\$ 54,557	\$ (1,625)	\$ (3,208)	\$ 1,310,149	

(a) The unrealized loss position of this security was \$0.4 million at March 31, 2010.

The amortized cost, gross unrealized gains, gross unrealized losses, estimated fair value and OTTI of fixed income securities and the cost, gross unrealized gains, gross unrealized losses and estimated fair value of equity securities held by CNA Surety at December 31, 2009, by investment category, were as follows (dollars in thousands):

<u>December 31, 2009</u>	<u>Amortized Cost or Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>		<u>Estimated Fair Value</u>	<u>Unrealized OTTI Losses(a)</u>
			<u>Less Than 12 Months</u>	<u>More Than 12 Months</u>		
Fixed income securities:						
U.S. Treasury securities and obligations of U.S. Government and agencies:						
U.S. Treasury	\$ 17,378	\$ 970	\$ —	\$ —	\$ 18,348	\$ —
U.S. Agencies	9,794	337	—	—	10,131	—
Collateralized mortgage obligations — residential	30,709	1,383	—	—	32,092	—
Mortgage pass-through securities — residential	94,453	2,336	(232)	—	96,557	—
Obligations of states and political subdivisions	696,505	35,847	(882)	(2,902)	728,568	—
Corporate bonds	334,136	11,478	(1,248)	(257)	344,109	—
Collateralized mortgage obligations — commercial	10,024	—	—	(351)	9,673	—
Other asset-backed securities:						
Second mortgages/home equity loans — residential	5,501	—	—	(740)	4,761	(1,399)
Consumer credit receivables	11,055	528	—	—	11,583	—
Other	9,715	686	—	—	10,401	—
Total fixed income securities	1,219,270	53,565	(2,362)	(4,250)	1,266,223	\$ (1,399)
Equity securities	1,429	181	—	—	1,610	—
Total	<u>\$ 1,220,699</u>	<u>\$ 53,746</u>	<u>\$ (2,362)</u>	<u>\$ (4,250)</u>	<u>\$ 1,267,833</u>	

(a) The unrealized loss position of this security was \$0.5 million at December 31, 2009.

The following table provides the composition of fixed income securities with an unrealized loss at March 31, 2010 in relation to the total of all fixed income securities in an unrealized loss position by contractual maturities:

<u>Contractual Maturity</u>	<u>% of Estimated Fair Value</u>	<u>% of Unrealized Loss</u>
Due after one year through five years	20%	6%
Due after five years through ten years	33	19
Due after ten years	39	63
Asset-backed securities	8	12
Total	<u>100%</u>	<u>100%</u>

The following table summarizes for fixed income securities in an unrealized loss position at March 31, 2010 and December 31, 2009, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position (dollars in thousands):

<u>Unrealized Loss Aging</u>	<u>March 31, 2010</u>		<u>December 31, 2009</u>	
	<u>Estimated Fair Value</u>	<u>Gross Unrealized Loss</u>	<u>Estimated Fair Value</u>	<u>Gross Unrealized Loss</u>
Fixed income securities:				
Investment grade (a):				
0-6 months	\$ 143,354	\$ 1,625	\$ 162,087	\$ 2,362
7-12 months	—	—	—	—
13-24 months	—	—	11,176	469
Greater than 24 months	34,695	1,656	32,932	2,065
Total investment grade	178,049	3,281	206,195	4,896
Non-investment grade:				
Greater than 24 months	17,205	1,552	17,346	1,716
Total	<u>\$ 195,254</u>	<u>\$ 4,833</u>	<u>\$ 223,541</u>	<u>\$ 6,612</u>

(a) Investment grade is determined by using the Standard & Poor's ("S&P") rating. If a security is not rated by S&P, the Moody's Investor Services ("Moody's") rating is used. As of March 31, 2010 and December 31, 2009, all of the Company's fixed income securities were rated by S&P or Moody's.

Management believes the Company has the ability to hold all fixed income securities to maturity. However, the Company may dispose of securities prior to their scheduled maturity due to changes in interest rates, prepayments, tax and credit considerations, liquidity or regulatory capital requirements or other similar factors. As a result, the Company considers all of its fixed income securities (bonds) and equity securities as available-for-sale, and as such, they are carried at fair value.

A security is in an unrealized loss position, or impaired, if the fair value of the security is less than its amortized cost adjusted for accretion, amortization and previously recorded OTTI losses. When a security is impaired, the impairment is evaluated to determine whether it is temporary or other-than-temporary.

A significant judgment in the valuation of investments is the determination of when an other-than-temporary decline in value has occurred. The Company follows a consistent and systematic process for identifying securities that sustain other-than-temporary declines in value. The Company has established a watch list that is reviewed by the Chief Financial Officer and one other executive officer on at least a quarterly basis. The watch list includes individual securities that fall below certain thresholds or that exhibit evidence of impairment indicators including, but not limited to, a significant adverse change in the financial condition and near-term prospects of the investment or a significant adverse change in legal factors, the business climate or credit ratings.

When a security is placed on the watch list, it is monitored for further market value changes and additional news related to the issuer's financial condition. The focus is on objective evidence that may influence the evaluation of impairment factors. The decision to record an other-than-temporary impairment loss incorporates both quantitative criteria and qualitative information.

