

State Auto Financial CORP  
Form DEF 14A  
March 30, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**SCHEDULE 14A**

**Proxy Statement Pursuant to Section 14(a) of the**

**Securities Exchange Act of 1934**

**(Amendment No. \_\_)**

Filed by the Registrant  Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

**Confidential, for Use of the Commission Only** (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant to §240.14a-12

**STATE AUTO FINANCIAL CORPORATION**

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(Name of Registrant as Specified In Its Charter)

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(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

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(4) Date Filed:

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**STATE AUTO FINANCIAL CORPORATION**  
**NOTICE OF ANNUAL MEETING OF SHAREHOLDERS**

To the Shareholders of

STATE AUTO FINANCIAL CORPORATION:

Notice is hereby given that the Annual Meeting of Shareholders of State Auto Financial Corporation (the Company) will be held at the Company's principal executive offices located at 518 East Broad Street, Columbus, Ohio, on May 4, 2007, at 10:00 a.m., local time, for the following purposes:

1. To elect three Class I directors, each to hold office for a three-year term and until a successor is elected and qualified;
2. To consider and vote upon a proposal to amend the Company's 1991 Employee Stock Purchase and Dividend Reinvestment Plan and Trust to increase the number of shares available to be purchased under the Plan;
3. To consider and vote upon a proposal to approve the material terms of the Company's Leadership Bonus Plan;
4. To consider and vote upon a proposal to approve the material terms of the Company's Long-Term Incentive Plan;
5. To ratify the selection of Ernst & Young LLP as the Company's independent registered public accounting firm for 2007; and
6. To transact such other business as may properly come before the meeting or any adjournment thereof.

The close of business on March 9, 2007, has been fixed as the record date for the determination of shareholders entitled to notice of and to vote at the meeting and any adjournment thereof.

In order that your shares may be represented at this meeting and to assure a quorum, please indicate your voting instructions by telephone, via the Internet or by signing and returning the enclosed proxy promptly. Instructions for indicating your voting instructions by telephone or via the Internet are included on the enclosed proxy. A return addressed envelope, which requires no postage, is enclosed if you choose to submit your voting instructions by mail. In the event you are able to attend and wish to vote in person, at your request we will cancel your proxy.

By Order of the Board of Directors

ROBERT P. RESTREPO, JR.

Chairman, President and CEO

Dated: March 30, 2007

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**STATE AUTO FINANCIAL CORPORATION**

**PROXY STATEMENT**

**GENERAL**

This Proxy Statement is furnished in connection with the solicitation of proxies by the Board of Directors of State Auto Financial Corporation (the Company) to be used at its Annual Meeting of Shareholders to be held May 4, 2007 (the Annual Meeting). Shares represented by properly executed proxies will be voted at the Annual Meeting in accordance with the choices indicated on the proxy. A proxy may be revoked at any time, insofar as it has not been exercised, by delivery to the Company of a subsequently dated proxy or by giving notice of revocation to the Company in writing or in open meeting. A shareholder's presence at the Annual Meeting does not by itself revoke the proxy.

The mailing address of the principal executive offices of the Company is 518 East Broad Street, Columbus, Ohio 43215. The approximate date on which this Proxy Statement and the form of proxy are first being sent or given to shareholders is March 30, 2007.

**PROXIES AND VOTING**

The close of business on March 9, 2007, has been fixed as the record date for the determination of shareholders entitled to notice of and to vote at the Annual Meeting and any adjournment thereof. On the record date there were outstanding and entitled to vote 41,079,773 of the Company's common shares, without par value (the Common Shares). Each Common Share is entitled to one vote.

For Proposal One (election of directors), the nominees receiving the highest number of votes will be elected as the Class I directors. Shareholders do not have the right to cumulate their votes in the election of directors.

For Proposal Two (proposal to amend the Company's 1991 Employee Stock Purchase and Dividend Reinvestment Plan and Trust (the Employee Stock Purchase Plan)) to increase the number of shares available to be purchased under that Plan, the vote required to approve the amendment is the favorable vote of a majority of the outstanding Common Shares.

For Proposal Three (proposal to approve the material terms of the Company's Leadership Bonus Plan (the Leadership Bonus Plan or LBP)), Proposal Four (proposal to approve the material terms of the Company's Long-Term Incentive Plan (the Long-Term Incentive Plan or LTIP)) and Proposal Five (ratification of the selection of Ernst & Young LLP as the Company's independent registered public accounting firm), the vote required to approve such Proposals is the favorable vote of a majority of the outstanding Common Shares that are voted on each such Proposal.

All Common Shares represented by properly executed proxies will be voted at the Annual Meeting in accordance with the choices indicated on the proxy. If no choices are indicated on a proxy, the Common Shares represented by that proxy will be voted as follows: (1) for the election of the nominees listed in this Proxy Statement as Class I directors; (2) for the approval of the amendment to the Employee Stock Purchase Plan; (3) for the approval of the material terms of the Leadership Bonus Plan; (4) for the approval of the material terms of the Long-Term Incentive Plan; and (5) for the ratification of the selection of Ernst & Young LLP as the

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Company's independent registered public accounting firm for 2007. Any proxy may be revoked at any time prior to its exercise by delivering to the Company a subsequently dated proxy or by giving notice of revocation to the Company in writing or in open meeting. A shareholder's presence at the Annual Meeting does not by itself revoke the proxy.

Abstentions will be considered as Common Shares present and entitled to vote at the Annual Meeting and will be counted for purposes of determining whether a quorum is present. Abstentions will not be counted in determining the votes cast for the election of directors and will not have a positive or negative effect on the outcome of the election. Abstentions will be counted as votes cast regarding Proposals Two through Five and will have the same effect as a vote against those Proposals.

If your Common Shares are held in street name, you will need to instruct your broker regarding how to vote your Common Shares. If you do not provide voting instructions to your broker, and if your broker does not have discretion to vote your Common Shares without your instructions, a broker non-vote will occur. Broker non-votes will not be counted in determining the votes cast for the election of directors or with respect to Proposals Three through Five and will not have a positive or negative effect on the outcome of these Proposals. With respect to Proposal Two, because passage of this Proposal requires the favorable vote of a majority of the outstanding Common Shares, broker non-votes will have the same effect as a vote against Proposal Two. State Automobile Mutual Insurance Company (State Auto Mutual), which owns approximately 65% of the outstanding Common Shares, has expressed an intention to vote in favor of each of the Proposals to come before the meeting.

### **PROPOSAL ONE: ELECTION OF DIRECTORS**

#### **Nominees for Class I Directors**

The number of directors currently is fixed at nine. Our Board of Directors is divided into three classes, Class I, Class II and Class III, with three directors in each Class. The term of office of directors in one Class expires annually at each annual meeting of shareholders at such time as their successors are elected and qualified. Directors in each Class are elected for three-year terms. The term of office of the Class I directors expires concurrently with the holding of the Annual Meeting, and the current Class I directors are Alexander B. Trevor and Paul W. Huesman. Mr. Huesman will retire from our Board concurrently with the expiration of his term of office at the Annual Meeting. There is currently one vacancy in Class I due to the resignation of John R. Lowther from our Board in November 2006. Mr. Lowther resigned from our Board in connection with the announcement of his pending retirement from the Company in 2007. In March 2007, the Nominating and Governance Committee of our Board recommended that Mr. Trevor, along with Thomas E. Markert and Robert E. Baker, be nominated for election as Class I directors at the Annual Meeting.

At the Annual Meeting, it is the intention of the persons named in the accompanying form of proxy, unless a contrary position is indicated on such proxy, to vote the proxy for the election of the three nominees named in the following table as Class I directors, each to hold office until the 2010 annual meeting of shareholders and until a successor is elected and qualified. Each of the nominees has consented to being named in this Proxy Statement and to serve if elected. In the event that any nominee named in the table as a Class I director is unable to serve (which is not anticipated), the persons named in the proxy may vote it for another nominee of their choice.

Proxies cannot be voted at the Annual Meeting for a greater number of persons than the three nominees named in this Proxy Statement.

#### **Majority Voting Policy for Incumbent Directors**

Our Board of Directors has adopted a majority voting policy for incumbent directors (the Majority Voting Policy) which is reflected in our Corporate Governance Guidelines. The Majority Voting Policy provides that if a nominee for director who is an incumbent director does not receive the vote of at least the majority of the votes

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cast at any meeting for the election of directors at which a quorum is present, and no successor has been elected at such meeting, then that incumbent director will promptly tender his or her resignation to the Board of Directors. For purposes of the Majority Voting Policy, a majority of votes cast means that the number of Common Shares voted for a director's election exceeds 50% of the number of votes cast with respect to that director's election or, in the case where the number of nominees exceeds the number of directors to be elected, cast with respect to election of directors generally. Votes cast (i) include votes to withhold authority in each case, and (ii) exclude abstentions with respect to that director's election or, in the case where the number of nominees exceeds the number of directors to be elected, abstentions with respect to election of directors generally.

The Nominating and Governance Committee will make a recommendation to our Board of Directors as to whether to accept or reject the tendered resignation, or whether other action should be taken. Our Board of Directors will act on the tendered resignation, taking into account the Nominating and Governance Committee's recommendation, and publicly disclose (by a press release, a filing with the Securities and Exchange Commission or other broadly disseminated means of communication) its decision regarding the tendered resignation and the rationale behind the decision within 90 days from the date of the certification of the election results. The Nominating and Governance Committee, in making its recommendation, and our Board of Directors, in making its decision, may each consider any factors or other information that the Committee or Board, as the case may be, considers appropriate and relevant. The director who tenders his or her resignation will not participate in the recommendation of the Nominating and Governance Committee or the decision of our Board of Directors with respect to his or her resignation. If such incumbent director's resignation is not accepted by our Board of Directors, such director will continue to serve until the next annual meeting and until his or her successor is duly elected, or his or her earlier resignation or removal. If a director's resignation is accepted by our Board of Directors, then our Board of Directors, in its sole discretion, may fill any resulting vacancy pursuant to the provisions of our Code of Regulations.



