



Corporate Governance Roundtable Discussion

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The Millstein Center for Corporate Governance & Performance has collaborated with Standard & Poor's Ratings Services to convene a series of one-day conferences examining how different firms use, or do not use, corporate governance in rating corporations and how they incorporate these ratings into their analyses. These conferences provide an opportunity for market participants to describe and compare their approaches to corporate governance issues and gain further insight from Yale and Millstein Center faculty on the relationship between corporate governance and corporate performance. The views and opinions reflected in this report are those of the participants of the Nov. 2, 2006, Rating Corporate Governance and Performance Roundtable, and do not necessarily reflect the views and opinions of the firms they represent.

Rating Corporate Governance and Performance: Report on Roundtable One

On Nov. 2, 2006, the Millstein Center held the first in a series of roundtables to examine and discuss how market participants with different objectives—such as auditors, proxy advisors, credit rating agencies, and director and officer liability insurers evaluate corporate governance. In contrast to general discussions of good and bad governance, the roundtable invited participants to drill specifically into the ways they might factor governance considerations into the decisions they make about corporations they audit, underwrite, or rate.

This first roundtable brought together representatives of Deloitte & Touche USA LLP, Grant Thornton, Institutional Shareholder Services (ISS), American International Group, Inc. (AIG/National Union), and Standard & Poor's Ratings Services (collectively, the participating firms) with affiliated Yale and Millstein Center faculty (see Appendix A for the list of Roundtable participants). In future roundtables other market participants (e.g., investment banks, stock exchange representatives, regulators, and other governance ratings firms, credit rating agencies, auditors, and director and officer liability insurers) will be invited to attend.

The discussion was organized around two fictional company scenarios drafted by Standard & Poor's governance specialists and credit rating analysts that were circulated to participants in advance. One, *HypothetiCo Inc.*, focused specifically on the task of a credit rating agency. It required selected participants to act as a Credit Rating Committee and resolve a CreditWatch action. (We emphasize that Standard & Poor's actual credit rating committee deliberations are confidential and typically consider a much wider range of issues than we wanted to focus on in the roundtable discussion.) The other case, *Conjecture Insurance Holding Company Ltd.*, provided a more open-ended opportunity to discuss governance issues as they apply to underwriting, auditing, governance rating, and credit rating issues, and involved a non-public, Bermuda-based insurance holding company seeking a listing on the New York Stock Exchange.

The roundtable began with a brief overview of Standard & Poor's credit rating process and the role corporate governance plays in that process. The roundtable chair selected participants to form a rating committee, to which Standard & Poor's credit and governance analysts presented their views and recommendations. All participants discussed the analysts' presentations, and committee members explained their votes on how to resolve the CreditWatch. After a mid-day break, Standard & Poor's representatives presented *Conjecture Insurance*. The analyses of the auditors, insurers, credit raters, and governance raters were then presented and discussed with regard to both of the fictional companies.

The following captures and distills the major lessons from the roundtable: It encapsulates themes heard and understood by the report writers, but is not a verbatim account of the day's discussions. After presenting some general remarks about the issues faced by the participating firms, the cases are discussed in detail.

Risk: A Unifying Theme

In one way or another, all participants focused on the identification and evaluation of risk relevant to their activities. However, it quickly became apparent that 'risk' could mean different things to each.

Because Standard & Poor's corporate credit ratings are its opinion regarding an obligor's capacity and willingness to pay interest and principal on schedule, the central feature of its risk assessment is the likelihood these payments will be made in a timely manner. The assessment of an issuer's governance is one of the steps involved in Standard & Poor's assignment of a financial risk score, which together with a business risk score feeds into the formation of Standard & Poor's credit rating. An inaccurate or misleading credit rating jeopardizes the credibility of its opinions on creditworthiness.

Auditors have a closer, ongoing relationship with their clients than a credit rating agency has with issuers of debt. Audits are highly interactive and in-depth exercises that can surface key governance issues such as the quality of board oversight of management, or specifics of the internal control environment. In addition, both Deloitte and Grant Thornton have rigorous and detailed reviews when accepting a new client and/or retaining an existing one, and an assessment of a company's governance can play a part in these reviews.

The risk for D&O insurers, such as National Union, centers on the potential for costly losses, either through the settlement of claims or through defending litigation. The overwhelming majority of claims come from public company shareholders although little is understood as yet about the correlation between classic measures of public company governance and D&O insurance losses. A demonstrable link between governance and potential loss and the extent to which the losses can be quantified and built into the actuarial determinations that feed into the pricing of policies remains a key challenge.

The risk for governance rating organizations involves the effects on the value and imputed meaning of the ratings they supply. For example, ISS offers a product, its Corporate Governance Quotient (CGQ®), which is offered as an *objective* evaluation of a company's governance—that is, a rating that is determined by facts such as the number of directors over a certain age, etc. The roundtable explored how these objective governance ratings are created, understood and used by the other participating firms. The discussion allowed this first roundtable to begin to unravel complexities in the meaning of objectivity and how that concept applies to the evaluation of corporations and the executives and directors who lead them.

The Case Studies

Case Study One: HypothetiCo Inc.

HypothetiCo Inc. is a relatively small (less than \$500 million in total revenue) manufacturer and direct seller of specialized computer hardware and accessories (see Appendix B for the complete case study). It has several larger competitors and its share price has been languishing. Standard & Poor's corporate credit rating for the company is 'BB', and the rating is on CreditWatch with negative implications.

A hedge fund, Aggravation Capital, has acquired a significant stake in HypothetiCo Inc. and has insisted on appointing three directors. Aggravation has agitated for a debt-financed share repurchase program and expansion into foreign markets (the "Forward Asia" strategy). The CreditWatch placement was prompted by these actions.

Credit Rating Committee

(The committee included representatives from AIG/National Union, Deloitte, Grant Thornton, Institutional Shareholder Services, the Yale Law School, and the Millstein Center for Corporate Governance and Performance. In the ordinary course of business, Standard & Poor's does not communicate details of rating committee deliberations.)

The committee began with a statement by the roundtable chair of its rules: one person, one vote, with possible actions of extending the CreditWatch, changing the rating, or changing the outlook. The committee then heard from one of Standard & Poor's credit analysts about the reasons for the CreditWatch placement and the analyst's recommendations.

The committee's discussion revolved around incipient changes to HypothetiCo's financial structure through a debt-financed share repurchase program, and what appeared to be the deteriorating effectiveness of the board of directors. Standard & Poor's governance specialists and the primary credit analyst met with the CEO, the CFO, the chair of the board's governance committee, and the company's lead director, Ms. Suzanne Overcommitted. Their attempts to meet with one of the new Aggravation directors were not successful.

The governance review also found:

- The directors appointed by Aggravation Capital had indicated their desire to join a number of committees, including the finance committee. Other board members are resisting. Charlie Challenging is the only director—including the CEO—speaking with the Aggravation Capital directors. With a tenure of 10 years, Charlie is one of the longest-serving directors, and he seems to be playing a constructive, albeit limited, role.
- Aggravation Capital appears to have growing influence on board actions, as evidenced by the decision to pursue the share repurchase. Mr. Leader, the CEO, appears to have gone along with this

proposal despite his previous assurances that HypothetiCo would not pursue large buyback programs (and particularly debt-financed ones).

