

GALLAGHER ARTHUR J & CO  
Form 10-Q  
October 31, 2012  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended September 30, 2012

or

**Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from            to

Commission File Number: 1-9761

**ARTHUR J. GALLAGHER & CO.**

(Exact name of registrant as specified in its charter)

Edgar Filing: GALLAGHER ARTHUR J & CO - Form 10-Q

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**36-2151613**  
(I.R.S. Employer  
Identification No.)

**Two Pierce Place, Itasca, Illinois 60143-3141**  
(Address of principal executive offices) (Zip code)

**(630) 773-3800**  
(Registrant's telephone number, including area code)

**Not Applicable**  
(Former name, former address and former fiscal year, if changed since last report)

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

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

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

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

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

The number of outstanding shares of the registrant's common stock, \$1.00 par value, as of September 30, 2012 was 124,387,000.

**Table of Contents**

**Arthur J. Gallagher & Co.**

**Index**

	<b>Page No.</b>
<b>Part I. <u>Financial Information</u></b>	
Item 1. <u>Financial Statements (Unaudited):</u>	
<u>Consolidated Statement of Earnings for the Three-month and Nine-month Periods Ended September 30, 2012 and 2011</u>	3
<u>Consolidated Statement of Comprehensive Earnings for the Three-month and Nine-month Periods Ended September 30, 2012 and 2011</u>	4
<u>Consolidated Balance Sheet at September 30, 2012 and December 31, 2011</u>	5
<u>Consolidated Statement of Cash Flows for the Nine-month Periods Ended September 30, 2012 and 2011</u>	6
<u>Consolidated Statement of Stockholders' Equity for the Nine-month Period Ended September 30, 2012</u>	7
<u>Notes to September 30, 2012 Consolidated Financial Statements</u>	8-27
<u>Report of Independent Registered Public Accounting Firm</u>	28
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	29-52
Item 3. <u>Quantitative and Qualitative Disclosure About Market Risk</u>	52-53
Item 4. <u>Controls and Procedures</u>	53
<b>Part II. <u>Other Information</u></b>	
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	53-54
Item 6. <u>Exhibits</u>	54
<u>Signature</u>	55
<u>Exhibit Index</u>	56

**Table of Contents****Part I Financial Information****Item 1. Financial Statements (Unaudited)****Arthur J. Gallagher & Co.****Consolidated Statement of Earnings****(Unaudited-in millions, except per share data)**

	Three-month period ended September 30,		Nine-month period ended September 30,	
	2012	2011	2012	2011
Commissions	\$ 346.0	\$ 308.0	\$ 962.7	\$ 829.7
Fees	248.2	225.1	706.0	628.8
Supplemental commissions	16.6	14.5	50.3	42.0
Contingent commissions	7.7	9.9	37.0	34.6
Investment income	2.7	2.6	8.0	6.7
Net gains on books of business sales	0.7	0.8	1.4	4.4
Revenues from clean coal activities	28.4	1.9	80.3	10.0
Other net revenues	0.1		1.4	0.1
<b>Total revenues</b>	<b>650.4</b>	<b>562.8</b>	<b>1,847.1</b>	<b>1,556.3</b>
Compensation	373.9	345.2	1,082.4	965.1
Operating	121.6	110.5	353.6	312.7
Cost of revenues from clean coal activities	27.7	0.7	74.4	12.4
Interest	10.7	10.3	32.1	30.4
Depreciation	10.7	9.4	30.6	26.6
Amortization	25.8	20.0	73.1	54.7
Change in estimated acquisition earnout payables	3.7	(4.3)	1.0	(6.0)
<b>Total expenses</b>	<b>574.1</b>	<b>491.8</b>	<b>1,647.2</b>	<b>1,395.9</b>
Earnings before income taxes	76.3	71.0	199.9	160.4
Provision for income taxes	14.6	24.3	38.4	56.8
Net earnings	\$ 61.7	\$ 46.7	\$ 161.5	\$ 103.6
Basic net earnings per share	\$ 0.50	\$ 0.41	\$ 1.35	\$ 0.93
Diluted net earnings per share	0.50	0.41	1.33	0.93
Dividends declared per common share	0.34	0.33	1.02	0.99

See notes to consolidated financial statements.

**Table of Contents****Arthur J. Gallagher & Co.****Consolidated Statement of Comprehensive Earnings****(Unaudited - in millions)**

	<b>Three-month period ended</b>		<b>Nine-month period ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Net earnings	\$ 61.7	\$ 46.7	\$ 161.5	\$ 103.6
Change in pension liability, net of taxes	1.0	0.2	2.0	0.7
Foreign currency translation	19.6	(15.1)	17.4	(13.7)
Change in fair value of derivative investments, net of taxes	1.7	(0.9)	2.0	(1.3)
<b>Comprehensive earnings</b>	<b>\$ 84.0</b>	<b>\$ 30.9</b>	<b>\$ 182.9</b>	<b>\$ 89.3</b>

See notes to consolidated financial statements.

**Table of Contents****Arthur J. Gallagher & Co.****Consolidated Balance Sheet****(In millions)**

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
	<b>(Unaudited)</b>	
Cash and cash equivalents	\$ 305.2	\$ 291.2
Restricted cash	805.5	692.5
Premiums and fees receivable	1,031.7	1,027.1
Other current assets	182.5	188.6
<b>Total current assets</b>	<b>2,324.9</b>	<b>2,199.4</b>
Fixed assets - net	101.0	91.3
Deferred income taxes	240.9	240.2
Other noncurrent assets	245.9	235.8
Goodwill - net	1,373.9	1,155.3
Amortizable intangible assets - net	722.7	561.5
<b>Total assets</b>	<b>\$ 5,009.3</b>	<b>\$ 4,483.5</b>
Premiums payable to insurance and reinsurance companies	\$ 1,703.6	\$ 1,621.9
Accrued compensation and other accrued liabilities	285.1	304.1
Unearned fees	67.7	69.7
Other current liabilities	33.9	67.9
Corporate related borrowings - current		10.0
<b>Total current liabilities</b>	<b>2,090.3</b>	<b>2,073.6</b>
Corporate related borrowings - noncurrent	725.0	675.0
Other noncurrent liabilities	557.8	491.3
<b>Total liabilities</b>	<b>3,373.1</b>	<b>3,239.9</b>
<b>Stockholders' equity:</b>		
Common stock - issued and outstanding 124.4 shares in 2012 and 114.7 shares in 2011	124.4	114.7
Capital in excess of par value	1,017.9	693.2
Retained earnings	519.7	482.9
Accumulated other comprehensive loss	(25.8)	(47.2)
<b>Total stockholders' equity</b>	<b>1,636.2</b>	<b>1,243.6</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 5,009.3</b>	<b>\$ 4,483.5</b>

See notes to consolidated financial statements.

**Table of Contents****Arthur J. Gallagher & Co.****Consolidated Statement of Cash Flows****(Unaudited - in millions)**

	<b>Nine-month period ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
Cash flows from operating activities:		
Net earnings	\$ 161.5	\$ 103.6
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Net gain on investments and other	(1.4)	(1.2)
Depreciation and amortization	103.7	81.3
Change in estimated acquisition earnout payables	1.0	(6.0)
Amortization of deferred compensation and restricted stock	6.4	5.3
Stock-based and other noncash compensation expense	5.5	11.4
Effect of changes in foreign exchange rates	0.9	0.1
Net change in restricted cash	(65.7)	3.0
Net change in premiums receivable	75.1	95.2
Net change in premiums payable	(55.5)	(80.2)
Net change in other current assets	12.2	20.6
Net change in accrued compensation and other accrued liabilities	(42.6)	(34.9)
Net change in fees receivable/unearned fees	(7.9)	(6.6)
Net change in income taxes payable	12.9	(9.8)
Net change in deferred income taxes	3.3	28.3
Net change in other noncurrent assets and liabilities	(30.0)	(24.5)
<b>Net cash provided by operating activities</b>	<b>179.4</b>	<b>185.6</b>
Cash flows from investing activities:		
Net additions to fixed assets	(36.1)	(35.3)
Cash paid for acquisitions, net of cash acquired	(137.9)	(241.8)
Net proceeds from sales of operations/books of business	8.9	12.7
Net proceeds (funding) of investment transactions	10.7	(3.7)
<b>Net cash used by investing activities</b>	<b>(154.4)</b>	<b>(268.1)</b>
Cash flows from financing activities:		
Proceeds from issuance of common stock	60.9	54.8
Tax impact from issuance of common stock	3.7	2.2
Repurchases of common stock		(1.1)
Dividends paid	(119.7)	(108.6)
Borrowings on line of credit facility	162.0	102.0
Repayments on line of credit facility	(172.0)	(102.0)
Borrowings of long-term debt	50.0	125.0
<b>Net cash (used) provided by financing activities</b>	<b>(15.1)</b>	<b>72.3</b>
<b>Effect of changes in foreign exchange rates on cash and cash equivalents</b>	<b>4.1</b>	<b>1.8</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>14.0</b>	<b>(8.4)</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>291.2</b>	<b>249.8</b>

Edgar Filing: GALLAGHER ARTHUR J & CO - Form 10-Q

Cash and cash equivalents at end of period	\$ 305.2	\$ 241.4
Supplemental disclosures of cash flow information:		
Interest paid	\$ 38.0	\$ 33.8
Income taxes paid	17.0	31.0

See notes to consolidated financial statements.

- 6 -



**Table of Contents****Arthur J. Gallagher & Co.****Consolidated Statement of Stockholders Equity****(Unaudited - in millions)**

	Common Stock		Capital in	Retained	Accumulated	Total
	Shares	Amount	Excess of	Earnings	Other	
			Par Value		Loss	
Balance at December 31, 2011	114.7	\$ 114.7	\$ 693.2	\$ 482.9	\$ (47.2)	\$ 1,243.6
Net earnings				161.5		161.5
Change in pension liability, net of taxes of \$1.3 million					2.0	2.0
Foreign currency translation					17.4	17.4
Change in fair value of derivative instruments, net of taxes of \$1.3 million					2.0	2.0
Compensation expense related to stock option plan grants			5.2			5.2
Tax impact from issuance of common stock			3.7			3.7
Common stock issued in:						
Thirty-three acquisition transactions	7.3	7.3	252.2			259.5
Stock option plans	2.1	2.1	52.2			54.3
Employee stock purchase plan	0.2	0.2	6.4			6.6
Deferred compensation and restricted stock	0.1	0.1	4.7			4.8
Other compensation expense			0.3			0.3
Common stock repurchases						
Cash dividends declared on common stock				(124.7)		(124.7)
Balance at September 30, 2012	124.4	\$ 124.4	\$ 1,017.9	\$ 519.7	\$ (25.8)	\$ 1,636.2

See notes to consolidated financial statements.

---

**Table of Contents**

**Notes to September 30, 2012 Consolidated Financial Statements (Unaudited)**

**1. Nature of Operations and Basis of Presentation**

Arthur J. Gallagher & Co. and its subsidiaries, collectively referred to herein as we, our or us, provide insurance brokerage and risk management services to a wide variety of commercial, industrial, institutional and governmental organizations through two reportable operating segments. Commission and fee revenue generated by the brokerage segment is primarily related to the negotiation and placement of insurance for our clients. Fee revenue generated by the risk management segment is primarily related to claims management, information management, risk control consulting (loss control) services and appraisals in the property/casualty market. Investment income and other revenue is generated from our investment portfolio, which includes invested cash and restricted funds, as well as tax-advantaged, clean energy and other investments. We are headquartered in Itasca, Illinois, have operations in 17 countries and offer client-service capabilities in more than 110 countries through a global network of correspondent insurance brokers and consultants.

We have prepared the accompanying unaudited consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements have been omitted pursuant to such rules and regulations. We believe the disclosures are adequate to make the information presented not misleading. The unaudited consolidated financial statements included herein are, in the opinion of management, prepared on a basis consistent with our audited consolidated financial statements for the year ended December 31, 2011 and include all normal recurring adjustments necessary for a fair presentation of the information set forth. The quarterly results of operations are not necessarily indicative of the results of operations to be reported for subsequent quarters or the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011.

Certain reclassifications have been made to the amounts reported in the prior year's unaudited consolidated financial statements in order to conform to the current year presentation.

In the preparation of our unaudited consolidated financial statements as of September 30, 2012, management evaluated all material subsequent events or transactions that occurred after the balance sheet date through the date on which the financial statements were issued, for potential recognition or disclosure therein.

**2. Effect of New Accounting Pronouncements**

**Other Comprehensive Income**

In June 2011, the Financial Accounting Standards Board (which we refer to as the FASB) issued ASU 2011-05, *Comprehensive Income (Topic 220)* to make the presentation of items within other comprehensive income (which we refer to as OCI) more prominent. The guidance requires companies to present items of net income, items of OCI and total comprehensive income in one continuous statement or two separate consecutive statements. We adopted this guidance for reporting in the first quarter of 2012 by presenting the required information in two separate consecutive statements in the accompanying unaudited consolidated financial statements. We were able to make the changes required by this guidance without incurring any costs or operational challenges because we had all of the necessary information, and previously presented it in the statement of stockholders' equity and notes to our consolidated financial statements.