**Table of Contents****Backgrounds and Beneficial Ownership Information for Nominees and Continuing Directors**

Set forth below is information about each of the Class I director nominees:

**Class I Director Nominees**

(Terms expiring in 2010)

<b>Name of Director Nominee and Position(s) with Company</b>	<b>Age(1)</b>	<b>Principal Occupation(s) During the Past Five Years</b>	<b>A Director of the Company Since</b>	<b>Common Shares Owned Beneficially as of March 9, 2007(2)(3)(4)</b>	<b>% Of Class</b>
Robert E. Baker Director Nominee	60	President of Puroast Coffee Inc., a maker of specialty coffee products, 10/04 to present; Vice President of Corporate Marketing for ConAgra Foods, Inc., one of North America's largest packaged food companies, 4/99 to 10/04.	N/A	0	*
Thomas E. Markert Director Nominee	49	Global Chief Marketing and Client Service Officer, AC Nielsen, a leading global provider of marketing research and information services company, 1/04 to present; for more than five years prior thereto, Mr. Markert held various executive positions within AC Nielsen.	N/A	0	*
Alexander B. Trevor Director	62	President of Nuvocom Incorporated, a provider of patent litigation support services, 10/96 to present. Mr. Trevor is also a director of Applied Innovation, Inc., a network management solutions company.	2006	0	*

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Set forth below is information about the directors whose terms of office continue after the Annual Meeting:

**Class II Directors****(Terms expiring in 2008)**

<b>Name of Director and Position(s) with Company</b>	<b>Age(1)</b>	<b>Principal Occupation(s) During the Past Five Years</b>	<b>A Director of the Company Since</b>	<b>Common Shares Owned Beneficially as of March 9, 2007(2)(3)(4)</b>	<b>% Of Class</b>
David J. D Antoni(5) Director	62	Retired from Ashland, Inc. since 9/04; Senior Vice President and Group Operating Officer, Ashland, Inc., 3/99 to 9/04; President of APAC, Inc., a subsidiary of Ashland, Inc., 7/03 to 1/04; Senior Vice President of Ashland, Inc. and President, Ashland Chemical, a division of Ashland, Inc., 7/88 to 3/99. Ashland, Inc. is a chemical, energy and transportation construction company. Mr. D Antoni is also a director of Omnova Solutions Inc., a producer of decorative and functional surfaces, coatings and specialty chemicals, and Compass Minerals International, Inc., a producer and distributor of inorganic minerals.	1995	56,400	*
David R. Meuse Director	62	Principal of Stonehenge Financial Holdings, Inc., a provider of financial and advisory resources, 8/99 to present. Mr. Meuse is also a director of Diamond Hill Investment Group, Inc., a provider of investment management services and manager of mutual funds and private investment funds.	2006	15,000	*
S. Elaine Roberts Director	54	President and Chief Executive Officer of the Columbus Regional Airport Authority, a public port authority which oversees the operations of Port Columbus, Rickenbacker and Bolton Field airports in Franklin County, Ohio, 01/03 to present; Executive Director of Columbus Airport Authority, 12/00 to 01/03; Executive Director of Rhode Island Airport Corporation, 12/94 to 12/00.	2002	8,400	*

**Table of Contents****Class III Directors****(Terms expiring in 2009)**

<b>Name of Director Nominee and Position(s) with Company</b>	<b>Age(1)</b>	<b>Principal Occupation(s) During the Past Five Years</b>	<b>A Director of the Company Since</b>	<b>Common Shares Owned Beneficially as of March 9, 2007(2)(3)(4)</b>	<b>% Of Class</b>
Robert P. Restrepo, Jr.(6)  Chairman, President and  Chief Executive Officer	56	Chairman of the Board and Chief Executive Officer of the Company, State Auto Property & Casualty Insurance Company ( State Auto P&C ), Milbank Insurance Company ( Milbank ), State Auto National Insurance Company ( National ) and Farmers Casualty Insurance Company ( Farmers Casualty ), each a wholly owned subsidiary of the Company and of State Automobile Mutual Insurance Company ( State Auto Mutual ), 2/06 to present; President of the Company, State Auto P&C, Milbank, National, Farmers Casualty, and State Auto Mutual, 3/06 to present; Senior Vice President, Insurance Operations, Main Street American Group, a property and casualty insurance underwriting business, 4/05 to 2/06; President and Chief Executive Officer for two property and casualty insurance subsidiaries of Allmerica Financial Corporation (now known as Hanover Insurance Group), 1998 to 2003.	2006	20,500	*
Richard K. Smith(7)  Director	62	Retired as Partner of KPMG, LLP, a public accounting firm, since 6/97; Partner of KPMG, LLP for more than five years prior to 6/97.	1999	18,400	*
Paul S. Williams  Director	47	Managing Director with Major, Lindsey & Africa, LLC, an attorney search consulting firm, 4/05 to present; officer of Cardinal Health, Inc., a provider of products and services to healthcare providers and manufacturers, for more than five years prior to 4/05, last serving as that company s Executive Vice President, Chief Legal Officer and Secretary.	2003	4,525	*

\* Less than one (1%) percent.

(1) Ages shown are as of the date of the Annual Meeting.

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- (2) Except as indicated in the notes to this table, the persons named in the table have sole voting and investment power with respect to all Common Shares shown as beneficially owned by the named person. With respect to stock options, this table includes only stock options for Common Shares which are currently exercisable or exercisable within 60 days of March 9, 2007.
- (3) The amounts reported include Common Shares attributable to options granted under both the Company's Equity Incentive Compensation Plan for Mr. Restrepo (10,000) and Common Shares attributable to options granted under both the Company's 1991 Directors Stock Option Plan and 2000 Directors Stock Option Plan for Messrs. D. Antoni (15,400), Smith (10,400), Williams (4,200) and Ms. Roberts (7,400).
- (4) The amounts reported for Messrs. D. Antoni, Smith, Williams and Ms. Roberts do not include Restricted Share Units granted under the Outside Directors Restricted Share Unit Plan. See Board of Directors and Board Committees Compensation of Directors and Director Compensation Table for further information regarding this Plan and the number of Restricted Share Units held by these directors.
- (5) Includes 12,000 Common Shares owned by Mr. D. Antoni's spouse, as to which he disclaims beneficial ownership.
- (6) Includes 10,500 Common Shares received by Mr. Restrepo pursuant to the terms of a restricted share agreement entered into in connection with his employment by the Company. All 10,500 of these Common Shares are subject to a risk of forfeiture if Mr. Restrepo's employment is terminated for any reason prior to March 2, 2009 (or if he violates any provision of the restricted share agreement prior to that date). These Common Shares are also subject to restrictions on transfer until March 2, 2009. See Compensation of Executive Officers Contractual Arrangements with Named Executive Officers Robert P. Restrepo, Jr. and Grants of Plan-Based Awards in 2006 for additional information concerning these restricted Common Shares.
- (7) Includes 5,000 Common Shares owned by Mr. Smith's spouse, as to which he disclaims beneficial ownership.

**Beneficial Ownership Information for Named Executive Officers and Executive Group**

In addition to the Common Shares owned beneficially by Mr. Restrepo, as set forth above, Steven E. English, Mark A. Blackburn, Steven R. Hazelbaker, Richard L. Miley, Cynthia A. Powell and John R. Lowther, who are listed as Named Executive Officers in the Summary Compensation Table on page 40 of this Proxy Statement, beneficially owned the number of Common Shares set forth below as of March 9, 2007(1):

Named Executive Officer	Common Shares Beneficially Owned(2)	Stock Options(3)	Percent	
			Total Beneficial Ownership of Common Shares	of Class
Steven E. English	1,559	9,283	10,842	*
Mark A. Blackburn	7,425	61,698	69,123	*
Steven R. Hazelbaker	4,441	15,317	19,758	*
Richard L. Miley	104,269(4)	87,200(4)	191,469(4)	*
Cynthia A. Powell	7,681	34,600	42,281	*
John R. Lowther	21,693	69,899	91,592(5)	*

As of March 9, 2007, our directors and executive officers as a group (16 persons) beneficially owned 567,681 (1.4%) Common Shares, which included options for 310,498 Common Shares and 10,500 restricted Common Shares which have been issued to Mr. Restrepo subject to a risk of forfeiture. See Compensation of Executive Officers Contractual Arrangements Robert P. Restrepo, Jr. and Grants of Plan-Based Awards in 2006 for additional information concerning these restricted Common Shares.

\* Less than one (1%) percent.

- (1) Does not include beneficial ownership information for Robert H. Moone or Steven J. Johnston, who are also listed as Named Executive Officers in the Summary Compensation Table. We no longer have current beneficial ownership information for these persons because their employment with the Company ended on May 31, 2006, in the case of Mr. Moone, and June 19, 2006, in the case of Mr. Johnston.

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- (2) These persons and/or their spouses have sole voting and investment power with respect to all Common Shares beneficially owned by them.
- (3) With respect to stock options, this table includes only stock options for Common Shares which are currently exercisable or exercisable within 60 days of March 9, 2007.
- (4) Includes 16,218 Common Shares and stock options exercisable for 43,600 Common Shares owned by Cathy B. Miley, an executive officer of the Company and Mr. Miley's spouse, as well as 71,600 Common Shares owned jointly with Ms. Miley.
- (5) Includes 2,000 stock options exercisable for Common Shares that Mr. Lowther assigned to trusts for the benefit of his children and 7,011 Common Shares owned by his spouse as to which he disclaims beneficial ownership.

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**PROPOSAL TWO: APPROVAL OF AMENDMENT TO EMPLOYEE STOCK PURCHASE PLAN**

**Proposal**

At the Annual Meeting, shareholders will be asked to consider and vote upon a proposal to approve an amendment to the State Auto Financial Corporation 1991 Employee Stock Purchase and Dividend Reinvestment Plan, or Employee Stock Purchase Plan, to increase the number of Common Shares available for purchase under the Employee Stock Purchase Plan from 2,400,000 to 3,400,000. The Board of Directors approved the amendment on March 2, 2007. At the Annual Meeting, unless otherwise indicated, proxies will be voted to approve the amendment to the Employee Stock Purchase Plan.

**Reason for Amendment**

A total of 2,400,000 Common Shares have been reserved for issuance under the Employee Stock Purchase Plan. As of March 9, 2007, 2,265,225 of these 2,400,000 Common Shares had been purchased under the Employee Stock Purchase Plan. If additional Common Shares are not added to the Employee Stock Purchase Plan, the Plan will cease to function in the near future. Management desires to continue to have this stock purchase plan available because it provides a convenient and low-cost mechanism for employees to acquire or increase a proprietary interest in the Company. For example, in the last two years, employees have purchased 161,468 Common Shares under the Employee Stock Purchase Plan.

**Description of the Employee Stock Purchase Plan**

The following discussion describes the important aspects of the Employee Stock Purchase Plan. This discussion is intended to be a summary of the material provisions of the Employee Stock Purchase Plan. Because it is a summary, some details that may be important to you are not included. For this reason, the entire Employee Stock Purchase Plan, including the proposed amendment, is attached as Exhibit A to this Proxy Statement. You are encouraged to read the Employee Stock Purchase Plan, including the proposed amendment, in its entirety.

***Purpose***

The purpose of the Employee Stock Purchase Plan is to provide each employee of the Company or its parent or subsidiaries with an opportunity to acquire or increase a proprietary interest in the Company by enabling such employees to purchase Common Shares through payroll deductions. Because the employee stock purchase feature of the Employee Stock Purchase Plan is intended to qualify as an employee stock purchase plan described in Section 423 of the Internal Revenue Code of 1986, as amended (the Code), eligible employees may purchase Common Shares at a discount to their fair market value, as described below.

***Eligibility***

All employees of the Company or its parent or subsidiary corporations are eligible to participate in the Employee Stock Purchase Plan. As of February 22, 2007, there were 1,015 employees participating in the Employee Stock Purchase Plan, which represents approximately 50% of the eligible participants.

***Stock Purchases; Purchase Price; Reinvestment of Cash Dividends***

Employees who desire to participate in the Employee Stock Purchase Plan may do so by making an election prior to either of two annual subscription periods. Participating employees may elect to contribute, by payroll deduction, from one percent to six percent of their base pay toward the purchase of Common Shares. Amounts accumulated in the plan account of each participating employee through the last pay period during a subscription period will be credited to the purchase of Common Shares from the Company. Unless withdrawn by the participant, Common Shares purchased under the plan will be held for the participant by an agent, currently National City Bank.

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The purchase price for Common Shares purchased under the plan is the lesser of 85% of the fair market value of the Common Shares on the last trading day before the subscription period or on the last trading day of the subscription period. The subscription periods are June 1 through November 30 and December 1 through May 31.

Cash dividends received with respect to Common Shares held by the agent for the benefit of participants will be applied by the agent to the purchase of Common Shares in the open market, and Common Shares so purchased are credited to the accounts of the respective participants.