- It remains unclear whether the proposed repurchase is the first of several repurchase programs, and what the substance and outcome of the Forward Asia strategy would be. Mr. Leader told us there would be no large acquisitions, yet Aggravation Capital is still speaking publicly about Forward Asia in the press.

After nearly an hour of robust discussion, committee members voted to lower the rating on HypothetiCo to 'BB-' from 'BB', take it off CreditWatch, and assign a negative outlook, in line with the initial recommendation from the primary credit analyst. Several members of the committee arrived at the same rating decision via different reasoning. Among the most frequently cited reasons for lowering the rating were:

- The use of debt to fully fund the share repurchase program would adversely affect HypothetiCo's financial flexibility and weaken key credit measures, such as the ratio of total debt to EBITDA, a key ratio in corporate ratings. The expected pro forma debt to EBITDA number for HypothetiCo compares unfavorably to the three-year average ratio for U.S. Industrials companies rated in the 'BB' category (3.5x). This argument found support among voters, particularly given increasing competition and plans to pursue a \$300 million manufacturing upgrade over the next two years.
- Many voters saw the decision to pursue large buybacks as a meaningful change in the company's financial policy that was led by Aggravation Capital, and was unlikely to be in the best long-term interests of creditors. Given the company's historical reluctance to pursue repurchases, some voters believed this change signaled a growing emphasis on shareholders at the expense of current debt holders. There was concern that more share buybacks would follow.
- The Forward Asia strategy could lead to integration and other increased business risks, particularly given the firm's lack of acquisition experience.
- Finally, the committee expressed concern about the deteriorating relationships on the board. The fact that the company could not provide access to Aggravation directors and that many of the directors were not speaking to each other was viewed particularly negatively. The activism represented a distraction for managers and board members. Additionally, several voters expressed concern that there could be pressure to replace the CEO.

While the vote was unanimous to lower the rating, some committee members argued for maintaining the CreditWatch with negative implications until more information could be obtained about the acquisition strategy and the CEO's future. Ultimately, a majority of the committee concurred in removing the rating from CreditWatch and assigning a negative outlook. A research update, reflecting the rating change, would be prepared and published by the primary credit analyst following the committee (see Appendix C).

Case Study Two: Conjecture Insurance Holding Company Ltd.

Conjecture Insurance is a privately held Bermuda insurance company contemplating a public offering of up to 30% of its shares on the New York Stock Exchange (see Appendix D for the complete case study). The original investors (and current owners) have put in place a number of protections in addition to that naturally furnished by their continuing majority stake. Among the issues for roundtable participants to consider were the composition of the board; executive compensation practices; shareholder rights restrictions (and related tax considerations); the company's retention of its

current audit firm; and whether a large dividend payment was paid to the company's original investors before the IPO.

Roundtable Discussion of Conjecture Insurance and of Auditing, Underwriting, and Governance-Rating Issues in HypothetiCo Inc.

In contrast to the rating committee structure for the discussion of Case One, Case Two was discussed in a more free-flowing manner, with each participant presenting the issues the case would raise in its business context and its analysis of those issues. They also compared and contrasted Conjecture Insurance with HypothetiCo Inc. relevant to their own business issues, whether auditing, underwriting, or governance rating. Yale and Millstein Center faculty also contributed to these discussions, but for ease of presentation we have organized and presented them under the issues relevant to the participating firms.

Auditing Issues

Deloitte and Grant Thornton shared many similarities in their respective client acceptance processes, including using industry experts to review a company's financial and business prospects, and gaining more insight about financial trends in the relevant economic sectors. Each audit firm wants to meet with the potential client's audit committee, and with management. These meetings involve the completion of background checks for principal officers and ensuring that directors classified as independent live up to that billing. Another critical area of investigation is determining whether the company has any significant accounting deficiencies or material weaknesses and if so, how management is addressing them.

Deloitte and Grant Thornton rely to differing extents on confidential screening systems. Deloitte uses its sophisticated 'radar' system (called DDAR) to assess the risk involved in accepting new clients, and as an early warning system for clients with a heightened risk of business failure and financial statement fraud. DDAR analyzes various metrics including revenue recognition, asset valuation, and governance metrics for evaluating the risk of fraud, and liquidity and profitability metrics for evaluating the risk of failure. The metric results are signaled through a traffic-light system (red, yellow, green), and the results for all metrics are combined to establish an overall risk index rating.

Grant Thornton has an internal unit to perform extensive background checks on all prospective clients' officers and directors. In addition, they have worked with external suppliers to develop a screening system that scores companies on a variety of potential risk factors, including financial statement fraud, governance issues, and business failure. The results from the background checks and screening system are used by office, regional, and national management to determine whether to accept a new client.

Like the credit ratings process, corporate governance ratings and issues are considered among a number of other factors. If governance issues were flagged red, the governance report or reports would be looked at more closely to understand the basis of the governance rating. The roundtable learned that the profession (including the Big Four and next level of audit firms) has had preliminary discussions about collaborating on a "best practice" risk management tool.

For *HypothetiCo Inc.*, both audit firms would examine any prior experience with Aggravation Capital, and would be particularly interested in information about its strategy and success rate. Both audit firms had reservations about accepting *Conjecture Holding Co Ltd*, as a new client, and for

broadly similar reasons, i.e., that insurance companies generally pose high risk and an IPO represents a significant risk event in and of itself.

Both audit firms expressed reservations about the rationale for the *Conjecture* dividend paid to the founding investors prior to going public, and were concerned about the payments to be made to the CEO and others based upon mere completion of the offering. The offering underwriter's identity and reputation would be significant considerations were either firm to even contemplate accepting this company as an audit client. Of course, since the company had expressed in its draft registration statement that it wanted to stay with its pre-IPO auditor, these questions appear to be moot, but it is possible that, should *Conjecture* continue with the IPO process, it might be compelled to seek a higher-profile audit firm.

Overall, audit client acceptance and continuance processes appear to be more time-intensive and detail-oriented than those of other participating firms. For example, it appears the auditors were the only roundtable constituency that completed background checks on directors and officers as a *routine* part of their client acceptance work. These processes have not changed significantly since the implementation of Sarbanes-Oxley, but both audit firms made the point that they were, since SOX enactment, spending more time with the audit committee at the commencement of the client acceptance process and on an ongoing basis.

Underwriting Issues

The roundtable learned from National Union that the overwhelming majority of most costly claims it faces are securities class actions filed on behalf of public company shareholders. As yet, there is little understanding of the correlation between classic measures of public company governance and D&O insurance losses. The impact on insurance losses of board composition, separation of the roles of Chair and CEO and similar types of board structural issues are wholly unclear. Positive governance ratings might be taken into account when assessing the premium to be charged, particularly where those ratings exhibited unanimity. However, a D&O insurer is more concerned with the nature of an insured company's ownership and parent/subsidiary relationships, industry class, and market capitalization than board centered governance metrics.