**Testing Goodwill for Impairment**

In August 2011, the FASB issued ASU 2011-08, *Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment* that gives companies the option to perform a qualitative assessment that may allow them to skip the annual two-step test on goodwill impairment. The previously mandated two-step test requires companies to first assess goodwill for impairment by quantitatively comparing the fair value of a reporting unit with its carrying amount, including goodwill. If the reporting unit's fair value is less than its carrying amount, an analysis must then be performed to measure the amount of the goodwill impairment, if any. ASU 2011-08 gives companies the option to first perform a qualitative assessment to determine whether it is more likely than not (a likelihood of more than 50%) that the fair value of a reporting unit is less than its carrying amount. If a company concludes that this is the case, it must perform the two-step test. Otherwise, a company does not have to perform the two-step test.

**Table of Contents**

Using the optional qualitative screen introduced in the new guidance to test goodwill for impairment will require significant judgment. The qualitative assessment should consider not only company-specific information but all significant inputs used to determine fair value. Companies that use the screen will have to consider and weigh both positive and negative evidence that has a significant effect on a reporting unit's fair value and thoroughly document their analyses. Companies that appropriately apply the screen and achieve a positive result do not have to perform the annual two-step test and achieve the intended cost relief. The ASU is effective for fiscal years beginning after December 15, 2011. We do not plan to use the qualitative assessment provisions of this new guidance for our 2012 annual goodwill impairment review.

**3. Business Combinations**

During the nine-month period ended September 30, 2012, we acquired substantially all of the net assets of the following firms in exchange for our common stock and/or cash. These acquisitions have been accounted for using the acquisition method for recording business combinations (in millions except share data):

Name and Effective Date of Acquisition	Common Shares Issued (000s)	Common Share Value	Cash Paid	Accrued Liability	Escrow Deposited	Recorded Earnout Payable	Total Recorded Purchase Price	Maximum Potential Earnout Payable
Riley & Associates, Inc. January 1, 2012	64	\$ 1.9	\$ 0.7	\$	\$ 0.3	\$ 1.2	\$ 4.1	\$ 1.6
Detlefs & Company Benefit Resources, LLC February 1, 2012	52	1.7	0.6		0.1		2.4	1.4
First Premium Insurance Group, Inc. (FPI) February 1, 2012	599	19.9	0.4		1.0	2.8	24.1	7.0
Gary Johnson & Associates, Inc. February 1, 2012	55	1.8	0.7		0.1	0.3	2.9	1.4
ProSource Financial, LLC February 1, 2012	207	7.3	6.7		0.5	1.3	15.8	9.5
BenefitLink Resource Group, Inc. (BRG) March 1, 2012	357	12.3			0.5	6.0	18.8	8.0
Human Resource Management Systems, LLC March 1, 2012	143	5.0	1.7		0.1	1.8	8.6	5.3
Wischmeyer Financial, LP March 1, 2012	142	4.9	1.6		0.1	1.4	8.0	5.5
Besselman & Little Agency, LLC April 1, 2012	195	7.0	2.4		0.1	1.8	11.3	4.6
Schiff, Kreidler-Shell Insurance and Risk Services (SKS) April 1, 2012	744	27.6	13.3			1.4	42.3	18.5
CGM Gallagher Group Limited (CGM) April 1, 2012			12.0				12.0	
VEBA Service Group, LLC May 1, 2012	162	5.8	2.0		0.1	2.2	10.1	4.2

**Table of Contents**

Name and Effective Date of Acquisition	Common Shares Issued (000s)	Common Share Value	Cash Paid	Accrued Liability	Escrow Deposited	Recorded Earnout Payable	Total Recorded Purchase Price	Maximum Potential Earnout Payable
Professional Claims Managers, Inc. May 1, 2012	175	\$ 5.4	\$ 2.2	\$	\$ 0.6	\$ 1.3	\$ 9.5	\$ 3.9
Insurance Dialogue Limited (IDL) May 1, 2012			26.7				26.7	
Grossman & Associates, Inc. June 1, 2012	99	3.3			0.1	0.6	4.0	5.6
Broker Benefit Services, LLC June 1, 2012	180	6.2	2.1		0.1	1.4	9.8	4.0
Whitehaven Insurance Group, Inc. June 1, 2012	75	2.6	0.6		0.2	0.7	4.1	1.6
Contego Underwriting Limited July 1, 2012			7.1			5.0	12.1	6.3
Grace/Mayer Insurance Agency, Inc. (GMI) July 1, 2012	549	19.5	1.5		2.6	2.4	26.0	7.0
G.S. Chapman & Associates Insurance Brokers, Inc. (GSC) July 1, 2012	905	28.6	7.0		6.7	6.6	48.9	19.5
Miller Buettner & Parrott, Inc. July 1, 2012	127	4.4	1.5		0.1	1.1	7.1	6.0
Triad USA, Inc. July 1, 2012	164	5.6	1.9		0.2	1.4	9.1	7.3
Blenheim Park Ltd. (BPL) August 1, 2012	254	9.1	5.0			12.3	26.4	17.2
Sunday and Associates, Inc. August 1, 2012	99	3.3			0.1	0.9	4.3	2.6
Acumus Limited (ACL) September 21, 2012			25.0	5.5			30.5	
Thirteen other acquisitions completed in 2012	208	7.0	9.9		0.7	4.0	21.6	8.4
	5,555	\$ 190.2	\$ 132.6	\$ 5.5	\$ 14.3	\$ 57.9	\$ 400.5	\$ 156.4

In 2007, we acquired a 38.5% equity interest in CGM for \$11.9 million and accounted for our non-controlling interest in CGM's common stock using equity method accounting. CGM is an insurance intermediary and risk management company that provides property/casualty, health, risk management and other related services to clients throughout the Caribbean. CGM is headquartered in St. Lucia and has operations in Jamaica, Barbados, St. Vincent and St. Lucia. Effective April 1, 2012, we increased our ownership interest in CGM to 80%, with the option to increase our ownership in CGM to 100%, and consolidated its operations into our consolidated financial statements. CGM's acquisition date balance sheet and the excess of the purchase price over the estimated fair value of the tangible net assets acquired at the acquisition date, has been included in the tables above and below, respectively. We recognized a loss of \$3.5 million and a corresponding reduction in goodwill for the decrease in fair value of our initial 38.5% equity interest in CGM upon the acquisition of the additional 41.5% equity interest. The carrying

---

**Table of Contents**

value of our non-controlling interest in CGM was \$13.6 million as of the acquisition date. The fair value of our initial 38.5% equity interest in CGM was determined by allocating, on a pro rata basis, the fair value of the CGM entity as adjusted for the prior non-controlling ownership position. We determined the fair value of the CGM entity using the valuation techniques discussed below related to net assets acquired.

Effective May 1, 2012, we acquired a 78.5% ownership interest in IDL, with the option to increase our ownership in IDL to 100%, and consolidated its operations into our consolidated financial statements. IDL is a retail insurance broker that provides personal lines insurance within the homeowner and automobile markets in the U.K. IDL's acquisition date balance sheet and the excess of the purchase price over the estimated fair value of the tangible net assets acquired at the acquisition date, has been included in the tables above and below, respectively.

Common shares issued in connection with acquisitions are valued at closing market prices as of the date on which the consideration was paid for the applicable acquisition. We record escrow deposits that are returned to us as a result of adjustments to net assets acquired as reductions of goodwill when the escrows are settled. The maximum potential earnout payables disclosed in the foregoing table represent the maximum amount of additional consideration that could be paid pursuant to the terms of the purchase agreement for the applicable acquisition. The amounts recorded as earnout payables, which are primarily based upon the estimated future operating results of the acquired entities over a two- to three-year period subsequent to the acquisition date, are measured at fair value as of the acquisition date and are included on that basis in the recorded purchase price consideration in the foregoing table. We will record subsequent changes in these estimated earnout obligations, including the accretion of discount on these obligations, in our consolidated statement of earnings, when incurred.

The fair value of these earnout obligations is based on the present value of the expected future payments to be made to the sellers of the acquired entities in accordance with the provisions outlined in the respective purchase agreements. In determining fair value, we estimated the acquired entity's future performance using financial projections developed by management for the acquired entity and market participant assumptions that were derived for revenue growth and/or profitability. We estimated future payments using the earnout formula and performance targets specified in each purchase agreement and these financial projections. We then discounted these payments to present value using a risk-adjusted rate that takes into consideration market-based rates of return which reflect the ability of the acquired entity to achieve the targets. Changes in financial projections, market participant assumptions for revenue growth and/or profitability, or the risk-adjusted discount rate, would result in a change in the fair value of recorded earnout obligations.

During each of the three-month periods ended September 30, 2012 and 2011, we recognized \$2.4 million and \$2.3 million, respectively, of expense in our consolidated statement of earnings related to the accretion of the discount recorded for earnout obligations related to our 2009 to 2012 acquisitions. During the nine-month periods ended September 30, 2012 and 2011, we recognized \$7.0 million and \$6.2 million, respectively, of expense in our consolidated statement of earnings related to the accretion of the discount recorded for earnout obligations related to our 2009 to 2012 acquisitions. In addition, during the three-month periods ended September 30, 2012 and 2011, we recognized \$1.3 million of expense and \$6.6 million of income, respectively, related to net adjustments in the estimated fair value of earnout obligations related to revised projections of future performance for twelve and eight acquisitions, respectively. In addition, during the nine-month periods ended September 30, 2012 and 2011, we recognized \$6.0 million and \$12.2 million, respectively, of income related to net adjustments in the estimated fair value of earnout obligations related to revised projections of future performance for thirty-one and thirteen acquisitions, respectively. The aggregate amount of maximum potential earnout obligations related to acquisitions made in 2009 and subsequent years was \$314.4 million as of September 30, 2012, of which \$114.8 million was recorded in our consolidated balance sheet as of September 30, 2012, based on the estimated fair value of the expected future payments to be made.

**Table of Contents**

The following is a summary of the estimated fair values of the net assets acquired at the date of each acquisition made in 2012 (in millions):

	FPI	BRG	SKS	IDL	GMI	GSC	BPL	ACL	Thirty Other Acquisitions	Total
Cash	\$ 0.2	\$ 1.7	\$ 0.4	\$	\$ 0.2	\$ 0.7	\$ 1.6	\$ 0.6	\$ 8.4	\$ 13.8
Other current assets	5.5		5.6	9.6	2.1	0.8	4.9	11.1	37.5	77.1
Fixed assets	0.5	0.1	0.1	0.4	0.1	0.1	0.3	0.1	1.8	3.5
Noncurrent assets				3.8	1.8			6.4		12.0
Goodwill	13.8	9.7	24.8	11.1	18.3	19.3	16.5	17.9	78.7	210.1
Expiration lists	14.1	8.7	27.2	19.4	15.3	29.0	11.9	9.7	89.8	225.1
Non-compete agreements	0.3	0.2	0.4		0.1	0.2	0.3	0.5	2.8	4.8
Trade names				0.6						0.6
<b>Total assets acquired</b>	<b>34.4</b>	<b>20.4</b>	<b>58.5</b>	<b>44.9</b>	<b>37.9</b>	<b>50.1</b>	<b>35.5</b>	<b>46.3</b>	<b>219.0</b>	<b>547.0</b>
Current liabilities	4.8	1.6	5.6	10.7	6.0	1.2	5.7	13.2	37.4	86.2
Noncurrent liabilities	5.5		10.6	7.5	5.9		3.4	2.6	24.8	60.3
<b>Total liabilities assumed</b>	<b>10.3</b>	<b>1.6</b>	<b>16.2</b>	<b>18.2</b>	<b>11.9</b>	<b>1.2</b>	<b>9.1</b>	<b>15.8</b>	<b>62.2</b>	<b>146.5</b>
<b>Total net assets acquired</b>	<b>\$ 24.1</b>	<b>\$ 18.8</b>	<b>\$ 42.3</b>	<b>\$ 26.7</b>	<b>\$ 26.0</b>	<b>\$ 48.9</b>	<b>\$ 26.4</b>	<b>\$ 30.5</b>	<b>\$ 156.8</b>	<b>\$ 400.5</b>

These acquisitions are expected to allow us to, among other things, expand into desirable geographic locations, further extend our presence in the retail and wholesale insurance brokerage services industries and increase the volume of general services currently provided. The excess of the purchase price over the estimated fair value of the tangible net assets acquired at the acquisition date was allocated to goodwill, expiration lists, non-compete agreements and trade names in the amounts of \$210.1 million, \$225.1 million, \$4.8 million and \$0.6 million, respectively, within the brokerage segment.

Provisional estimates of fair value are established at the time of the acquisition and are subsequently reviewed within the first year of operations subsequent to the acquisition date to determine the necessity for adjustments. The fair value of the tangible assets and liabilities for each applicable acquisition at the acquisition date approximated their carrying values. The fair value of expiration lists was established using the excess earnings method, which is an income approach based on estimated financial projections developed by management for each acquired entity using market participant assumptions. We estimate fair value as the present value of the benefits anticipated from ownership of the subject customer list in excess of returns required on the investment in contributory assets necessary to realize those benefits. The rate used to discount the net benefits was based on a risk-adjusted rate that takes into consideration market-based rates of return and reflects the risk of the asset relative to the acquired business. The fair value of non-compete agreements was established using the profit differential method, which is an income approach based on estimated financial projections developed by management for the acquired company using market participant assumptions and various non-compete scenarios.