## **Federal Income Tax Information**

The employee stock purchase feature of the Employee Stock Purchase Plan is intended to qualify as an employee stock purchase plan described in Section 423 of the Code. As such, participants will recognize no income for federal income tax purposes upon the grant or exercise of the right to purchase Common Shares. The compensation deducted to purchase Common Shares under the Employee Stock Purchase Plan during a subscription period, however, will be includable in the participant's income.

If a participant disposes of Common Shares purchased under the employee stock purchase feature of the Employee Stock Purchase Plan within two years after the last trading day preceding the subscription period in which such Common Shares were purchased (the Grant Date), the participant must include in ordinary income, as compensation, an amount equal to the excess of the fair market value of the Common Shares on the purchase date over the purchase price paid for such Shares under the Employee Stock Purchase Plan. The employer company will be allowed a deduction in an amount equal to the amount included in the participant's income as compensation. If the participant does not dispose of the Common Shares purchased under the employee stock purchase feature of the Employee Stock Purchase Plan until after the expiration of the two-year holding period described above or if the participant dies while holding the Common Shares acquired under the employee stock purchase feature of the Employee Stock Purchase Plan, the participant must include in income, as compensation, in the taxable year in which disposition or death occurs, an amount equal to the lesser of (i) the excess of the fair market value of the Common Shares at the time of their disposition or death over the purchase price paid for the Common Shares under the plan, or (ii) the excess of the fair market value of the Common Shares on the Grant Date over the option price as of the Grant Date. The basis of the participant in the Common Shares purchased under the employee stock purchase feature of the Employee Stock Purchase Plan will equal the amount paid for the Common Shares plus the amount, if any, included in the participant's income as compensation. Any compensation resulting from the disposition of the Common Shares will be includable in the income of the participant in the participant's taxable year in which the disposition of the Common Shares occurs. The participant's holding period for the Common Shares purchased under the employee stock purchase feature of the plan will commence on the Grant Date. Any gain in excess of the basis will be treated as long-term capital gain if the participant's holding period for the Common Shares is more than one year.

Participants must include in ordinary income any dividends received on the Common Shares held by National City Bank under the Employee Stock Purchase Plan, even though such dividends are invested in Common Shares. The participant's basis in the Common Shares purchased with such dividends will equal the amount paid for such Common Shares and the participant's holding period will commence on the day such Common Shares are purchased.

**Table of Contents****2006 Information Pertaining to Named Executive Officers and Other Groups**

The following table sets forth, with respect to each of the persons named in the Summary Compensation Table and certain groups of employees, certain information about Common Shares purchased under the Employee Stock Purchase Plan during 2006(1):

Name	Number of		Net Value of
	Common	Average	Common
	Shares	Per Share	Shares
	Purchased	Purchase	Realized(3)
		Price(2)	
Robert P. Restrepo, Jr. Chairman, President and Chief Executive Officer	0	0	0
Steven E. English Vice President and Chief Financial Officer	370	\$ 27.625	\$ 1,953
Mark A. Blackburn Executive Vice President and Chief Operating Officer	606	\$ 27.625	\$ 3,217
Steven R. Hazelbaker Vice President	421	\$ 27.625	\$ 2,231
Richard L. Miley Vice President	397	\$ 27.625	\$ 2,104
Cynthia A. Powell Vice President, Treasurer and Chief Accounting Officer	408	\$ 27.625	\$ 2,154
John R. Lowther Acting General Counsel/Senior Advisor	302	\$ 27.625	\$ 1,472
All executive officers as a group (9 persons)	2,808	\$ 27.625	\$ 14,873
All participants, other than executive officers, as a group (1,006 persons)	74,764	\$ 27.625	\$ 395,738

- (1) Does not include information for Robert H. Moone or Steven J. Johnston, who are also listed as Named Executive Officers in the Summary Compensation Table. We do not have the information included in this table for these persons because their employment with the Company ended on May 31, 2006, in the case of Mr. Moone, and June 19, 2006, in the case of Mr. Johnston.



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- (2) Represents 85% of the average fair market value of the Common Shares on the two Grant Dates in 2006.
- (3) Represents the net value of the Common Shares on the purchase date determined by subtracting the net purchase price from the fair market value of the Common Shares on the purchase date of each subscription period that ended in 2006 and multiplying that amount by the number of shares purchased for each subscription period.

### **Reasons for Shareholder Approval**

The Company's shareholders are being asked to approve the amendment to the Employee Stock Purchase Plan so that the Employee Stock Purchase Plan can continue to meet the requirements of Section 423 of the Code, which will enable eligible employees to continue to purchase Common Shares at a discount from their fair market value. Shareholder approval is also required under the terms of the Employee Stock Purchase Plan.

The favorable vote of a majority of the outstanding Common Shares is required to approve the amendment to the Employee Stock Purchase Plan. The effect of an abstention or broker non-vote is the same as a vote against this proposal.

**THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR APPROVAL OF THE AMENDMENT TO THE EMPLOYEE STOCK PURCHASE PLAN.**

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**PROPOSAL THREE: APPROVAL OF MATERIAL TERMS OF LEADERSHIP BONUS PLAN**

**Proposal**

At the Annual Meeting, shareholders will be asked to consider and vote upon a proposal to approve the material terms of the State Auto Financial Corporation Leadership Bonus Plan, or Leadership Bonus Plan or LBP. The Board of Directors approved the terms of the Leadership Bonus Plan on March 2, 2007. At the Annual Meeting, unless otherwise indicated, proxies will be voted to approve the material terms of the Leadership Bonus Plan.

**Reason for Leadership Bonus Plan**

The Leadership Bonus Plan provides for an annual cash incentive bonus opportunity for the Company's executive officers and other key management employees based upon the achievement of corporate and individual performance goals in relation to the Company's achievement of its annual plan goals. The Board of Directors implemented the Leadership Bonus Plan to advance the interests of the Company and its shareholders by providing employees in leadership positions with an incentive bonus for achieving the strategic objectives of the Company. The Leadership Bonus Plan is also intended to provide for performance-based compensation which will not be subject to the deduction limitations under Section 162(m) of the Code as applicable to covered employees of the Company.

The Leadership Bonus Plan has been designed to take into account certain limits on the ability of a public corporation to claim tax deductions for compensation paid to certain highly compensated executives. Section 162(m) of the Code generally denies a corporate tax deduction for annual compensation exceeding \$1.0 million paid to any person who is considered a covered employee under Section 162(m) of the Code. However, qualified performance-based compensation paid to covered employees is exempt from this limitation. Covered employees are executive officers and other persons listed in a public corporation's summary compensation table. These executive officers and other persons are also known as named executive officers, or NEOs. For the Company, its covered employees, or NEOs, are those persons listed in the Summary Compensation Table found on page 40 of this Proxy Statement. Qualified performance-based compensation is compensation paid based solely upon the achievement of objective performance goals, the material terms of which are approved by the shareholders of the paying corporation.

**Description of Leadership Bonus Plan**

The following discussion describes the important aspects of the Leadership Bonus Plan. This discussion is intended to be a summary of the material provisions of the Leadership Bonus Plan. Because it is a summary, some details that may be important to you are not included. For this reason, the entire Leadership Bonus Plan is attached as Exhibit B to this Proxy Statement. You are encouraged to read the Leadership Bonus Plan in its entirety.

***Purpose***

The purposes of the Leadership Bonus Plan are to advance the interests of the Company and its shareholders by providing employees in leadership positions with an incentive bonus for achieving the strategic objectives of the Company, to focus management on key measures that drive superior financial and business performance and that build shareholder value over the long term, to provide compensation opportunities that are externally competitive and internally consistent with the Company's strategic objectives and total reward strategies and to provide bonus opportunities that reward executives, managers and key professionals who are in a position to make significant contributions to the overall success of the Company.

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### ***Administration***

The Compensation Committee of the Company's Board of Directors will administer the Leadership Bonus Plan. Among other things, the Compensation Committee will have the authority to select participants in the Leadership Bonus Plan from among the Company's employees who hold executive, management or selected professional positions and who are responsible for or contribute to the management, growth and/or profitability of the business of the Company, one of its subsidiaries or affiliates, or business segments in a material way. The Compensation Committee will also approve the performance goals, bonus amounts and other terms and conditions of awards under the Leadership Bonus Plan (subject to the terms of the Leadership Bonus Plan). The Compensation Committee will also have the authority to establish and amend rules and administrative processes relating to the Leadership Bonus Plan and to make all other determinations necessary and advisable for the administration of the Leadership Bonus Plan. All decisions made by the Compensation Committee pursuant to the Leadership Bonus Plan will be made in the Compensation Committee's sole discretion and will be final and binding.

### ***Eligibility***

Employees who hold an executive, management or selected professional position in the Company and who are designated by the Compensation Committee are eligible to be granted awards under the Leadership Bonus Plan. An employee who becomes eligible after the beginning of a performance period may participate on a pro-rated basis for that performance period, as determined by the Compensation Committee in its sole discretion. Participation is based primarily on the leadership position of an employee. As of March 20, 2007, 198 employees were eligible to participate in the Leadership Bonus Plan.

### ***Term of Awards***

Awards under the Leadership Bonus Plan will consist of cash amounts payable upon the achievement of specified objective performance goals during a specified performance period. It is anticipated that most performance periods will begin on the first day of the Company's fiscal year and end on the last day of that year. At the beginning of a performance period for a given award, the Compensation Committee will approve the performance goal(s) and the amount of the award, each as recommended by executive management, which will be earned if the performance goal(s) are achieved in full, together with any lesser amount that will be earned if the performance goal(s) are only partially achieved. After the end of the performance period, the Compensation Committee will certify the extent to which the performance goals are achieved and determine the amount of the award that is payable; provided, however, that the Compensation Committee will have the discretion to determine that the actual amount paid with respect to an award will be less than (but not greater than) the amount earned with respect to covered employees.

### ***Performance Goals; Maximum Award***

The performance goals for awards will be based upon the achievement of one or more of the following performance measures of the State Auto Group over the performance period: (i) earnings; (ii) return on capital; (iii) revenue; (iv) premiums; (v) net income; (vi) earnings per share; (vii) combined ratio; (viii) loss ratio; (ix) expense ratio; (x) assets; (xi) equity; (xii) cash flow; (xiii) stock price; (xiv) total shareholders' return; (xv) premium growth; and (xvi) corporate surplus growth. Corporate surplus growth is defined in the Leadership Bonus Plan as growth in State Auto Mutual's surplus less the impact of the value of its holdings of the Company. The State Auto Group consists of the Company and its related entities, subsidiaries and affiliates, including State Auto Mutual.

For eligible employees who are not covered employees (i.e., non-NEOs), the performance goals for awards may include one or more individual performance measures over the performance period. Performance measures applicable to covered employees will not include individual performance related to the achievement of

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personal goals unless a separate award is issued specific to such goals. However, any compensation paid to a covered employee with respect to the achievement of personal goals will not be considered performance-based compensation for purposes of Section 162(m) of the Code.

The maximum award that may be paid to any participant for any performance period is \$2.5 million.

### ***Termination of Employment***

A participant whose employment terminates during the performance period because of death, disability or upon the attainment of early or normal retirement age (as defined in the Company's defined benefit retirement plan) will receive a bonus equal to 100% of the participant's target bonus, pro-rated based upon the length of time that the participant was employed by the Company during the performance period, unless the Compensation Committee determines otherwise. In addition, a participant whose employment is terminated by the Company (other than for cause) during the fourth quarter of the performance period, will receive a pro rata portion of the award, based upon the length of participation prior to termination, unless the Compensation Committee determines otherwise. A participant whose employment terminates for any other reason before the end of the performance period for an award will not be entitled to any payment with respect to that award.