In determining whether an equity security is other-than-temporarily impaired, the Company considers a number of factors including, but not limited to: (a) the length of time and the extent to which the market value has been less than book value, (b) the financial condition and near-term prospects of the issuer, (c) the intent and ability of the Company to retain its investment for a period of time sufficient to allow for any anticipated recovery in value and (d) general market conditions and industry or sector specific factors. Currently, the Company's equity portfolio is comprised solely of mutual funds related to the Company's deferred compensation plan, which is an unfunded, nonqualified deferred compensation plan for a select group of management or highly compensated employees. Due to the nature of the plan, the Company does not assert the ability to hold these securities until their recovery in value. As such, if any of these securities are in an unrealized loss position, they are considered to be other-than-temporarily impaired.

For equity securities for which an other-than-temporary impairment loss has been identified, the security is written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

Fixed income securities in an unrealized loss position that the Company intends to sell, or it more likely than not will be required to sell before recovery of amortized cost, are considered to be other-than-temporarily impaired. These securities are written down to fair value and the resulting losses are recognized in realized gains/losses in the Condensed Consolidated Statements of Income.

The remaining fixed income securities in an unrealized loss position are evaluated to determine if a credit loss exists. To determine if a credit loss exists, the Company considers a number of factors including, but not limited to: (a) the financial condition and near-term prospects of the issuer, (b) credit ratings of the securities, (c) whether the debtor is current on interest and principal payments, (d) the length of time and the extent to which the market value has been less than book value and (e) general market conditions and industry or sector specific factors.

In addition to these factors, the Company considers the results of discounted cash flow modeling using assumptions representative of current market conditions as well as those specific to the Company's particular security holdings. For asset-backed and mortgage-backed securities, the focus of this analysis is on assessing the sufficiency and quality of underlying collateral and timing of cash flows. Significant assumptions considered by the Company in its cash flow projections include delinquency rates, probable risk of default, over collateralization and credit support from lower level tranches. If the discounted expected cash flows for a security equal or exceed the amortized cost of that security, no credit loss exists and the security is deemed to be temporarily impaired.

Fixed income securities in an unrealized loss position for which management believes a credit loss exists are considered to be other-than-temporarily impaired. For these fixed income securities, the Company bifurcates OTTI losses into a credit component and a non-credit component. The credit component, which represents the difference between the discounted expected cash flows and the fixed income security's amortized cost, is recognized in earnings. The non-credit component is recognized in other comprehensive income and represents the difference between fair value and the discounted cash flows that the Company expects to collect.

At March 31, 2010, the Company holds 271 fixed income securities in an unrealized gain position with a total estimated fair value of \$1,113.0 million and an aggregate gross unrealized gain of \$54.4 million.

The following table summarizes securities in a gross unrealized loss position by investment category and by credit rating. The table also discloses the corresponding count of securities in an unrealized loss position and estimated fair value by category (in thousands of dollars):

March 31, 2010	Gross Unrealized Losses					Count	Estimated Fair Value
	AAA	AA	A	BBB	Total		
Fixed income securities:							
Investment grade(a):							
U.S. Treasury securities and obligations of U. S. Government and agencies:							
Mortgage pass-through securities — residential	\$ 45	\$ —	\$ —	\$ —	\$ 45	1	\$ 10,529
Obligations of states and political subdivisions	457	997	791	—	2,245	16	82,271
Corporate bonds	10	181	394	279	864	19	82,955
Other asset-backed securities:							
Second mortgages/home equity loans — residential	<u>127</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>127</u>	<u>1</u>	<u>2,294</u>
Total investment grade	<u>639</u>	<u>1,178</u>	<u>1,185</u>	<u>279</u>	<u>3,281</u>	<u>37</u>	<u>178,049</u>
Non-investment grade:							
Obligations of states and political subdivisions	—	—	—	—	1,126	2	15,063
Other asset-backed securities:							
Second mortgages/home equity loans — residential	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>426</u>	<u>1</u>	<u>2,142</u>
Total non-investment grade	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>1,552</u>	<u>3</u>	<u>17,205</u>
Total	<u>\$ 639</u>	<u>\$ 1,178</u>	<u>\$ 1,185</u>	<u>\$ 279</u>	<u>\$ 4,833</u>	<u>40</u>	<u>\$ 195,254</u>

(a) Securities are categorized using the S&P rating. If a security is not rated by S&P, the Moody's rating is used. At March 31, 2010, all of the Company's fixed income securities were rated by S&P or Moody's.

The Company holds three non-investment grade securities in an unrealized loss position at March 31, 2010. Two of these are obligations of states and political subdivisions issued by governmental utility authorities. At March 31, 2010, one of these securities had an unrealized loss of \$0.2 million, or 4.7% of its amortized cost, and the other had an unrealized loss of \$0.9 million, or 8.1% of its amortized cost. The unrealized loss position of each of these securities improved slightly at March 31, 2010 compared to December 31, 2009. Based on the underlying fundamentals of these securities, the Company continues to believe that all interest and principal will be paid according to their contractual terms. The Company has no current intent to sell these securities, nor is it more likely than not that it will be required to sell prior to recovery of amortized cost. As such, the Company has not recorded an OTTI loss on these securities at March 31, 2010.

The other security rated below investment grade and in an unrealized loss position is an asset-backed security collateralized by sub-prime home loans originated prior to 2005. During 2010, the Company received repayments on this security of \$0.2 million, or approximately 6% of the par value outstanding at December 31, 2009. However, this security was determined to have an additional credit loss of \$0.1 million during the three months ended March 31, 2010 which was recorded in earnings. The non-credit component of this security's OTTI recognized in accumulated other comprehensive income at March 31, 2010 was \$0.4 million. The Company believes the unrealized loss on this security is primarily attributable to broader economic conditions and liquidity concerns and is not indicative of the quality of the underlying collateral. The unrealized loss on this security at December 31, 2009 was \$0.5 million. The Company also recognized a credit-related loss of \$0.1 million on this security in the second quarter of 2009. The Company has no current intent to sell this security, nor is it more likely than not that it will be required to sell prior to recovery of the adjusted amortized cost.