Expiration lists, non-compete agreements and trade names related to our acquisitions are amortized using the straight-line method over their estimated useful lives (ten years for trade names, three to fifteen years for expiration lists and three to five years for non-compete agreements), while goodwill is not subject to amortization. We use the straight-line method to amortize these intangible assets because the pattern of their economic benefits cannot be reasonably determined with any certainty. We review all of our intangible assets for impairment periodically (at least annually) and whenever events or changes in business circumstances indicate that the carrying value of the assets may not be recoverable. In reviewing intangible assets, if the fair value is less than the carrying amount of the respective (or underlying) asset, an indicator of impairment would exist and further analysis would be required to determine whether or not a loss would need to be charged against current period earnings. Based on the results of impairment reviews during the three-month and nine-month periods ended September 30, 2012, we wrote off \$0.3 million and \$3.4 million, respectively, of amortizable intangible assets related to the brokerage segment. No such indicators were noted in the three-month and nine-month periods ended September 30, 2011.

**Table of Contents**

Of the \$225.1 million of expiration lists, \$4.8 million of non-compete agreements and \$0.6 million of trade names related to our 2012 acquisitions, \$121.5 million, \$2.5 million and \$0.6 million, respectively, is not expected to be deductible for income tax purposes. Accordingly, we recorded a deferred tax liability of \$40.4 million and a corresponding amount of goodwill in 2012 related to the nondeductible amortizable intangible assets.

During the nine-month period ended September 30, 2012, we issued 425,000 shares of our common stock and paid \$3.4 million in cash related to earnout obligations of four acquisitions made prior to 2009 and recorded additional goodwill of \$0.1 million. During the nine-month period ended September 30, 2011, we issued 153,000 shares of our common stock, paid \$7.3 million in cash and accrued \$10.2 million in liabilities related to earnout obligations of seventeen acquisitions made prior to 2009 and recorded additional goodwill of \$11.7 million.

Our consolidated financial statements for the nine-month period ended September 30, 2012 include the operations of the acquired entities from their respective acquisition dates. The following is a summary of the unaudited pro forma historical results, as if these entities had been acquired at January 1, 2011 (in millions, except per share data):

	Three-month period ended September 30,		Nine-month period ended September 30,	
	2012	2011	2012	2011
Total revenues	\$ 653.6	\$ 601.8	\$ 1,902.8	\$ 1,679.8
Net earnings	62.0	49.2	165.6	115.7
Basic net earnings per share	0.50	0.42	1.35	0.99
Diluted net earnings per share	0.49	0.41	1.34	0.99

The unaudited pro forma results above have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which actually would have resulted had these acquisitions occurred at January 1, 2011, nor are they necessarily indicative of future operating results. Annualized revenues of the businesses acquired during the nine-month period ended September 30, 2012 totaled approximately \$155.5 million. For the nine-month period ended September 30, 2012, total revenues and net earnings recorded in our unaudited consolidated statement of earnings related to our 2012 acquisitions in the aggregate were \$62.6 million and \$2.0 million, respectively.

**4. Intangible Assets**

The carrying amount of goodwill at September 30, 2012 and December 31, 2011 allocated by domestic and foreign operations is as follows (in millions):

	Brokerage	Risk Management	Corporate	Total
<b>At September 30, 2012</b>				
United States	\$ 1,085.9	\$ 18.5	\$	\$ 1,104.4
Foreign, principally Australia, Canada and the U.K.	267.4	2.1		269.5
Total goodwill net	\$ 1,353.3	\$ 20.6	\$	\$ 1,373.9
<b>At December 31, 2011</b>				
United States	\$ 951.0	\$ 18.5	\$	\$ 969.5
Foreign, principally Australia, Canada and the U.K.	185.6	0.2		185.8
Total goodwill net	\$ 1,136.6	\$ 18.7	\$	\$ 1,155.3

**Table of Contents**

The changes in the carrying amount of goodwill for the nine-month period ended September 30, 2012 are as follows (in millions):

	<b>Brokerage</b>	<b>Risk Management</b>	<b>Corporate</b>	<b>Total</b>
Balance as of December 31, 2011	\$ 1,136.6	\$ 18.7	\$	\$ 1,155.3
Goodwill acquired during the period	210.1			210.1
Goodwill related to earnouts recognized during the period	0.1			0.1
Goodwill adjustments due to appraisals and other acquisition adjustments	(0.6)	(0.2)		(0.8)
Goodwill related to transfers of operations between segments	(2.0)	2.0		
Foreign currency translation adjustments during the period	9.1	0.1		9.2
<b>Balance as of September 30, 2012</b>	<b>\$ 1,353.3</b>	<b>\$ 20.6</b>	<b>\$</b>	<b>\$ 1,373.9</b>

Major classes of amortizable intangible assets at September 30, 2012 and December 31, 2011 consist of the following (in millions):

	<b>September 30, 2012</b>	<b>December 31, 2011</b>
Expiration lists	\$ 1,066.8	\$ 837.5
Accumulated amortization - expiration lists	(367.3)	(296.7)
	699.5	540.8
Non-compete agreements	30.4	26.3
Accumulated amortization - non-compete agreements	(22.9)	(21.3)
	7.5	5.0
Trade name	20.5	19.0
Accumulated amortization - trade name	(4.8)	(3.3)
	15.7	15.7
<b>Net amortizable assets</b>	<b>\$ 722.7</b>	<b>\$ 561.5</b>

Estimated aggregate amortization expense for each of the next five years is as follows:

2012 (remaining three months)	\$ 25.7
2013	102.4
2014	99.7
2015	94.5
2016	89.0
<b>Total</b>	<b>\$ 411.3</b>



---

**Table of Contents**

**5. Credit and Other Debt Agreements**

**Note Purchase Agreement** - We are a party to an amended and restated note purchase agreement dated December 19, 2007, with certain accredited institutional investors, pursuant to which we issued and sold \$100.0 million in aggregate principal amount of our 6.26% Senior Notes, Series A, due August 3, 2014 and \$300.0 million in aggregate principal amount of our 6.44% Senior Notes, Series B, due August 3, 2017, in a private placement. These notes require semi-annual payments of interest that are due in February and August of each year.

We are also a party to a note purchase agreement dated November 30, 2009, with certain accredited institutional investors, pursuant to which we issued and sold \$150.0 million in aggregate principal amount of our 5.85% Senior Notes, Series C, due in three equal installments on November 30, 2016, November 30, 2018 and November 30, 2019, in a private placement. These notes require semi-annual payments of interest that are due in May and November of each year.

We are also a party to a note purchase agreement dated February 10, 2011, with certain accredited institutional investors, pursuant to which we issued and sold \$75.0 million in aggregate principal amount of our 5.18% Senior Notes, Series D, due February 10, 2021 and \$50.0 million in aggregate principal amount of our 5.49% Senior Notes, Series E, due February 10, 2023, in a private placement. These notes require semi-annual payments of interest that are due in February and August of each year.

We are also a party to a note purchase agreement dated July 10, 2012, with certain accredited institutional investors, pursuant to which we issued and sold \$50.0 million in aggregate principal amount of our 3.99% Senior Notes, Series F, due July 10, 2020, in a private placement. These notes require semi-annual payments of interest that are due in January and July of each year.

Under the terms of the note purchase agreements, we may redeem the notes at any time, in whole or in part, at 100% of the principal amount of such notes being redeemed, together with accrued and unpaid interest and a make-whole amount. The make-whole amount is derived from a net present value computation of the remaining scheduled payments of principal and interest using a discount rate based on U.S. Treasury yields plus 0.5% and is designed to compensate the purchasers of the notes for their investment risk in the event prevailing interest rates at the time of prepayment are less favorable than the interest rates under the notes. We do not currently intend to prepay the notes.

The note purchase agreements contain customary provisions for transactions of this type, including representations and warranties regarding us and our subsidiaries and various financial covenants, including covenants that require us to maintain specified financial ratios. We were in compliance with these covenants as of September 30, 2012. The note purchase agreements also provide customary events of default, generally with corresponding grace periods, including, without limitation, payment defaults with respect to the notes, covenant defaults, cross-defaults to other agreements evidencing our or our subsidiaries' indebtedness, certain judgments against us or our subsidiaries and events of bankruptcy involving us or our material subsidiaries.

The notes issued under the note purchase agreements are senior unsecured obligations of ours and rank equal in right of payment with our Credit Agreement discussed below.

**Credit Agreement** - On July 15, 2010, we entered into an unsecured multicurrency credit agreement (which we refer to as the Credit Agreement), which expires on July 14, 2014, with a group of twelve financial institutions.

The Credit Agreement provides for a revolving credit commitment of up to \$500.0 million, of which up to \$75.0 million may be used for issuances of standby or commercial letters of credit and up to \$50.0 million may be used for the making of swing loans, as defined in the Credit Agreement. We may from time to time request, subject to certain conditions, an increase in the revolving credit commitment up to a maximum aggregate revolving credit commitment of \$600.0 million.

The Credit Agreement provides that we may elect that each borrowing in U.S. dollars be either base rate loans or Eurocurrency loans, as defined in the Credit Agreement. All loans denominated in currencies other than U.S. dollars will be Eurocurrency loans. Interest rates on base rate loans and outstanding drawings on letters of credit in U.S. dollars under the Credit Agreement are based on the base rate, as defined in the Credit Agreement. Interest rates on Eurocurrency loans or outstanding drawings on letters of credit in currencies other than U.S. dollars are based on an adjusted London Interbank Offered Rate, as defined in the Credit Agreement, plus a margin of 1.45%, 1.65%, 1.85% or 2.00%, depending on the financial leverage ratio we maintain. Interest rates on swing loans are based, at our election, on either the base rate, as defined in the Credit Agreement, or such alternate rate as may be quoted by the lead lender. The annual facility fee related to the Credit Agreement is either .30%, .35%, .40% or .50% of the used and unused portions of the revolving credit commitment, depending on the financial leverage ratio we maintain.



**Table of Contents**

The terms of our Credit Agreement include various financial covenants, including covenants that require us to maintain specified levels of net worth and financial leverage ratios. We were in compliance with these covenants as of September 30, 2012. The Credit Agreement also includes customary events of default, with corresponding grace periods, including, without limitation, payment defaults, cross-defaults to other agreements evidencing indebtedness and bankruptcy-related defaults.

At September 30, 2012, \$15.9 million of letters of credit (for which we had \$8.6 million of liabilities recorded at September 30, 2012) were outstanding under the Credit Agreement. There were no borrowings outstanding under the Credit Agreement at September 30, 2012. Accordingly, as of September 30, 2012, \$484.1 million remained available for potential borrowings under the Credit Agreement, of which \$59.1 million may be in the form of additional letters of credit.

See Note 12 to these unaudited consolidated financial statements for additional discussion on our contractual obligations and commitments as of September 30, 2012.

The following is a summary of our corporate debt (in millions):

	September 30, 2012	December 31, 2011
<b>Note Purchase Agreements:</b>		
Semi-annual payments of interest, fixed rate of 6.26%, balloon due 2014	\$ 100.0	\$ 100.0
Semi-annual payments of interest, fixed rate of 6.44%, balloon due 2017	300.0	300.0
Semi-annual payments of interest, fixed rate of 5.85%, \$50 million due in 2016, 2018 and 2019	150.0	150.0
Semi-annual payments of interest, fixed rate of 5.18%, balloon due 2021	75.0	75.0
Semi-annual payments of interest, fixed rate of 5.49%, balloon due 2023	50.0	50.0
Semi-annual payments of interest, fixed rate of 3.99%, balloon due 2020	50.0	
<b>Total Note Purchase Agreements</b>	<b>725.0</b>	<b>675.0</b>
<b>Credit Agreement:</b>		
Periodic payments of interest and principal, prime or LIBOR plus up to 2.00%, expires July 14, 2014		10.0
	<b>\$ 725.0</b>	<b>\$ 685.0</b>

The fair value of the \$725.0 million in debt under the note purchase agreements at September 30, 2012 was \$826.8 million due to the long-term duration and fixed interest rates associated with these debt obligations. No active or observable market exists for our private placement long-term debt. Therefore, the estimated fair value of this debt is based on discounted future cash flows, which is a Level 3 fair value measurement, using current interest rates available for debt with similar terms and remaining maturities. To estimate an all-in interest rate for discounting, we obtain market quotes for notes with the same terms as ours, which we have deemed to be the closest approximation of current market rates. We have not adjusted this rate for risk profile changes, covenant issues or credit ratings changes.

**Table of Contents****6. Earnings Per Share**

The following table sets forth the computation of basic and diluted net earnings per share (in millions, except per share data):

	Three-month period ended		Nine-month period ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Net earnings	\$ 61.7	\$ 46.7	\$ 161.5	\$ 103.6
Weighted average number of common shares outstanding	123.1	112.6	119.7	111.0
Dilutive effect of stock options using the treasury stock method	1.4	0.5	1.5	0.7
Weighted average number of common and common equivalent shares outstanding	124.5	113.1	121.2	111.7
Basic net earnings per share	\$ 0.50	\$ 0.41	\$ 1.35	\$ 0.93
Diluted net earnings per share	\$ 0.50	\$ 0.41	\$ 1.33	\$ 0.93

Options to purchase 1.4 million and 5.0 million shares of common stock were outstanding at September 30, 2012 and 2011, respectively, but were not included in the computation of the dilutive effect of stock options for the three-month periods then ended. Options to purchase 1.0 million and 3.8 million shares of common stock were outstanding at September 30, 2012 and 2011, respectively, but were not included in the computation of the dilutive effect of stock options for the nine-month periods then ended. These options were excluded from the computation because the options' exercise prices were greater than the average market price of our common shares during the respective period, and therefore would be anti-dilutive to earnings per share under the treasury stock method.