### ***Amendment and Termination***

The Leadership Bonus Plan may be amended, modified, suspended or terminated by the Compensation Committee at any time, but no such amendment, modification, suspension or termination will affect the payment of any award for a performance period that has already ended or increase the amount of any award. No new awards may be granted during any period of suspension of the Leadership Bonus Plan or after its termination.

### **Reasons for Shareholder Approval**

The Company's shareholders are being asked to approve the material terms of the Leadership Bonus Plan so that compensation paid by the Company under the Leadership Bonus Plan to certain of its highly compensated executive officers qualifies as performance-based compensation under Section 162(m) of the Code, which will then permit the Company to claim tax deductions for the payment of this compensation without the limitations imposed by Section 162(m) of the Code.

The favorable vote of a majority of the outstanding Common Shares present in person or by proxy at the Annual Meeting is required to approve the material terms of the Leadership Bonus Plan. The effect of an abstention is the same as a vote against this proposal. Broker non-votes will not have a positive or negative effect on the outcome of this proposal.

**THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR APPROVAL OF THE MATERIAL TERMS OF THE LEADERSHIP BONUS PLAN.**

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**PROPOSAL FOUR: APPROVAL OF MATERIAL TERMS OF LONG-TERM INCENTIVE PLAN**

**Proposal**

At the Annual Meeting, shareholders will be asked to consider and vote upon a proposal to approve the material terms of the State Auto Financial Corporation Long-Term Incentive Plan, or LTIP. The Board of Directors approved the terms of the LTIP on March 2, 2007. At the Annual Meeting, unless otherwise indicated, proxies will be voted to approve the material terms of the LTIP.

**Reason for the LTIP**

The LTIP provides for a long-term cash incentive bonus opportunity for the Company's executive officers and other key management employees, managers and professionals based upon the achievement of corporate performance goals in relation to the Company's performance compared with the Company's peer group of regional property and casualty companies. The Board of Directors implemented the LTIP to advance the interests of the Company and its shareholders by providing employees in leadership positions with an incentive bonus for achieving the long-term operating performance objectives of the Company. The LTIP is also intended to provide for performance-based compensation which will not be subject to the deduction limitations under Section 162(m) of the Code as applicable to covered employees of the Company.

The LTIP has been designed to take into account certain limits on the ability of a public corporation to claim tax deductions for compensation paid to certain highly compensated executives. Section 162(m) of the Code generally denies a corporate tax deduction for annual compensation exceeding \$1.0 million paid to any person who is considered a covered employee under Section 162(m) of the Code. However, qualified performance-based compensation paid to covered employees is exempt from this limitation. Covered employees are executive officers and other persons listed in a public corporation's summary compensation table. These executive officers and other persons are also known as named executive officers, or NEOs. For the Company, its covered employees, or NEOs, are those persons listed in the Summary Compensation Table found on page 40 of this Proxy Statement. Qualified performance-based compensation is compensation paid based solely upon the achievement of objective performance goals, the material terms of which are approved by the shareholders of the paying corporation.

**Description of the LTIP**

The following discussion describes the important aspects of the LTIP. This discussion is intended to be a summary of the material provisions of the LTIP. Because it is a summary, some details that may be important to you are not included. For this reason, the entire LTIP is attached as Exhibit C to this Proxy Statement. You are encouraged to read the LTIP in its entirety.

***Purpose***

The purposes of the LTIP are to advance the interests of the Company and its shareholders by providing employees in leadership positions with an incentive bonus that aligns performance and results with the expectations of shareholders and the Company's goals, recognizes and rewards long-term operating performance compared with the Company's peer group of regional property and casualty companies, provides compensation opportunities that are externally competitive and internally consistent with the Company's growth objectives and total compensation strategies and provides award opportunities that reward executives who achieve financial and operating results for the Company that impact the achievement of the Company's goals.

***Administration***

The Compensation Committee of the Company's Board of Directors will administer the LTIP. Among other things, the Compensation Committee will have the authority to select participants in the LTIP from among the

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Company's employees who hold executive, management or selected professional positions and who are responsible for or contribute to the management, growth and/or profitability of the business of the Company, one of its subsidiaries or affiliates, or business segments in a material way. The Compensation Committee will also approve the performance goals, bonus amounts and other terms and conditions of awards under the LTIP (subject to the terms of the LTIP). The Compensation Committee will also have the authority to establish and amend rules and administrative processes relating to the LTIP and to make all other determinations necessary and advisable for the administration of the LTIP. All decisions made by the Compensation Committee pursuant to the LTIP will be made in the Compensation Committee's sole discretion and will be final and binding.

### ***Eligibility***

Employees who hold an executive, management or selected professional position in the Company and who are designated by the Compensation Committee are eligible to be granted awards under the LTIP. An employee who becomes eligible after the beginning of a performance period may participate on a pro-rated basis for that performance period, as determined by the Compensation Committee in its sole discretion. Participation is based primarily on the leadership position of an employee. As of March 20, 2007, 198 employees are eligible to participate in the LTIP.

### ***Term of Awards***

Awards under the LTIP will consist of performance award units which represent the right of the participant to receive an amount in cash equal to the value related to the performance award units issued and payable upon the achievement of specified objective performance goals during a specified performance period. It is anticipated that most performance periods will be a three-year rolling period beginning on the date an award is granted and ending on the last day of the third calendar year following the grant. At the beginning of a performance period for a given award, the Compensation Committee will establish the performance goal(s) and the amount of the award, which will be earned if the performance goal(s) are achieved in full, together with any lesser amount that will be earned if the performance goal(s) are only partially achieved. After the end of the performance period, the Compensation Committee will certify the extent to which the performance goals are achieved and determine the amount of the award that is payable; provided, however, that the Compensation Committee will have the discretion to determine that the actual amount paid with respect to an award will be less than (but not greater than) the amount earned.

### ***Performance Goals; Maximum Award***

The performance goals for awards will be based upon the achievement of one or more of the following performance measures of the State Auto Group over the performance period: (i) earnings; (ii) return on capital; (iii) revenue; (iv) premiums; (v) net income; (vi) earnings per share; (vii) combined ratio; (viii) loss ratio; (ix) expense ratio; (x) assets; (xi) equity; (xii) cash flow; (xiii) stock price; (xiv) total shareholders' return; and (xv) Company performance as respects the State Auto Group's statutory combined ratio and total revenue growth and the Company's book value per share relative to the same performance measures for a group of peer companies. The State Auto Group consists of the Company and its related entities, subsidiaries and affiliates, including State Auto Mutual.

The maximum award that may be paid to any participant for any performance period is \$2.5 million.

### ***Termination of Employment***

A participant whose employment terminates during the performance period because of death or disability will receive a bonus equal to 100% of the participant's target bonus, pro-rated based upon the length of time that the participant was employed by the Company during the performance period, unless the Compensation Committee determines otherwise. A participant whose employment terminates during the performance period

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upon the attainment of early or normal retirement age (as defined in the Company's defined benefit retirement plan) will receive a bonus based on the actual performance results at the end of the performance period, pro-rated based upon the length of time that the participant was employed by the Company during the performance period, unless the Compensation Committee determines otherwise. In addition, a participant whose employment is terminated by the Company (other than for cause) during the performance period, will receive a pro rata portion of the award, based upon the length of participation prior to termination, unless the Compensation Committee determines otherwise. A participant whose employment terminates for any other reason before the end of the performance period for an award will not be entitled to any payment with respect to that award.

### ***Change in Control***

In the event of a change in control or potential change in control of the Company (generally defined by reference to the acquisition of a specified percentage of voting power, or a change in the composition of the Board of Directors, or an acquisition of the Company that requires shareholder approval, or a transaction involving the Company or its affiliates that requires shareholder approval and has the effect of causing the Company to cease to be a public company), all participants will become vested in and entitled to their awards calculated based on their individual awards times a fraction, the numerator of which is the number of days from the beginning of the performance period to the date of the change in control or potential change in control and the denominator of which is the total number of days in the performance period. The amount so calculated will be the minimum amount payable as a final award for the performance period in which the change in control or potential change in control occurs.

### ***Amendment and Termination***

The LTIP may be amended, modified, suspended or terminated by the Compensation Committee at any time, but no such amendment, modification, suspension or termination will affect the payment of any award for a performance period that has already ended or increase the amount of any award. No new awards may be granted during any period of suspension of the LTIP or after its termination.

### **Reasons for Shareholder Approval**

The Company's shareholders are being asked to approve the material terms of the LTIP so that compensation paid by the Company under the LTIP to certain of its highly compensated executive officers qualifies as performance-based compensation under Section 162(m) of the Code, which will then permit the Company to claim tax deductions for the payment of this compensation without the limitations imposed by Section 162(m) of the Code.

The favorable vote of a majority of the outstanding Common Shares present in person or by proxy at the Annual Meeting is required to approve the material terms of the LTIP. The effect of an abstention is the same as a vote against this proposal. Broker non-votes will not have a positive or negative effect on the outcome of this proposal.

**THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR APPROVAL OF THE MATERIAL TERMS OF THE LONG-TERM INCENTIVE PLAN.**

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**PROPOSAL FIVE: RATIFICATION OF SELECTION OF INDEPENDENT PUBLIC ACCOUNTANTS**

The Audit Committee of the Company's Board of Directors has selected Ernst & Young LLP as the Company's independent registered public accounting firm for 2007. Although not required, the Board of Directors is submitting the selection of Ernst & Young LLP to the Company's shareholders for ratification. Ernst & Young LLP has served as the Company's independent registered public accounting firm since 1994. The Audit Committee and the Board of Directors believe that the appointment of Ernst & Young LLP for 2007 is appropriate because of the firm's reputation, qualifications and experience.

The favorable vote of a majority of the outstanding Common Shares that are voted on this proposal at the Annual Meeting is required to approve the ratification of the selection of Ernst & Young LLP. The effect of an abstention is the same as a vote against this proposal. Broker non-votes will not have a positive or negative effect on the outcome of this proposal.

**THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS A VOTE FOR RATIFICATION OF THE SELECTION OF ERNST & YOUNG LLP AS THE COMPANY'S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR 2007.**

The Audit Committee will reconsider the appointment of Ernst & Young LLP if its selection is not ratified by the Company's shareholders. Even if the selection of Ernst & Young LLP is ratified by shareholders, the Audit Committee, in its discretion, could decide to terminate the engagement of Ernst & Young LLP and to engage another independent registered public accounting firm if the Audit Committee determines such action to be necessary or desirable.



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**BOARD OF DIRECTORS AND BOARD COMMITTEES**

**Board Meetings**

Our Board of Directors held 12 meetings during the fiscal year ended December 31, 2006. Each incumbent director attended at least 75% of the meetings of both the Board and the meetings of all committees on which he or she served, with the exception of David J. D. Antoni, who did not attend three of eight Audit Committee meetings, and Alexander B. Trevor, who did not attend one of two Independent Committee meetings. A majority of our directors are independent as defined by the Nasdaq Marketplace Rules. See Corporate Governance Director Independence.