Of the 37 investment grade securities in an unrealized loss position, only one was in a unrealized loss position that exceeded 10% of the security's amortized cost. This security, issued by a governmental utility authority, which had an unrealized loss of 10.6% of amortized cost, was also the largest unrealized loss in dollars (\$0.6 million). Only one other security was in an unrealized loss position that exceeded 5% of that security's amortized cost. This security, an asset-backed security collateralized by sub-prime home loans

originated prior to 2005, had an unrealized loss of 5.3% of amortized cost, or \$0.1 million. Gross unrealized losses on the Company's investment grade fixed income portfolio have improved from \$4.9 million at December 31, 2009 to \$3.3 million at March 31, 2010. The Company believes that the unrealized losses are primarily due to credit spread widening, and to a lesser extent, market illiquidity and certain asset classes being out of favor with investors.

As of December 31, 2009, \$405.5 million of the Company's investments were guaranteed by one of three major mono-line bond insurers. This includes \$403.3 million of bonds of states and political obligations, or about 55% of the Company's investments in this category of security. Investments in obligations of states and political subdivisions represent approximately 56% of the Company's invested assets. The ratings on these securities reflect the higher of the underlying rating of the issuer or the insurer's rating. Of the \$403.3 million of bonds that were insured, \$95.8 million of these securities reflect credit rating enhancement due to the guarantee. The underlying ratings of the enhanced securities are \$65.3 million AA, \$29.9 million A and \$0.6 million BBB. The underlying ratings of all municipal holdings remain very strong and carry an average rating of AA. The Company views bond insurance as credit enhancement and not credit substitution and a credit review is performed on each issuer of bonds purchased. Based on the strong underlying credit quality of its insured bonds, the Company believes that any impact of potential ratings downgrades or other difficulties of the mono-line bond insurers would not have a significant impact on the Company's financial position or results of operations.

The Company has no current intent to sell any of the securities in an unrealized loss position, nor is it more likely than not that it will be required to sell these securities prior to recovery of amortized cost. Except as described above for the one sub-prime home loan asset-backed security, the Company believes that all of the securities in an unrealized loss position will recover in value and that none of these unrealized losses were indicative of credit losses. Based on the current facts and circumstances of the Company's particular security holdings, the Company has determined that no additional OTTI losses related to the securities in an unrealized loss position are required to be recorded.

Invested assets are exposed to various risks, such as interest rate, market and credit risks. Due to the level of risk associated with certain of these invested assets and the level of uncertainty related to changes in the value of these assets, it is possible that changes in risks in the near term may significantly affect the amounts reported in the Condensed Consolidated Balance Sheets and Condensed Consolidated Statements of Income.

FORWARD-LOOKING STATEMENTS

This report includes a number of statements, which relate to anticipated future events (forward-looking statements) rather than actual present conditions or historical events. Forward-looking statements generally include words such as "believes," "expects," "intends," "anticipates," "estimates" and similar expressions. Forward-looking statements in this report include expected developments in the Company's insurance business, including losses and loss reserves; the impact of routine ongoing insurance reserve reviews being conducted by the Company; the routine state regulatory examinations of the Company's primary insurance company subsidiaries, and the Company's responses to the results of those reviews and examinations; the Company's expectations concerning its revenues, earnings, expenses and investment activities; expected cost savings and other results from the Company's expense reduction and restructuring activities; and the Company's proposed actions in response to trends in its business.

Forward-looking statements, by their nature, are subject to a variety of inherent risks and uncertainties that could cause actual results to differ materially from the results projected. Many of these risks and uncertainties cannot be controlled by the Company.

Some examples of these risks and uncertainties are:

- general economic and business conditions;
- changes in financial markets such as fluctuations in interest rates, long-term periods of low interest rates, credit conditions and currency, commodity and stock prices;
- the ability of the Company's contract principals to fulfill their bonded obligations;
- the effects of corporate bankruptcies on surety bond claims, as well as on capital markets;
- changes in foreign or domestic political, social and economic conditions;

- regulatory initiatives and compliance with governmental regulations, judicial decisions, including interpretation of policy provisions, decisions regarding coverage, trends in litigation and the outcome of any litigation involving the Company, and rulings and changes in tax laws and regulations;
- regulatory limitations, impositions and restrictions upon the Company, including the effects of assessments and other surcharges for guaranty funds and other mandatory pooling arrangements;
- the impact of competitive products, policies and pricing and the competitive environment in which the Company operates, including changes in the Company's books of business;
- product and policy availability and demand and market responses, including the level of ability to obtain rate increases and decline or non-renew underpriced accounts, to achieve premium targets and profitability and to realize growth and retention estimates;
- development of claims and the impact on loss reserves, including changes in claim settlement practices;
- the performance of reinsurance companies under reinsurance contracts with the Company;
- results of financing efforts, including the Company's ability to access capital markets;
- changes in the Company's composition of operating segments;
- the sufficiency of the Company's loss reserves and the possibility of future increases in reserves;
- the risks and uncertainties associated with the Company's loss reserves; and,
- the possibility of further changes in the Company's ratings by ratings agencies, including the inability to access certain markets or distribution channels and the required collateralization of future payment obligations as a result of such changes, and changes in rating agency policies and practices.