**7. Stock Option Plans****Long-Term Incentive Plan**

On May 10, 2011, our stockholders approved the Arthur J. Gallagher 2011 Long-Term Incentive Plan (which we refer to as the LTIP), which replaced our previous stockholder-approved Arthur J. Gallagher & Co. 2009 Long-Term Incentive Plan (which we refer to as the 2009 LTIP). The LTIP term began May 10, 2011 and it terminates on the date of the annual meeting of stockholders that occurs during the year of the seventh anniversary of its effective date, unless terminated earlier by our board of directors. All of our officers, employees and non-employee directors are eligible to receive awards under the LTIP. The compensation committee of our board of directors determines the participants under the LTIP. The LTIP provides for non-qualified and incentive stock options, stock appreciation rights, restricted stock, restricted stock units and performance units, any or all of which may be made contingent upon the achievement of performance criteria. A stock appreciation right entitles the holder to receive, upon exercise and subject to withholding taxes, cash or shares of our common stock (which may be restricted stock) with a value equal to the difference between the fair market value of our common stock on the exercise date and the base price of the stock appreciation right. Subject to the LTIP limits, the compensation committee has the discretionary authority to determine the size of awards.

Shares of our common stock available for issuance under the LTIP include authorized and unissued shares of common stock or authorized and issued shares of common stock reacquired and held as treasury shares or otherwise, or a combination thereof. The number of available shares will be reduced by the aggregate number of shares that become subject to outstanding awards granted under the LTIP. To the extent that shares subject to an outstanding award granted under either the LTIP or the 2009 LTIP are not issued or delivered by reason of the expiration, termination, cancellation or forfeiture of such award or by reason of the settlement of such award in cash, then such shares will again be available for grant under the LTIP. Shares that are subject to a stock appreciation right and were not issued upon the net settlement or net exercise of such stock appreciation right, shares that are used to pay the exercise price of an option, delivered to or withheld by us to pay withholding taxes, and shares that are purchased on the open market with the proceeds of an option exercise, may not again be made available for issuance.

**Table of Contents**

The maximum number of shares available under the LTIP for restricted stock, restricted stock unit awards and performance unit awards settled with stock (i.e., all awards other than stock options and stock appreciation rights) is 1.2 million. To the extent necessary to be qualified performance-based compensation under Section 162(m) of the Internal Revenue Code (which we refer to as the IRC): (i) the maximum number of shares with respect to which options or stock appreciation rights or a combination thereof that may be granted during any fiscal year to any person is 200,000; (ii) the maximum number of shares with respect to which performance-based restricted stock or restricted stock units that may be granted during any fiscal year to any person is 100,000; and (iii) the maximum amount that may be payable with respect to performance units granted during any fiscal year to any person is \$3.0 million.

The LTIP provides for the grant of stock options, which may be either tax-qualified incentive stock options or non-qualified options and stock appreciation rights. The compensation committee determines the period for the exercise of a non-qualified stock option, tax-qualified incentive stock option or stock appreciation right, provided that no option can be exercised later than seven years after its date of grant. The exercise price of a non-qualified stock option or tax-qualified incentive stock option and the base price of a stock appreciation right cannot be less than 100% of the fair market value of a share of our common stock on the date of grant, provided that the base price of a stock appreciation right granted in tandem with an option will be the exercise price of the related option.

Upon exercise, the option exercise price may be paid in cash, by the delivery of previously owned shares of our common stock, through a net-exercise arrangement, or through a broker-assisted cashless exercise arrangement. The compensation committee determines all of the terms relating to the exercise, cancellation or other disposition of an option or stock appreciation right upon a termination of employment, whether by reason of disability, retirement, death or any other reason. Stock option and stock appreciation right awards under the LTIP are non-transferable.

On March 16, 2012, the compensation committee granted 1,355,000 options to our officers and key employees that become exercisable at the rate of 34%, 33% and 33% on the anniversary date of the grant in 2015, 2016 and 2017, respectively. On March 8, 2011, the compensation committee granted 851,000 options under the 2009 LTIP to our officers and key employees that become exercisable at the rate of 20% per year on each anniversary date of the grant. The 2012 and 2011 options expire seven years from the date of grant, or earlier in the event of certain terminations of employment.

**Other Information**

All of our stock option plans provide for the immediate vesting of all outstanding stock option grants in the event of a change in control of our company, as defined in the applicable plan documents.

During the three-month periods ended September 30, 2012 and 2011, we recognized \$2.2 million and \$2.0 million, respectively, of compensation expense related to our stock option grants. During the nine-month periods ended September 30, 2012 and 2011, we recognized \$5.2 million and \$5.0 million, respectively, of compensation expense related to our stock option grants.

For purposes of expense recognition, the estimated fair values of the stock option grants are amortized to expense over the options vesting period. We estimated the fair value of stock options at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2012	2011
Expected dividend yield	4.0%	4.5%
Expected risk-free interest rate	1.2%	2.7%
Volatility	26.9%	26.8%
Expected life (in years)	5.0	6.0

Option valuation models require the input of highly subjective assumptions including the expected stock price volatility. The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. Because our employee and director stock options have characteristics significantly different from those of traded options, and because changes in the selective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of our employee and non-employee director stock options. The weighted average fair value per option for all options granted during the nine-month periods ended September 30, 2012 and 2011, as determined on the grant date using the Black-Scholes option pricing model, was \$5.49 and \$5.25, respectively.



**Table of Contents**

The following is a summary of our stock option activity and related information for 2012 (in millions, except exercise price and year data):

	Nine-month period ended September 30, 2012			
	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Beginning balance	10.6	\$ 27.20		
Granted	1.4	35.71		
Exercised	(2.1)	25.98		
Forfeited or canceled	(0.1)	30.87		
Ending balance	9.8	\$ 28.62	3.54	\$ 70.3
Exercisable at end of period	5.8	\$ 27.38	2.68	\$ 49.0
Ending vested and expected to vest	9.7	\$ 28.58	3.52	\$ 70.1

Options with respect to 10.0 million shares (less any shares of restricted stock issued under the LTIP see Note 9 to these unaudited consolidated financial statements) were available for grant under the LTIP at September 30, 2012.

The total intrinsic value of options exercised during the nine-month periods ended September 30, 2012 and 2011 was \$19.1 million and \$6.9 million, respectively. As of September 30, 2012, we had approximately \$19.2 million of total unrecognized compensation expense related to nonvested options. We expect to recognize that expense over a weighted average period of approximately four years.

Other information regarding stock options outstanding and exercisable at September 30, 2012 is summarized as follows (in millions, except exercise price and year data):

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 5.79 - \$ 24.90	2.4	2.92	\$ 24.25	1.6	\$ 24.27
24.99 - 27.25	2.4	3.11	26.94	1.7	26.94
27.35 - 29.42	2.2	2.59	29.10	1.8	29.11
29.45 - 35.71	2.8	5.19	33.44	0.7	31.51
\$ 5.79 - \$ 35.95	9.8	3.54	\$ 28.62	5.8	\$ 27.38

**8. Deferred Compensation**

We have a Deferred Equity Participation Plan, which is a non-qualified plan that generally provides for distributions to certain of our key executives when they reach age 62 or after their actual retirement. Under the provisions of the plan, we typically contribute shares of our

## Edgar Filing: GALLAGHER ARTHUR J & CO - Form 10-Q

common stock or cash, in an amount approved by the compensation committee, to a rabbi trust on behalf of the executives participating in the plan. Distributions under the plan may not normally be made until the participant reaches age 62 and are subject to forfeiture in the event of voluntary termination of employment prior to age 62. All distributions of stock contributions from the plan, except for accumulated non-invested dividends, are made in the form of our common stock and all distributions of cash contributions are distributed in cash.

- 19 -



**Table of Contents**

Our common stock that is issued under the plan to the rabbi trust is valued at historical cost, which equals its fair market value at the date of grant. When common stock is issued, we record an unearned deferred compensation obligation as a reduction of capital in excess of par value in the accompanying consolidated balance sheet, which is amortized to compensation expense ratably over the vesting period of the participants. Future changes in the fair market value of our common stock owed to the participants do not have any impact on the amounts recorded in our consolidated financial statements. During the three-month periods ended September 30, 2012 and 2011, we charged \$0.3 million and \$0.4 million, respectively, to stock-based compensation expense related to this plan. During the nine-month periods ended September 30, 2012 and 2011, we charged \$0.9 million and \$1.0 million, respectively, to stock-based compensation expense related to this plan. At September 30, 2012 and December 31, 2011, we recorded \$5.9 million (related to 610,000 shares) and \$6.8 million (related to 629,000 shares), respectively, of unearned deferred compensation as a reduction of capital in excess of par value in the accompanying consolidated balance sheet. The total intrinsic value of our unvested common stock under the plan at September 30, 2012 and December 31, 2011 was \$21.9 million and \$21.0 million, respectively.

In first quarter 2012 and 2011, the compensation committee approved \$7.3 million and \$6.5 million, respectively, of cash awards in the aggregate to certain key executives under the Deferred Equity Participation Plan that were contributed to the rabbi trust in first quarter 2012 and first quarter 2011, respectively. The fair value of the funded cash award assets at September 30, 2012 and December 31, 2011 was \$40.5 million and \$28.6 million, respectively, and has been included in other noncurrent assets in the accompanying consolidated balance sheet. During the three-month periods ended September 30, 2012 and 2011, we charged \$1.2 million and \$0.8 million, respectively, to compensation expense related to these cash awards. During the nine-month periods ended September 30, 2012 and 2011, we charged \$3.2 million and \$2.5 million, respectively, to compensation expense related to these cash awards. During the nine-month periods ended September 30, 2012 and 2011, cash and equity awards with an aggregate fair value of \$0.7 million and \$0.5 million were vested and distributed to executives under this plan.

**9. Restricted Stock and Cash Awards****Restricted Stock Awards**

As discussed in Note 7 to these unaudited consolidated financial statements, on May 10, 2011, our stockholders approved the LTIP, which replaced our previous stockholder approved 2009 LTIP. The LTIP provides for the grant of a stock award either as restricted stock or as restricted stock units. In either case, the compensation committee may determine that the award will be subject to the attainment of performance measures over an established performance period. Stock awards are non-transferable and subject to forfeiture if the holder does not remain continuously employed with us during the applicable restriction period or, in the case of a performance-based award, if applicable performance measures are not attained. The compensation committee will determine all of the terms relating to the satisfaction of performance measures and the termination of a restriction period, or the forfeiture and cancellation of a restricted stock award upon a termination of employment, whether by reason of disability, retirement, death or any other reason. The compensation committee may grant unrestricted shares of common stock or units representing the right to receive shares of common stock to employees who have attained age 62.

The agreements awarding restricted stock units will specify whether such award may be settled in shares of our common stock, cash or a combination of shares and cash and whether the holder will be entitled to receive dividend equivalents, on a current or deferred basis, with respect to such award. Prior to the settlement of a restricted stock unit, the holder of a restricted stock unit will have no rights as a stockholder of the company. The maximum number of shares available under the LTIP for restricted stock, restricted stock units and performance units settled with stock (i.e., all awards other than stock options and stock appreciation rights) is 1.2 million. At September 30, 2012, 0.9 million shares were available for grant under the LTIP for such awards.

In first quarter 2012 and 2011, we granted 332,000 and 200,000 units, respectively, of our common stock to employees under the LTIP and 2009 LTIP, respectively, with an aggregate fair value of \$11.9 million and \$6.2 million, respectively, at the date of grant. These 2012 and 2011 restricted stock awards (consisting of restricted stock units) vest as follows: 332,000 units granted in first quarter 2012 and 200,000 units granted in first quarter 2011, vest in full based on continued employment through March 16, 2016 and March 8, 2015, respectively. In second quarter 2012 and 2011, we granted 20,000 and 20,000 units, respectively, of our common stock to non-employee directors under the LTIP and 2009 LTIP, respectively, with an aggregate fair value of \$0.7 million and \$0.6 million, respectively, at the date of grant. These grants vest in full one year from the date of grant.

**Table of Contents**

We account for restricted stock awards at historical cost, which equals its fair market value at the date of grant. When restricted stock units are granted, the aggregate amount to be expensed is determined based on the fair value of our common stock at the date of grant and the number of units granted, which is then amortized to stock-based compensation expense (and an increase to capital in excess of par value ) ratably over the vesting period of the participants. Future changes in the fair value of our common stock that is owed to the participants do not have any impact on the amounts recorded in our consolidated financial statements. During the three-month periods ended September 30, 2012 and 2011, we charged \$1.7 million and \$1.1 million, respectively, to compensation expense related to restricted stock unit awards granted in 2006 through 2012. During the nine-month periods ended September 30, 2012 and 2011, we charged \$5.5 million and \$4.3 million, respectively, to compensation expense related to restricted stock unit awards granted in 2006 through 2012. The total intrinsic value of unvested restricted stock units at September 30, 2012 and 2011 was \$33.8 million and \$23.2 million, respectively. During the nine-month periods ended September 30, 2012 and 2011, equity awards (including accrued dividends) with an aggregate fair value of \$7.2 million and \$3.9 million were vested and distributed to employees under this plan.

