CNA SURETY CORP
Form 10-Q
August 12, 2002

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

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

For the quarterly period ended June 30, 2002

OR

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

Commission file number: 1-13277

CNA SURETY CORPORATION
(Exact name of Registrant as specified in its Charter)

| | |
|---|---|
| Delaware<br>(State or other jurisdiction of<br>incorporation or organization) | 36-4144905<br>(I.R.S. Employer<br>Identification No.) |
| CNA Plaza, Chicago, Illinois<br>(Address of principal executive offices) | 60685<br>(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 X No
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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:

42,942,229 shares of Common Stock, $.01 par value as of August 2, 2002.

CNA SURETY CORPORATION AND SUBSIDIARIES

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INDEPENDENT ACCOUNTANTS' REPORT

To the Board of Directors and Stockholders of
CNA Surety Corporation
Chicago, Illinois

We have reviewed the accompanying condensed consolidated balance sheet of CNA Surety Corporation and subsidiaries as of June 30, 2002, and the related condensed consolidated statements of income for the three-month and six-month periods ended June 30, 2002 and 2001 and the related condensed consolidated statements of stockholders' equity and of cash flows for the six-month periods ended June 30, 2002 and 2001. These financial statements are the responsibility of the Corporation's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and of making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to such condensed consolidated financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of CNA Surety Corporation and subsidiaries as of December 31, 2001, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated February 11, 2002, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2001 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Deloitte & Touche LLP
Chicago, Illinois
August 5, 2002

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CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Amounts in thousands, except per share data)

| | (Unaudite June 30 2002 |
|---|---|
| ASSETS | |
| Invested assets and cash: | |
| Fixed income securities, at fair value (amortized cost: $467,099 and $464,102) ... | $ 487,29 |
| Equity securities, at fair value (cost: $58,377 and $42,614) .................... | 48,19 |
| Short-term investments, at cost (approximates fair value) ....................... | 54,59 |
| Other investments, at fair value ................................................ | 5,11 |
| Cash ............................................................................ | 13,24 |
| Total invested assets and cash .................................................. | 608,43 |
| Deferred policy acquisition costs ............................................... | 97,14 |
| Insurance receivables: | |
| Premiums, including $28,771 and $29,829 from affiliates (net of allowance for doubtful accounts: $1,955 and $2,614) ........................................ | 42,02 |
| Reinsurance, including $42,770 and $58,027 from affiliates ...................... | 153,38 |
| Intangible assets (net of accumulated amortization: $25,523 and $25,523) .......... | 143,78 |
| Property and equipment, at cost (less accumulated depreciation: $15,537 and $14,138) ............................................. | 17,66 |

| | |
|---|---|
| Prepaid reinsurance premiums | 9,42 |
| Other assets | 9,22 |
| Total assets | $ 1,081,09 |
| LIABILITIES | |
| Reserves: | |
| Unpaid losses and loss adjustment expenses | $ 308,74 |
| Unearned premiums | 211,79 |
| Total reserves | 520,53 |
| Debt | 76,19 |
| Deferred income taxes, net | 25,96 |
| Payable for securities purchased | 46 |
| Current income taxes payable | 2,39 |
| Reinsurance and other payables to affiliates | 9,00 |
| Other liabilities | 40,17 |
| Total liabilities | $ 674,73 |
| Commitments and contingencies (See Note 5) | |
| STOCKHOLDERS' EQUITY | |
| Common stock, par value $.01 per share, 100,000 shares authorized; 44,359 shares issued and 42,915 shares outstanding at June 30, 2002 and 44,229 shares issued and 42,780 shares outstanding at December 31, 2001 | 44 |
| Additional paid-in capital | 255,52 |
| Retained earnings | 159,71 |
| Accumulated other comprehensive income | 6,16 |
| Treasury stock, at cost | (15,50 |
| Total stockholders' equity | 406,35 |
| Total liabilities and stockholders' equity | $ 1,081,09 |

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

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CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Amounts in thousands, except per share data)
(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2002 | 2001 | 2002 | 2001 |
| Revenues: | | | | |

| | | | | |
|---|---|---|---|---|
| Net earned premium | $ 75,742 | $ 78,850 | $142,963 | $155,59 |
| Net investment income | 7,121 | 7,480 | 14,227 | 15,21 |
| Net realized investment gains | 1,601 | 192 | 1,323 | 16 |
| Total revenues | 84,464 | 86,522 | 158,513 | 170,97 |
| Expenses: | | | | |
| Net losses and loss adjustment expenses | 19,606 | 16,813 | 36,253 | 32,89 |
| Net commissions, brokerage and other underwriting | 45,594 | 48,184 | 87,146 | 95,02 |
| Interest expense | 445 | 957 | 903 | 2,54 |
| Amortization of intangible assets | -- | 1,524 | -- | 3,04 |
| Total expenses | 65,645 | 67,478 | 124,302 | 133,51 |
| Income before income taxes | 18,819 | 19,044 | 34,211 | 37,46 |
| Income taxes | 5,917 | 6,701 | 10,752 | 13,17 |
| Net income | $ 12,902 | $ 12,343 | $ 23,459 | $ 24,28 |
| Earnings per share | $ 0.30 | $ 0.29 | $ 0.55 | $ 0.5 |
| Earnings per share, assuming dilution | $ 0.30 | $ 0.29 | $ 0.55 | $ 0.5 |
| Weighted average shares outstanding | 42,900 | 42,738 | 42,868 | 42,72 |
| Weighted average shares outstanding, assuming dilution | 43,066 | 42,931 | 43,038 | 42,92 |