Any forward-looking statements made in this report are made by the Company as of the date of this report. The Company does not have any obligation to update or revise any forward-looking statement contained in this report, even if the Company's expectations or any related events, conditions or circumstances change.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

CNA Surety's investment portfolio is subject to economic losses due to adverse changes in the fair value of its financial instruments, or market risk. Interest rate risk represents the largest market risk factor affecting the Company's consolidated financial condition due to its significant level of investments in fixed income securities. Increases and decreases in prevailing interest rates generally translate into decreases and increases in the fair value of the Company's fixed income portfolio. The fair value of these interest rate sensitive instruments may also be affected by the credit-worthiness of the issuer, prepayment options, relative value of alternative investments, the liquidity of the instrument, income tax considerations and general market conditions. The Company manages its exposure to interest rate risk primarily through an asset/liability matching strategy. The Company's exposure to interest rate risk is mitigated by the relative short-term nature of its insurance and other liabilities. The targeted effective duration of the Company's investment portfolio is approximately 5 years, consistent with the expected duration of its insurance and other liabilities.

The tables below summarize the estimated effects of certain hypothetical changes in interest rates. It is assumed that the changes occur immediately and uniformly across each investment category. At March 31, 2010 and December 31, 2009, the selected hypothetical changes in market interest rates reflect the Company's expectations of the reasonably possible scenarios over a one-year period and the hypothetical fair values are based upon the same prepayment assumptions that were utilized in computing fair values. Significant variations in market interest rates could produce changes in the timing of repayments due to prepayment options available. The fair value of such instruments could be affected and therefore actual results might differ from those reflected in the following tables.

	Fair Value at March 31, 2010	Hypothetical Change in Interest Rate (bp=basis points)	Estimated Fair Value After Hypothetical Change in Interest Rate	Hypothetical Percentage Decrease in Stockholders' Equity
(Dollars in thousands)				
U.S. Government and government agencies and authorities	\$ 147,057	200 bp increase	\$ 136,332	(0.7)%
		150 bp increase	139,343	(0.5)
		100 bp increase	142,282	(0.3)
		50 bp increase	145,056	(0.1)
States, municipalities and political subdivisions	729,436	200 bp increase	652,292	(5.3)
		150 bp increase	672,523	(3.9)
		100 bp increase	693,550	(2.5)
		50 bp increase	715,376	(1.0)
Corporate bonds	395,473	200 bp increase	362,963	(2.2)
		150 bp increase	371,515	(1.6)
		100 bp increase	380,360	(1.0)
		50 bp increase	389,509	(0.4)
Mortgage-backed and asset-backed	<u>36,331</u>	200 bp increase	34,774	(0.1)
		150 bp increase	35,201	(0.1)
		100 bp increase	35,638	—
		50 bp increase	36,084	—
Total fixed income securities available-for-sale	<u>\$ 1,308,297</u>	200 bp increase	1,186,361	(8.3)
		150 bp increase	1,218,582	(6.1)
		100 bp increase	1,251,830	(3.8)
		50 bp increase	1,286,025	(1.5)

	Fair Value at December 31, 2009	Hypothetical Change in Interest Rate (bp=basis points)	Estimated Fair Value After Hypothetical Change in Interest Rate	Hypothetical Percentage Decrease in Stockholders' Equity
(Dollars in thousands)				
U.S. Government and government agencies and authorities	\$ 157,128	200 bp increase	\$ 144,937	(0.9)%
		150 bp increase	148,310	(0.6)
		100 bp increase	151,570	(0.4)
		50 bp increase	154,580	(0.2)
States, municipalities and political subdivisions	728,568	200 bp increase	641,122	(6.2)
		150 bp increase	661,735	(4.7)
		100 bp increase	683,176	(3.2)
		50 bp increase	705,453	(1.6)
Corporate bonds	344,109	200 bp increase	310,703	(2.4)
		150 bp increase	318,610	(1.8)
		100 bp increase	326,806	(1.2)
		50 bp increase	335,301	(0.6)
Mortgage-backed and asset-backed	<u>36,418</u>	200 bp increase	34,525	(0.1)
		150 bp increase	34,982	(0.1)
		100 bp increase	35,450	(0.1)
		50 bp increase	35,928	—
Total fixed income securities available-for-sale	<u>\$ 1,266,223</u>	200 bp increase	1,131,287	(9.6)
		150 bp increase	1,163,637	(7.2)
		100 bp increase	1,197,002	(4.9)
		50 bp increase	1,231,262	(2.4)

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains a system of disclosure controls and procedures which are designed to ensure that information required to be disclosed by the Company in reports that it files or submits to the Securities and Exchange Commission under the Securities and Exchange Act of 1934 as amended (the “Exchange Act”), including this report, is recorded, processed, summarized and reported on a timely basis. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed under the Exchange Act is accumulated and communicated to the Company’s management on a timely basis to allow decisions regarding required disclosure.

The Company’s principal executive officer and its principal financial officer undertook an evaluation of the Company’s disclosure controls and procedures (as defined in Rules 13a — 15(e) and 15d — 15(e) under the Exchange Act) as of the end of the period covered by this report and concluded that the Company’s controls and procedures were effective.

There were no changes in the Company’s internal control over financial reporting that occurred during the Company’s last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS — Information on the Company’s legal proceedings is set forth in Note 8 of the Condensed Consolidated Financial Statements included under Part 1, Item 1.

ITEM 1a. RISK FACTORS — Information on the Company’s risk factors is set forth in Item 1A “Risk Factors” in the Company’s Annual Report on Form 10-K for the year ended December 31, 2009.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS — None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES — None.

ITEM 4. — None.

ITEM 5. OTHER INFORMATION — Reports on Form 8-K:

February 5, 2010; CNA Surety Corporation Earnings Press Release issued on February 5, 2010.