**Cash Awards**

On March 16, 2012, pursuant to our Performance Unit Program (which we refer to as the Program), the compensation committee approved provisional cash awards of \$13.1 million in the aggregate for future grant to our officers and key employees that are denominated in units (368,000 units in the aggregate), each of which was equivalent to the value of one share of our common stock on the date the provisional award was approved. The Program consists of a one-year performance period based on our financial performance and a two-year vesting period. At the discretion of the compensation committee and as determined based on our performance, the officer or key employee will be granted a percentage of the provisional cash award units that equates to the EBITAC growth achieved (as defined in the Program). At the end of the performance period, eligible employees will be granted a number of units based on achievement of the performance goal and subject to approval by the compensation committee. Granted units for the 2012 provisional award will fully vest based on continuous employment through January 1, 2015. The ultimate award value will be equal to the trailing twelve-month stock price on December 31, 2014, multiplied by the number of units subject to the award, but limited to between 0.5 and 1.5 times the original value of the units determined as of the grant date. The fair value of the granted units will be paid out in cash as soon as practicable in 2015. If an eligible employee leaves us prior to the vesting date, the entire award will be forfeited. We did not recognize any compensation expense during the nine-month period ended September 30, 2012 related to the 2012 provisional award under the Program.

On March 8, 2011, pursuant to the Program, the compensation committee approved provisional cash awards of \$14.4 million in the aggregate for future grant to our officers and key employees that were denominated in units (464,000 units in the aggregate), each of which was equivalent to the value of one share of our common stock on the date the provisional award was approved. Terms of the 2011 provisional award were similar to the terms discussed above for the 2012 provisional award. Based on our performance for 2011, we granted 432,000 units under the Program in first quarter 2012 that will fully vest on January 1, 2014. During the three-month period ended September 30, 2012, we charged \$1.9 million to compensation expense related to these awards. During the nine-month period ended September 30, 2012, we charged \$5.7 million to compensation expense related to these awards.

On March 2, 2010, pursuant to the Program, the compensation committee approved provisional cash awards of \$17.0 million in the aggregate for future grant to our officers and key employees that are denominated in units (706,000 units in the aggregate), each of which is equivalent to the value of one share of our common stock on the date the provisional award was approved. Terms of the 2010 provisional award were similar to the terms discussed above for the 2012 provisional award. However, based on company performance for 2010, we did not grant any units in 2011 related to the 2010 provisional award under the Program. We did not recognize any compensation expense during 2012 or 2011 related to this provisional award.

During the nine-month period ended September 30, 2012, cash awards related to the 2009 provisional award with an aggregate fair value of \$26.5 million (1.1 million units in the aggregate) were vested and distributed to employees under the Program. No cash awards were vested or distributed during the nine-month period ended September 30, 2011 related to the 2008 provisional award because, based on our performance for 2008, we did not grant any units in 2009 related to the 2008 provisional award under the Program.

**Table of Contents****10. Retirement Plans**

We have a noncontributory defined benefit pension plan that, prior to July 1, 2005, covered substantially all of our domestic employees who had attained a specified age and one year of employment. Benefits under the plan were based on years of service and salary history. In 2005, we amended our defined benefit pension plan to freeze the accrual of future benefits for all domestic employees, effective on July 1, 2005. In the table below, the service cost component represents plan administration costs that are incurred directly by the plan.

The components of the net periodic pension benefit cost for the plan consists of the following (in millions):

	Three-month period ended September 30,		Nine-month period ended September 30,	
	2012	2011	2012	2011
Service cost	\$ 0.1	\$ 0.1	\$ 0.3	\$ 0.3
Interest cost on benefit obligation	3.0	3.0	9.0	9.0
Expected return on plan assets	(3.8)	(3.8)	(11.4)	(11.3)
Amortization of net actuarial loss	1.8	0.4	5.4	1.2
Net periodic benefit (income) cost	\$ 1.1	\$ (0.3)	\$ 3.3	\$ (0.8)

We are not required under the IRC to make any minimum contributions to the plan for the 2012 plan year. We were required under the IRC to make a minimum contribution of \$0.3 million to the plan for the 2011 plan year. This level of required funding is based on the plan being frozen and the aggregate amount of our historical funding. During each of the nine-month periods ended September 30, 2012 and 2011, we made discretionary contributions of \$5.4 million to the plan. We are considering making additional discretionary contributions to the plan in 2012 and may be required to make significantly larger minimum contributions to the plan in future periods.

**11. Investments**

The following is a summary of our investments reported in other current and non-current assets in the accompanying consolidated balance sheet and the related funding commitments (in millions):

	September 30, 2012		December 31,
	Assets	Funding Commitments	2011 Assets
Chem-Mod LLC	\$ 5.1	\$	\$ 2.9
Clean-coal investments			
Non-controlling interest in five limited liability companies that own twelve 2009 Era Clean Coal Plants	8.1	0.1	8.9
Controlling interest in a limited liability company that owns two 2009 Era Clean Coal Plants	1.4		1.5
Non-controlling interest in six limited liability companies that own five 2011 Era Clean Coal Plants	10.3	3.3	
Controlling interest in a limited liability company that owns ten 2011 Era Clean Coal Plants	8.9	8.6	33.4
Notes receivable and interest from co-investor related to the sales of three 2009 Era Plants	8.2		8.0
Other investments	3.3	3.0	2.0
Total investments	\$ 45.3	\$ 15.0	\$ 56.7

**Chem-Mod LLC** - We hold a 42% controlling interest in Chem-Mod LLC, which possesses the exclusive marketing rights in the U.S. and Canada, for technologies used to reduce unwanted emissions created during the combustion of coal. The clean coal production plants discussed below, as well as those owned by other unrelated parties, license and use Chem-Mod's technologies, The Chem-Mod Solution, in the production of refined coal. The Chem-Mod Solution uses a dual injection sorbent system to reduce mercury, sulfur dioxide and other toxic emissions at

coal-fired power plants.

## **Table of Contents**

We believe that the application of The Chem-Mod Solution qualifies for refined coal tax credits under IRC Section 45 when used by clean coal production plants placed in service by December 31, 2011. Chem-Mod has been marketing its technologies principally to coal-fired power plants owned by utility companies, including those utilities that are operating with the IRC Section 45 clean coal production plants in which we hold an investment. To date, the Chem-Mod technologies have been permitted for use by coal-fired utilities in sixteen states. Six other states are considering similar approvals.

Chem-Mod is determined to be a variable interest entity (which we refer to as a VIE). We are the controlling manager of Chem-Mod and therefore consolidate its operations into our consolidated financial statements. At September 30, 2012, total assets and total liabilities of this VIE included in our consolidated balance sheet were \$5.1 million and \$1.3 million, respectively. For the nine-month period ended September 30, 2012, total revenues and expenses were \$19.1 million and \$11.5 million (including non-controlling interest of \$10.4 million), respectively. We are under no obligation to fund Chem-Mod's operations in the future.

**Chem-Mod International LLC** - At September 30, 2012, we held a non-controlling 20% interest in Chem-Mod International LLC, which has the rights to market The Chem-Mod Solution in countries other than the U.S. and Canada. Such marketing activity has been limited to date.

**C-Quest Technology LLC** - At September 30, 2012, we held a non-controlling 8% interest in C-Quest's global operation. C-Quest possesses rights, information and technology for the reduction of carbon dioxide emissions created by burning fossil fuels. Thus far, C-Quest's operations have been limited to laboratory testing. C-Quest is determined to be a VIE, but due to our lack of control over the operation of C-Quest, we do not consolidate this investment into our consolidated financial statements. We also have options to acquire an additional 19% interest in C-Quest's global operations for \$9.5 million at any time on or prior to August 1, 2013.

## **Clean Coal Investments**

We have investments in limited liability companies that own 29 clean coal production plants which produce refined coal using proprietary technologies owned by Chem-Mod. We believe the production at these plants is qualified to receive refined coal tax credits under IRC Section 45. The fourteen plants which were placed in service prior to December 31, 2009 (which we refer to as the 2009 Era Plants) can receive tax credits through 2019 and the fifteen plants which were placed in service prior to December 31, 2011 (which we refer to as the 2011 Era Plants) can receive tax credits through 2021.

**2009 Era Plants** - Twelve plants are operating under long-term production contracts and we are seeking long-term production agreements and co-investors for the other two plants.

**2011 Era Plants** - Five plants are operating under long-term production contracts. We have signed long-term production contracts for two plants that may resume production prior to December 31, 2012. We have signed a long-term production agreement for one plant that may resume production in early 2013. We are in negotiations for long-term production agreements for three plants that may resume production in mid-2013. We have agreements in principle with co-investors for the sale of majority ownership interests in four plants. We are seeking long-term production agreements for the remaining four plants.

For all plants that are not yet operating, we estimate that we will invest an additional \$2.0 to \$3.0 million per plant, net of co-investor funding, to connect and house each of them. We plan to sell majority ownership interests in such plants to co-investors and relinquish control of the plants thereby becoming a non-controlling, minority investor.

Pursuant to connecting and housing one 2009 Era Plant and two 2011 Era Plants, each of which are not currently operating, we have invested \$2.2 million in capital expenditures and are currently committed to an additional \$8.7 million under engineering and construction contracts. In addition, we are committed to a total of \$3.3 million of capital improvements to two other 2011 Era Plants that are currently operating.

Twelve of the 2009 Era Plants and five of the 2011 Era Plants are owned by limited liability companies, which we have determined to be VIEs. In 2010, we sold majority ownership interests in the limited liability companies that own the twelve 2009 Era Plants and

Edgar Filing: GALLAGHER ARTHUR J & CO - Form 10-Q

became a non-controlling, minority investor, effective March 1, 2010. In 2012, we sold majority ownership interests in six limited liability companies that own the

- 23 -

**Table of Contents**

five 2011 Era Plants and became a non-controlling, minority investor, effective January 1, 2012. The membership agreements for the operations of each of these entities contain provisions that preclude an individual member from being able to make major decisions that would denote control. As a result of these sale transactions, we deconsolidated these entities and because we do not control the operations of these entities, we account for the investments using equity method accounting. At September 30, 2012, total assets and total liabilities of these VIEs were \$110.7 million and \$57.6 million, respectively. For the nine-month period ended September 30, 2012, total revenues and expenses were \$550.3 million and \$609.7 million, respectively. Each investor funds its portion of the operations of the limited liability companies in proportion to its investment ownership percentage. There are no additional debts that we are committed to fund related to these investments.

As of September 30, 2012, we have a promissory note from a co-investor as part of the consideration for the sale of ownership interests in three of the 2009 Era Plants. The note bears interest at 4.7% per annum and is due in installments through February 15, 2020. As of September 30, 2012, the carrying value of the note, including interest, was \$8.2 million.

**Other Investments** - At September 30, 2012, we owned a non-controlling, minority interest in three venture capital funds totaling \$2.8 million, a 20% non-controlling interest in an investment management company totaling \$0.5 million, twelve certified low-income housing developments with zero carrying value and two real estate entities with zero carrying value. The low-income housing developments and real estate entities have been determined to be VIEs, but are not required to be consolidated due to our lack of control over their respective operations. At September 30, 2012, total assets and total debt of these VIEs were approximately \$60.0 million and \$20.0 million, respectively.

**12. Commitments, Contingencies and Off-Balance Sheet Arrangements**

In connection with our investing and operating activities, we have entered into certain contractual obligations and commitments. See Notes 5 and 11 to these unaudited consolidated financial statements for additional discussion of these obligations and commitments. Our future minimum cash payments, including interest, associated with our contractual obligations pursuant to the note purchase agreements and Credit Agreement, operating leases and purchase commitments at September 30, 2012 were as follows (in millions):

Contractual Obligations	Payments Due by Period						Total
	2012	2013	2014	2015	2016	Thereafter	
Note purchase agreements	\$	\$	\$ 100.0	\$	\$ 50.0	\$ 575.0	\$ 725.0
Credit Agreement							
Interest expense on debt	4.4	43.0	43.0	36.7	36.7	77.1	240.9
Total debt obligations	4.4	43.0	143.0	36.7	86.7	652.1	965.9
Operating lease obligations	18.7	64.4	48.4	40.7	30.4	53.2	255.8
Less sublease arrangements	(3.2)	(2.0)	(1.5)	(0.6)			(7.3)
Outstanding purchase obligations	4.1	9.2	5.7	1.5	1.3	0.3	22.1
Total contractual obligations	\$ 24.0	\$ 114.6	\$ 195.6	\$ 78.3	\$ 118.4	\$ 705.6	\$ 1,236.5

The amounts presented in the table above may not necessarily reflect our actual future cash funding requirements, because the actual timing of the future payments made may vary from the stated contractual obligation.

**Note Purchase Agreements and Credit Agreement** - See Note 5 to these unaudited consolidated financial statements for a discussion of the terms of the note purchase agreements and the Credit Agreement.

**Operating Lease Obligations** - Our corporate segment's executive offices and certain subsidiary and branch facilities of our brokerage and risk management segments are located at Two Pierce Place, Itasca, Illinois, where we lease approximately 306,000 square feet of space, or approximately 60% of the building. The lease commitment on this property expires February 28, 2018.