The volatility of a cyclical business is, in and of itself, an underwriting risk: Being able to assess when a company has hit "bottom" and may be commencing an upswing is crucial. Actuarial analysis is helpful to D&O insurers on a portfolio basis, but assessing risk on a case-by-case basis for those serving as a particular company's directors and officers continues to be the central challenge. There is a tremendous amount of subjectivity in underwriting, and it was emphasized to the roundtable that underwriting is an art as much as a science.

D&O insurance is characterized by the low frequency but high severity of claims. The insurance business is also cyclical and largely driven by supply and demand. For example, the kinds of capacity exits made after Sept. 11, 2001, were further compounded by post-Enron and WorldCom D&O insurance price increases. In 2006, prices moderated with a more stable capacity characterizing the market, along with a slowdown in the frequency of securities class actions (claims dropped by 17%). Nevertheless, the severity of claims' settlement amounts continues to skyrocket. Although the Enron and WorldCom settlements were huge (in the billions of dollars), even excluding them, securities class action settlements now average \$28.5 million.

Because of the complexity of class action litigation and the length of time to settle cases, the business is long-tail, meaning that insurers will have little idea of the loss costs embedded in their current books for five years or more. National Union does undertake risk modeling, with the general approach beginning with predicted losses as a function of market capitalization, to which specific risk adjustments are thereafter made, e.g., SOX compliance, insider trading safeguards, and those relating to Reg. FD. A company's revenue recognition policies also are a major focus in National Union's risk assessments.

Contemporary concerns for D&O insurers include options backdating, private equity and hedge fund activities where a crowded field may lead to riskier deals, and the potential for investor backlash from these deals. In addition, the new disclosure requirements on executive compensation could lead to litigation and the use of insurance, at least in the short term.

Looking at the two case studies, had *HypothetiCo Inc.* been a D&O client since 1998, and had there been no history of claims since that date, National Union said it probably would be prepared to put up \$15 million in D&O insurance and would charge about \$800,000 for that cover. However, there is concern about Aggravation Capital, which might lead to a reduction in the coverage. Historically positive factors for the company would be that it managed to conduct an IPO without a shareholder suit, the company's geographic spread, and its modest leverage. Negatives include the divided board, the problems that come with any insured confronting a competitive landscape and what the company might consider doing to augment stock price appreciation for shareholders, particularly if it was considering an acquisition as well.

To move forward on insurance renewal, National Union would want to meet with the CEO to get additional information on the board's functioning now that the Aggravation directors have seats. It would also want updates on executive compensation and stock option programs, SOX compliance and internal control and compliance issues, including those relating to insider trading and to gain better insight into their process for complying with Reg. FD. There would also be a focus on revenue recognition practices, new product development and a fuller understanding of how any acquisitions by the company would be undertaken.

It is unlikely National Union would even provide a quote for *Conjecture Insurance Holding Co Ltd.* First, as noted, an IPO puts the company into a high-risk category, although if the company were a client prior to going public, and National Union knew a good deal more about them, it could make a difference. Overall, National Union is more conservative when it comes to offering D&O coverage on insurance companies.

Governance Rating Issues

Institutional Shareholder Services emphasized that the users of governance ratings want comparable measures of governance across companies in their portfolios. In particular, they want broad-based, global measures of comparison along with more in-depth comparisons of industry sectors, in order to know where one company falls in relation to its peers. Currently, ISS has governance ratings on 8,000 companies and corporate governance quotients CGQ[®] are regularly updated to reflect changing governance profiles at these companies.

Users of the service want to be able to track trends over a period of years, whether on an individual-company basis or on a sector or geographic basis. The granularity of ISS' index/industry ratings (to two decimal places) are used by investors who employ quantitative modeling methodologies; indicating that

users of the ratings are moving from risk assessment models to ones that use governance ratings to evaluate and compare corporate performance

ISS faces and responds to a number of criticisms. One is that ISS is a “box ticker.” That is clearly a *part* of what it does: For example, whether a company makes a certain disclosure on its Web site is a yes/no question that is perfectly proper to answer in a check-the-box manner. It is the aggregate of answers to questions like that and proprietary methodology for weighting and aggregating those information points that allows ISS to construct an overall *and* comparable CGQ.

A rather more trenchant criticism is that the ISS approach is a one-size-fits-all model, incapable of taking into account jurisdictional, ownership-structure, and business life-cycle differences, among others. ISS is in the process of incorporating these factors into its model. Consequently, it is fair to say that ISS currently has a U.S.-centric model that takes domestic best practices and applies them globally. It has established a group of external experts to begin work on upgrading the CGQ model to incorporate legislative and regulative differences in disparate regions around the globe (the chair of this group is William Crist, former president of CalPERS’ board of administration).

A significant question for the ISS’s 1,700 institutional clients is how well ISS can qualitatively assess those in the executive suite and on the board. ISS regards the *independence* of the board from management as an effective measure of that qualitative assessment. However, it is possible in a specific case, like *Conjecture Insurance*, that a director who sits on a subsidiary board and would, in consequence, not be independent, may nevertheless exhibit the independence of mind that all agree is a hallmark of effectiveness for a non-executive director.

Like the credit ratings agencies, ISS has concerns about companies focusing on their behavior merely to raise their score in its system, rather than concentrating on running their business to fulfill their own objectives. Participants also recognize that different clients employ the ratings for different purposes. Hedge funds use them to gauge performance, while pension funds might be more concerned with risk. D&O insurers and others use them for risk assessment purposes too, so the CGQ has a wide variety of applications for those working in the capital markets. Many ISS clients obtain the underlying data and use it in their own risk or performance models.

An advantage of the ISS approach is that its very detachment from the interactive process that characterizes the approach of the other participating firms means that ISS is unlikely to ever be co-opted by the very people it is trying to assess. As an example, ISS can call a board dysfunctional without having concern about problems with subsequent access such an evaluation could entail. Thus, while ISS acknowledges that important features of an evaluation of corporate governance can involve subjective assessment, its clients demand that the information that constitutes the CGQ be derived and presented in a nonsubjective, objective fashion.

ISS endeavors to be as transparent as possible to the companies it rates. All rated companies have free access to their data and ISS encourages them to contact it in order to correct any mistakes ISS might inadvertently have made. The goal going forward is for ISS to be in a position to give more context around the CGQ ratings, rather than have them serve merely as a heads-up or red flag. In particular, such an enhancement will permit a broader understanding of why and how a company may be doing better or worse over time.

Credit Rating Issues

For Standard & Poor's, *Conjecture Insurance* manifests three major concerns: earnings volatility, a sharply changing business environment, and maintaining awareness of underwriting risks. Each has the potential to lead to credit deterioration, but concern is mitigated by the importance that the company has hitherto attached to catastrophe modeling and the maintenance of strict underwriting risk policies.