February 8, 2010; Compensatory Arrangements of Certain Officers.

ITEM 6. EXHIBITS

	<u>Exhibit Number</u>
Form of Administrative Services Agreement by and between CNA Surety Corporation and Continental Casualty Company.	10 (49)
Certification pursuant to Rule 13a—14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Chief Executive Officer.	31 (1)
Certification pursuant to Rule 13a—14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 - Chief Financial Officer.	31 (2)
Certification pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - Chief Executive Officer.	32 (1)*
Certification pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 - Chief Financial Officer.	32 (2)*

* Exhibits 32(1) and 32(2) are being furnished and shall not be deemed “filed” for the purpose of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities of that Section. These Exhibits shall not be incorporated by reference into any registration statement or other document pursuant to the Securities Act of 1933, as amended.

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

CNA SURETY CORPORATION (Registrant)

/s/ John F. Welch

John F. Welch
President and Chief Executive Officer

/s/ John F. Corcoran

John F. Corcoran
Senior Vice President and Chief Financial Officer

Date: April 30, 2010

EXHIBIT INDEX

- 10(49) Form of Administrative Services Agreement by and between CNA Surety Corporation and Continental Casualty Company.
- 31(1) Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 — Chief Executive Officer.
- 31(2) Certification pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 — Chief Financial Officer.
- 32(1) Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 — Chief Executive Officer.
- 32(2) Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 — Chief Financial Officer.

ADMINISTRATIVE SERVICES AGREEMENT

THIS ADMINISTRATIVE SERVICES AGREEMENT (“*Agreement*”) is made effective as of January 1, 2010 by and between Continental Casualty Company (“*CCC*”), an Illinois insurance company, and CNA Surety Corporation, a Delaware corporation (“*Surety*”).

WITNESSETH:

WHEREAS, CNA Financial Corporation, a Delaware corporation (“*CNAF*”), indirectly owns all of the issued and outstanding common stock of CCC and CCC owns the majority of the issued and outstanding common stock of Surety;

WHEREAS, CCC is the employer of the individuals who perform services for CNAF, along with CNAF’s subsidiaries and affiliates (collectively, the “*CNA Companies*”), and is the primary CNAF subsidiary that contracts with third parties to obtain goods and services on behalf of the CNA Companies;

WHEREAS, both parties acknowledge and agree that it is to their mutual benefit to have CCC provide certain administrative services to Surety in exchange for fair and reasonable compensation, all in accordance with the terms and conditions set forth herein; and

WHEREAS, both parties acknowledge and agree that it is to their mutual benefit to have Surety provide certain administrative services to CCC in exchange for fair and reasonable compensation, all in accordance with the terms and conditions set forth herein;

NOW THEREFORE, for and in consideration of the mutual covenants and agreements set forth herein, the receipt and sufficiency of which the parties hereby acknowledge, the parties agree as follows:

1. Administrative Services To Be Provided by CCC. In exchange for the CCC Administrative Services Fee (as defined in Section 6), CCC shall provide to Surety certain administrative services which shall include, but not be limited to, the services described below (collectively, the “*CCC Administrative Services*”):

(a) Corporate Insurance. CCC will place certain corporate insurance policies for the protection of the assets and revenues of CNAF and will assist in coordinating coverage between CCC and Surety.

(b) Internal Audit. CCC will perform various operating, claims, underwriting, information technology systems, designated underwriting authority and financial and premium audits annually or as otherwise mutually determined.

(c) Financial Accounting & Reporting. CCC will assist Surety with various accounting/financial reporting issues, including monthly and quarterly financial close activities, as well as with other related matters as needed.

(d) Information Technology. Where permitted by the underlying license or use agreements, CCC will provide Surety access to CCC’s voice and data networks, as well as access to CCC’s enterprise software, obtaining any necessary permission or licensing as may be required.

(e) Business Reports. Where permitted by the underlying license or subscription agreements, CCC will provide Surety access to certain third party business reports to which CCC subscribes, obtaining any necessary permission or licensing as may be required.

(f) Compliance. CCC will assist Surety with its Sarbanes-Oxley compliance program, as well as other compliance programs, and periodically provide compliance auditing services. Surety may also utilize CCC’s online Risk Control Tracking System (RCTS) for Sarbanes-Oxley compliance reporting purposes.

(g) Contract Administration. CCC will provide contract administration services to Surety, including, without limitation, sourcing, procurement and negotiation services, as needed.

(h) Real Estate Services. CCC will procure and provide office space to Surety including the negotiation of rents and lease terms, as well as the provision of facilities planning and management services, all as needed.

(i) Human Resources. CCC will provide associate survey and compensation survey materials and other various human resource materials to Surety on an annual basis. In addition, CCC will make available to Surety CCC's web-based training.

(j) Legal. CCC will provide contract review and legal counsel to Surety as needed.

(k) Marketing. CCC will provide marketing services to Surety as needed.

(l) Organizational Development and Training. CCC will provide Surety with access to hard-copy and on-line training materials and standard talent review tools for succession planning.

(m) Tax Preparation. CCC will assist Surety with state and federal income tax preparation and provide tax consulting services as needed.

Surety may, from time to time, elect to expand or otherwise modify the specific CCC Administrative Services enumerated above at mutually acceptable rates determined in accordance with the methodologies applicable to the calculation of the CCC Administrative Services Fee, as further described in Section 6.