We generally operate in leased premises at our other locations. Certain of these leases have options permitting renewals for additional periods. In addition to minimum fixed rentals, a number of leases contain annual escalation clauses which are generally related to increases in an inflation index.





**Table of Contents**

We have leased certain office space to several non-affiliated tenants under operating sublease arrangements. In the normal course of business, we expect that the leases will not be renewed or replaced. We adjust charges for real estate taxes and common area maintenance annually based on actual expenses, and we recognize the related revenues in the year in which the expenses are incurred. These amounts are not included in the minimum future rentals to be received in the contractual obligations table above.

**Outstanding Purchase Obligations** - As a service company, we typically do not have a material amount of outstanding purchase obligations at any point in time. The amount disclosed in the contractual obligations table above represents the aggregate amount of unrecorded purchase obligations that we had outstanding as of September 30, 2012. These obligations represent agreements to purchase goods or services that were executed in the normal course of business.

**Off-Balance Sheet Commitments** - Our total unrecorded commitments associated with outstanding letters of credit and funding commitments as of September 30, 2012 were as follows (in millions):

Off-Balance Sheet Commitments	Amount of Commitment Expiration by Period						Total Amounts Committed
	2012	2013	2014	2015	2016	Thereafter	
Letters of credit	\$	\$	\$	\$	\$	\$ 15.9	\$ 15.9
Funding commitments		12.2				2.8	15.0
<b>Total commitments</b>	<b>\$ 12.2</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>	<b>\$ 18.7</b>	<b>\$ 30.9</b>

Since commitments may expire unused, the amounts presented in the table above do not necessarily reflect our actual future cash funding requirements. See Note 11 to these unaudited consolidated financial statements for a discussion of our funding commitments related to our corporate segment and the Off-Balance Sheet Debt section below for a discussion of our letters of credit. All of the letters of credit represent multiple year commitments that have annual, automatic renewing provisions and are classified by the latest commitment date.

Since January 1, 2002, we have acquired 226 companies, all of which were accounted for using the acquisition method for recording business combinations. Substantially all of the purchase agreements related to these acquisitions contain provisions for potential earnout obligations. For all of our 2009 to 2012 acquisitions that contain potential earnout obligations, such obligations are measured at fair value as of the acquisition date and are included on that basis in the recorded purchase price consideration for the respective acquisition. The amounts recorded as earnout payables are primarily based upon estimated future operating results of the acquired entities over a two- to three-year period subsequent to the acquisition date. The aggregate amount of maximum potential earnout obligations related to these acquisitions was \$314.4 million, of which \$114.8 million was recorded in our consolidated balance sheet as of September 30, 2012 based on the estimated fair value of the expected future payments to be made.

**Off-Balance Sheet Debt** - Our unconsolidated investment portfolio includes investments in enterprises where our ownership interest is between 1% and 50%, in which management has determined that our level of influence and economic interest is not sufficient to require consolidation. As a result, these investments are accounted for using the equity method. None of these unconsolidated investments had any outstanding debt at September 30, 2012 or December 31, 2011 that was recourse to us.

At September 30, 2012, we had posted two letters of credit totaling \$10.2 million, in the aggregate, related to our self-insurance deductibles, for which we had a recorded liability of \$8.6 million. We have an equity investment in a rent-a-captive facility, which we use as a placement facility for certain of our insurance brokerage operations. At September 30, 2012, we had posted \$5.7 million of letters of credit to allow the rent-a-captive facility to meet minimum statutory surplus requirements and for additional collateral related to premium and claim funds held in a fiduciary capacity. These letters of credit have never been drawn upon.

**Litigation** - We are the defendant in various legal actions related to employment matters and otherwise incident to the nature of our business. We believe we have meritorious defenses and intend to defend ourselves vigorously in all unresolved legal actions. In addition, we are the plaintiff in certain legal actions with and relating to former employees regarding alleged breaches of non-compete or other restrictive covenants, theft of trade secrets, breaches of fiduciary duties and related causes of action. Neither the outcomes of these legal actions nor their effect upon our business, financial condition or results of operations can be determined at this time.



**Table of Contents**

**Contingent Liabilities** - We purchase insurance to provide protection from errors and omissions (which we refer to as E&O) claims that may arise during the ordinary course of business. We currently retain the first \$5.0 million of each and every E&O claim. Our E&O insurance provides aggregate coverage for E&O losses up to \$175.0 million in excess of our retained amounts. We have historically maintained self-insurance reserves for the portion of our E&O exposure that is not insured. We periodically determine a range of possible reserve levels using actuarial techniques that rely heavily on projecting historical claim data into the future. Our E&O reserve in the September 30, 2012 consolidated balance sheet is above the lower end of the most recently determined actuarial range by \$1.3 million and below the upper end of the actuarial range by \$4.3 million. We can make no assurances that the historical claim data used to project the current reserve levels will be indicative of future claim activity. Thus, the E&O reserve level and corresponding actuarial range could change in the future as more information becomes known, which could materially impact the amounts reported and disclosed herein.

**Tax-advantaged Investments No Longer Held** - Between 1996 and 2007, we developed and then sold portions of our ownership in various energy related investments, many of which qualified for tax credits under IRC Section 29. In connection with the sales to other investors, we provided various indemnities. At September 30, 2012, the maximum potential amount of future payments that we could be required to make under these indemnification obligations totaled approximately \$195.0 million, net of the applicable income tax benefit. In addition, we recorded tax benefits in connection with our ownership in these investments. At September 30, 2012, we had exposure on \$129.2 million of previously earned tax credits. In 2004, 2007 and 2009, the IRS examined several of these investments and all examinations were closed without any changes being proposed by the IRS. However, any future adverse tax audits, administrative rulings or judicial decisions could disallow previously claimed tax credits or cause us to be subject to liability under our indemnification obligations. Because of the contingent nature of these exposures, no liabilities have been recorded in our September 30, 2012 consolidated balance sheet related to these indemnification obligations.

**13. Accumulated Other Comprehensive Loss**

The after-tax components of our accumulated other comprehensive loss consist of the following:

	Pension Liability	Foreign Currency Translation	Fair Value of Derivative Investments	Accumulated Other Comprehensive Loss
Balance as of December 31, 2011	\$ (49.0)	\$ 4.4	\$ (2.6)	\$ (47.2)
Net change in period	2.0	17.4	2.0	21.4
Balance as of September 30, 2012	\$ (47.0)	\$ 21.8	\$ (0.6)	\$ (25.8)

The foreign currency translation during the nine-month period ended September 30, 2012 primarily relates to the net impact of changes in the value of the local currencies relative to the U.S. dollar for our operations in Australia, Canada and the U.K.

**14. Segment Information**

We have identified three reportable operating segments: brokerage, risk management and corporate.

The brokerage segment is primarily comprised of our retail and wholesale insurance brokerage operations. The brokerage segment generates revenues through commissions paid by insurance underwriters and through fees charged to our clients. Our brokers, agents and administrators act as intermediaries between insurers and their customers and we do not assume underwriting risks.

The risk management segment provides contract claim settlement and administration services for enterprises that choose to self-insure some or all of their property/casualty coverages and for insurance companies that choose to outsource some or all of their property/casualty claims departments. These operations also provide claims management, loss control consulting and insurance property appraisal services. Revenues are principally generated on a negotiated per-claim or per-service fee basis.

The corporate segment manages our clean energy and other investments. This segment also holds all of our corporate debt.



**Table of Contents**

Allocations of investment income and certain expenses are based on reasonable assumptions and estimates primarily using revenue, headcount and other information. We allocate the provision for income taxes to the brokerage and risk management segments as if those segments were preparing income tax provisions on a separate company basis. Reported operating results by segment would change if different methods were applied.

Financial information relating to our segments for 2012 and 2011 is as follows (in millions):

	<b>Three-month period ended September 30,</b>		<b>Nine-month period ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
<b>Brokerage</b>				
Total revenues	\$ 479.7	\$ 421.9	\$ 1,338.5	\$ 1,143.1
Earnings before income taxes	\$ 82.0	\$ 75.0	\$ 203.8	\$ 178.6
Identifiable assets at September 30, 2012 and 2011			\$ 3,835.0	\$ 3,220.2
<b>Risk Management</b>				
Total revenues	\$ 142.2	\$ 139.0	\$ 426.9	\$ 403.1
Earnings before income taxes	\$ 18.2	\$ 13.5	\$ 54.9	\$ 34.6
Identifiable assets at September 30, 2012 and 2011			\$ 547.9	\$ 510.0
<b>Corporate</b>				
Total revenues	\$ 28.5	\$ 1.9	\$ 81.7	\$ 10.1
Loss before income taxes	\$ (23.9)	\$ (17.5)	\$ (58.8)	\$ (52.8)
Identifiable assets at September 30, 2012 and 2011			\$ 626.4	\$ 517.0

**Table of Contents**

**Review by Independent Registered Public Accounting Firm**

The interim consolidated financial statements at September 30, 2012 and for the three-month and nine-month periods ended September 30, 2012 and 2011 have been reviewed by Ernst & Young LLP, our independent registered public accounting firm, and their report is included herein.

**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders

Arthur J. Gallagher & Co.

We have reviewed the consolidated balance sheet of Arthur J. Gallagher & Co. as of September 30, 2012, and the related consolidated statements of earnings and comprehensive earnings for the three-month and nine-month periods ended September 30, 2012 and 2011, the consolidated statement of cash flows for the nine-month periods ended September 30, 2012 and 2011, and the consolidated statement of stockholders' equity for the nine-month period ended September 30, 2012. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, 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 the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Arthur J. Gallagher & Co. as of December 31, 2011, and the related consolidated statements of earnings, stockholders' equity, and cash flows for the year then ended, not presented herein, and in our report dated February 14, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2011, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP  
Ernst & Young LLP

Chicago, Illinois

October 31, 2012

## **Table of Contents**

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The discussion and analysis that follows relates to our financial condition and results of operations for the three-month and nine-month periods ended September 30, 2012. Readers should review this information in conjunction with the unaudited consolidated financial statements and notes included in Item 1 of Part I of this quarterly report on Form 10-Q and the audited consolidated financial statements and notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in our annual report on Form 10-K for the year ending December 31, 2011.

#### **Information Concerning Forward-Looking Statements**

This quarterly report contains forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995 (which we refer to as the PSLRA) found at Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (which we refer to as the Exchange Act). Statements contained in this report that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the PSLRA and the Exchange Act.

Forward-looking statements may include, but are not limited to, discussions concerning liquidity and capital resources, acquisition strategy, revenues, expenses, earnings, cash flow, capital structure and financial losses, as well as market and industry conditions, premium rates, financial markets, interest rates, foreign exchange rates, contingencies and matters relating to our operations and income taxes (including expectations regarding our clean energy investments). In addition, when used in this report, the words anticipates, believes, could, should, estimates, contemplates, expects, intends, plans and variations thereof and similar expressions are intended to identify forward-looking statements.

Forward-looking statements made by us or on our behalf are subject to risks and uncertainties that could cause our actual results to be materially different than those expressed in our forward-looking statements, including but not limited to the following:

Our revenues, which consist primarily of commissions and fees based on insurance premiums, may vary significantly from period to period as a result of the volatility and cyclical nature of insurance premiums;

The recent recession and the current or any future economic downturn could adversely affect our business in a number of ways, including by causing our clients to purchase less insurance coverage, by leading to a continued reduction in the number of claims we process or by causing insurance companies with which we do business to experience liquidity problems and withdraw from writing certain coverages, or fail;

Our ability to grow has been enhanced through acquisitions, which may or may not be available on acceptable terms in the future and which, if consummated, may or may not be advantageous to us;

Our growing international operations expose us to certain risks such as exchange rate fluctuations, geopolitical risk, and risks related to regulatory requirements, including those imposed by the U.S. Foreign Corrupt Practices Act and the U.K. Bribery Act 2010;

We are subject to regulation worldwide including insurance industry and federal and state employment regulation, and such regulations could change at any time;

We are subject to a number of contingencies and legal proceedings that would adversely affect our results, if ultimately determined to be unfavorable to us;

## Edgar Filing: GALLAGHER ARTHUR J & CO - Form 10-Q

The portion of our revenues consisting of contingent and supplemental commissions is less predictable than standard commissions, and our results could be adversely affected if we are unable to meet insurance companies' thresholds for paying these types of commissions, or for contingent commissions, if insurance companies increase their estimates of loss reserves (over which we have no control);

An inability to recruit and retain key personnel (including those that manage our interests in our clean energy investments), or a failure in succession planning for key members of management, could adversely affect our operations;

Rising employee benefits costs (including pension expense) could reduce our profitability;

- 29 -



## **Table of Contents**

Significant uncertainties related to our Internal Revenue Code (which we refer to as the IRC) Section 45-related investments (including uncertainties due to our lack of control over such operations) could negatively impact our ability to take full advantage of our proportionate share of the tax credits they generate;

Our IRC Section 45-related investments could subject us to environmental and product liability claims and environmental compliance costs;

We have direct exposure and may incur significant obligations under tax indemnity agreements relating to historically claimed tax credits under IRC Section 29;

Improper disclosure or theft of our clients' confidential information and the personal data of their employees as a result of a cybersecurity incident or otherwise, could result in legal liability or harm our reputation;

Our debt agreements contain restrictions and covenants that could significantly impact our ability to operate our business;

Changes in our accounting estimates and assumptions could adversely affect our financial position and operating results;

Our success could be compromised if we are unable to keep pace with new technological developments and implement technology solutions for our clients and for internal efficiency purposes; and

A disaster or significant disruption to business continuity could have a material adverse effect on our operations.