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

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CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(Amounts in thousands)
(Unaudited)

| | Common Stock Shares Outstanding | Common Stock | Additiona Paid-In Capital |
|---|---|---|---|
| Balance, December 31, 2000 | 42,702 | $ 441 | $ 253,49 |
| Comprehensive income: | | | |
| Net income | -- | -- | -- |
| Other comprehensive income: | | | |
| Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $152 | -- | -- | -- |

| | | | |
|---|---|---|---|
| Total comprehensive income ............................ | | | |
| Purchase of treasury stock .................................. | -- | -- | -- |
| Stock options exercised and other ........................... | 49 | 1 | 32 |
| Dividends paid to stockholders .............................. | -- | -- | -- |
| Balance, June 30, 2001 ...................................... | 42,751 | $ 442 | $ 253,82 |
| Balance, December 31, 2001 .................................. | 42,780 | $ 442 | $ 254,13 |
| Comprehensive income: | | | |
| Net income ................................................ | -- | -- | -- |
| Other comprehensive income: | | | |
| Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $428 ...... | -- | -- | -- |
| Total comprehensive income ............................ | | | |
| Issuance of treasury stock to employee stock purchase program | 5 | | |
| Stock options exercised and other ........................... | 130 | 2 | 1,38 |
| Dividends paid to stockholders .............................. | -- | -- | -- |
| Balance, June 30, 2002 ...................................... | 42,915 | $ 444 | $ 255,52 |

| | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasur Stock (at cos |
|---|---|---|---|
| Balance, December 31, 2000 .................................. | $ 135,308 | $ 267 | $ (15,48 |
| Comprehensive income: | | | |
| Net income ................................................ | 24,287 | -- | -- |
| Other comprehensive income: | | | |
| Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $152 ...... | -- | 156 | -- |
| Total comprehensive income............................ | | | |
| Purchase of treasury stock .................................. | -- | -- | -- |
| Stock options exercised and other ........................... | -- | -- | -- |
| Dividends paid to stockholders .............................. | (10,257) | -- | -- |
| Balance, June 30, 2001 ...................................... | $ 149,338 | $ 423 | $ (15,48 |
| Balance, December 31, 2001 .................................. | $ 149,128 | $ 278 | $ (15,55 |
| Comprehensive income: | | | |
| Net income ................................................ | 23,459 | -- | -- |
| Other comprehensive income: | | | |
| Change in unrealized gains on securities (after income taxes), net of reclassification adjustment of $428....... | -- | 5,888 | -- |
| Total comprehensive income............................ | | | |
| Issuance of treasury stock to employee stock purchase program | | | 5 |
| Stock options exercised and other ........................... | -- | -- | -- |
| Dividends paid to stockholders .............................. | (12,869) | -- | -- |

| | | | |
|---|---|---|---|
| Balance, June 30, 2002 | $ 159,718 | $ 6,166 | $ (15,50 |

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



CNA SURETY CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Amounts in thousands)
(Unaudited)

| | |
|---|---|
| OPERATING ACTIVITIES: | |
| Net income | $ |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Depreciation and amortization | |
| Accretion of bond discount, net | |
| Net realized investment losses | |
| Changes in: | |
| Insurance receivables | |
| Reserve for unearned premiums | |
| Reserve for unpaid losses and loss adjustment expenses | |
| Deferred policy acquisition costs | |
| Deferred income taxes, net | |
| Reinsurance and other payables to affiliates | |
| Prepaid reinsurance premiums | |
| Other assets and liabilities, net | |
| Net cash provided by operating activities | |
| INVESTING ACTIVITIES: | |
| Fixed income securities: | |
| Purchases | ( |
| Maturities | |
| Sales | |
| Purchases of equity securities | |
| Proceeds from the sale of equity securities | |
| Changes in short-term investments | |
| Purchases of property and equipment | |
| Changes in receivables/payables for securities sold/purchased, net | |
| Other, net | |
| Net cash provided by (used in) investing activities | |
| FINANCING ACTIVITIES: | |

| | |
|---|---|
| Principal payments on long-term debt | |
| Dividends to stockholders | |
| Issuance of treasury stock to employee stock purchase plan | |
| Employee stock option exercises | |
| Net cash used in financing activities | |
| Increase in cash | |
| Cash at beginning of period | |
| Cash at end of period | $ |
| Supplemental Disclosure of Cash Flow Information: | |
| Cash paid during the period for: | |
| Interest | $ |
| Income taxes | $ |

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

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CNA SURETY CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2002
(Unaudited)

1. Significant Accounting Policies

Principles of Consolidation

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

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("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 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 2001 Annual Report to Shareholders. Certain financial information that is normally 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. Certain reclassifications have been made to the 2001 Financial Statements to conform with the presentation in the 2002 Condensed Consolidated Financial

Statements.

Accounting Changes

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141 and No. 142 entitled "Business Combinations" ("SFAS No. 141") and "Goodwill and Other Intangible Assets" ("SFAS No. 142"), respectively. SFAS No. 141 requires that the purchase method of accounting be used for all business combinations subsequent to June 30, 2001 and specifies criteria for recognizing intangible assets acquired in a business combination. The Company will adopt this standard for any future business combinations. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. Any impairment loss for the excess of the carrying amount of an intangible asset over its fair value would be recognized as a charge to operations. Intangible assets with definite useful lives will continue to be amortized over their respective estimated useful lives. The Company has adopted the provisions of Statement No. 142 effective January 1, 2002.

Although all of the Company's products are sold through the same independent insurance agent and broker distribution network, the Company's underwriting and management reporting are organized by the two broad types of surety products or operating segments - contract surety and commercial surety, which also includes fidelity bonds and other insurance products for these purposes. These two operating segments are comprised of five components: large commercial, small commercial, large contract, small contract and international contract and commercial. The small, large and international components of



commercial have been aggregated into one operating segment (reporting unit) and the small, large and international components of contract have been aggregated into one operating segment (reporting unit) because of their similar economic characteristics.