While the rationale for seeking a public listing is not evident in the materials the company has supplied to Standard & Poor's, some of the company's competitors have undertaken similar offerings. Standard & Poor's fundamental concern is whether the result of the listing will provide a further level of discipline for the board and management, or merely serve to distract their attention from the full-time job of maintaining competitive advantage *and* risk controls.

Although the company has had a rating from Standard & Poor's since its founding, it is becoming a new entity both legally and also in terms of its ownership and control. Consequently, a governance review was initiated and Standard & Poor's governance specialists have preliminarily identified the following issues for follow-up:

- Can the founding directors explain the reasons for the public listing initiative in a way that is credit neutral or positive, for example in terms of access to equity funding/market discipline?
- Will the increase in the board size impair or improve its functioning?
- Do the new directors have appropriate skills for an insurance holding company?
- Are the directors' profiles a source of comfort for the current rating?
- Do the restrictions on shareholder rights pose risks for minority holders that could lead to shareholder dissatisfaction with the company during the initial offering or at some later date?
- Conversely, do those restrictions safeguard—and is it desirable from a credit perspective—that the company will continue to be controlled by its present owners?
- Can the company provide compelling reasons for continuing to utilize the services of its current auditor?
- Was there, and if there was, what was the rationale for the large dividend payment made to the current shareholders before the public offering?
- What is the status of the Shareholder Agreement in the documentation—does it predate the decision to go public and/or was it rewritten in anticipation of going public?
- Does the bonus for the CEO raise concerns about the independence and effectiveness of the new board?

The governance specialists will ask to review board and committee minutes for the past three years. On the basis of what they can learn from that documentation, they will then interview both new and long-standing board members about this recapitalization and the rationale behind going public. They will also seek to interview the company's CFO, heads of risk management and underwriting, and the accounting firm that will continue to act as the company's auditor. Interviewee responses concerning the company's decision to retain its auditor and the current and projected executive and staff compensation arrangements are expected to shed light on relevant governance risks when the rating committee meets to decide the public rating on *Conjecture*.

Conclusion

This first roundtable, through the variety of its participants, heard that the participating firms view corporate governance through different lenses. First, it is important to note that governance factors are

monitored and considered by the participating firms, although less so for the D&O underwriter. However, the discussion revealed that no single governance factor, or combination of factors, is definitive in its effect on auditing, credit rating, or underwriting decisions. Further, the discussion often centered on actions actually taken or to be taken, such as the proposed share repurchase in *HypothetiCo Inc.* and recent dividends that may have been paid by *Conjecture Insurance*, and not simply on the structure within which those decisions occurred. Structural governance issues, such as the presence of Aggravation Capital directors, were part of the background context within which corporate actions are assessed.

There was substantial inclination on the part of auditors and credit raters to investigate potential governance issues on a case-by-case basis, and in a fairly in-depth manner. For example, only costly exploration revealed the poor communication among the *HypothetiCo Inc.* directors, a factor that seemed to weigh more heavily in the participating firms' thinking than did the mere presence of the Aggravation Capital directors.

Finally, consistent with their willingness to do in-depth analysis, auditors and credit raters appear to use governance ratings as preliminary screens when deciding whether to incur the added costs their own in-depth analysis entails. Underwriters, lacking hard evidence on the actuarial connections between governance indicators and insurance losses, seem to rely less on governance ratings than the other participating firms. No participant indicated that governance issues factor into their decisions in a rigid fashion. Rather, governance considerations end up factoring into their decisions in a flexible and judgmental way.

The Millstein Center for Corporate Governance & Performance
Standard & Poor's Ratings Services
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APPENDIX A

Moderator

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APPENDIX B | Case Study One

(This Appendix is for the Millstein Center Corporate Governance Roundtable Discussion purposes only and does not represent the full range of committee materials or published comment of Standard & Poor's Ratings Services.)

HypothetiCo Inc.

BB/Watch Neg/ —, (NYSE: HPTC)

Rating Committee Background Information

HypothetiCo is a 30-year-old, California-based, Delaware-incorporated manufacturer of computer hardware and accessories with direct selling operations to specialist commercial and consumer purchasers of its products; principally art directors in the magazine publishing and online advertising sectors. The company was founded in 1976 in the Encino, Calif. basement of its then-teenage founder, John Hypothes, with \$200 borrowed from his friends.

It has grown from these humble beginnings to achieve \$414 million in revenues and net income of \$21 million in 2005. As of Dec. 31, 2005, its balance sheet showed total assets of \$264 million, total liabilities of \$218 million, and total shareholders' equity of \$46 million.

The corporation has faced significant competitive pressure from larger rivals in recent years. However, the company has achieved modest growth in market share over the past five years, driven by its specialist market knowledge, niche market position, and strong product development record. HypothetiCo's development and manufacturing operations are located in California (1976), the Irish Republic (1987), and the People's Republic of China (2004), with 50% of a 5,000 strong workforce in the U.S., 40% in Ireland, and 10% in the PRC. Given the specialist and technical nature of its products, it has a small sales force tightly integrated with its development and manufacturing operations at its three development and manufacturing locations.

Since 2001, the company's share price has languished, with bumps in equity prices prompted by takeover or buyout rumors rather than earnings growth or product innovations. The company's IPO occurred in July 1998 and the Mr. Hypothes cashed out and left the company at that time. He is no longer involved in the business. HPTC shares currently trade (in inflation adjusted dollar values) at 85% of their IPO price.

The languishing share price led to some shareholder discontent, which in turn led to the introduction of a number of shareholder proposals in the early 2000s that involved removal its poison pill and adoption of annual elections for directors. All these proposals were defeated. In late 2004, after another contentious shareholder meeting, the HypothetiCo board decided to voluntarily adopt a number of corporate governance enhancements, including the removal of its shareholder rights plan (poison pill) and declassification of its board. HypothetiCo also announced it would voluntarily adopt a majority voting standard for directors, which would take effect at the Oct. 4, 2006, annual meeting of shareholders.

However, by 2006, the company was facing a new challenge in the form of a proxy contest. The company resolved what it called a 'potentially expensive and distracting' proxy battle in September, by agreeing to give dissident shareholder Aggravation Capital Partners three seats on its (now) ten-member, annually elected board. Aggravation first disclosed that it had acquired 10.2% of the company's capital in January 2006, and mounted its proxy contest in late May on the basis that

shareholders should back its ‘Forward Asia’ development and marketing plan. The plan, details of which could be found on www.SaveHypothetiCo.org, included a substantial increase in share repurchases and the engagement of an outside advisor to pursue potential acquisitions in China. The dissidents garnered support among institutional investors by arguing for a separation of Chairman and CEO (both positions have been held by John Leader since 1999) and pointing to the company’s languishing share price. The company has since announced it will pursue a share repurchase program.