2. Services To Be Provided By Surety. In exchange for the Surety Administrative Services Fee (as defined in Section 7), Surety, through its subsidiary Western Surety Company, shall provide to CCC certain administrative services which shall include, but not be limited to, the services described below (collectively, the "*Surety Administrative Services*"):

(a) Agency Licensing Services. Surety will assist CCC, along with other subsidiaries and affiliates of CCC, with the provision of certain agency licensing, appointment and related agent record-keeping services, as needed.

(b) Agency Contracts. Surety will assist CCC, along with other subsidiaries and affiliates of CCC, with the maintenance of agency contracts, as needed.

CCC may, from time to time, elect to expand or otherwise modify the specific Surety Administrative Services enumerated above at mutually acceptable rates determined in accordance with the methodologies applicable to the calculation of the Surety Administrative Services Fee, as further described in Section 7.

3. Employees. CCC authorizes its employees (collectively, the "*CCC Employees*") to perform the CCC Administrative Services for Surety and Surety consents to receive the CCC Administrative Services through the CCC Employees. Similarly, Surety authorizes its employees (collectively, the "*Surety Employees*") to perform the Surety Administrative Services for CCC and CCC consents to receive the Surety Administrative Services through the Surety Employees. Notwithstanding any provision in this Agreement to the contrary, however, CCC shall continue to remain the sole employer of the CCC Employees and Surety shall continue to remain the sole employer of the Surety Employees.

4. Control & Responsibility. CCC shall provide all CCC Administrative Services under the sole ultimate direction and control of Surety's senior management. Similarly, Surety shall provide all Surety Administrative Services under the sole ultimate direction and control of CCC's senior management. As a result, notwithstanding any provision in this Agreement to the contrary, Surety shall retain ultimate liability and responsibility for the CCC Administrative Services and CCC shall retain ultimate liability and responsibility for the Surety Administrative Services.

5. Term. The term of this Agreement ("*Term*") shall commence effective as of January 1, 2010 and shall automatically renew each year until the earlier to occur of the following: (a) either party elects to terminate this Agreement by providing written notice to the remaining party at least thirty (30) days in advance of the date on which the termination is to take effect; or (b) a change in control occurs as to either party such that it is no longer ultimately owned, in whole or in part, by CNAF, in which event this Agreement shall automatically terminate immediately upon the date on which the change in control takes effect.

6. CCC Administrative Services Fee.

(a) In exchange for the CCC Administrative Services, Surety hereby covenants and agrees to remit to CCC compensation in the manner set forth in Appendix A attached hereto and incorporated herein (“*CCC Administrative Services Fee*”). The CCC Administrative Services Fee shall be: (1) substantially equivalent to the parties’ good faith estimate of Surety’s anticipated usage of the then current definition of the CCC Administrative Services; (2) based on an equitable allocation of the actual costs incurred by CCC in providing the CCC Administrative Services including, without limitation, salaries, rent, utility charges, legal expenses and auditing fees, as well as sales, excise, value added and real estate taxes; and (3) in conformity with customary insurance accounting practices consistently applied in compliance with applicable governmental rules and regulations in a manner that reflects the reasonable, customary and usual charges for the CCC Administrative Services established in accordance with prudent and rational cost accounting methodologies and in conformity with applicable arm’s length pricing regulations. The CCC Administrative Services Fee shall also include reimbursement to CCC for any and all third party charges CCC incurs in connection with the CCC Administrative Services, plus an arm’s length markup of certain costs to the extent they involve any of the CCC Administrative Services that are not eligible for allocation to Surety under the services cost method (SCM), as defined by the U.S. Internal Revenue Service from time to time (*see e.g.*, Treasury Regulation §1.482-9T(b)).

(b) The portion of the CCC Administrative Services Fee related to procuring and providing office space, along with related real estate services, to Surety pursuant to Section 1(h) (“*CCC Real Estate Services Fee*”) is initially calculated based on Surety’s percentage of rentable square feet in each office location as negotiated between both parties at the time the lease is executed. For the purpose of calculating the CCC Real Estate Services Fee, Surety’s percentage of rentable square feet will remain unchanged until any one of the following conditions is met: (1) Surety request to occupy and subsequently occupies additional space in the office location; (2) the percentage is renegotiated between both parties due to a significant change in the number of occupants in the office location; (3) the lease term is modified; or (4) the lease expires. Although CCC shall monitor periodic changes to Surety’s percentage of rentable square feet, for administrative convenience, the parties shall true up the CCC Real Estate Services Fee on an annual basis through the ordinary course of reconciling accounts between the parties. The results of the true up shall be mutually agreed by the parties, as evidenced by the approval of CCC’s Controller and Surety’s Chief Financial Officer (or their respective designees), which approval need not be in writing. Except as provided in this Section 6(b) and Sections 6(c) and 6(d), the CCC Administrative Services Fee shall be fixed and shall not be subject to any true up or other modification, regardless of Surety’s use or non-use of the CCC Administrative Services.

(c) The addition or deletion of any recurring CCC Administrative Services that are material in nature or dollar amount shall be provided at mutually acceptable rates determined in accordance with the methodologies applicable to the calculation of the CCC Administrative Services Fee, as described in this Section 6. The adjustment to the CCC Administrative Services Fee shall be evidenced by a mutually executed updated version of Appendix A which shall automatically supersede and replace in its entirety the then current version of Appendix A.

(d) The addition or deletion of any non-recurring CCC Administrative Services, whether or not material in nature or dollar amount, shall be provided at mutually acceptable rates determined in accordance with the methodologies applicable to the calculation of the CCC Administrative Services Fee, as described in this Section 6. The adjustment to the CCC Administrative Services Fee shall be mutually approved by CCC’s Controller and Surety’s Chief Financial Officer (or their respective designees), which approval need not be in writing.