The foregoing and other risks and uncertainties are described in more detail in Item 1A, Risk Factors, in our Annual Report on Form 10-K for the year ended December 31, 2011.

Readers are cautioned not to place undue reliance on any forward-looking statements contained in this report, which speak only as of the date set forth on the signature page of this report. We undertake no obligation to publicly release the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after such date or to reflect the occurrence of anticipated or unanticipated events.

### **Information Regarding Non-GAAP Measures and Other**

In this discussion and analysis, we provide information regarding EBITDAC, EBITDAC margin, adjusted EBITDAC, adjusted EBITDAC margin, adjusted EBITDAC margin excluding Heath Lambert, diluted net earnings per share (as adjusted), organic revenue measures for each operating segment, adjusted revenues, adjusted compensation and operating expenses, adjusted compensation expense ratio and adjusted operating expense ratio. These measures are not in accordance with, or an alternative to, the GAAP information provided in this quarterly report on Form 10-Q. We believe that these presentations provide useful information to management, analysts and investors regarding financial and business trends relating to our results of operations and financial condition. Our industry peers provide similar supplemental non-GAAP information related to organic revenues and EBITDAC, although they may not use the same or comparable terminology and may not make identical adjustments. The non-GAAP information we provide should be used in addition to, but not as a substitute for, the GAAP information provided. Certain reclassifications have been made to the prior year amounts reported in this quarterly report on Form 10-Q in order to conform them to the current-year presentation.

**Adjusted presentation** - We believe that the adjusted presentations of the 2012 and 2011 information presented on the following pages provides stockholders and other interested persons with useful information regarding certain financial metrics of the company that will assist such persons in analyzing our operating results as they develop a future earnings outlook for us. The after-tax amounts related to the adjustments were computed using the normalized effective tax rate for each respective period.

**Adjusted revenues, expenses and net earnings** - We define these measures as revenues, compensation expense and operating expense, respectively, each adjusted to exclude net gains realized from sales of books of business, New Zealand earthquake claims administration, workforce related charges, lease termination related charges and acquisition related integration costs, as applicable. Acquisition related integration costs include costs related to transactions not expected to occur on an ongoing basis in the future once we fully assimilate the applicable acquisition. These costs are typically associated with redundant workforce, extra lease space, duplicate services and external costs incurred to assimilate the acquired business with our IT related systems.

---

## **Table of Contents**

**Adjusted ratios** - Compensation expense ratio and operating expense ratio are defined as adjusted compensation expense and adjusted operating expense, respectively, each divided by adjusted revenues.

**Earnings Measures** - We believe that the presentation of EBITDAC, EBITDAC margin, adjusted EBITDAC, adjusted EBITDAC margin, adjusted EBITDAC margin excluding Heath Lambert and diluted net earnings per share (as adjusted), provides a meaningful representation of our operating performance. We consider EBITDAC and EBITDAC margin as a way to measure financial performance on an ongoing basis. Adjusted EBITDAC, adjusted EBITDAC margin, adjusted EBITDAC margin excluding Heath Lambert and diluted net earnings per share (as adjusted), are presented to improve the comparability of our results between periods by eliminating the impact of the items that have a high degree of variability.

**EBITDAC** - We define this measure as net earnings before interest, income taxes, depreciation, amortization and the change in estimated acquisition earnout payables.

**EBITDAC margin** - We define this measure as EBITDAC divided by total revenues.

**Adjusted EBITDAC** - We define this measure as EBITDAC adjusted to exclude net gains realized from sales of books of business, earnout related compensation charges, workforce related charges, lease termination related charges and acquisition related integration costs, as applicable.

**Adjusted EBITDAC margin** - We define this measure as adjusted EBITDAC divided by total revenues, as adjusted to exclude net gains realized from sales of books of business and New Zealand earthquake claims administration.

**Adjusted EBITDAC margin excluding Heath Lambert** - We define this measure as adjusted EBITDAC further adjusted to exclude the EBITDAC associated with the acquired Heath Lambert operations divided by total revenues, as adjusted to exclude net gains realized from sales of books of business, New Zealand earthquake claims administration, supplemental commission timing amounts and the revenues associated with the acquired Heath Lambert operations.

**Diluted net earnings per share (as adjusted)** - We define this measure as net earnings adjusted to exclude the after-tax impact of net gains realized from sales of books of business, New Zealand earthquake claims administration, workforce related charges, lease termination related charges, acquisition related integration costs, adjustments to the change in estimated acquisition earnout payables and effective income tax rate impact, divided by diluted weighted average shares outstanding. The effective income tax rate impact represents the difference in income tax expense for tax amounts derived using the actual effective tax rate compared to tax amounts derived using a normalized effective tax rate.

**Organic Revenues** - Organic change in commission and fee revenues excludes the first twelve months of net commission and fee revenues generated from acquisitions accounted for as purchases and the net commission and fee revenues related to operations disposed of in each year presented. These commissions and fees are excluded from organic revenues in order to help interested persons analyze the revenue growth associated with the operations that were a part of our business in both the current and prior year. In addition, change in organic revenues excludes the impact of supplemental and contingent commission revenues and the period-over-period impact of foreign currency translation. The amounts excluded with respect to foreign currency translation are calculated by applying current year foreign exchange rates to the same prior year periods. For the risk management segment, organic change in base domestic and international fees excludes international performance bonus fees and New Zealand earthquake claims administration, to improve the comparability of our results between periods by eliminating the impact of the items that have a high degree of variability or due to the limited-time nature of these revenue sources.

**Reconciliation of Non-GAAP Information Presented to GAAP Measures** - This quarterly report on Form 10-Q includes tabular reconciliations to the most comparable GAAP measures for adjusted revenues, adjusted compensation expense and operating expense, EBITDAC, EBITDAC margin, adjusted EBITDAC, adjusted EBITDAC margin, adjusted EBITDAC margin excluding Heath Lambert, diluted net earnings per share (as adjusted) and organic revenue measures.

## Edgar Filing: GALLAGHER ARTHUR J & CO - Form 10-Q

**Other Information** - Allocations of investment income and certain expenses are based on reasonable assumptions and estimates primarily using revenue, headcount and other information. We allocate the provision for income taxes to the brokerage and risk management segments as if those segments were computing income tax provisions on a separate company basis. As a result, the provision for income taxes for the corporate segment reflects the entire benefit to us of the IRC Section 45 credits generated in 2012, because that is the segment which produced the

- 31 -

---

**Table of Contents**

credits. The law that provides for IRC Section 45 credits expires on December 31, 2019 and 2021 for different portions of our related investments. We anticipate reporting an effective tax rate of approximately 38.0% to 40.0% in both our brokerage and risk management segments for the foreseeable future. Reported operating results by segment would change if different allocation methods were applied.

**Overview and Third Quarter 2012 Highlights**

We are engaged in providing insurance brokerage and third-party property/casualty claims settlement and administration services to entities in the U.S. and abroad. Throughout 2012, we have expanded and expect to continue to expand our international operations through both acquisitions and organic growth. We generate approximately 80% of our revenues domestically, with the remaining 20% derived in Australia, Bermuda, Canada, New Zealand and the U.K. (based on third quarter 2012 reported revenues). We expect that our international revenue will continue to grow as a percentage of our total revenues in 2012 compared to 2011. We have three reportable segments: brokerage, risk management and corporate, which contributed approximately 72%, 23% and 5%, respectively, to revenues during the nine-month period ended September 30, 2012. Our major sources of operating revenues are commissions, fees and supplemental and contingent commissions from brokerage operations and fees from risk management operations. Investment income is generated from our investment portfolio, which includes invested cash and fiduciary funds, as well as clean energy and other investments.

We have generated positive organic growth in the last seven quarterly periods in both the brokerage and risk management segments. Based on our experience with customers, we are seeing further evidence of market firming and our customers' businesses are showing growth. The first quarter 2012 Council of Insurance Agents and Brokers (which we refer to as CIAB) survey indicated that rates were up, on average 4.4% across all sized accounts. The second quarter 2012 CIAB report indicated that rates were up, on average 4.3% across all sized accounts. The third quarter 2012 CIAB report was not published as of the filing date of this report, but we anticipate similar rate trends in third quarter 2012 as those of the first and second quarters of 2012. If the third quarter report does show a similar trend, it will be the fifth quarterly survey in a row showing rate increases. Rates are continuing to rise as insurance carriers tighten their underwriting standards. However, the demand for insurance continues to be restrained due to the sluggish economic recovery, which could offset the favorable pricing trend. The CIAB represents the leading domestic and international insurance brokers, who write approximately 80% of the commercial property/casualty premiums in the U.S.

Our operating results improved in third quarter 2012 compared to the same period in 2011 in both our brokerage and risk management segments:

In our brokerage segment, total revenues and adjusted total revenues were both up 14%, base organic commission and fee revenues were up 4%, net earnings were up 7% and adjusted EBITDAC was up 20%. In addition, we completed eleven acquisitions with annualized revenues totaling \$56.6 million in third quarter 2012.

In our risk management segment, total revenues and adjusted total revenues were up 2% and 5%, respectively, base organic fees were up 5%, net earnings were up 34% and adjusted EBITDAC was up 6%.

In our combined brokerage and risk management segments, total revenues and adjusted total revenues were up 11% and 12%, respectively, organic growth in base commissions and fee revenues was 4%, net earnings were up 11% and adjusted EBITDAC was up 18%.

In our corporate segment, our clean energy investments contributed \$11.0 million to net earnings in the third quarter of 2012.

**Table of Contents**

The following provides non-GAAP information that management believes is helpful when comparing 2012 revenues, EBITDAC and diluted net earnings (loss) per share with the same periods in 2011:

**For the Three-Month Periods Ended September 30,**

Segment	Revenues			EBITDAC			Diluted Net Earnings (Loss) Per Share		
	2012	2011	Chg	2012	2011	Chg	2012	2011	Chg
	(in millions)			(in millions)					
Brokerage, as adjusted	\$ 479.0	\$ 421.1	14%	\$ 122.0	\$ 101.3	20%	\$ 0.43	\$ 0.40	8%
Net gains on book sales	0.7	0.8		0.7	0.8				
Heath Lambert integration costs				(4.2)	(5.5)		(0.02)	(0.03)	
Workforce & lease termination				(1.1)	(0.3)		(0.01)		
Acquisition related adjustments					(0.6)			0.03	
Effective income tax rate impact								0.01	
<b>Brokerage, as reported</b>	<b>479.7</b>	<b>421.9</b>		<b>117.4</b>	<b>95.7</b>		<b>0.40</b>	<b>0.41</b>	
Risk Management, as adjusted	140.3	133.2	5%	22.6	21.4	6%	0.09	0.09	%
New Zealand earthquake claims administration	1.9	5.8		0.3	1.4			0.01	
GAB Robins integration costs					(4.1)			(0.02)	
Workforce & lease termination				(0.1)	(1.0)			(0.01)	
<b>Risk Management, as reported</b>	<b>142.2</b>	<b>139.0</b>		<b>22.8</b>	<b>17.7</b>		<b>0.09</b>	<b>0.07</b>	
<b>Total Brokerage &amp; Risk Management, as reported</b>	<b>621.9</b>	<b>560.9</b>		<b>140.2</b>	<b>113.4</b>		<b>0.49</b>	<b>0.48</b>	
Corporate, as reported	28.5	1.9		(13.0)	(7.0)		0.01	(0.07)	
<b>Total Company, as reported</b>	<b>\$ 650.4</b>	<b>\$ 562.8</b>		<b>\$ 127.2</b>	<b>\$ 106.4</b>		<b>\$ 0.50</b>	<b>\$ 0.41</b>	
<b>Total Brokerage &amp; Risk Management, as adjusted</b>	<b>\$ 619.3</b>	<b>\$ 554.3</b>	<b>12%</b>	<b>\$ 144.6</b>	<b>\$ 122.7</b>	<b>18%</b>	<b>\$ 0.52</b>	<b>\$ 0.49</b>	<b>6%</b>

**For the Nine-Month Periods Ended September 30,**

Segment	Revenues			EBITDAC			Diluted Net Earnings (Loss) Per Share		
	2012	2011	Chg	2012	2011	Chg	2012	2011	Chg
	(in millions)			(in millions)					
Brokerage, as adjusted	\$ 1,337.1	\$ 1,138.7	17%	\$ 309.8	\$ 253.9	22%	\$ 1.07	\$ 0.97	10%
Net gains on book sales	1.4	4.4		1.4	4.4		0.01	0.02	
Heath Lambert integration costs				(12.3)	(8.5)		(0.06)	(0.04)	
Workforce & lease termination				(4.7)	(2.2)		(0.02)	(0.01)	
Acquisition related adjustments					(6.4)		0.03	0.03	
<b>Brokerage, as reported</b>	<b>1,338.5</b>	<b>1,143.1</b>		<b>294.2</b>	<b>241.2</b>		<b>1.03</b>	<b>0.97</b>	
Risk Management, as adjusted	419.3	389.6	8%	67.3	59.8	13%	0.27	0.26	4%
New Zealand earthquake claims administration	7.6	13.5		1.5	3.6		0.01	0.02	
GAB Robins integration costs					(11.3)			(0.06)	
Workforce & lease termination				(0.1)	(5.2)			(0.03)	
<b>Risk Management, as reported</b>	<b>426.9</b>	<b>403.1</b>		<b>68.7</b>	<b>46.9</b>		<b>0.28</b>	<b>0.19</b>	

Edgar Filing: GALLAGHER ARTHUR J & CO - Form 10-Q

Total Brokerage & Risk Management, as reported	1,765.4	1,546.2		362.9	288.1		1.31	1.16	
Corporate, as reported	81.7	10.1		(26.2)	(22.0)		0.02	(0.23)	
Total Company, as reported	\$ 1,847.1	\$ 1,556.3		\$ 336.7	\$ 266.1		\$ 1.33	\$ 0.93	
Total Brokerage & Risk Management, as adjusted	\$ 1,756.4	\$ 1,528.3	15%	\$ 377.1	\$ 313.7	20%	\$ 1.34	\$ 1.23	9%

- 33 -

**Table of Contents****Results of Operations****Brokerage**

The brokerage segment accounted for 72% of our revenue during the nine-month period ended September 30, 2012. Our brokerage segment is primarily comprised of retail and wholesale brokerage operations. Our retail brokerage operations negotiate and place property/casualty, employer-provided health and welfare insurance and retirement solutions, principally for middle-market commercial, industrial, public entity, religious and not-for-profit entities. Many of our retail brokerage customers choose to place their insurance with insurance underwriters, while others choose to use alternative vehicles such as self-insurance pools, risk retention groups or captive insurance companies. Our wholesale brokerage operations assist our brokers and other unaffiliated brokers and agents in the placement of specialized, unique and hard-to-place insurance programs.