Other than Aggravation Capital, 5% plus shareholders include Fidelity Investments (9%), and Oppenheimer Funds (5.3%), and HypothetiCo is widely held by other institutional investors. Corporate culture is somewhat insular and retains many of the principles of the founder, despite his departure after the IPO. HypothetiCo, for example, has stayed away from all but small, technology-based acquisitions, avoids outside consultants, and prefers to develop all of its technologies in-house.

The CreditWatch placement (HypothetiCo was placed on CreditWatch shortly after the company agreed to give three seats to Aggravation) reflects the impact the share repurchase announcement will have on debt ratios in the context of HypothetiCo’s narrow business base, relatively modest size, and cyclical capital requirements. It also reflects corporate governance concerns relating to board functioning and effectiveness following the appointment of the three additional board members.

We plan to resolve the CreditWatch placement in the near term by ascertaining the specific means to be used for financing the share repurchase plan and also establish through a meeting with the company what impact the board-level changes will have on the company’s business strategy (including acquisition policy) and financial policies, including whether there may be a greater emphasis on shareholder returns going forward.

Resolution of the CreditWatch will also depend upon the outcome of a review of HypothetiCo’s corporate governance practices that will focus on board functioning and effectiveness following the appointment of the three additional board members.

Rating Presentation

Company:	HypothetiCo Inc.	
Analyst:	Molly Toll-Reed	
Date:	Nov. 3, 2006	
Purpose:	Resolve CreditWatch	
Recommendation:	To	From
Corporate Credit Rating	_____	BB/WatchNeg/—

Rating History:

Sept. 3, 2006	BB/WatchNeg/—
Feb. 14, 2001	BB/Stable/—

Debt Maturities:

2006: 0
 2007: 0
 2008: \$50 million
 2009: \$100 million
 2010: 0

Background/Recommendation

The ratings on HypothetiCo were placed on CreditWatch with negative implications on Sept. 3, 2006, following the company's agreement to give dissident shareholder Aggravation Capital Partners three seats on its (now) ten-member board of directors and following the company's September 29 announcement that it would conduct a debt-financed Dutch auction self-tender offer to repurchase \$200 million of its shares (representing approximately 15% of the current outstanding). In resolving the CreditWatch, we met with members of management as well as with the outside director that chairs the board's corporate governance committee. We were not able to meet with any of the newly appointed Aggravation directors. (N.B.: Shareholders at the 2006 annual meeting elected all directors.)

Major Rating Factors

Strengths

- Consistent record of product development;
- Modest leverage;
- Significant recurring revenue and earnings base from services and supplies; and
- HypothetiCo owns its own technology.

Weaknesses

- An increasing shareholder focus/orientation;
- Highly competitive industry conditions, with larger, more diversified competitors;
- Cyclical capital requirements;
- Niche industry position; and
- Potential governance concerns: board effectiveness.

Business Description

See above.

Business Risk Profile

Industry Characteristics:

- Maturing industry, with growth in markets expected to slow in remainder of 2006 into 2007;
- Installed base leveling out; maintenance of market share is key; and
- Highly competitive market; hardware and accessories sold at little margin; profits driven by supplies for the hardware and service.

Company Position:

- HypothetiCo owns its own technology for hardware, software, and supplies.
- HypothetiCo is the only major competitor in its industry specializing in art and art directors. The company's narrow business profile has been partially offset by consistent execution and leading technology position. Management has historically been averse to making acquisitions outside its niche market segment.
- Have made modest market share gains with a large installed base, but maturing industry conditions will dampen revenue and earnings growth.

- Commercial business: 60% of customers are on long-term (more than three-year) service contracts, compared with an average of 40% among competitors.
- Consistent, if cautious management and execution.

Profitability/Peer Group Comparisons:

- HypothetiCo's operating profitability has been very consistent (annual EBITDA margins in the 12%-14% range), but is at risk over the intermediate term because it is in a maturing industry, with slower growth rates and highly competitive pricing conditions.
- The two major competitors are larger and much more diversified; comparable operating profitability is not available. However, as the technology leader, HypothetiCo prices at a modest premium to competing products.
- Return on capital is currently a bit low for the rating level at about 10%; driven by HypothetiCo's conservative use of debt.

Financial Risk Profile

Accounting:

- HypothetiCo's leverage is adjusted to include capitalized operating leases (\$47.6 million as of Sept. 30, 2006).
- We are not aware of any off-balance sheet liabilities not already incorporated in our analysis of leverage.

Governance, Risk Tolerance, Financial Policy:

- Since the CreditWatch placement, we conducted a limited governance review of HypothetiCo.
- Our review involved telephone interviews with CEO John Leader, the CFO, and with lead director Susan Overcommitted. We were not able to meet with representatives from Aggravation Capital.
- The board has been in a state of flux since the Aggravation representatives joined, and it appears (from the share repurchase decision) that the new directors have growing influence on the board and on financial policy.
- Despite the repurchase decision, there are many unknowns: This may be the first of a number of repurchase programs, for example. It also remains unknown how the new directors will affect business policy: Senior management, which remains unchanged, is still opposed to increasing leverage or pursuing anything other than smaller, roll-up acquisitions of the type they have completed in the past.
- Board effectiveness is under some stress. CEO Leader, for example, still wants little contact with the new directors from Aggravation.
- Except for Perry Pushover and the Aggravation directors, there is very little industry experience or financial experience on the board; most are lawyers or well-known members of the community.
- One director, Charlie Challenging, is not considered independent because the company rents office space from his firm, paying rental fees of \$900,000 in 2005. At the same time, Mr. Challenging is, among all directors, the more demanding and questioning of management, according to what we were told by Ms. Overcommitted and CEO Leader.

Cash Flow Adequacy:

- Working capital requirements are expected to be moderate as revenue growth slows.
- Capital expenditures are cyclical, driven by new tooling and capacity requirements for the manufacture of highly profitable supplies. The manufacturing of hardware products is outsourced to low-cost geographies.
- Free operating cash flow has been consistently positive but cyclical. Free operating cash flow to total debt typically ranges between 5% and 25%.
- Higher operating margin than peers; this appears to have been an attraction to Aggravation Capital.

Capital Structure, Asset Protection:

- Leverage currently is modest for the rating level, at 2.5x.
- HypothetiCo uses a combination of cash balances and bank debt to fund periods of higher capital expenditures. The company has outlined plans for a two-year manufacturing upgrade and expansion, to start in the first quarter of 2007, at a total cost of \$300 million.
- Aside from cash and receivables, HypothetiCo's primary asset is its installed base of proprietary hardware and accessories. Given that supplies and services generate the vast majority of the company's gross and operating margins, HypothetiCo would have to lose both market share and its installed base to see a decline in gross margin dollars.
- Indeed, Aggravation Capital is optimistic about this gross margin protection part of the business model: They have argued to us that HypothetiCo has a "good story to tell" and simply "needs to get its story out there."

Liquidity/Short-Term Factors:

- As of Sept. 30, 2006, HypothetiCo had cash and marketable securities of \$250 million.
- The company has limited borrowing capacity under a \$200 million revolving credit facility maturing Jan. 31, 2009, which is currently unused.
- There are no debt maturities until 2008 and 2009.
- Aggravation Capital has indicated in its filings and public statements that it feels the company can support significantly higher (permanent) leverage, given good operating margins and strong recurring revenues.