7. Surety Administrative Services Fee.

(a) In exchange for the Surety Administrative Services, CCC hereby covenants and agrees to remit to Surety compensation in the manner set forth in Appendix B attached hereto and incorporated herein (“*Surety Administrative Services Fee*”). The Surety Administrative Services Fee shall be: (1) substantially equivalent to the parties’ good faith estimate of CCC’s anticipated usage of the then current definition of the Surety Administrative Services; (2) based on an equitable allocation of the actual costs incurred by Surety in providing the Surety Administrative Services including, without limitation, salaries, rent, utility charges, legal expenses and auditing fees, as well as sales, excise, value added and real estate taxes; and (3) in conformity with customary insurance accounting practices consistently applied in compliance with applicable governmental rules and regulations in a manner that reflects the reasonable, customary and usual charges for the Surety Administrative Services established in accordance with prudent and rational cost accounting methodologies. The Surety Administrative Services Fee shall also include reimbursement to Surety for any and all third party charges Surety incurs in connection with the Surety Administrative Services including, but not limited to, those imposed by state insurance regulators, plus an arm’s length markup of certain costs to the extent they involve any of the Surety Administrative Services that are not eligible for allocation to CCC at cost. Except as provided in Sections 7(b) and 7(c), the Surety Administrative Services Fee shall be fixed and shall not be subject to any true up or other modification, regardless of CCC’s use or non-use of the Surety Administrative Services.

(b) The addition or deletion of any recurring Surety Administrative Services that are material in nature or dollar amount shall be provided at mutually acceptable rates determined in accordance with the methodologies applicable to the calculation of the Surety Administrative Services Fee, as described in this Section 7. The adjustment to the Surety Administrative Services Fee shall be evidenced by a mutually executed updated version of Appendix B which shall automatically supersede and replace in its entirety the then current version of Appendix B.

(c) The addition or deletion of any non-recurring Surety Administrative Services, whether or not material in nature or dollar amount, shall be provided at mutually acceptable rates determined in accordance with the methodologies applicable to the calculation of the Surety Administrative Services Fee, as described in this Section 7. The adjustment to the Surety Administrative Services Fee shall be mutually approved by CCC's Controller and Surety's Chief Financial Officer (or their respective designees), which approval need not be in writing.

8. Compliance with Laws. Both parties shall comply with applicable laws in effect from time to time including, without limitation, the Foreign Corrupt Practices Act of 1977 and the Patriot Act, as well as regulations and restrictions imposed by the U.S. Treasury's Office of Foreign Assets Control.

9. Choice of Law; Severability. This Agreement shall be governed by and construed in accordance with the laws of the state of Illinois without regard to conflict or choice of law principles. If any covenant, condition, or provision herein is held to be invalid, the invalidity thereof shall be severable from the remainder of this Agreement and shall not in any way affect any other covenant, condition or provision herein.

10. Entire Agreement. This Agreement constitutes the entire agreement between CCC and Surety relating to the administrative services they provide to one another, and any prior agreements whether verbal or written have been superseded, merged and integrated into this Agreement including, without limitation, that certain Restated Administrative Services Agreement, dated as of July 1, 2004, by and between the parties, which agreement shall be automatically be terminated and of no further force and effect immediately upon the date upon which this Agreement takes effect. Notwithstanding the foregoing, however, any reinsurance agreements between the parties shall continue to remain in full force and effect and shall not be superseded, merged or integrated into this Agreement.

11. Successors & Assigns; No Third Party Beneficiaries. This Agreement shall be binding on and inure to the benefit of both parties and their respective successors and permitted assigns and may not be modified or amended orally, but only in a writing signed by all parties. Surety may not assign its rights or obligations under this Agreement without the prior written consent of CCC, which consent may be withheld in CCC's sole and absolute discretion. This Agreement shall be solely for the benefit of the parties hereto and no other person or entity (with the exception of successors and permitted assigns) shall be a third-party beneficiary.

12. Non-Waiver. No failure or delay by either party in exercising any right with respect to this Agreement shall operate as a waiver thereof, nor shall any single or partial exercise thereof preclude any other or further exercise thereof or the exercise of any other right.

13. Counterparts. This Agreement may be executed in counterparts, each of which shall constitute an original, but all of which together shall constitute one and the same instrument. In addition, this Agreement may be executed via facsimile and that facsimile signatures shall be valid and binding for all purposes

IN WITNESS WHEREOF, the parties have executed and delivered this Administrative Services Agreement as of the date first above written.

Continental Casualty Company

CNA Surety Corporation

By: _____
Printed Name: _____
Title: _____

By: _____
Printed Name: _____
Title: _____

Attest:

By: _____
Printed Name: _____
Title: _____

Appendix A
Administrative Services Agreement by and between Continental Casualty Company and
CNA Surety Corporation (“Agreement”)

Administrative Services Fee

Pursuant to Section 6 of the Agreement, the CCC Administrative Services Fee shall be four million four hundred sixty-nine thousand one hundred forty dollars (\$4,469,140). The CCC Administrative Services Fee shall be payable in twelve (12) equal installments on or before the last day of each month during the Term, either through cash or an inter-company credit. If the Term ends during the course of a calendar year, the CCC Administrative Services Fee shall be equitably pro-rated.

Based on surveys conducted by CCC to identify all planned activities to be performed by CCC for the benefit of Surety, the estimated cost of providing the CCC Administrative Services was determined by using time and cost estimates developed by subject matter experts during the 2010 annual corporate planning cycle. Hourly cost rates are based on average employee cost rates by pay grade and include, without limitation, the cost of employee salaries, benefits, payroll taxes, space utilization, end-user computing, corporate insurance, and human resources support.