**Board Committees and Committee Meetings**

Our Board has established an Audit Committee, a Compensation Committee, a Nominating and Governance Committee, an Investment Committee and a standing Independent Committee. All of the members of the Audit, Compensation, Nominating and Governance and Independent Committees are independent as defined by the Nasdaq Marketplace Rules. In addition, all of the members of the Audit Committee are independent as defined by the applicable rules of the Securities and Exchange Commission (the SEC). Our Board has adopted charters for each of the foregoing Committees. The current charters for each of these Committees, along with our Corporate Governance Guidelines, Director Ethical Principles, Employee Code of Business Conduct and Code of Ethics for Senior Financial Officers, are available on our website at [www.stfc.com](http://www.stfc.com) under Corporate Governance (<http://www.stfc.com/corp.gov/index.htm>).

The Audit Committee is charged with several responsibilities, including: (1) appointment, compensation, retention and oversight of the work performed by our independent auditors; (2) reviewing our accounting functions, operations and management; (3) considering the adequacy and effectiveness of our internal controls and internal auditing methods and procedures; (4) meeting and consulting with our independent auditors and with our financial and accounting personnel concerning the foregoing matters; (5) reviewing with our independent auditors the scope of their audit and the results of their examination of our financial statements; (6) participating in the process of administering our Employee Code of Business Conduct and our Director Ethical Principles set forth in our Corporate Governance Guidelines; (7) establishing procedures for receipt, retention and treatment of compliance regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of concerns regarding accounting or auditing matters; and (8) approving in advance any other work performed by our independent auditors that they are permitted by law to perform for us. Present members of the Audit Committee are Chairperson Richard K. Smith, David J. D. Antoni, David R. Meuse and Paul S. Williams. Based on a recommendation of the Audit Committee, our Board has designated Richard K. Smith as the Audit Committee Financial Expert. The Audit Committee held eight meetings during 2006.

The Compensation Committee is charged with several responsibilities, including: (1) administering our Amended and Restated Equity Incentive Compensation Plan (the Equity Incentive Compensation Plan), our 1991 Stock Option Plan and our Outside Directors Restricted Share Unit Plan; (2) evaluating and approving the compensation, fringe benefits and perquisites provided to our executive officers and adopting compensation policies applicable to our officers; and (3) evaluating the compensation provided to the members of the Board and its committees. The Compensation Committee will also be charged with administering the Leadership Bonus Plan and LTIP, assuming the material terms of these Plans are approved by shareholders. See Proposal Three: Approval of Material Terms of Leadership Bonus Plan and Proposal Four: Approval of Material Terms of Long-Term Incentive Plan contained elsewhere in this Proxy Statement. Present members of the Compensation Committee are Chairperson Paul S. Williams, David J. D. Antoni, Richard K. Smith and Alexander B. Trevor. The Compensation Committee held nine meetings during 2006.

The Nominating and Governance Committee is charged with several responsibilities, including: (1) selecting nominees for election as directors; (2) reviewing the performance of our Board and individual directors; and (3) annually reviewing and recommending to our Board changes to our Corporate Governance

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Guidelines and Director Ethical Principles. The members of the Nominating and Governance Committee are Chairperson David J. D. Antoni, David R. Meuse, S. Elaine Roberts and Paul S. Williams. The Nominating and Governance Committee met seven times in 2006. See also Corporate Governance Nomination of Directors contained elsewhere in this Proxy Statement.

The Investment Committee oversees our investment functions and those of our insurance subsidiaries. The members of the Investment Committee are Chairperson Paul W. Huesman, S. Elaine Roberts, Richard K. Smith, David R. Meuse and Alexander B. Trevor. The Investment Committee met four times in 2006.

The standing Independent Committee principally serves to review inter-company transactions between or among us and our subsidiaries, on the one hand, and State Auto Mutual and its subsidiaries, on the other. The Independent Committee also helps determine which entity, our Company or State Auto Mutual, is best suited to take advantage of transactional opportunities presented by a third party. The members of the standing Independent Committee are Chairperson S. Elaine Roberts, Richard K. Smith, Alexander B. Trevor and Paul S. Williams. The Independent Committee, which only meets as needed, met two times in 2006.

**Compensation of Directors and Director Compensation Table**

Name	Fees Earned or	Stock Awards	Total
	Paid in Cash		
	(\$)	\$(1)	(\$)
David J. D. Antoni	67,000	49,670	116,670
Paul W. Huesman	46,000	49,670	95,670
David R. Meuse	35,750	48,983	84,733
S. Elaine Roberts	54,000	49,670	103,670
Richard K. Smith	73,000	49,670	122,670
Alexander B. Trevor	34,750	48,983	83,733
Paul S. Williams	67,000	49,670	116,670

(1) We account for our Outside Director Restricted Share Unit Plan as a liability plan and do not apply Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (SFAS 123R), to the Restricted Share Units awarded under the Outside Directors Restricted Share Unit Plan. Each Restricted Share Unit is worth the equivalent of one Common Share. Each Restricted Share Unit is payable in cash or stock at the election of the outside director. In addition to the 1,400 Restricted Share Units granted as of the Annual Shareholders Meeting in 2006, the Outside Directors Restricted Share Unit Plan also contemplates that each director receives additional units that are the equivalent of dividend reinvestment on Common Shares. The total dollar amount shown in the stock award column represents the cash value of the total number of Restricted Share Units awarded in 2006, including from the dividend reinvestment feature, valued at \$34.68 per Restricted Share Unit (\$34.68 was the closing price of Common Shares as of the last business day of 2006).

In 2006, our outside directors received an annual cash retainer of \$25,000. This annual cash retainer was increased at the beginning of 2007 to \$32,000 as authorized by the Compensation Committee in November 2006. In addition, outside directors receive a fee of \$1,000 for each board meeting (regular or special) and committee meeting attended in person or telephonically. Outside directors are also reimbursed for travel expenses incurred in attending board and committee meetings. Each committee chairperson also receives an additional \$5,000 annual retainer (up to a maximum of \$5,000 for all committees chaired), other than the Audit Committee chairperson, who receives an additional retainer of \$10,000. The Lead Director is also paid a supplemental retainer equal to \$10,000 annually. Mr. D. Antoni waived his 2006 retainer for serving as chairperson of the

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Nominating and Governance Committee. Outside directors may defer all or a portion of the cash fees under our deferred compensation plan for directors. For 2006, only one director elected to defer payment of his or her meeting fees and retainers. These amounts of cash compensation totaled to the figures shown in the first column in the 2006 Director Compensation Table.

Outside directors also received Restricted Share Units pursuant to the Outside Directors Restricted Share Unit Plan. A Restricted Share Unit is a unit representing one Common Share. The value of each Restricted Share Unit, on any particular day, is equal to the last reported sale price of a Common Share on the Nasdaq National Market System on the most recent previous trading day. Under the Outside Directors Restricted Share Unit Plan, promptly following each annual meeting of our shareholders, each outside director is granted 1,400 Restricted Share Units. In addition, whenever a dividend is made with respect to the Common Shares, participants receive, with respect to each Restricted Share Unit held in the account of the participant on the dividend record date, additional Restricted Share Units in an amount equal to the value of the dividend. The administrative committee of the Outside Directors Restricted Share Unit Plan has the authority to decrease or increase the annual award of Restricted Share Units to outside directors to a minimum of 500 and a maximum of 5,000 without further shareholder approval. Under the Outside Directors Restricted Share Unit Plan, outside directors must, in general, hold their Restricted Share Units until they conclude their board service, after which time these Restricted Share Units are settled in cash or Common Shares, as elected by the outside director, with payments made in a single lump sum or annual installments over a five-or ten-year period, as selected by the outside director.

The following table sets forth the number of Restricted Share Units owned by each of our current outside directors as of March 9, 2007:

<b>Name</b>	<b>Number of Restricted Share Units</b>
David J. D. Antoni	2,838.302
Paul W. Huesman	2,838.302
David R. Meuse	1,412.430
S. Elaine Roberts	2,838.302
Richard K. Smith	2,838.302
Alexander B. Trevor	1,412.430
Paul S. Williams	2,838.302

Outside Directors receive no other forms of compensation other than as described in this section Compensation of Directors.

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### **CORPORATE GOVERNANCE**

#### **Director Independence**

The Nominating and Governance Committee has affirmatively determined that six of our eight directors, namely David J. D'Antoni, David R. Meuse, S. Elaine Roberts, Richard K. Smith, Alexander B. Trevor and Paul S. Williams, are independent as defined by the Nasdaq Marketplace Rules. The Nominating and Governance Committee made this determination based upon information included in director questionnaires provided by each of the incumbent directors and reviewed by the Nominating and Governance Committee. In the course of its review, the Nominating and Governance Committee concluded that Mr. Meuse's service on the board of directors of Central Benefits Insurance Company did not represent a conflict of interest because Central Benefits does not engage in the lines of business underwritten by our insurance subsidiaries and affiliates, based on representations from Mr. Meuse and information available to the Nominating and Governance Committee about the nature of Central Benefits' business. No other outside director presented any issues reflecting a potential conflict of interest with respect to the performance of their fiduciary duties as directors of our Company.

Our Corporate Governance Guidelines, which are posted at <http://www.stfc.com/corp.gov/index>, expressly provide that four of the five standing committees are to be comprised solely of independent directors. Our Board's Audit, Compensation, Standing Independent and Nominating and Governance Committee meet this standard. The only non-management director who serves on any committee is Paul W. Huesman, who is chairperson of the Investment Committee. Our Board of Directors has concluded that the Investment Committee does not need to be comprised solely of independent directors as members. As noted above, Mr. Huesman is retiring from our Board in conjunction with the Annual Meeting.

Robert P. Restrepo, Jr., who is our employee, and Mr. Huesman, who has a family member who is an executive officer of an insurance agency which does a substantial amount of business with us, are not independent directors under the standards set forth in the Nasdaq Marketplace Rules.

Based on information developed from each candidate, the Nominating and Governance Committee believes that Robert E. Baker and Thomas W. Markert, the two non-incumbent director nominees for election as Class I directors at the Annual Meeting, will qualify as independent directors under the standards set forth in the Nasdaq Marketplace Rules. Assuming their election, at that point, eight of our nine directors will be independent.

#### **Communications with the Board**

As further described in our Corporate Governance Guidelines, we provide a process by which security holders may send communications to our Board. Any security holder who desires to communicate with one or more of our directors may send such communication to any or all directors through our Corporate Secretary, by e-mail to [corporatesecretary@stateauto.com](mailto:corporatesecretary@stateauto.com) or in writing to Corporate Secretary at our principal executive offices, 518 East Broad Street, Columbus, Ohio 43215. Security holders should designate whether such communication should be sent to a specific director or to all directors. The Corporate Secretary is responsible for forwarding such communication to the director or directors so designated by the security holder.

#### **Director Attendance at Annual Meeting of Shareholders**

Our Corporate Governance Guidelines provide that directors are expected to attend our annual meetings of shareholders. All of our directors who were directors last year attended last year's annual meeting of shareholders.

#### **Executive Sessions of Non-Management Directors; Lead Director**

Since 2002, our Board has met in executive session, without management present, prior to or following each regular quarterly Board meeting. Consistent with our Corporate Governance Guidelines and the Nasdaq

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Marketplace Rules, during 2006, there were four executive sessions with only independent directors present, each of which was followed or preceded by an executive session with only non-management directors present. Our Corporate Governance Guidelines provide that the Lead Director acts as the presiding director at these executive sessions.

In March 2006, Mr. D. Antoni was elected by our Board as the Lead Director. The Lead Director's responsibilities include, among other things, leading the executive session of our independent and non-management directors, being a principal point of contact with our Chairman and CEO, working with the Chairman to develop a regular board meeting schedule and an annual agenda for such meetings, securing input from other directors on agenda items, ensuring the adequate flow of information from management to our Board and delivering the CEO's performance evaluation on behalf of the Compensation Committee of our Board.