Relevant Ratios:

EBITDA Interest Coverage:	5.5x	(has ranged between 3.5x-6x)
Free Cash Flow/Total Debt:	22.4%	(has ranged between 5% and 25%)
EBITDA/Sales:	13.8%	(has ranged between 12%-14%)
Total Debt/EBITDA:	2.5x	(has ranged between 2x-3.6x)

HypothetiCo Inc. Director Profiles			
John Leader	54	Director (Since 1998)	CEO (Since 1998) & Chairman (Since 1999), HypothetiCo Inc. Mr. Leader was appointed CEO in June 1998. Chief Operating Officer (1996-1998), and VP, Business Products Division (1990-1996).
Charlie P. Challenging [^]	62	Director (Since 1995)	Managing Director and Founder (Since 1990), Challenging/Properties, a property-development firm in Encino. Mr. Challenging is not considered independent because HypothetiCo rents office space from his company.
Sue Softouch ^{§+}	64	Director (Since 1997)	Principal (Since 1999), Healthy Living Consulting Group, a private non-profit organization promoting organic foods and holistic well-being to government and major corporations.
Walter Walkover ^{§+}	71	Director (Since 1992)	President (Since 1988), Encino International University. Trustee, Encino Foundation for the Arts; Director, National Association for Highest Education.
Larry N. Lawyer ^{^+}	58	Director (Since 2000)	Partner (Since 1989), DeFend Settle & Sue LP
Perry Pushover ^{*¶}	67	Director (Since 1992)	Former Chairman of the Board and CEO (1989-1997) of FirstCyber Corp., a computer hardware manufacturer, San Rafael, CA. Director, Standard Cyber Products, Inc., and Director, InternetEquity Partners LLP, a private investment firm.
Suzanne L. Overcommitted ^{*^±}	51	Director (Since 2001)	Professional director and retired lawyer. Director, Starlight Neutraceuticals Corp., Sanguine Omnimedia Inc. Trustee, Encino Symphony Orchestra; Trustee, Encino Museum of Modern Art; Trustee, Encino Memorial Hospital and Cancer Research Center; Director, Encino Foundation for the Arts.
Marshall J. Aggrava [^]	48	Director (Since 2006)	Founder and Partner (Since 1996), Aggravation Capital Partners, Greenwich, CT. Director of High-Flyer Logistics Inc., CyberMegaTech Corp., and Qivox.com
Stanley Takedown [§]	53	Director (Since 2006)	Partner (Since 2000), Aggravation Capital Partners, Greenwich, CT. Director at HyperInfo Corp., TechnologyFirst! Corp., and BuyAndHoldAnd Sell.com
Arthur Pastiche [*]	59	Director (Since 2006)	Managing Director (Since 2002), Widows & Orphans LLC, Chicago, IL, a venture capital firm with interests in technology companies worldwide. Nominated by Aggravation Capital Partners.

* Member, Audit Committee, ^ Member, Finance Committee, + Member, Compensation Committee, § Member, Nominating & Governance Committee,

¶ Audit Committee Financial Expert, ± Lead Director

APPENDIX C

(This Appendix is for the Millstein Center Corporate Governance Roundtable Discussion purposes only and does not represent the full range of committee materials or published comment of Standard & Poor's Ratings Services.)

Research Update:

HypothetiCo Inc. Rating Lowered To 'BB-'; Remains On Negative Outlook

Publication date: 2-Nov-2006

*Primary Credit Analyst: Martha Toll-Reed, New York (1) 212-438-7867
molly_toll-reed@standardandpoors.com*

Rationale

On Nov. 2, 2006, Standard & Poor's Ratings Services lowered its corporate credit rating on Encino, CA-based HypothetiCo Inc. to 'BB-' from 'BB', and removed its ratings from CreditWatch, where they were placed with negative implications on Sept. 3, 2006. The downgrade reflects the company's increased leverage, a more acquisitive growth strategy, and concerns about corporate governance, including an increased emphasis on shareholder returns driven by minority shareholder influence. The outlook is negative.

Ratings reflect a narrow product and customer base, relatively modest size, and cyclical capital requirements. These factors are partially offset by the company's good position within its market niche, a significant base of recurring service and supplies revenues and consistent profitability. HypothetiCo manufactures and sells specialized computer hardware and accessories, primarily to the domestic magazine publishing and online advertising sectors. Total revenues for fiscal 2005 were \$414 million.

HypothetiCo is the only major competitor in the global, highly competitive computer hardware industry with a niche customer focus. The company faces significant competitive pressure from larger rivals, but has achieved modest growth in market share over the past five years, driven by its specialist market knowledge, strong product development record and consistent execution. However, maturing industry conditions are expected to dampen organic revenue and earnings growth. HypothetiCo historically made small, domestic acquisitions to bolster technology capabilities within its market segment. The company recently stated its strategic intent to expand its market presence through acquisitions, particularly in Asia, which could pose integration and operation challenges.

HypothetiCo's operating profitability has been very consistent, with annual EBITDA margins in the 12%-14% range. Profitability is supported by contractually recurring, high-margin service and supplies revenues. Nevertheless, over the intermediate term, profitability is likely to be pressured by slower industry growth rates and highly competitive pricing conditions. Leverage currently is modest for the rating level at 2.5x.

However, HypothetiCo's board of directors recently approved a Dutch auction self-tender to repurchase \$200 million of its shares, which the company intends to fund with a combination of debt and cash. Proforma for completion of the share repurchases, we expect total debt to EBITDA to be between 4.0x and 4.5x. In addition, funding requirements for a planned two-year capacity expansion program will preclude a material reduction in debt over the near to intermediate term. The current rating does not incorporate the potential for additional debt-funded share repurchases.

Liquidity

As of Sept. 30, 2006 HypothetiCo had cash and marketable securities of \$250 million. The company has borrowing capacity under a \$200 million revolving credit facility maturing Jan. 31, 2009, which is currently unused. There are no debt maturities until 2008 (\$50 million).

With moderate revenue growth rates and good profitability, cash flow from operations has been consistently positive. However, capex is cyclical, driven by new tooling and capacity requirements for the manufacture of highly profitable supplies. The company has outlined plans for a two-year manufacturing upgrade and expansion, starting in fiscal 2007, at a total cost of approximately \$300 million.

Outlook

The negative outlook reflects HypothetiCo's diminished financial flexibility and more aggressive financial policy. Ratings could be lowered if the use of debt to fund acquisitions or additional share repurchases leads to leverage in excess of 4.5x. A stable outlook could be achieved over the intermediate term if HypothetiCo maintains consistent profitability and operating cash flow, and sustains leverage levels below 4x.

APPENDIX D | Case Study Two

(This Appendix is for the Millstein Center Corporate Governance Roundtable Discussion purposes only and does not represent the full range of committee materials or published comment of Standard & Poor's Ratings Services.)