As provided in Section 6(b) of the Agreement, the parties shall true up the CCC Real Estate Services Fee on an annual basis through the ordinary course of reconciling accounts between the parties. The results of the true up shall be mutually agreed by the parties, as evidenced by the approval of CCC’s Controller and Surety’s Chief Financial Officer (or their respective designees), which approval need not be in writing. Except as provided in Section 6(b) and Sections 6(c) and 6(d) of the Agreement, the CCC Administrative Services Fee shall be fixed and shall not be subject to any true up or other modification, regardless of Surety’s use or non-use of the CCC Administrative Services.

The expansion or other modification of the specific CCC Administrative Services shall be provided at mutually acceptable rates determined in accordance with the methodologies applicable to the calculation of the CCC Administrative Services Fee, as further described in Section 6 of the Agreement. The addition or deletion of any non-recurring CCC Administrative Services shall be mutually approved by CCC’s Controller and Surety’s Chief Financial Officer (or their respective designees), which approval need not be in writing, but the addition or deletion of any recurring CCC Administrative Services that are material in nature or dollar amount shall be evidenced by a mutually executed updated version of Appendix A which shall automatically supersede and replace in its entirety the then current version of Appendix A.

Appendix B
Administrative Services Agreement by and between Continental Casualty Company and
CNA Surety Corporation (“Agreement”)

Surety Administrative Services Fee

Pursuant to Section 7 of the Agreement, the Surety Administrative Services Fee shall initially be set at one million three hundred thirty-five thousand fifty-five dollars (\$1,335,055).

The Surety Administrative Services Fee shall be payable in twelve (12) equal installments on or before the last day of each month during the Term, either through cash or an inter-company credit. If the Term ends during the course of a calendar year, the Surety Administrative Services Fee shall be equitably pro-rated. On or before the last day of each month, Surety shall provide CCC with a statement of all third party fees it incurred during such month in connection with the Surety Administrative Services. Reimbursement of such fees shall be payable, either through cash or an inter-company credit, within ten (10) business days.

Based on surveys conducted by Surety to identify all planned activities to be performed by Surety for the benefit of CCC, the estimated cost of providing the Surety Administrative Services was determined by using time and cost estimates developed by subject matter experts during the 2010 annual corporate planning cycle. Hourly cost rates are based on an average employee cost rate, and include, without limitation, the cost of employee salaries, benefits, payroll taxes, space utilization, end-user computing, corporate insurance, and human resources support.

Except as provided in Sections 7(b) and 7(c) of the Agreement, the Surety Administrative Services Fee shall be fixed and shall not be subject to any true up or other modification, regardless of CCC’s use or non-use of the Surety Administrative Services.

The expansion or other modification of the specific Surety Administrative Services shall be provided at mutually acceptable rates determined in accordance with the methodologies applicable to the calculation of the Surety Administrative Services Fee, as further described in Section 7 of the Agreement. The addition or deletion of any non-recurring Surety Administrative Services shall be mutually approved by CCC’s Controller and Surety’s Chief Financial Officer (or their respective designees), which approval need not be in writing, but the addition or deletion of any recurring Surety Administrative Services that are material in nature or dollar amount shall be evidenced by a mutually executed updated version of Appendix B which shall automatically supersede and replace in its entirety the then current version of Appendix B.

CERTIFICATION PURSUANT TO
 RULE 13A-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934,
 AS ADOPTED PURSUANT TO
 SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, John F. Welch certify that:

1. I have reviewed this quarterly report on Form 10-Q of CNA Surety Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 (the "Exchange Act") Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
 - d) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 30, 2010

/s/ John F. Welch

 John F. Welch
 President and Chief Executive Officer

CERTIFICATION PURSUANT TO
 RULE 13A-14(A) OF THE SECURITIES EXCHANGE ACT OF 1934,
 AS ADOPTED PURSUANT TO
 SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, John F. Corcoran, certify that:

1. I have reviewed this quarterly report on Form 10-Q of CNA Surety Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 (the "Exchange Act") Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this quarterly report based on such evaluation; and
 - d) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: April 30, 2010

/s/ John F. Corcoran

John F. Corcoran

Senior Vice President and Chief Financial Officer

WRITTEN STATEMENT OF THE CHIEF EXECUTIVE OFFICER
OF CNA SURETY CORPORATION
PURSUANT TO 18 U.S.C. SECTION 1350
(AS ADOPTED BY SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002)

The undersigned, the Chief Executive Officer of CNA Surety Corporation (the “Company”), hereby certifies that, to his knowledge:

- The Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 filed on the date hereof with the Securities and Exchange Commission (the “Report”) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: April 30, 2010

/s/ John F. Welch

John F. Welch
President and Chief Executive Officer

The foregoing certification is being furnished solely pursuant to 18 U.S.C. Section 1350 and is not being filed as part of the Report or as a separate disclosure document.

WRITTEN STATEMENT OF THE CHIEF FINANCIAL OFFICER
OF CNA SURETY CORPORATION
PURSUANT TO 18 U.S.C. SECTION 1350
(AS ADOPTED BY SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002)

The undersigned, the Chief Financial Officer of CNA Surety Corporation (the "Company"), hereby certifies that, to his knowledge:

- The Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 filed on the date hereof with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: April 30, 2010

/s/ John F. Corcoran
John F. Corcoran
Senior Vice President and Chief Financial Officer

The foregoing certification is being furnished solely pursuant to 18 U.S.C. Section 1350 and is not being filed as part of the Report or as a separate disclosure document.