The goodwill test for impairment consists of a two-step process that begins with an estimation of the fair value of the entity's reporting units. The first step of the test is a screen for potential impairment and the second step measures the amount of impairment, if any. SFAS No. 142 required an entity to complete the first step of the transitional goodwill impairment test within six months of adopting the Statement. In accordance with SFAS No. 142, the Company identified two reporting units which constitute components of its business that include goodwill.

The Company completed the first step of the transitional goodwill impairment test as of June 30, 2002 and has determined that the fair value of each reporting unit exceeded the reporting unit's carrying amount, and as such no impairment was taken.

In accordance with the transition guidance provided in SFAS No. 142, the Company has classified its intangible assets as intangibles with indefinite lives and has completed its initial impairment test. No asset impairment was indicated for these indefinite lived intangibles.

In determining whether there is an impairment of goodwill or other intangible assets, the Company calculated its estimated fair value using the present value of estimated expected future cash flows. The resulting estimated fair value was then compared to the net book value, including goodwill. If the net book value exceeded the estimated fair value, the Company would have measured the amount of impairment loss by comparing the implied estimated fair value of goodwill with the carrying amount of that goodwill. To the extent that the carrying amount of the goodwill exceeds its implied fair value, a goodwill impairment loss would be recognized. This impairment test will be performed annually and whenever facts and circumstances indicate that there is a possible impairment of goodwill. The Company believes the methodology it uses in testing impairment of goodwill provides a reasonable basis in determining whether an impairment charge should be taken.

The adoption of this standard eliminated the Company's amortization of goodwill and intangibles as of December 31, 2001 and therefore, increased the Company's reported second quarter and six month net income by $1.5 million, or 3 cents per share, and $2.9 million, or 7 cents per share, respectively, as compared to the prior year. If the provisions of this standard were applied to prior periods, net income for the first three and six month periods ended June 30, 2001 would have been $13.8 million, or $0.33 per share $27.2 million, or $0.64 per share.

In October 2001, the FASB issued SFAS No. 144 entitled "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"). SFAS No. 144 addresses accounting and reporting for the impairment or disposal of long-lived assets. This statement supersedes FASB Statement No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." The provisions of this statement were effective for CNA Surety beginning January 1, 2002. The initial adoption of this standard had no impact on the Company's financial position or results of operations.



2. Investments

The estimated fair value and amortized cost of fixed income and equity securities held by CNA Surety at June 30, 2002 and December 31, 2001, by investment category, were as follows (dollars in thousands):

| June 30, 2002 | Amortized Cost or Cost | Gross Unrealized Gains | Unr |
|---|---|---|---|
| Fixed income securities: | | | |
| U.S. Treasury securities and obligations of | | | |
| U.S. Government and agencies: | | | |
| U.S. Treasury ............................ | $ 14,611 | $ 690 | $ |
| U.S. Agencies ............................ | 22,940 | 2,702 | |
| Collateralized mortgage obligations ......... | 264 | 4 | |
| Mortgage pass-through securities ........... | 25,376 | 562 | |
| Obligations of states and political subdivisions . | 296,082 | 11,369 | |
| Corporate bonds ................................ | 73,419 | 3,264 | |
| Non-agency collateralized mortgage obligations ... | 11,506 | 240 | |
| Other asset-backed securities: | | | |
| Second mortgages/home equity loans ............ | 5,441 | 307 | |
| Credit card receivables ....................... | 7,000 | 305 | |
| Manufactured housing .......................... | 7,095 | 395 | |
| Other ......................................... | 1,009 | 138 | |
| Redeemable preferred stock ...................... | 2,356 | 453 | |
| Total fixed income securities .............. | 467,099 | 20,429 | |

| | | | |
|---|---|---|---|
| Equity securities | 58,377 | 2,646 | ( |
| Total | $ 525,476 | $ 23,075 | $ ( |

| December 31, 2001 | Amortized Cost or Cost | Gross Unrealized Gains | Unr |
|---|---|---|---|
| Fixed income securities: | | | |
| U.S. Treasury securities and obligations of U.S. Government and agencies: | | | |
| U.S. Treasury | $ 24,751 | $ 561 | $ |
| U.S. Agencies | 67,539 | 2,119 | |
| Collateralized mortgage obligations | 411 | 4 | |
| Mortgage pass-through securities | 22,165 | 231 | |
| Obligations of states and political subdivisions | 217,757 | 5,029 | |
| Corporate bonds | 71,029 | 2,007 | |
| Non-agency collateralized mortgage obligations | 12,898 | 132 | |
| Other asset-backed securities: | | | |
| Second mortgages/home equity loans | 15,784 | 537 | |
| Credit card receivables | 10,000 | 327 | |
| Manufactured housing | 7,314 | 342 | |
| Other | 1,019 | 108 | |
| Redeemable preferred stock | 13,435 | 122 | |
| Total fixed income securities | 464,102 | 11,519 | |
| Equity securities | 42,614 | 2,620 | |
| Total | $ 506,716 | $ 14,139 | $ ( |



3. Reinsurance

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

| | Three Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2002 | | 2001 | |
| | Written | Earned | Written | Earned |
| Direct | $ 36,521 | $ 32,975 | $ 31,499 | $ 29,386 |
| Assumed | 58,931 | 51,961 | 54,283 | 52,464 |
| Ceded | (9,057) | (9,194) | (4,958) | (3,000) |
| | $ 86,395 | $ 75,742 | $ 80,824 | $ 78,850 |

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2002 | | 2001 | |
| | Written | Earned | Written | Earned |
| Direct .......... | $ 73,293 | $ 64,688 | $ 64,156 | $ 57,006 |
| Assumed ......... | 104,273 | 101,502 | 97,110 | 104,086 |
| Ceded ........... | (26,778) | (23,227) | (7,815) | (5,493) |
| | $ 150,788 | $ 142,963 | $ 153,451 | $ 155,599 |

Assumed premiums primarily includes all surety business written or renewed, net of reinsurance, by CCC and CIC, and their affiliates, after the September 30, 1997 merger ("Merger Date") of CCC Surety Operations and Capsure Holdings Corp. that is reinsured by Western Surety pursuant to intercompany reinsurance and related agreements.