Conjecture Insurance Holding Company Ltd.

A+/Stable

Primary Credit Analyst: Damien Magarelli

Governance Review

Profile

Conjecture Insurance Holding Company Ltd. is a privately held, Bermuda-based insurance holding company with operating subsidiaries in the U. S. and the U.K. The company and its subsidiaries were formed 10 years ago from the reconstruction of Mega Insurance Ltd. The 'A+' insurer financial strength rating on Conjecture reflects its strong position in property/casualty commercial and personal lines, but aggressive pressure from competitors, volatility of earnings, and concerns about risk management remain a rating weakness. That weakness is offset to some extent by the importance the company attaches to catastrophe modeling and strict underwriting risk tolerances. Both operating subsidiaries, incorporated in New York and England, are rated one notch below the 'A+' rating, as Conjecture benefits from the geographic and line of business diversification of its two operating companies.

Litigation

The company is involved in a number of lawsuits at this time related to the use of used car replacement parts as opposed to new parts within its U.S.-based personal lines company.

Exposure

Because the company increased its catastrophe exposure following the events of Sept. 11, 2001, it manages its catastrophe exposure on a global basis. At the enterprise-holding company level, catastrophe risk is mitigated through the use of reinsurance purchases.

New Company

In August 2006, Conjecture announced the formation of a new Bermudan holding company, Conjecture Insurance Holding (Public). Following formation transactions scheduled for December 2006, Public's equity will be listed on the NYSE and up to 30% made available for purchase in an IPO. The offering will remit approximately \$340 million (\$325 million net) to Public. Following a board level review of the new company's capital needs and the operating subsidiaries business plans for product line expansion, the proceeds will used to augment Public's investment portfolio and broaden the subsidiaries product platform.

New Rating—Key Considerations

The issue is whether to maintain the current Conjecture rating for Conjecture Public and existing notching for the operating subsidiaries. The majority ownership stakes in Conjecture Public will reflect the current ownership profile, as diminished by the public offering. The current Conjecture rating will be withdrawn upon completion of the investment portfolio and subsidiary transfers, which will occur immediately before the IPO. The current company's share capital will be canceled and the company deregistered in accordance with the provisions of Bermudan company law.

Conjecture's now enlarged board and entire management team will transfer to Conjecture Public. The current board (enlarged from four to nine members) is intended to ensure and supplement SEC and NYSE independence requirements for controlled, publicly listed companies.

Governance Review

The review is intended to assess the support Conjecture Public can give to the maintenance of the current rating level for the new company. It will focus on the new board's composition including any indications of its likely effectiveness; certain restrictions on shareholder rights contained in the new company's bylaws; any impact the blockholder status will have on the new publicly listed company's governance, in particular the impact of the bylaws on outside shareholders; and the decision to continue the engagement of the present auditor once the company goes public. Although the company will not publish full details of its executive compensation levels and practices until the filing of its first proxy statement in 2007, certain details concerning bonuses connected with the public offering and executive perquisites connected with incorporation in Bermuda are detailed in the registration statement. These details will be used to draw inferences about the likely size and components of compensation practices at Conjecture Public.

(The Conjecture Public credit team is also planning to assess the rated subsidiaries' governance following this review—particularly in the areas of their own independent board processes, the degree of autonomous decision making about executive pay at these companies, parent provided services, and their sales force bonus policies.)

Conjecture Insurance Public (Extracts from the Draft Registration Statement provided to Standard & Poor's)

Share Capital

The company's share capital upon completion of the IPO will consist of 50 million authorized but unissued preferred shares and 200 million common shares of which 100 million will be issued and outstanding.

- The preferred shares will have such rights including dividend and voting rights as the board may exclusively determine.
- The common shares shall each have one vote per share on all matters submitted to a vote of security holders and equivalent rights to any dividend as the board, in its sole discretion, shall determine.

Ownership

Four shareholders who between them in equal shares owned 100% of the company's predecessor Conjecture Insurance Holding Company Ltd. will collectively own approximately 70% of the shares of Conjecture Insurance Public following the IPO. Accordingly the four below identified shareholders will

hold a controlling interest in the company (See Shareholders Agreement below). The entities that will each own approximately 17.5% of the company's outstanding common following the IPO are:

- Exclusion Limited Insurance Co, a publicly listed company (NYSE: ERR) incorporated in Bermuda;
- BigG International Group, a publicly listed insurance company (NYSE: BIGG) incorporated in The Cayman Islands;
- XXA Group. A private insurance company incorporated in England and Wales with subsidiaries in Asia; abd
- Gain Equity Partners, a private equity firm.

Shareholders Agreement (extract)

"...and the above shareholders will vote FOR the election of directors and the appointment of auditors at the first and subsequent annual meetings of shareholders, so long as the nominee directors and auditor appointment are previously agreed by *all* the company's directors then in office, prior to said annual meetings.

"...The above named shareholders each agree to offer exclusive preemptive rights to each and any of the other named shareholders regarding any sale of securities following the IPO until the earlier of 2012, or such time as the ownership of one (or more) of the above named shareholders falls below 7.5% of the then outstanding share capital."

Board of Directors

All directors will seek re-election to the board at Conjecture Insurance Public's first annual meeting in 2007 to varying terms of one, two and three years and thereafter one-third of the board (i.e., three directors) will retire at each annual meeting of the company.

Directors are elected by a plurality of the votes cast in person or by proxy, so that the board members who receive the most votes will be elected to the nine available board seats.

Director biographies and membership of the board's audit, compensation and nominating and governance committees (in parentheses, * = Chair) are listed below along with the director's country of residence:

George Goodchair, age 66, has been Executive Chair and a director of Conjecture Insurance Holding Co Ltd since June 1996, and will become Chair of the successor public company upon completion of the IPO. Mr. Goodchair was Chairman, President and CEO of Exclusion Limited Insurance Co (ERR: NYSE) from June 1990 until his retirement in October 1995 and President and CEO of ERR from August 1989 to July 1991. Subsequent to his retirement he served as a consultant to ERR until September 1999. Mr. Goodchair was a director of ERR from 1989 through May 2006. Prior to joining ERR, Mr. Goodchair was President and CEO of Prime financial services operations (which is now part of BancUS). Mr. Goodchair is currently Chairman and CEO of GoodTime Beverage, a Virginia-based hard-cider company. Mr. Goodchair is a member of the Executive Committee of the Board of Trustees of Lucre College and a founding trustee of the Foundation for Insurance Studies (Bermuda). (Bermuda)

Sidney Dominant, age 52, has been President and Chief Executive Officer of Conjecture Insurance Holding Co Ltd since December 2000 and will become CEO of Conjecture Insurance Public upon completion of the IPO. Mr. Dominant served as Vice Chairman of ERR from May 2003 until August