## **Nomination of Directors**

The Nominating and Governance Committee sets the minimum qualifications for persons it will consider to recommend for nomination for election or re-election (election and re-election are hereafter collectively referred to as "election") as a director of the Company. These minimum qualifications are described in the Nominating and Governance Committee's charter, which is posted on our website as set forth in this section. The following matters will be considered in the Nominating and Governance Committee's determination of persons to recommend for nomination as directors of the Company: (i) status as independent based on the then-current Nasdaq rules; (ii) business or professional skill and experience; (iii) temperament; (iv) integrity; (v) educational background; and (vi) judgment. The objective of the Nominating and Governance Committee in this regard is to nominate for election as directors persons who share our values and possess the following minimum qualifications: high personal and professional integrity; the ability to exercise sound business judgment; an inquiring mind; professional demeanor; and the time available to devote to Board activities and the willingness to do so. The Nominating and Governance Committee will consider these criteria in the context of an assessment of the perceived needs of our Board as a whole and will seek to achieve diversity of occupational and personal backgrounds. Ultimately, the Nominating and Governance Committee's intention is to select nominees for election to our Board who the Nominating and Governance Committee believes will be effective, in conjunction with the other members of our Board, in collectively serving the long-term interests of the shareholders. In the context of recommending an incumbent director to be nominated for election to our Board, the Nominating and Governance Committee will focus its assessment on the contributions of such person during his or her Board tenure and such person's independence at that time.

In addition to incumbent directors who will be evaluated for re-nomination as described above, the Nominating and Governance Committee may maintain a list of other potential candidates whom the Nominating and Governance Committee may evaluate pursuant to the criteria set forth above for consideration as Board members. By following the procedures set forth below, shareholders may recommend potential candidates to be included on this list. As a matter of policy, the Nominating and Governance Committee will consider and evaluate such candidates recommended by shareholders in the same manner as all other candidates for nomination to our Board who are not incumbent directors.

The Charter of the Nominating and Governance Committee details the process by which our Board of Directors fills vacancies on the Board. The Nominating and Governance Committee's Charter provides that, in the absence of extraordinary circumstances, when a director vacancy arises for any reason, the Nominating and Governance Committee will first look to the list of names of potential nominees, as described above, and make a preliminary evaluation of such person(s) based on the criteria set forth above. If there are no names on the list or if all of the names on this list are eliminated following such evaluation process, the Nominating and Governance Committee may solicit other potential nominees names from our other directors, directors of our parent, the Chairman or other persons who the Nominating and Governance Committee reasonably believes would have the opportunity to possess first hand knowledge of a suitable candidate based on the criteria described above. The Nominating and Governance Committee may also hire a director search firm, as contemplated below. This

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process was followed in identifying Robert E. Baker and Thomas W. Markert, the two non-incumbent director nominees for election as Class I directors at the Annual Meeting, to fill the vacancy created by the resignation of John R. Lowther in November 2006 and the vacancy to be created upon the retirement of Paul W. Huesman concurrent with the Annual Meeting.

Once the Nominating and Governance Committee has preliminarily concluded that a person(s) may meet the criteria described above, the Nominating and Governance Committee will, at a minimum, obtain from such person(s) a completed Prospective Director Questionnaire which shall solicit information regarding the person's business experience, educational background, personal information and information relating to the person's business, personal or family relationships with the Company and other directors, among other matters. Following a review of such completed Prospective Director Questionnaire by the Nominating and Governance Committee and the Chairman and counsel for the Company, the Nominating and Governance Committee will conduct at least one interview with a person(s) whose candidacy it desires to pursue. Based on all information secured from the prospective nominee, which will include a background check and a criminal record check, the Nominating and Governance Committee will meet and decide whether or not to recommend such person(s) for nomination for election as a director of the Company. Any decision by the Nominating and Governance Committee in this regard will reflect its judgment of the ability of the person(s) to fulfill the objectives outlined above.

With respect to the existing and pending vacancies noted above, the Nominating and Governance Committee discussed the needs of our Board in terms of business background and skill sets that might be offered by new directors. After making that assessment, the Nominating and Governance Committee reviewed the lists compiled from previous director searches and solicited input from our other directors and our parent, State Auto Mutual. Finally, the Nominating and Governance Committee retained a search firm to identify potential candidates. The two persons being nominated for election for the first time at the Annual Meeting were identified by this search firm retained by the Nominating and Governance Committee.

We have adopted procedures by which shareholders may recommend individuals for membership to our Board. As described in its charter, it is the policy of the Nominating and Governance Committee to consider and evaluate candidates recommended by shareholders for membership on our Board in the same manner as all other candidates for nomination to our Board who are not incumbent directors. If a shareholder desires to recommend an individual for Board membership, then that shareholder must provide a written notice to the Secretary of the Company at 518 East Broad Street, Columbus, Ohio 43215 (the Recommendation Notice). For a recommendation to be considered by the Nominating and Governance Committee, the Recommendation Notice must contain, at a minimum, the following: (i) the name and address, as they appear on our books, and telephone number of the shareholder making the recommendation, including information on the number of shares owned; (ii) if such person is not a shareholder of record or if such shares are owned by an entity, reasonable evidence of such person's ownership of such shares or such person's authority to act on behalf of such entity; (iii) the full legal name, address and telephone number of the individual being recommended, together with a reasonably detailed description of the background, experience and qualifications of that individual; (iv) a written acknowledgement by the individual being recommended that he or she has consented to that recommendation and consents to our undertaking of an investigation into that individual's background, experience and qualifications in the event that the Nominating and Governance Committee desires to do so; (v) the disclosure of any relationship of the individual being recommended with our Company or any of our subsidiaries or affiliates, whether direct or indirect; and (vi) if known to the shareholder, any material interest of such shareholder or individual being recommended in any proposals or other business to be presented at our next annual meeting of shareholders (or a statement to the effect that no material interest is known to such shareholder).

As of March 20, 2007, we had not received any such recommendations from shareholders for nominees for our Board.

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### **Other Governance Issues of Interest**

Our Corporate Governance Guidelines as currently in effect illustrate the evolving nature of our corporate governance policies. Several changes made to our Corporate Governance Guidelines reflect our Board of Directors sensitivity to governance issues. For example, Guideline #5 expresses our Board's policy with respect to changes in the size of our Board, stating:

*An increase or decrease in the size of the Board would be largely dependent upon a material increase in the complexity of the Company's business or material changes in the workload for independent directors.*

Our Corporate Governance Guidelines also address the issue of service on other boards. Guideline #22 provides, in part, that a director should not serve on the audit committee of more than three public company boards, and a rebuttable presumption is created that a director of our Company serving on more than a total of four public company boards is not in the interest of our shareholders.

On the issue of supermajority voting requirements, our Code of Regulations and Articles of Incorporation do not require supermajority voting to approve mergers or business combinations. Furthermore, except under limited circumstances, only the shareholders can approve amendments to the Code of Regulations. This governance rule reflects Ohio law and is documented in Guideline #34 of our Corporate Governance Guidelines.

Another change resulting from the evolution of our Corporate Governance Guidelines is a process of annual performance evaluations of individual directors. This is documented at Guideline #7 of our Corporate Governance Guidelines. The Nominating and Governance Committee engaged in this process for the first time in the fall of 2006.

Another area of development is director continuing education. We sponsored an ISS-certified continuing education program for our directors in May 2006. All but two of our incumbent outside directors attended that program. We plan to host another director continuing education program this year for our directors and those of other local companies who might wish to attend.

Our Corporate Governance Guidelines also include a majority voting policy. See [Proposal One: Election of Directors Majority Voting Policy for Incumbent Directors](#) for a discussion of this policy.

### **Availability of Corporate Governance Documents**

The following documents are available on our website at [www.stfc.com](http://www.stfc.com) under [Corporate Governance](#) :

The charters for our Audit Committee, Compensation Committee, Nominating and Governance Committee, Investment Committee and standing Independent Committee;

Our Corporate Governance Guidelines, including Director Ethical Principles;

Our Employee Code of Business Conduct; and

Our Code of Ethics for Senior Financial Officers.

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**COMPENSATION OF EXECUTIVE OFFICERS**

Pursuant to our 2005 Management Agreement, our executive officers, as well as every other person providing services to our Company and our subsidiaries, are employees of State Auto P&C, with State Auto Mutual acting as the common paymaster and common agent for these employees. The costs and expenses associated with the employees of State Auto P&C are reimbursed to State Auto Mutual, as paymaster, in accordance with the terms of this management agreement. See [Related Person Transactions Transactions Involving State Auto Mutual](#) on page 68 for a discussion of our 2005 Management Agreement.

**Compensation Discussion and Analysis**

The purpose of this Compensation Discussion and Analysis section (this [CD&A](#) ) is to discuss the what, why and how of the various elements of our compensation system for our executive officers, including those persons identified as Named Executive Officers in the Summary Compensation Table (the [NEOs](#) ). Before addressing those matters, we would like to outline the framework of this discussion.

In May 2005, Robert H. Moone, who was then our Chief Executive Officer, announced his intention to retire the following year. At that point, the Boards of Directors of our Company and State Auto Mutual appointed a special joint committee of independent directors which consisted of our Company's Compensation Committee and the State Auto Mutual Nominating and Governance Committee (the [Joint Selection Committee](#) ) to lead the evaluation and selection process for our new CEO. At the outset of this process, the Joint Selection Committee decided to conduct a national search for external candidates, in addition to considering internal candidates. After the completion of a thorough search process, at a special joint meeting of the Boards of Directors of our Company and State Auto Mutual held on February 10, 2006, the Joint Selection Committee recommended the appointment of Robert P. Restrepo, Jr. as Chairman and Chief Executive Officer of all State Auto companies. The Boards of Directors of our Company and State Auto Mutual accepted this recommendation, and Mr. Restrepo was elected as Chairman and Chief Executive Officer at this meeting. The Joint Selection Committee also negotiated an employment agreement with Mr. Restrepo. See [Contractual Arrangements with Named Executive Officers Robert P. Restrepo, Jr.](#) for a summary of the material terms of Mr. Restrepo's employment and related agreements.

We are also required to include in the Summary Compensation Table any individual who served as our principal executive officer or principal financial officer during the last completed fiscal year. As indicated above, Mr. Moone served as our CEO until Mr. Restrepo's appointment. For this reason, Mr. Moone is included in the Summary Compensation Table. On June 5, 2006, Steven J. Johnston, who at that time was our Chief Financial Officer, gave notice that he was leaving State Auto, and on June 19, 2006, we entered into an agreement with Mr. Johnston regarding his separation from employment which included, among other things, Mr. Johnston's resignation as our CFO. On December 13, 2006, the Boards of Directors of our Company and State Auto Mutual appointed Steven E. English as our new CFO. At the time of his appointment, Mr. English was a Vice President of State Auto. Between the time of Mr. Johnston's resignation and Mr. English's appointment, Cynthia A. Powell, our Treasurer and Chief Accounting Officer, also served as our principal financial officer. For these reasons, Mr. Johnston, Mr. English and Ms. Powell are included in the Summary Compensation Table. See [Contractual Arrangements with Named Executive Officers Steve J. Johnston](#) for a summary of the material terms of Mr. Johnston's separation agreement.