The Company's ceded reinsurance program changed significantly in 2002 as compared to 2001. As a result, ceded written and earned premiums increased in the three and six month periods of 2002 as compared to the same periods in 2001. Ceded written premiums increased $4.1 million and $19.0 million to $9.1 million and $26.8 million, respectively, for the three and six month periods ended June 30, 2002. The increase in ceded written premiums for the second quarter included $7.5 million for the Company's new $40 million excess of $20 million per principal excess of loss coverage. The increase in ceded written premiums for the six months ended June 30, 2002 included $15.0 million for the Company's new $40 million excess of $20 million per principal excess of loss coverage and $8.5 million for the purchase of extended discovery coverage on the Company's $55 million excess of $5 million per principal excess of loss coverage that was in place for 2001.

The material differences between the new excess of loss reinsurance program and the Company's 2001 program are as follows. The annual aggregate coverage decreased from $115 million in 2001 to $100 million in 2002 with a sub-limit of $60 million for large commercial accounts. The minimum annual premium for the 2002 excess of loss treaty is $30.0 million compared to $17.2 million of reinsurance premiums paid in 2001. The 2002 excess of loss treaty provides the Company with coverage on a per principal basis of 90% of $40 million excess of $20 million retained by the Company. The higher net retention per principal together with other changes in reinsurance coverage associated with the 2002 excess of loss reinsurance contract and the extended discovery and related provisions of the excess of loss reinsurance contract in place for 2001 may increase the variability of the Company's future results of operations and cash flows.



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 |
|---|---|
| | 2002 |

| | $ | Ratio | |
|---|---|---|---|
| Gross losses and loss adjustment expenses .................. | $ 23,092 | 27.2% | $ |
| Ceded amounts ............................................ | (3,486) | 37.9 | |
| Net losses and loss adjustment expenses .................... | $ 19,606 | 25.9% | $ |

| | Six Months Ended | | |
|---|---|---|---|
| | 2002 | | |
| | $ | Ratio | |
| Gross losses and loss adjustment expenses .................. | $ 41,156 | 24.8% | $ |
| Ceded amounts ............................................ | (4,903) | 21.1 | |
| Net losses and loss adjustment expenses .................... | $ 36,253 | 25.4% | $ |

4. 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 June 30, | | |
|---|---|---|---|
| | 2002 | 2001 | |
| Reserves at beginning of period: | | | |
| Gross .................................................. | $ 312,225 | $ 212,014 | $ |
| Ceded reinsurance ...................................... | 154,043 | 76,651 | |
| Net reserves at beginning of period .................... | 158,182 | 135,363 | |
| Net incurred loss and loss adjustment expenses: | | | |
| Provision for insured events of current period ........... | 18,679 | 16,674 | |
| Increase (decrease) in provision for insured events of prior periods ........................................ | 927 | 139 | |
| Total net incurred .................................. | 19,606 | 16,813 | |
| Net payments attributable to: | | | |
| Current period events .................................. | 1,156 | 7,233 | |
| Prior period events .................................... | 16,559 | 13,548 | |
| Total net payments .................................. | 17,715 | 20,781 | |
| Net reserves at end of period ............................ | 160,073 | 131,395 | |

| | | | |
|---|---|---|---|
| Ceded reinsurance at end of period | 148,673 | 75,128 | |
| Gross reserves at end of period | $ 308,746 | $ 206,523 | $ |

5. Legal Proceedings

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

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CNA SURETY CORPORATION AND SUBSIDIARIES

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

The following is a discussion and analysis of CNA Surety Corporation ("CNA Surety" or the "Company") and its insurance subsidiaries' operating results, liquidity and capital resources, and financial condition. This discussion should be read in conjunction with the Consolidated Financial Statements of CNA Surety and notes thereto. Management believes the most significant accounting policies and related disclosures for purposes of understanding the Company's results of operations and financial condition pertain to deferred acquisition costs, reinsurance and reserves for unpaid losses and loss adjustment expenses. The Company's accounting policies related to reserves 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. These areas are highly subjective and require management's most complex judgments because of the need to make estimates about the effects of matters that are inherently uncertain. For these reasons, disclosure on these topics is contained in Item 1. Business of the Company's 2001 Annual Report on Form 10-K as well as in the Management's Discussion and Analysis of Financial Condition and Results of Operations and Consolidated Financial Statements and notes thereto within the 2001 Annual Report to Shareholders. Refer to the 2001 Annual Report to Shareholders Note 1, Significant Accounting Policies, and Notes 7 and 8, Reinsurance and Reserves for Losses and Loss Adjustment Expenses, respectively, for further discussion.

Formation of CNA Surety 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") and Universal Surety of America ("USA"), 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. CNAF owns approximately 64% of the outstanding common stock of CNA Surety. Loews Corporation owns approximately 90% of the outstanding common stock of CNAF. 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"). CIC was acquired by CNAF on May 10, 1995. The combined surety operations of CCC and CIC are referred to herein as

CCC Surety Operations.

