

GALLAGHER ARTHUR J & CO
Form 10-Q
October 30, 2008
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2008 or

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

Commission File Number 1-9761

ARTHUR J. GALLAGHER & CO.

(Exact name of registrant as specified in its charter)

DELAWARE

36-2151613

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(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)
Two Pierce Place, Itasca, Illinois 60143-3141
(Address of principal executive offices) (Zip code)
(630) 773-3800
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

The number of outstanding shares of the registrant's Common Stock, \$1.00 par value, as of September 30, 2008 was 95,000,000.

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Arthur J. Gallagher & Co.

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

	Three-month period ended September 30,		Nine-month period ended September 30,	
	2008	2007	2008	2007
Commissions	\$ 244.9	\$ 228.9	\$ 697.2	\$ 645.7
Fees	177.8	163.0	510.8	473.4
Investment income (loss):				
Brokerage and Risk Management	10.3	8.4	26.6	23.2
Financial Services and Corporate	(2.3)	8.1	1.0	67.6
Investment gains (losses)	(2.5)	2.3	(2.7)	3.4
Total revenues	428.2	410.7	1,232.9	1,213.3
Compensation	250.0	228.7	733.4	671.2
Operating	99.9	86.0	273.0	248.1
Investment expenses	3.6	10.1	7.8	91.5
Interest	7.1	5.6	20.9	9.4
Depreciation	8.0	6.8	22.8	21.6
Amortization	10.2	7.1	29.4	21.3
Total expenses	378.8	344.3	1,087.3	1,063.1
Earnings from continuing operations before income taxes	49.4	66.4	145.6	150.2
Provision for income taxes	7.7	14.0	45.9	30.7
Earnings from continuing operations	41.7	52.4	99.7	119.5
Discontinued operations:				
Loss on discontinued operations before income taxes	(3.6)	(1.0)	(36.3)	(6.1)
Gain on disposal of operations	(0.2)		12.2	
Provision (benefit) for income taxes	0.1	(0.4)	3.0	(2.0)
Loss from discontinued operations	(3.9)	(0.6)	(27.1)	(4.1)
Net earnings	\$ 37.8	\$ 51.8	\$ 72.6	\$ 115.4
Basic net earnings (loss) per share:				
Earnings from continuing operations	\$ 0.44	\$ 0.56	\$ 1.07	\$ 1.23
Loss from discontinued operations	(0.04)	(0.01)	(0.29)	(0.04)
Net earnings	\$ 0.40	\$ 0.55	\$ 0.78	\$ 1.19
Diluted net earnings (loss) per share:				
Earnings from continuing operations	\$ 0.44	\$ 0.54	\$ 1.07	\$ 1.22

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Loss from discontinued operations	(0.04)		(0.29)	(0.04)
Net earnings	\$ 0.40	\$ 0.54	\$ 0.78	\$ 1.18

See notes to consolidated financial statements.

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

	September 30, 2008 (Unaudited)	December 31, 2007
Cash and cash equivalents	\$ 249.6	\$ 255.9
Restricted cash	588.4	601.4
Investments - current	5.1	7.5
Premiums and fees receivable	784.0	1,303.7
Other current assets	116.7	107.3
Total current assets	1,743.8	2,275.8
Investments - noncurrent	22.6	26.3
Fixed assets - net	87.5	87.9
Deferred income taxes	275.0	292.6
Other noncurrent assets	122.9	118.0
Goodwill - net	527.8	440.6
Amortizable intangible assets - net	417.6	315.6
Total assets	\$ 3,197.2	\$ 3,556.8
Premiums payable to insurance and reinsurance companies	\$ 1,377.5	\$ 1,874.0
Accrued compensation and other accrued liabilities	250.1	281.3
Unearned fees	45.8	44.1
Other current liabilities	26.6	32.8
Corporate related borrowings - current	118.0	
Total current liabilities	1,818.0	2,232.2
Corporate related borrowings - noncurrent	400.0	400.0
Other noncurrent liabilities	204.2	209.1
Total liabilities	2,422.2	2,841.3
Stockholders' equity:		
Common stock - issued and outstanding 95.0 shares in 2008 and 92.0 shares in 2007	95.0	92.0
Capital in excess of par value	194.6	120.2
Retained earnings	478.4	495.9
Accumulated other comprehensive earnings	7.0	7.4
Total stockholders' equity	775.0	715.5
Total liabilities and stockholders' equity	\$ 3,197.2	\$ 3,556.8

See notes to consolidated financial statements.