Finally, we are required to include in the Summary Compensation Table any individual who would have been an NEO but for the fact that such individual was not serving as an executive officer at the end of our fiscal year. In accordance with this requirement, we have included compensation matters for John R. Lowther, who resigned on November 3, 2006, as our Senior Vice President, Secretary and General Counsel in connection with the announcement of his pending retirement in 2007. In connection with the announcement of his pending retirement, we entered into a retirement agreement with Mr. Lowther. See [Contractual Arrangements with Named Executive Officers John R. Lowther](#) for a summary of the material terms of Mr. Lowther's retirement agreement.



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Our compensation program for our NEOs and other executive officers includes traditional elements such as salary, short-term incentive plans, long-term incentive plans, a defined benefit pension plan, a supplemental executive retirement plan, a defined contribution plan and a non-qualified defined contribution plan, as well as other life insurance and health insurance benefits generally made available to our employees. Perquisites include (i) a corporate club membership (non-golfing) used by one of our NEOs; (ii) company-paid premiums on whole life insurance policies with policy limits not to exceed \$50,000 per policy; (iii) reimbursement for up to \$500 of financial planning assistance which is made available to all persons who receive stock options; and (iv) the opportunity to have the NEO's spouse accompany him or her on insurance agent incentive trips as hosts.

Because of new leadership, 2006 was a year of transition for us. As noted above, Mr. Moone's retirement was planned well in advance. Because of the pending leadership change, the Compensation Committee was reluctant to make significant changes in any of the compensation plans or programs for 2006 because it wanted to receive the input of Mr. Moone's successor on those matters. Several changes in our compensation program are being implemented for 2007 as a result of Mr. Restrepo's input and decisions, some of which will be noted in the course of this CD&A.

The objective of our executive compensation program is to provide competitive compensation that will attract and retain executive talent. Our executive compensation program is designed to reward individuals appropriately for their individual performance and its impact on our performance; offer incentives that encourage a focus on underwriting profit while achieving sales goals; foster the attainment of company-wide goals over the long term; and drive behaviors that are reasonably expected to build shareholder value over the long term. The fundamental objective is to compensate our executive officers at or close to median compensation levels relative to a set of peer companies. The set of peer companies is selected by the Compensation Committee with input from its compensation consultant. The Compensation Committee believes that superior performance warrants executive compensation in excess of market medians, with total compensation in the range of the 75th percentile of the set of peer companies being considered acceptable compensation.

The Compensation Committee has its compensation consultant perform a review of the insurance company officer compensation marketplace every other year, with the last full review completed in the fall of 2004. At that time, the compensation consultant used a set of 27 peer companies in assessing the relative position of compensation paid to senior officers, including our NEOs, which included the following: W.R. Berkley Corporation, White Mountains Insurance Group, American Financial Group, Inc., Allmerica Financial Corporation, Old Republic International Corporation, Cincinnati Financial Corporation, Unitrin, Inc., Kingsway Financial Services, Inc., Arch Capital Group Ltd., Mercury General Corporation, The Commerce Group, Inc., Ohio Casualty Corporation, Selective Insurance Group, Inc., 21st Century Insurance Group, Erie Indemnity Company, HCC Insurance Holdings, Inc., Infinity Property and Casualty Corporation, PMA Capital Corporation, Philadelphia Consolidated Holding Corp., Harleysville Group, Inc., Horace Mann Educators Corporation, Argonaut Group, Inc., Alfa Corporation, The Midland Company, Vesta Insurance Group, Inc., Safety Insurance Group, Inc., and United Fire & Casualty Company. Peer companies were selected based on their size and business overlap with the State Auto Group(1). In terms of the latter, the compensation consultant, with the concurrence of the Compensation Committee, selected companies with a significant portion of their business in personal and commercial automobile, homeowners and property and casualty insurance. In terms of the former, the compensation consultant sought to focus on companies that were similar to the State Auto Group in terms of premium volume, total assets, market capitalization and number of employees. While some of these companies are substantially larger than the State Auto Group, and others are smaller, the size of the median peer company is comparable to the State Auto Group:

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(1) See page 70 of this Proxy Statement for the list of companies included in the State Auto Group.

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	<b>Median Peer Company</b>	<b>State Auto Group</b>
Revenue	\$ 1.301 billion	\$ 1.298 billion
Total Assets	\$ 3.438 billion	\$ 3.055 billion
Market Capitalization	\$ 1.197 billion	\$ 1.050 billion
Employees	2,452	2,060

This broad based peer information is buttressed by available compensation survey information on insurance company executive compensation compiled by other compensation consulting firms.

Ultimately, the Compensation Committee is responsible for setting compensation policies applicable to our CEO and the other NEOs. The Compensation Committee determines our CEO's base salary and incentive compensation and works with the Nominating and Governance Committee of State Auto Mutual to evaluate the CEO's performance. It also approves salary and bonus arrangements for other NEOs and other executive officers. It approves management's recommendations regarding other aspects of the compensation and benefit programs we have in place for other officers and employees. However, in making its compensation decisions relating to both form of compensation and amount, the Compensation Committee has consistently relied upon competitive information obtained from its compensation consultant. The Compensation Committee has directly engaged the services of Towers Perrin as its compensation consultant for the last five years.

The competitive landscape, as gleaned from the work done by its compensation consultant, is a constant consideration in its decision making process. However, the duties of the Compensation Committee should not overshadow the importance of our executive management's input into our compensation system. This is illustrated by the process that resulted in the changes to the compensation program in and for 2007, as described below. Management developed the elements of the program and presented them to the Compensation Committee for its consideration, review and ultimate approval prior to implementing the new program.

**Base Salary**

Each NEO's annual base salary is the amount of regular cash compensation paid to such NEOs on a bi-weekly basis. It is the basic consideration in the employment relationship. The purpose of the annual base salary is to compensate the NEO based on that person's skills, competencies, experience and job performance. It also reflects the compensation marketplace for executive talent based on a competitive analysis performed by the Compensation Committee's compensation consultant. Our practice has been to adjust salaries annually, except in the case of a new hire, who typically receives a salary adjustment after six months on the job and then again after one year. Annual merit salary increases reflect a subjective assessment of the respective NEO's performance as well as the nature and extent of the person's responsibilities, including any changes in the same during the previous year. It also reflects the consequences of such person's decisions on our successes or failures as a whole. In the case of the CEO's merit increase, this subjective assessment is conducted by the Compensation Committee and the Nominating and Governance Committee of State Auto Mutual. As a result, merit increases focus on individual results as well as a discretionary evaluation of that individual's performance over the course of the year. The other NEOs had their performance evaluated by the CEO or the CFO, since two of our NEOs reported to the CFO at the time 2006 merit increases were determined.

The base salary of our NEOs is intended to reflect an amount substantially equivalent to the median base compensation paid to executive officers performing similar responsibilities at comparable insurance companies, both public and private. The objective is for base salary to approximate the market median or 50th percentile among these companies, based upon competitive information developed by the Compensation Committee's compensation consultant.

Aside from Mr. Restrepo, each of our NEOs listed in the Summary Compensation Table received salary increases in or for 2006. Our standard practice has been to have annual merit raises determined in late December

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of each year to be effective for the start of the next year. Subject to the approval of the Compensation Committee, Mr. Moone was responsible for determining the amount of 2006 annual merit raises for our NEOs who reported directly to him at that time (December 2005), a group which included Mr. Blackburn, Mr. Johnston, Mr. Lowther, Mr. Hazelbaker and Mr. Miley. Each of these individuals received from Mr. Moone a merit raise based on an assessment of their individual performance and market median base salary data as developed by the compensation consultant for the Compensation Committee. Some executives also received promotional increases to reflect new or additional job responsibilities. The following table summarizes these decisions:

Named Executive Officer	Base Annual Salary as of December 31, 2005	Base Annual Salary as of December 31, 2006	Rationale Behind Increase
<b>Current Executives</b>			
Mr. Restrepo(1)	\$ 600,000	\$ 600,000	New hire
Mr. Blackburn(2)	\$ 270,000	\$ 425,000	Normal merit and promotion to Executive Vice President and COO
Mr. English(2)	\$ 162,000	\$ 250,000	Increase in duties and subsequent promotion to CFO
Ms. Powell(2)	\$ 173,000	\$ 200,000	Normal merit and promotion to Treasurer and Chief Accounting Officer
Mr. Hazelbaker	\$ 190,000	\$ 194,000	Normal merit and internal pay equity
Mr. Miley	\$ 178,000	\$ 183,000	Normal merit
<b>Former Executives</b>			
Mr. Moone	\$ 565,000	\$ 620,000(3)	Excellent company performance Progress in succession Progress in diversity Contributions over his career Assistance in transition
Mr. Johnston	\$ 303,000	\$ 314,000(3)	Normal merit
Mr. Lowther	\$ 268,000	\$ 278,000	Normal merit

(1) Mr. Restrepo's employment did not commence until February 10, 2006.

(2) The salary as of December 31, 2006 reflects two salary increases.

(3) Employment terminated prior to December 31, 2006.

When salaries for the calendar year 2006 were originally set in December 2005, neither the Compensation Committee nor the then-CEO considered other elements of compensation that were available to NEOs, such as annual bonus earned, option gains, and equity ownership. Our executive base salaries stand on their own. However, it is also true that as executives become more highly compensated in our compensation structure, an increasing percentage of total compensation is performance-based, be it through stock options or short-term incentive bonuses. Salary increases impact short-term incentive bonus opportunities, though, because the amounts of bonuses are based on percentages of base salary. Salary increases also affect the amount of the executives retirement benefit, since a key component of the defined benefit plan retirement formula is career average salary.

**Short-Term Incentive Plans**

We currently have two forms of short-term incentive plans available to our NEOs. One plan provides for a quarterly bonus if our combined ratio is lower than the current target set forth in the plan. We call this plan the Quality Performance Bonus Plan, or QPB Plan, which has been in place since 1991. All employees are eligible to participate in the QPB Plan upon satisfaction of a minimum service requirement. The other plan is an annual cash incentive bonus that we refer to as the Executive Bonus Plan, or EBP.

Compensation surveys indicate that annual performance bonuses for executives are and have been common place in our industry, as in most businesses. Accordingly, in order to maintain competitiveness of the total cash compensation payable to our executives, including our NEOs, the

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Compensation Committee created the EBP. The Compensation Committee's objective is for each NEO's total cash compensation to be in the range of the 50<sup>th</sup> percentile or median total cash compensation for performance that meets expectations, while total cash

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compensation in the range of the 75<sup>th</sup> percentile is acceptable for performance that exceeds expectations. Human capital is among the most important assets an insurer can possess, and the quality of its executive team is critical to the success of any company. The property casualty insurance business is changing more rapidly than ever before due to the impact of information technology. A company's ability to compete successfully in a crowded insurance marketplace depends on thoughtful strategies and effective execution of those strategies. The opportunity to earn a competitive annual bonus creates a significant incentive to achieve high levels of performance. The point of any incentive program is to drive performance, and our management and the Compensation Committee believe that for an insurance underwriting company like State Auto, the QPB Plan and EBP reinforce those behaviors that are likely to have the greatest impact on our ability to build value for our owners. The Compensation Committee further believes that the relative performance measures used in the EBP for 2006 ensure that bonuses are earned strictly based on our performance relative to that of the selected peer group. By outperforming our peers, we believe investors will more likely invest in our Company as compared to other stocks in our sector.