Pursuant to a reorganization agreement, CCC Surety Operations and Capsure merged their respective operations at the close of business on September 30, 1997 ("Merger Date"). Through reinsurance agreements, CCC and CIC ceded to Western Surety all of their net unearned premiums and loss and loss adjustment expense reserves, as of the Merger Date, and will cede to Western Surety all surety business written or renewed by CCC and CIC for a period of five years thereafter. Further, CCC and CIC have agreed to assume the obligation for any adverse development on recorded reserves for CCC Surety Operations as of the Merger Date, to limit the loss ratio on certain defined business written by CNA Surety through December 31, 2000 and to provide certain additional excess of loss reinsurance.

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Business

CNA Surety's insurance subsidiaries write surety and fidelity bonds in all 50 states through a combined network of approximately 35,000 independent agencies. CNA Surety's principal insurance subsidiaries are Western Surety and USA. The insurance subsidiaries write, on a direct basis or as business assumed from CCC and CIC, small fidelity and non-contract surety bonds, referred to as commercial bonds; small, medium and large contract bonds; and errors and omissions ("E&O") liability insurance. Western Surety is a licensed insurer in all 50 states, the District of Columbia and Puerto Rico. USA is licensed in 44 states and the District of Columbia. Western Surety's affiliated company, Surety Bonding Company of America ("SBCA"), is licensed in 28 states and the District of Columbia.

"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995

The statements which are not historical facts contained in this Form 10-Q are forward-looking statements that involve risks and uncertainties, including, but not limited to, product and policy demand and market response risks, the effect of economic conditions, the impact of competitive products, policies and pricing, product and policy development, regulatory changes and conditions, rating agency policies and practices, development of claims and the effect on loss reserves, the performance of reinsurance companies under reinsurance contracts with the Company, investment portfolio developments and reaction to market conditions, the results of financing efforts, the actual closing of contemplated transactions and agreements, the effect of the Company's accounting policies, and other risks detailed in the Company's Securities and Exchange Commission filings. No assurance can be given that the actual results of operations and financial condition will conform to the forward-looking statements contained herein.

Results of Operations

CNA Surety Results for Three- and Six- Months Ended June 30, 2002 and 2001

The components of net income for the Company for the three and six months ended June 30, 2002 and 2001 are summarized as follows (dollars in thousands, except per share amounts):

| | Three Months Ended June 30, | Six |
|---|---|---|

| | 2002 | 2001 | 2002 |
|---|---|---|---|
| Total revenues .................................... | $ 84,464 | $ 86,522 | $ 158,5 |
| Underwriting income ............................... | $ 10,542 | $ 13,853 | $ 19,5 |
| Net investment income ............................. | 7,121 | 7,480 | 14,2 |
| Net realized investment gains ..................... | 1,601 | 192 | 1,3 |
| Interest expense .................................. | 445 | 957 | 9 |
| Amortization of intangible assets ................. | -- | 1,524 | |
| Income before income taxes ........................ | 18,819 | 19,044 | 34,2 |
| Income taxes ...................................... | 5,917 | 6,701 | 10,7 |
| Net income ........................................ | $ 12,902 | $ 12,343 | $ 23,4 |
| Net income per share .............................. | $ 0.30 | $ 0.29 | $ 0. |

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Insurance Underwriting

Underwriting results for the Company for the three and six months ended June 30, 2002 and 2001 are summarized in the following table (dollars in thousands):

| | Three Months Ended June 30, | | Six |
|---|---|---|---|
| | 2002 | 2001 | 2002 |
| Gross written premiums ............................. | $ 95,452 | $ 85,782 | $ 177,56 |
| Net written premiums ............................... | $ 86,395 | $ 80,824 | $ 150,78 |
| Net earned premiums ................................ | $ 75,742 | $ 78,850 | $ 142,96 |
| Net losses and loss adjustment expenses ............ | 19,606 | 16,813 | 36,25 |
| Net commissions, brokerage and other ............... | 45,594 | 48,184 | 87,14 |
| Underwriting income ................................ | $ 10,542 | $ 13,853 | $ 19,56 |
| Loss ratio ......................................... | 25.9% | 21.3% | 25. |
| Expense ratio ...................................... | 60.2 | 61.1 | 60. |
| Combined ratio ..................................... | 86.1% | 82.4% | 86. |

Premiums Written

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 which cover losses arising from employee dishonesty and other insurance products.

Gross written premiums are shown in the table below (dollars in thousands):

| | Three Months Ended June 30, | | Six |
|---|---|---|---|
| | 2002 | 2001 | 2002 |
| Contract | $ 53,890 | $ 48,012 | $ 93,2 |
| Commercial | 34,897 | 31,432 | 69,9 |
| Fidelity and other | 6,665 | 6,338 | 14,3 |
| | $ 95,452 | $ 85,782 | $ 177,5 |

Gross written premiums increased 11.3%, or $9.7 million, for the three months ended June 30, 2002 over the comparable period in 2001. Gross written premiums for contract surety increased 12.2%, or $5.9 million, reflecting strength in public construction spending for the first half of 2002. Gross written premiums for commercial surety increased 11.0%, or $3.5 million, for the three months ended June 30, 2002 reflecting continued volume growth of small commercial products and improving rates on large commercial exposures partially offset by the impacts of the Company's ongoing efforts to reduce aggregate exposures on large commercial bonds. The estimated impact of the Company's exposure reduction efforts to date represents approximately $6 million in annual premium, assuming an average rate per $1,000 of bond exposure of $2.90, or 29 basis points. Fidelity and other products increased 5.2% to



$6.7 million for the three months ended June 30, 2002 as compared to the same period in 2001 due primarily to an increase in fidelity business partially offset by the discontinuance of the Company's agents' E&O business.