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

	Nine-month period ended September 30,	
	2008	2007
Cash flows from operating activities:		
Earnings from continuing operations	\$ 99.7	\$ 119.5
Adjustments to reconcile earnings from continuing operations to net cash provided by operating activities:		
Net (gain) loss on investments and other	2.7	(3.4)
Depreciation and amortization	52.2	42.9
Amortization of deferred compensation and restricted stock	5.2	5.3
Stock-based compensation expense	8.4	9.6
Net change in restricted cash	3.8	(16.5)
Net change in premiums receivable	88.1	196.9
Net change in premiums payable	(66.3)	(165.6)
Net change in other current assets	(15.2)	4.7
Net change in accrued compensation and other accrued liabilities	(45.8)	(15.3)
Net change in fees receivable/unearned fees	10.6	(10.9)
Net change in income taxes payable	3.4	(1.8)
Net change in deferred income taxes	16.7	(9.5)
Net change in other noncurrent assets and liabilities	(21.4)	(5.3)
Net cash provided by operating activities of continuing operations	142.1	150.6
Loss from discontinued operations	(27.1)	(4.1)
Depreciation and amortization from discontinued operations	13.6	2.6
Other noncash items related to discontinued operations	4.6	
Net gain on disposal of discontinued operations	(12.2)	
Net cash provided by operating activities	121.0	149.1
Cash flows from investing activities:		
Net additions to fixed assets	(25.0)	(26.0)
Cash paid for acquisitions, net of cash acquired	(196.9)	(116.1)
Proceeds from sales of discontinued operations	31.8	
Proceeds from sale of consolidated operation		0.7
Net proceeds from investment transactions	8.3	0.2
Net cash used by investing activities	(181.8)	(141.2)
Cash flows from financing activities:		
Proceeds from issuance of common stock	20.7	19.4
Tax benefit from issuance of common stock	5.1	3.4
Repurchases of common stock	(1.2)	(194.1)
Dividends paid	(88.1)	(89.7)
Borrowings on line of credit facilities	187.0	283.9
Repayments on line of credit facilities	(69.0)	(283.9)
Borrowings of corporate related long-term debt		400.0
Repayments of investment related long-term debt		(3.5)
Net cash provided by financing activities	54.5	135.5

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Net (decrease) increase in cash and cash equivalents	(6.3)	143.4
Cash and cash equivalents at beginning of period	255.9	208.0
Cash and cash equivalents at end of period	\$ 249.6	\$ 351.4
Supplemental disclosures of cash flow information:		
Interest paid	\$ 26.9	\$ 5.2
Income taxes paid	34.2	36.8
	See notes to consolidated financial statements.	

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Notes to September 30, 2008 Consolidated Financial Statements (Unaudited)

1. Nature of Operations and Basis of Presentation

Arthur J. Gallagher & Co. (Gallagher) provides insurance brokerage and risk management services to a wide variety of commercial, industrial, institutional and governmental organizations. Commission and fee revenue generated by the Brokerage Segment is primarily related to the negotiation and placement of insurance for Gallagher's clients. Fee revenue generated by the Risk Management Segment is primarily related to claims management, information management, risk control services and appraisals in the property/casualty (P/C) market. Investment income and other revenue is generated from Gallagher's investment portfolio, which includes invested cash, fiduciary funds, tax advantaged, clean energy and other investments. Gallagher is headquartered in Itasca, Illinois, has operations in fourteen countries and does business in more than 100 countries globally through a network of correspondent brokers and consultants.

The accompanying unaudited consolidated financial statements have been prepared by Gallagher pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements have been omitted pursuant to such rules and regulations. Gallagher believes the disclosures are adequate to make the information presented not misleading. The unaudited consolidated financial statements included herein are, in the opinion of management, prepared on a basis consistent with the audited consolidated financial statements for the year ended December 31, 2007 and include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information set forth. The quarterly results of operations are not necessarily indicative of results of operations for subsequent quarters or the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in Gallagher's Annual Report on Form 10-K for the year ended December 31, 2007.

2. Effect of New Accounting Pronouncements

Fair Value Measurements

In 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair Value Measurement, which provides enhanced guidance for using fair value to measure assets and liabilities. SFAS 157 also responds to investors' requests for expanded information about the extent to which entities measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require or permit assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances.

Under SFAS 157, fair value refers to the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts business. SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity's own data. Fair value measurements are required to be separately disclosed by level within the fair value hierarchy.

SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for all interim periods within those fiscal years. The adoption of SFAS 157 did not have any impact on the amounts reported in Gallagher's 2008 consolidated financial statements.

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Fair Value Option

In 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS 159 is to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently.

Different measurement attributes have been required under U.S. generally accepted accounting principles (GAAP) for different assets and liabilities that can create artificial volatility in earnings. SFAS 159 helps to mitigate this type of accounting-induced volatility by enabling companies to report related assets and liabilities at fair value. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities.