***Quality Performance Bonus Plan***

Historically, under the QPB Plan, quarterly performance bonuses have been paid to all employees if the direct statutory combined ratio for all of our affiliated insurers combined exceeds a trigger point which is set annually. The amount of the QPB bonus received by employees is directly related to State Auto's direct loss ratio, once the combined ratio trigger is met. The QPB Plan was created to motivate employees to focus on the bottom line, i.e., underwriting profit, a key performance measure associated with our operating success. Moreover, the program helps build teamwork across all functions and all levels of State Auto because all employees are eligible and held to the same standard. Our management believes we have succeeded in that regard - our employees have earned a QPB bonus in 20 of the 28 quarters during the period from January 2000 to December 2006. The original intent of the QPB Plan was to share with our employees approximately 20% of the underwriting profit we achieve in excess of the annual trigger point, and to provide it quarterly to ensure prompt feedback on our performance in selecting and pricing insurance risks.

The other advantage of the QPB Plan is that the formula is incremental. The bonus is relatively smaller if the combined ratio target is exceeded by a small amount while it becomes more substantial if the target is exceeded by a substantial amount. In essence, the bonus formula is self-correcting in that the amounts paid as a bonus directly reflect the quality of the performance. Being strictly performance-based and purely formula-driven, we believe it plays a material role in the underwriting, pricing discipline, and expense management that we consider critical in profitably underwriting a book of business. We believe that we have been able to stand out from the crowd based on our underwriting success, fostered to a significant degree by the QPB Plan.

Under the QPB Plan for 2006, quarterly bonuses were paid to employees who had completed two full calendar quarters of service if the direct statutory combined ratio for the quarter was 98% or less for all combined affiliated insurers. Our line operations are conducted through regional or branch offices and when the program was established, it was decided that each branch's results should weigh more heavily in the bonus earned by the employees of that branch. Accordingly, in calculating the bonus for branch employees, 70% of the QPB bonus was based on the branch's underwriting profit while 30% was based on our overall underwriting profit, which strengthened the performance orientation of the plan by focusing on underwriting results that participants can control and influence. The QPB Plan is purely formulaic; no discretionary performance considerations affect whether the QPB bonus is paid or the amount each employee receives. All NEOs participate in the QPB Plan, and their QPB bonus was based solely on our overall results. The NEOs' QPB bonuses earned in 2006, which amounts are set out in the Summary Compensation Table, reflected the application of the formula set forth in the QPB Plan without variation. The only exception made from the provisions of the rules in the QPB Plan is that Mr. Restrepo received a dollar amount of bonus equivalent to the QPB bonus in the first and second quarter which was a negotiated term of his employment contract. The QPB Plan had a two-quarter service requirement as a condition of eligibility which the Compensation Committee did not apply to Mr. Restrepo by virtue of this alternative bonus to the QPB bonus. This exception allowed the Compensation Committee to approximate the

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bonus opportunity Mr. Restrepo had with his former employer, while at the same time preserving an element of consistency with our compensation structure. This also helped to ensure that Mr. Restrepo, a new leader from outside our Company, was invested in this employee benefit that has become a part of our culture.

Periodically, the QPB Plan has been modified in an effort to more properly incentivize the employees' performance or reflect changes in the property casualty insurance marketplace. Beginning in the second quarter of 2004, quarterly bonuses were reduced by 10% if we did not achieve targeted sales goals for the calendar quarter in which the bonus was earned. The combined ratio trigger was changed from 100% to 98% effective as of the beginning of the second quarter of 2005, consistent with our commitment to achieve an annual underwriting profit and reinforce the need for continuous improvement. In 2006, an annual maximum payout was imposed so that no employee's QPB bonus on an annual basis would exceed 35% of such employee's annual salary. This change was implemented in order to more appropriately align our cash compensation levels with the market for other employees. No NEO was affected by this maximum payout in 2006, nor was there an expectation that any corporate employee would be affected by the 35% maximum payout, because the corporate bonus percentages were historically simply not large enough to make the maximum payout applicable. For example, the QPB bonus percentages applicable to corporate employees for each quarter in 2006 were as follows: 33.4%, 0%, 15.9% and 37.8%, respectively. Annualized, these QPB bonuses paid for 2006 reflect 20.1% of the average of our NEO's base salary paid in 2006. When these QPB bonuses were paid, the bonus percentages reflected the application of the 10% reduction for not meeting our sales goal for the quarter.

In 2007, the QPB Plan is being modified to reduce the combined ratio trigger to an average of 96%. This more closely reflects our long-standing underwriting performance goal. In 2007, the trigger will be adjusted on a quarterly basis to reflect the seasonality of our results; the performance targets for the first through the fourth quarter are respectively 94%, 98%, 98%, and 94%. The other major change to the program is the elimination of the branch employee/corporate employee distinctions for bonus award calculation purposes. Every employee, regardless of whether the employee has line or staff responsibilities, will be paid the same percentage of quarterly salary, in the quarters in which a bonus is earned. This change reinforces the importance of the team effort required across our Company for us to achieve our strategic goals. Certain smaller branches results were much more volatile than others because of the disparity in the amount of business generated by each branch. It also eliminates a branch employee being over-rewarded based more on circumstances that are not within the control of that branch's employees. The percentage of profits intended to be shared in the QPB Plan was decreased to 15% from 20% based on competitive market analysis and an assessment of historical payouts under the QPB Plan. We simply did not need to fund as large a bonus pool as we had done in the past to offer our employees a competitive level of incentive compensation. Also, this facilitates our ability to restructure our total rewards program which is briefly discussed below.

Furthermore, to the extent our NEOs or other employees participate in the new Leadership Bonus Plan, discussed below, the amount of any QPB bonus earned during the year will be an offset against any bonus earned by that employee under the LBP. In other words, any QPB bonuses earned by these employees will serve as installment payments against their LBP bonus. If the QPB bonuses earned during the year exceed the bonus amounts earned under the LBP, the employee will not receive an LBP award. Nor would such employee be required to reimburse us for the overage. Finally, the 35% maximum payout and the 10% reduction for not achieving sales goals have been removed. The annual maximum payout became moot with the elimination of branch-based underwriting performance award calculations and the reduced amount of profits being shared. The 10% reduction for not achieving sales goals had been in place for at least two years and did not appear to affect employees' behaviors, so that was also eliminated from the QPB Plan.

The changes to the QPB Plan put in place in 2007 reflect changes in the property casualty insurance market place as well as our desire to restructure the overall incentive reward system. The QPB Plan as previously operated carried with it an unsustainable expense burden which precluded other important, useful changes in our compensation and performance reward system. These changes are being implemented in 2007 to make the compensation of more of our employees more performance-based and more at-risk. We want to incentivize

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those whose responsibilities directly drive our performance, rewarding them for strong performance while moderating compensation when performance is not as strong. We also want to change the performance measures to reflect elements over which we have more direct control as will be noted in more detail below.

***Executive Bonus Plan***

The annual Executive Bonus Plan, or EBP, is an individual annual cash incentive bonus arrangement with certain features that are universal among all NEOs. Historically, the EBP has rewarded these officers based on our performance relative to a set of publicly traded property casualty insurance companies, and this set has remained constant over the last five years. While the QPB Plan rewards our employees for results tied to internally established goals, the EBP rewards for how well our results compare to certain of our key competitors in our industry. Moreover, it supports our pay philosophy of providing relatively high payouts for relatively high levels of performance.

Opportunities under the plan range from 0% of salary to:

50% of salary for vice presidents

60% of salary for senior vice presidents

75% of salary for the CEO

In addition to the above, the CEO is eligible to receive an additional 25% of salary based on the Compensation Committee's discretionary evaluation of his performance for the year. No other participant in the EBP had a portion of their award expressly based on a discretionary evaluation of their individual performance. The Compensation Committee did not delegate this authority to the CEO and it was not in a position to fairly assess the annual contributions of all other participants. However, the Compensation Committee retains the discretion to act on its own initiative or at the suggestion of the CEO to increase a bonus award for a particular NEO beyond the amount determined by the formula.

Awards under the EBP were based on the following performance measures: (i) our statutory combined ratio for the calendar year; (ii) net written premium growth for the calendar year; and (iii) total shareholder return over the previous three years. These performance measures were selected because they are objectively measurable, universally reported by insurance companies (combined ratio and net written premium growth) or calculable for public company insurers. They also tend to be reliable indicators of successful performance. One NEO's EBP was different from the others because it included a measurement relating to the performance of the business unit he operates.

These performance measures are compared to the same results for the following nine publicly held insurers: Alfa Corporation, Allstate Insurance Company, Chubb, Cincinnati Financial Corporation, Harleysville Group Inc., EMC Insurance Group, Inc., Ohio Casualty Corporation, Safeco Corporation and Selective Insurance Group, Inc. (the EBP Peer Group). Some of these companies are included in the peer group used for determining competitive pay levels. Those companies that are not included are much larger than us and would not be appropriate to include in pay comparisons with our executives. Nonetheless, their business mix closely resembles that of State Auto's. As a result, they are appropriate for performance comparisons with our Company as they represent the types of companies that investment analysts and investors use to assess our performance. Overall, the Compensation Committee believes the EBP Peer Group is appropriate and reasonable for assessing our annual performance.

The EBP formula operated the same way in 2006 as it has in the last several years. The NEOs earned points based upon our rank for each of these criteria in comparison to the EBP Peer Group. Points ranged from 10 points for a 1st place finish in a category to 1 point for a 10th place finish. The object was to accumulate the

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greatest number of points out of a possible 30 points (three 1st place finishes in the three categories). The points system worked as follows:

<b>Total Points Earned</b>	<b>% of EBP Bonus</b>
30-27	100%
26-23	80%
22-19	60%
18-15	40%
14-11	20%
10 or less	0%

The only exception to the formula is set forth in the CEO's EBP which has an express discretionary element to it, as discussed above.

One of the difficulties of the 2006 EBP plan's performance criteria is the delay in securing peer information on underwriting results and premium growth. We rely on figures from A.M. Best Company for those two components and those typically are not available until late May or early June, long after the annual shareholders meeting proxy statement has been printed and mailed. As a result, the Summary Compensation Table included herein does not contain any compensation resulting from the EBP in 2006, except for Mr. Restrepo and Mr. Miley. We will update the Summary Compensation Table with a Form 8-K filing when the information becomes available regarding our NEOs' bonuses under the 2006 EBP.

Mr. Miley, whose business unit's performance was strong, earned his maximum bonus opportunity under his EBP, an amount equal to 50% of his salary. Under his EBP, Mr. Miley could earn as a bonus 2% of his business unit's pre-tax profit up to a maximum award of 50% of his salary. This amount is shown in the Summary Compensation Table in the Non-Equity Incentive Plan Compensation column (the Cash Incentive Plan Column). Mr. Miley's business unit's results are not included in our financial results, since the entity that constitutes his business unit is owned by State Auto Mutual and it is not engaged in the insurance underwriting business. In the case of Mr. Restrepo, his employment agreement guaranteed him a minimum bonus equal to 25% of his salary for the calendar year 2006. This amount is shown in the Summary Compensation Table in the Bonus column.

The compensation consultant of the Compensation Committee has indicated that the design of the EBP was relatively unusual among annual bonus plans, in that other insurers' annual incentive bonus plans tend to be based on performance measures tied to internally developed goals or objectives and not on specific results relative to peers. The compensation consultant also indicated our target of total cash compensation available from salary and QPB and EBP bonuses was at the lower end of market practice and did not afford top quartile pay for top quartile performance. As a result, the reward system for NEOs is being changed for 2007.

The new LBP, an annual incentive bonus plan, will be available to a much larger group of employees than was the EBP. Management and the Compensation Committee believe