Gross written premiums increased 10.1%, or $16.3 million, for the six months ended June 30, 2002 over the comparable period in 2001. Gross written premiums for commercial surety and contract surety increased 15.8%, or $9.6 million, and 8.0%, or $6.9 million, respectively for the six months ended June 30, 2002 reflecting trends comparable to the quarter. Fidelity and other products decreased 1.3% to $14.3 million for the six months ended June 30, 2002 as compared to the same period in 2001 due primarily to the discontinuance of the Company's agents' E&O business.

Net written premiums are shown in the table below (dollars in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2002 | 2001 | 2002 | 2001 |
| Contract ................. | $ 49,947 | $ 43,512 | $ 81,182 | $ 79,279 |
| Commercial ............... | 30,094 | 30,974 | 55,943 | 59,673 |
| Fidelity and other ........ | 6,354 | 6,338 | 13,663 | 14,499 |
| | $ 86,395 | $ 80,824 | $ 150,788 | $ 153,451 |

For the three months ended June 30, 2002, net written premiums increased 6.9% to $86.4 million as compared to the same period in 2001, reflecting the aforementioned gross production changes partially offset by higher reinsurance costs. Ceded written premiums increased $4.1 million to $9.1 million for the three months ended June 30, 2002. Ceded written premiums in the current quarter include $7.5 million for the Company's new $40 million excess of $20 million per principal excess of loss coverage. Net written premiums for contract surety business increased 14.8% to $49.9 million. Net written premiums for commercial surety decreased 2.8% to $30.1 million for the three months ended June 30, 2002. The fidelity and other products increased 0.3% to $6.4 million, for the three months ended June 30, 2002 as compared to the same period in 2001.

For the six months ended June 30, 2002, net written premiums decreased 1.7% to $150.8 million as compared to the same period in 2001, reflecting the effects of higher reinsurance costs and the Company's efforts to reduce large commercial bond exposures. Ceded written premiums increased $19.0 million to $26.8 million for the six months ended June 30, 2002. Ceded written premiums for the first six months of 2002 include $15.0 million for the Company's new $40 million excess of $20 million per principal excess of loss coverage and $8.5 million for the purchase of extended discovery coverage on our $55 million excess of $5 million per principal excess of loss coverage that was in place for 2001. Net written premiums for contract surety business increased 2.4% to $81.2 million. Net written premiums for commercial surety decreased 6.2% to $55.9 million for the first six months in 2002. The fidelity and other products decreased 5.8% to $13.7 million, for the first six months in 2002 as compared to the same period in 2001.

The material differences between the new excess of loss reinsurance program and the Company's 2001 program are as follows. The annual aggregate coverage decreases from $115 million in 2001 to $100 million in 2002 with a sub-limit of $60 million for large commercial accounts. The minimum annual premium for the 2002 excess of loss treaty is $30.0 million compared to $17.2 million of reinsurance premiums paid in 2001. The 2002 excess of loss treaty provides the Company with coverage on a per principal basis of 90% of $40 million excess of $20 million retained by the Company. The higher net retention per principal together with other changes in reinsurance coverage associated with the 2002 excess of loss reinsurance contract and the extended discovery and related provisions of the excess of loss reinsurance contract in place for 2001 may increase the variability of the Company's future results of operations and cash flows.

Underwriting Income

Underwriting income decreased 23.9% to $10.5 million for the three months ended June 30, 2002 compared to $13.9 million for the same period in 2001. Underwriting income decreased 29.3% to $19.6 million for the six months ended June 30, 2002 compared to the same period in 2001. These decreases are primarily due to the impact of increased reinsurance costs on net earned premium partially offset by reduced acquisition and underwriting expenses.

Net Loss Ratio

The net loss ratios for the three months ended June 30, 2002 and 2001 were 25.9% and 21.3%, respectively. The loss ratios included $0.9 million and $0.1 million of net unfavorable loss reserve development for the three months ended June 30, 2002 and 2001, respectively. Excluding the impact of loss reserve development, the loss ratios would have been 24.7% and 21.2% for the period ended June 30, 2002 and June 30, 2001, respectively. For the six months ended June 30, 2002 and 2001, the loss ratios were 25.4% and 21.1%, respectively. The loss ratios included $0.9 million of net unfavorable reserve development and $0.2 million of net favorable reserve development for the six months ended June 30, 2002 and 2001, respectively. Excluding the impact of loss reserve development, the loss ratios would have been 24.7% and 21.2% for the six month periods ended June 30, 2002 and June 30, 2001, respectively. The increases in the adjusted loss ratio for the three and six month periods in 2002 relate primarily to the estimated impact of the Company's $15 million higher per principal net retention on the Company's net loss ratio. The Company is using an initial 2002 accident year net loss ratio of 30.0 percent for the medium to large commercial and contract branch business compared to 22.5 percent when the per principal retention was $5 million. This business represents about 61% of the Company's gross premiums.

Expense Ratio

The expense ratio decreased to 60.2% for the three months ended June 30, 2002 compared to 61.1% for the same period in 2001. For the six months ended June 30, 2002, the expense ratio decreased to 60.9% from 61.1% for the same period in 2001. The decrease in the expense ratio for the three- and six- months ended June 30, 2002 primarily reflects reduced acquisition and underwriting expenses partially offset by the effect of higher reinsurance costs on net earned premiums. Net earned premiums declined 3.9% and 8.1% and operating expenses decreased at a higher rate of 5.4% and 8.3% for the three and six months ended June 30, 2002, respectively.