Our primary sources of compensation for our retail brokerage services are commissions paid by insurance companies, which are usually based upon a percentage of the premium paid by insureds, and brokerage and advisory fees paid directly by our clients. For wholesale brokerage services, we generally receive a share of the commission paid to the retail broker from the insurer. Commission rates are dependent on a number of factors, including the type of insurance, the particular insurance company underwriting the policy and whether we act as a retail or wholesale broker. Advisory fees are dependent on the extent and value of services we provide. In addition, under certain circumstances, both retail brokerage and wholesale brokerage services receive supplemental and contingent commissions. A supplemental commission is a commission paid by an insurance carrier that is above the base commissions paid, is determined by the insurance carrier and is established annually in advance of the contractual period based on historical performance criteria. A contingent commission is a commission paid by an insurance carrier based on the overall profit and/or volume of the business placed with that insurance carrier during a particular calendar year and is determined after the contractual period.

Financial information relating to our brokerage segment results for the three-month and nine-month periods ended September 30, 2012 as compared to the same periods in 2011, is as follows: (in millions, except per share, percentages and workforce data):

Statement of Earnings	Three-month period ended September 30,			Nine-month period ended September 30,		
	2012	2011	Change	2012	2011	Change
Commissions	\$ 346.0	\$ 308.0	\$ 38.0	\$ 962.7	\$ 829.7	\$ 133.0
Fees	106.8	86.8	20.0	281.4	227.7	53.7
Supplemental commissions	16.6	14.5	2.1	50.3	42.0	8.3
Contingent commissions	7.7	9.9	(2.2)	37.0	34.6	2.4
Investment income and net gains realized on books of business sales	2.6	2.7	(0.1)	7.1	9.1	(2.0)
Total revenues	479.7	421.9	57.8	1,338.5	1,143.1	195.4
Compensation	282.7	251.9	30.8	814.7	701.1	113.6
Operating	79.6	74.3	5.3	229.6	200.8	28.8
Depreciation	6.5	5.6	0.9	18.3	15.7	2.6
Amortization	25.2	19.4	5.8	71.1	52.9	18.2
Change in estimated acquisition earnout payables	3.7	(4.3)	8.0	1.0	(6.0)	7.0
Total expenses	397.7	346.9	50.8	1,134.7	964.5	170.2
Earnings before income taxes	82.0	75.0	7.0	203.8	178.6	25.2
Provision for income taxes	32.4	28.5	3.9	79.5	70.3	9.2
<b>Net earnings</b>	<b>\$ 49.6</b>	<b>\$ 46.5</b>	<b>\$ 3.1</b>	<b>\$ 124.3</b>	<b>\$ 108.3</b>	<b>\$ 16.0</b>
Diluted net earnings per share	\$ 0.40	\$ 0.41	\$ (0.01)	\$ 1.03	\$ 0.97	\$ 0.06





**Table of Contents**

	Three-month period ended September 30,			Nine-month period ended September 30,		
	2012	2011	Change	2012	2011	Change
<b>Other Information</b>						
Change in diluted net earnings per share	(2%)	(2%)		6%	(3%)	
Growth in revenues	14%	20%		17%	14%	
Organic change in commissions and fees	4%	2%		4%	2%	
Compensation expense ratio	59%	60%		61%	61%	
Operating expense ratio	17%	18%		17%	18%	
Effective income tax rate	40%	38%		39%	39%	
Workforce at end of period (includes acquisitions)				8,683	7,762	
Identifiable assets at September 30				\$ 3,835.0	\$ 3,220.2	
<b>EBITDAC</b>						
Net earnings	\$ 49.6	\$ 46.5	\$ 3.1	\$ 124.3	\$ 108.3	\$ 16.0
Provision for income taxes	32.4	28.5	3.9	79.5	70.3	9.2
Depreciation	6.5	5.6	0.9	18.3	15.7	2.6
Amortization	25.2	19.4	5.8	71.1	52.9	18.2
Change in estimated acquisition earnout payables	3.7	(4.3)	8.0	1.0	(6.0)	7.0
<b>EBITDAC</b>	<b>\$ 117.4</b>	<b>\$ 95.7</b>	<b>\$ 21.7</b>	<b>\$ 294.2</b>	<b>\$ 241.2</b>	<b>\$ 53.0</b>
EBITDAC margin	24%	23%		22%	21%	
EBITDAC growth	23%	7%		22%	4%	

The following provides non-GAAP information that management believes is helpful when comparing 2012 EBITDAC and adjusted EBITDAC to the same periods in 2011 (in millions):

	Three-month period ended September 30,		Nine-month period ended September 30,	
	2012	2011	2012	2011
Total EBITDAC - see computation above	\$ 117.4	\$ 95.7	\$ 294.2	\$ 241.2
Net gains from books of business sales	(0.7)	(0.8)	(1.4)	(4.4)
Heath Lambert integration costs	4.2	5.5	12.3	8.5
Earnout related compensation charge		0.6		6.4
Workforce and lease termination related charges	1.1	0.3	4.7	2.2
Adjusted EBITDAC	\$ 122.0	\$ 101.3	\$ 309.8	\$ 253.9
Adjusted EBITDAC change	20.4%	17.0%	22.0%	14.9%
Adjusted EBITDAC margin	25.5%	24.1%	23.2%	22.3%
Adjusted EBITDAC margin excluding Heath Lambert	26.0%	24.9%	23.6%	22.7%

Effective May 12, 2011, we acquired HLG Holdings, Ltd. (which we refer to as Heath Lambert) for cash, net of cash received, of £99.7 million (\$164.0 million). As of the acquisition date, Heath Lambert generated business in nearly all lines of property/casualty and employee benefit insurance products through 1,200 professionals in 16 offices throughout the U.K. The transaction was initially expected to generate approximately \$145.0 million to \$155.0 million in annualized revenue. As of the acquisition date, we expected that it could take up to two years to fully integrate the Heath Lambert operations into our existing operations.

**Table of Contents**

The following provides non-GAAP information of Heath Lambert that management believes is helpful when analyzing the impact of the Heath Lambert acquisition on our results for three-month and nine-month periods ended September 30, 2012 (in millions):

	<b>Three Months</b>	<b>Nine Months</b>
Total revenues	\$ 36.2	\$ 103.9
Compensation	(21.4)	(62.8)
Compensation - integration costs	(2.3)	(7.1)
Operating	(8.0)	(22.5)
Operating - integration costs	(1.9)	(5.2)
 EBITDAC	 \$ 2.6	 \$ 6.3
Adjusted EBITDAC (excludes integration costs)	\$ 6.8	\$ 18.6
Adjusted EBITDAC margin (excludes integration costs)	18.8%	17.9%
 Amortization	 \$ 1.4	 \$ 4.2

As expected, until the integration process is completed in 2013, the Heath Lambert operations will reduce the overall Brokerage Segment adjusted EBITDAC margins. Heath Lambert's current operating structure tends to produce lower compensation expense ratios and higher operating expense ratios in comparison to our other non-Heath Lambert related brokerage operations.

Our adjusted EBITDAC margin excluding Heath Lambert was 26.0% and 23.6% for the three-month and nine-month periods ended September 30, 2012. Our adjusted EBITDAC margin was 25.5% and 23.2% for the three-month and nine-month periods ended September 30, 2011.

**Commissions and fees** - The aggregate increase in commissions and fees for the three-month period ended September 30, 2012 compared to the same period in 2011, was principally due to revenues associated with acquisitions that were made in the twelve-month period ended September 30, 2012 (\$45.0 million). Commissions and fees in the three-month period ended September 30, 2012 included new business production and renewal rate increases of \$73.5 million, which was partially offset by lost business of \$60.5 million. Commissions increased 12% and fees increased 23% in the three-month period ended September 30, 2012 compared to the same period in 2011. Organic growth in commissions and fee revenues for the three-month period ended September 30, 2012 was 4% compared to 2% for the same period in 2011, principally due to net new business production and premium rate increases.

The aggregate increase in commissions and fees for the nine-month period ended September 30, 2012 compared to the same period in 2011, was principally due to revenues associated with acquisitions that were made in the twelve-month period ended September 30, 2012 (\$153.7 million). Commissions and fees in the nine-month period ended September 30, 2012 included new business production and renewal rate increases of \$168.2 million, which was partially offset by lost business of \$135.2 million. Commissions increased 16% and fees increased 24% in the nine-month period ended September 30, 2012 compared to the same period in 2011. Organic growth in commissions and fee revenues for the nine-month period ended September 30, 2012 was 4% compared to 2% for the same period in 2011, principally due to net new business production and premium rate increases.

**Table of Contents**

Items excluded from organic revenue computations yet impacting revenue comparisons for the three-month and nine-month periods ended September 30, 2012 and 2011 include the following (in millions):

For the Three-Month Periods Ended September 30,	2012 Organic Revenue		2011 Organic Revenue	
	2012	2011	2011	2010
<b>Base Commissions and Fees</b>				
Commission revenues as reported	\$ 346.0	\$ 308.0	\$ 308.0	\$ 251.9
Fee revenues as reported	106.8	86.8	86.8	74.8
Less commission and fee revenues from acquisitions	(45.0)		(61.9)	
Less disposed of operations		(1.5)		(2.5)
Levelized foreign currency translation		(1.0)		1.4
<b>Organic base commission and fee revenues</b>	<b>\$ 407.8</b>	<b>\$ 392.3</b>	<b>\$ 332.9</b>	<b>\$ 325.6</b>
Organic change in base commission and fee revenues		4.0%		2.2%
<b>Supplemental Commissions</b>				
Supplemental commissions as reported	\$ 16.6	\$ 14.5	\$ 14.5	\$ 10.2
Less supplemental commissions from acquisitions	(2.8)		(2.9)	
Less disposed of operations		(0.1)		
<b>Organic supplemental commissions</b>	<b>\$ 13.8</b>	<b>\$ 14.4</b>	<b>\$ 11.6</b>	<b>\$ 10.2</b>
Organic change in supplemental commissions		-4.2%		13.7%
<b>Contingent Commissions</b>				
Contingent commissions as reported	\$ 7.7	\$ 9.9	\$ 9.9	\$ 9.5
Less contingent commissions from acquisitions	(1.3)		(0.4)	
<b>Organic contingent commissions</b>	<b>\$ 6.4</b>	<b>\$ 9.9</b>	<b>\$ 9.5</b>	<b>\$ 9.5</b>
Organic change in contingent commissions		-35.4%		0.0%
<b>For the Nine-Month Periods Ended September 30,</b>				
<b>Base Commissions and Fees</b>				
Commission revenues as reported	\$ 962.7	\$ 829.7	\$ 829.7	\$ 713.1
Fee revenues as reported	281.4	227.7	227.7	198.2
Less commission and fee revenues from acquisitions	(153.7)		(124.9)	
Less disposed of operations		(7.2)		(2.5)
Levelized foreign currency translation		(3.0)		5.3
<b>Organic base commission and fee revenues</b>	<b>\$ 1,090.4</b>	<b>\$ 1,047.2</b>	<b>\$ 932.5</b>	<b>\$ 914.1</b>
Organic change in base commission and fee revenues		4.1%		2.0%
<b>Supplemental Commissions</b>				
Supplemental commissions as reported	\$ 50.3	\$ 42.0	\$ 42.0	\$ 48.7
Less supplemental commissions from acquisitions	(8.3)		(3.6)	
Less disposed of operations		(0.5)		
Timing items, net				(14.7)

Edgar Filing: GALLAGHER ARTHUR J & CO - Form 10-Q

Organic supplemental commissions	\$	42.0	\$	41.5	\$	38.4	\$	34.0
Organic change in supplemental commissions		1.2%				12.9%		