2004. Mr. Dominant was a director of ERR from 2001 through May 2006. Mr. Dominant previously served as President of ERR Bermuda Insurance Ltd. (“ERR Bermuda”) from July 1997 to May 1999, Executive Vice President, Underwriting from December 1996 to July 1997, and as Executive Vice President, Financial Lines from January 1995 to December 1996. Prior to joining ERR, Mr. Dominant spent 13 years working for various subsidiaries of the BigG International Group (BIGG: NYSE). Mr. Dominant completed his employment at BIGG after serving as Senior Vice President and Chief Financial Officer of BigG Risk Management. Before that, Mr. Dominant was Executive Vice President and Chief Financial Officer of NITWIT, a wholly owned subsidiary of BigG headquartered in Berlin, Germany. (United States)

Robert Twiselton-Montgomery, age 65, became a director of Conjecture Insurance Holding Co Ltd on its formation June 1996. From 1990 until his retirement in 1995, Mr. Twiselton-Montgomery was Chief Actuary of Fundamental Credit Rating Co. Mr. Twiselton-Montgomery is a director of XXA Group, XXA Asia Pacific Holdings. Mr. Twiselton-Montgomery is also a director of Conjecture Insurance (UK) Ltd., one of the Company’s subsidiaries. (United Kingdom)(Audit Committee: Compensation Committee)

Dominick T. O’Leary, age 64, became a director Conjecture Insurance Holding Co Ltd in August 2003. Until his retirement in August 2004, Mr. O’Leary was employed at CollegeTeacher’s Annuity (financial products) in a number of different capacities since 1986, most recently as Senior Managing Director, Annuities and Life Products Division. Mr. O’Leary is a member of the Board of Trustees of PupilPower America. (Republic of Ireland) (*Compensation Committee: Nominating and Governance Committee)

Stephen A. Litigious, age 66, joined the board in August 2006. Mr. Litigious is the founder and Chairman of Litigious Grabbit & Runne, an internationally recognized law firm, with its home office in Washington DC. Mr. Litigious has practiced law for more than 40 years and until 2003 was the CEO of Litigious Grabbit. Mr. Litigious is a director of Gain Equity Partners and a director of Conjecture Insurance (U.S.), one of the company’s subsidiaries. (U.S.) (Compensation Committee: *Nominating and Governance Committee)

Anthony Oldersperson, age 76, joined the board in September 2006. Mr. Oldersperson is currently an independent business consultant and serves on a total of five U.S.-based not-for-profit organizations. (U.S.) (Audit Committee)

Gregory Auditperson, age 63, joined the board in August 2006. He is a member and senior fellow of the Chamber of Commerce (U.S.). He became CFO of HugeCo in 1981 and was the company’s president from 1998 through 2000. Currently he serves on the board of Growinta Inc. an agricultural supply company. (U.S.) (Audit Committee* and designated audit committee financial expert)

Sidney Salesforce, age 42, joined the board in August 2006. He is Senior Vice President of SellingForce Inc a company specializing in growth strategies for corporate clients in the financial services industry. Prior to his current position Dr. Salesforce taught market strategy at the Stiff Collar School of

Management where he earned his doctoral degree in marketing. (U.S.) (Nominating and Governance Committee)

Margaret Gosforth, age 51, joined the board in October 2006. She is currently the CFO and COO and a director of DoWell Holdings a private group of companies headquartered in Hong Kong with diverse interests spanning highway construction, property investment, hotel and hospitality and the provision of life and annuity insurance products in the region. From 1981 until joining DoWell she was a Senior VP at Prudence Insurance Company of Great Britain holding a variety of posts including senior investment officer and senior risks and controls officer. (U. K. citizen, Resident in Hong Kong) (Audit Committee, Compensation Committee)

Director Independence

The board has determined that the following directors are independent under the revised listing standards of the New York Stock Exchange: Ms. Gosforth and Messrs Twiselton-Montgomery, O’Leary, Litigious, Oldersperson, Auditperson, and Salesforce. These independent directors constitute a substantial majority of the board.

Meetings of the Board of Directors and Board Committees

The board will hold four regularly scheduled meetings in each fiscal year and each of the audit and compensation committees will hold at least four meetings on the day prior to the board meeting and such other meetings as the committee members, collectively, in their absolute discretion shall require. Regularly scheduled meetings will be held in Bermuda at the company’s principal offices. Further details regarding the company’s governance practices will be disclosed in the company’s 2007 proxy statement.

Risk Factors

Matters Relating to the Company’s Articles of Incorporation

Questions relating to conflicts of interest may arise between us and ERR, BIGG, XXL, and Gain in a number of areas:

- Four of our directors were designated to our Board of Directors by these shareholders and, until their collective ownership of then-outstanding common shares of the company is first reduced to a percentage that is equal to or less than 30%, these shareholders will have the right to nominate such number of nominees for director as would equal two thirds of the nominees for election at each annual meeting.
- Our by-laws contain provisions that may make it more difficult for shareholders to replace directors even if the shareholders consider it beneficial to do so. In addition, these provisions could delay or prevent a change of control that a shareholder might consider favorable.
- These provisions may also prevent a shareholder from receiving the benefit from any premium over the market price of our common shares offered by a bidder in a potential takeover.
- Even in the absence of an attempt to effect a change in management or a takeover attempt, these provisions may adversely affect the prevailing market price of our common shares if they are viewed as discouraging takeover attempts in the future.

- If one of our officers, directors, or employees, who is also an officer, director, or employee of our four principal shareholders, acquires knowledge of a potential transaction or matter that may be a corporate opportunity for both us and those shareholders, our by-laws provide that such officer, director or employee will not be liable to us or our shareholders (including for breach of fiduciary duty as an officer, director or employee of ours) by reason of the fact that any of or all of the principal shareholders pursue or acquires such corporate opportunity for itself or themselves, directs such corporate opportunity to another person or does not present such corporate opportunity to us.
- Accordingly each of our present and future shareholders waive all claims or rights of action that such shareholder might have, individually or in the right of the company, against any of our directors, officers or employees for any act or failure to act in the performance of the duties of such director, officer or employee

Auditor

After careful consideration, the full board (nine directors) has decided to retain the services of Conjecture Insurance Holding Co Ltd. auditor, *Small, Competent & Co (Bermuda) Ltd.* *Small Competent* has audited the company's accounts according to U.S. GAAP since 1996. For reasons of cost and continuity the board determined that it was in the best interests of the company and its shareholders to continue to utilize their services. However, the audit committee of the board will periodically review the suitability of the engagement of the company's current auditor, particularly bearing in mind that upon completion of the IPO that the company will be the only publicly listed client of *Small Competent*.

Compensation & Other Emoluments

In connection with the public offering, the board determined that it would be in the best interests of the company to utilize approximately 5% of the proceeds of the public offering in order to reward and retain the company's management and staff (in total 212 individuals). In connection with that determination, the board has awarded a bonus of \$5 million to Mr. Sidney Dominant, irrevocably contingent upon the completion of the IPO.

In connection with his duties as CEO, Mr. Dominant benefits from a Bermudan housing allowance in the sum of \$600,000 per year together with travel emoluments for bimonthly travel to his family home in the U.S.

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