Investment Income

For the three months ended June 30, 2002, net investment income was $7.1 million compared to net investment income for the three months ended June 30, 2001 of $7.5 million. The 4.8% decrease in investment income primarily reflects the impact of lower investment yields. The annualized pretax yields for the Company's equity and fixed income portfolio were 5.0% and 5.5% for the three months ended June 30, 2002 and 2001, respectively. The annualized after-tax yields for the Company's equity and fixed income portfolio were 3.9% and 4.0% for the three months ended June 30, 2002 and 2001. Net investment income for the six months ended June 30, 2002 and 2001 was $14.2 million and $15.2 million, respectively. The average pretax yields were 5.0% and 5.6% for the six months ended June 30, 2002 and 2001. The annualized after-tax yields for the Company's equity and fixed income portfolio were 3.8% and 4.1% for the six months ended June 30, 2002 and 2001, respectively.

Net realized investment gains were approximately $1.6 million and $1.3 million for the three and six months ended June 30, 2002 compared to $0.2 million for each of the same periods in 2001.

Analysis of Other Operations

As of January 1, 2002, the Company adopted SFAS No. 142 which requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead be tested for impairment at least annually. The periodic amortization of goodwill and intangibles ceased as of December 31, 2001. Amortization expense was $1.5 million and $3.0 million for the three and six months ended June 30, 2001. The Company completed its goodwill-related impairment tests by June 30, 2002 and no impairment was indicated. Any future impairment loss for the excess of the carrying amount of an intangible asset over its fair value would be recognized as a charge to operations. Intangible assets primarily represent goodwill and identified intangibles arising from the acquisition of Capsure.

Interest expense decreased 53.5% for the second quarter of 2002 as compared to the same period in 2001, primarily due to lower interest rates. Average debt outstanding was $76.2 million for the second quarter in 2002 compared to $78.0 million in the second quarter of 2001. The weighted average interest rate for the three months ended June 30, 2002 was 2.1% compared to 4.7% for the same period in 2001. Interest expense decreased 64.5% for the first six months of 2002 as compared to the same period in 2001. Average debt outstanding was $76.2 million for the first six months in 2002 compared to $89.4 million in the first six months of 2001. The weighted average interest rate for the six months ended June 30, 2002 was 2.2% compared to 5.4% for the same period in 2001.

Income Taxes

Income tax expense was $5.9 million and $6.7 million and the effective income tax rates were 31.4% and 35.2% for the three months ended June 30, 2002 and 2001, respectively. For the six months ended June 30, 2002 and 2001, income tax expense was $10.8 million and $13.2 million and the effective income tax rates were 31.4% and 35.2%, respectively. The decrease in the estimated effective tax rate in 2002 primarily relates to the adoption of SFAS No. 142 which ended the periodic amortization the Company's goodwill and intangibles.



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 sales and maturities of investments. CNA Surety also may generate funds from additional borrowings under the credit facility described below. The primary cash flow uses are payments for claims, operating expenses, federal income taxes, debt service for the credit facility, as well as dividends to CNA Surety stockholders. 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. At June 30, 2002, the carrying value of the Company's insurance subsidiaries' invested assets was comprised of $481.5 million of fixed income securities, $47.6 million of equity securities, $33.7 million of short-term investments, $5.1 million of other investments and $8.2 million of cash. At December 31, 2001, he carrying value of the Company's insurance subsidiaries' invested assets was comprised of $466.6 million of fixed income securities, $35.8 million of equity securities, $38.9 million of short-term investments, $5.3 million of other investments and $0.8 million of cash.

Cash flow at the parent company level is derived principally from dividend and tax sharing payments from its insurance subsidiaries. The principal obligations at the parent company level are to service debt, pay operating expenses, including income taxes, and pay dividends to stockholders. At June 30, 2002, the parent company's invested assets consisted of $5.8 million of fixed income securities, $0.6 million of equity securities, $20.9 million of short-term investments and $5.0 million of cash. At December 31, 2001, the parent company's invested assets consisted of $5.2 million of fixed income securities, $14.7 million of short-term investments and $2.4 million of cash. As of June 30, 2002 and December 31, 2001, parent company short-term investments and cash included $10.7 million and $13.8 million, respectively, of restricted cash 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 $37.0 million for the six months ended June 30, 2002 and $12.4 million for the comparable period in 2001. The increase in net cash flow provided by operating activities primarily relates to collections of reinsurance recoverables and an increase in unearned premium reserves.

CNA Surety's bank borrowings are under a five-year unsecured revolving credit facility effective September 30, 1997 (the "Credit Facility") that provides for borrowings of up to $130 million. As of June 30, 2002, the Company has unused capacity under the revolver of approximately $55 million. The Company paid down outstanding borrowings under the Credit Facility by $10 million to $65 million on July 29, 2002.

The Credit Facility matures September 30, 2002. The Company is currently in discussions with members of its bank group and other lenders regarding the renewal or refinancing of the $65 million in outstanding borrowings under the Credit Facility. The Company expects to refinance its outstanding borrowings but anticipates the interest cost will be significantly higher than under the expiring Credit Facility.

The interest rate on borrowings under the Credit Facility may be fixed, at CNA Surety's option, for a



period of one, two, three, or six months and is based on, among other rates, the London Interbank Offered Rate ("LIBOR"), plus the applicable margin. The margin, including the facility fee, was 0.30% at March 31, 2002 and can vary based on CNA Surety's leverage ratio (debt to total capitalization) from 0.25% to 0.40%. As of June 30, 2002, the weighted average interest rate was 2.1% on the $75 million of outstanding borrowings. As of December 31, 2001, the weighted average interest rate was 2.5% on the $75.0 million of outstanding borrowings.

The Credit Facility contains, among other conditions, limitations on CNA

Surety with respect to the incurrence of additional indebtedness and requires the maintenance of certain financial ratios. As of June 30, 2002, the Company was in compliance with all restrictions and covenants contained in the Credit Facility agreement. The Credit Facility provides for the payment of all outstanding principal balances by September 30, 2002 with no required principal payments prior to such time. Principal prepayments, if any, and interest payments are expected to be funded primarily through dividends from CNA Surety's insurance subsidiaries.

In 1999 CNA Surety acquired certain assets of Clark Bonding Company, Inc., a Charlotte, North Carolina, insurance agency and brokerage doing business as The Bond Exchange for $5.9 million. As part of this acquisition, the Company incurred an additional $1.9 million of debt in the form of a promissory note. The promissory note matures on July 27, 2004 and has an interest rate of 5.0%. The balance of this promissory note at June 30, 2002 was $1.2 million.

As an insurance holding company, CNA Surety is dependent upon dividends and other permitted payments from its insurance subsidiaries to pay operating expenses, meet debt service requirements, as well as to pay cash dividends. The payment of dividends by the insurance subsidiaries is subject to varying degrees of supervision by the insurance regulatory authorities in South Dakota and Texas. In South Dakota, where Western Surety and SBCA are domiciled, insurance companies may only pay dividends from earned surplus excluding surplus arising from unrealized capital gains or revaluation of assets. In Texas, where USA is domiciled, an insurance company may only declare or pay dividends to stockholders from the insurer's earned surplus. 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 appropriate insurance department 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 2002 is based on statutory surplus and income at and for the year ended December 31, 2001. Without prior regulatory approval in 2002, CNA Surety's insurance subsidiaries may pay stockholder dividends of $51.5 million in the aggregate. CNA Surety received $12.0 million and $35.0 million in dividends from its insurance subsidiaries during the first six months of 2002 and 2001, respectively.

In accordance with the provisions of intercompany tax sharing agreements between CNA Surety and its subsidiaries, the tax of each subsidiary shall be determined based upon each subsidiary's separate return liability. Intercompany tax payments are made at such times as estimated tax payments would be required by the Internal Revenue Service ("IRS"). CNA Surety received tax sharing payments from its subsidiaries of $3.5 million for the six months ended June 30, 2002 and $12.2 million for the same period in 2001.



Western Surety, SBCA and USA each qualifies as an acceptable surety for federal and other public works project bonds pursuant to U.S. Department of Treasury regulations. The underwriting limitations of Western Surety, SBCA and USA, based on each insurer's statutory surplus, were $16.9 million, $0.4 million and $1.7 million, respectively, for the twelve month period ended June 30, 2002. Effective July 1, 2002 through June 30, 2003, the underwriting limitations of Western Surety, SBCA and USA are $20.7 million, $0.5 million and $1.3 million, respectively. Through the Quota Share Reinsurance Agreement between CCC and Western Surety Company, CNA Surety has access to CCC and its affiliates' U.S. Department of Treasury underwriting limitations. The Quota Share Reinsurance Agreement expires on September 30, 2002. CCC is under no obligation to renew the Quota Share Reinsurance Agreement, CNA Surety management believes that the Agreement will be renewed, although certain terms may change and the cost may increase. A failure to renew the Quota Share Treaty or a renewal on substantially different terms may have a material adverse impact on the Company's future results of operations. The underwriting limitations of CCC and its affiliates totaled $616.0 million for the twelve months ended June 30, 2002. Effective July 1, 2002 through June 30, 2003, the underwriting limitations of CCC and its affiliates total $382.9 million. The decrease in underwriting limitations for CCC and its affiliates are principally due to decreases in statutory surplus during 2001 as result of charges associated with changes in estimates with respect to prior accident year loss reserves and accruals for retrospective premiums. The CNA Surety management believes that the foregoing US Treasury underwriting limitations are sufficient for the conduct of its business and that the reduction in underwriting capacity of CCC and affiliates will not have a material adverse impact on the Company's results of operations.

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.



CNA SURETY CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings - None.

ITEM 2. Changes in the Rights of the Company's Security Holders - None.

ITEM 3. Defaults Upon Senior Securities - None.

ITEM 4. Submission of Matters to a Vote of Security Holders -

At the Annual Meeting of Shareholders of CNA Surety Corporation held on May 21, 2002, the Company's shareholders voted on the following proposals. The numbers of shares issued, outstanding and eligible to vote as of the record date of March 25, 2002 were 42,873,632. Proxies representing 39,330,870 shares or approximately 92 percent of the eligible voting shares were tabulated.

PROPOSAL I
Election of Directors.

| | Number of Shares/Votes | |
|---|---|---|
| | For | Authority Withheld |
| Giorgio Balzer | 39,236,264 | 94,606 |
| Philip H. Britt | 39,262,968 | 67,902 |
| Robert V. Deutsch | 39,170,275 | 160,595 |

| | | |
|---|---|---|
| Edward Dunlop | 39,255,575 | 75,295 |
| Melvin Gray | 39,263,068 | 67,802 |
| Roy E. Posner | 39,256,075 | 74,795 |
| Adrian M. Tocklin | 39,204,256 | 126,614 |
| Mark C. Vonnahme | 37,556,119 | 1,774,751 |
| Peter W. Wilson | 39,156,975 | 173,895 |

PROPOSAL II
To ratify the Board of Directors' appointment of the Company's independent auditors, Deloitte & Touche LLP for fiscal year 2002.

| | |
|---|---|
| For | 39,258,220 |
| Against | 1,038 |
| Abstain | 71,612 |

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CNA SURETY CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION (continued)

ITEM 5. Other Information - None.

ITEM 6. Exhibits and Reports on Form 8-K:
(a) Exhibits: - None

(b) Reports on Form 8-K:
May 9, 2002; CNA Surety Corporation Press Release issued on May 7, 2002.

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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 S. Heneghan
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John S. Heneghan
Vice President and Chief
Financial Officer

Date: August 12, 2002