SFAS 159 requires a company to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. SFAS 159 also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. SFAS 159 does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in SFAS 157 and SFAS No. 107, Disclosures about Fair Value of Financial Instruments.

SFAS 159 is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007. Gallagher elected not to report any financial assets or liabilities at fair value under SFAS 159 in its 2008 consolidated financial statements.

Business Combinations

In December 2007, the FASB issued SFAS No. 141 (revised 2007) (SFAS 141(R)), Business Combinations, which is a revision of SFAS 141, Business Combinations. The primary requirements of SFAS 141(R) are as follows:

Upon initially obtaining control, the acquiring entity in a business combination must recognize 100% of the fair value of the acquired assets, including goodwill, and assumed liabilities, with only limited exceptions, even if the acquirer has not acquired 100% of the target entity. As a consequence, the current step acquisition model will be eliminated.

Contingent consideration arrangements (i.e., potential earnout obligations) will be measured at fair value at the acquisition date and included on that basis in the purchase price consideration. The concept of recognizing contingent consideration at a later date, when the amount of that consideration is determinable beyond a reasonable doubt, will no longer be applicable.

All transaction costs will be expensed as incurred.

SFAS 141(R) is effective as of the beginning of an entity's first fiscal year beginning after December 15, 2008. Adoption is prospective and early adoption is not permitted. Gallagher is currently evaluating the impact that the adoption of SFAS 141(R) will have on its consolidated financial statements and notes thereto.

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The following is a summary of Gallagher's investments and the related outstanding letters of credit (LOCs) and funding commitments (in millions):

	September 30, 2008			December 31, 2007	
	Current	Noncurrent	Funding Commitments	Current	Noncurrent
Investments:					
Investments in Asset Alliance Corporation (AAC):					
Common stock	\$	\$ 7.3	\$	\$	\$ 9.3
Preferred stock		0.2		5.3	0.3
Distribution receivable	3.1				
Total AAC investments	3.1	7.5		5.3	9.6
Alternative energy investments:					
IRC Section 29 Syn/Coal production net receivables	2.0			1.6	
Equity interest in biomass projects and pipeline		8.9		0.3	8.8
Clean energy related ventures			0.5	0.1	0.8
Total alternative energy investments	2.0	8.9	0.5	2.0	9.6
Real estate and venture capital investments		6.2	1.3	0.2	7.1
Total investments	\$ 5.1	\$ 22.6	\$ 1.8	\$ 7.5	\$ 26.3

Asset Alliance Corporation - Through common stock and preferred stock investments, Gallagher effectively owns 20% of AAC, an investment management company that owns up to a two-thirds interest in nine private investment management firms (the Firms). AAC and the Firms collectively manage domestic and international investment hedge fund portfolios for various institutions and individuals, which portfolios totaled approximately \$3.2 billion at September 30, 2008. AAC has a proportional interest in the Firms' revenues or net earnings that result principally from fees and participation in investment returns from the managed investment portfolios. Gallagher accounts for the common stock portion of its holdings in AAC's common stock using equity method accounting and accounts for the dividend income on its preferred stock investments as it is earned.

In 2002, Beacon Hill Asset Management LLC (Beacon Hill) withdrew from managing hedge fund portfolios for AAC due to various legal, contractual and business issues. In 2003, investors in a Beacon Hill investment partnership filed a lawsuit to recover investment losses, naming AAC as a co-defendant. In fourth quarter 2006, all parties to this lawsuit entered into a settlement agreement, which was approved by the court in second quarter 2008. There was no financial impact to AAC or Gallagher as a result of the settlement and approval.

On January 15, 2008, AAC redeemed \$2.3 million of Gallagher's AAC preferred stock investment. AAC was contractually obligated to repurchase substantially all of the remaining balance of Gallagher's preferred stock investment in AAC by January 25, 2009. In lieu thereof, effective June 30, 2008, Gallagher and AAC entered into an agreement whereby AAC assigned a portion of its rights to the remaining proceeds in the fund formerly managed by Beacon Hill that will be released as a result of the settlement discussed above. The assignment gives Gallagher first priority to 60% of the distributions from the fund until the balance due to Gallagher from the redemption of Gallagher's AAC preferred stock is collected in full. The distribution receivable, which is guaranteed by AAC, is expected to be paid to Gallagher by the end of 2008.

Alternative Energy Investments - Gallagher made investments in partnerships formed to develop energy that qualified for tax credits under Internal Revenue Code (IRC) Section 29. These consist of (i) waste-to-energy (Biomass) partnerships which own the rights to gas emissions (Biogas) from landfills and the wells and infrastructure necessary to capture the Biogas and (ii) synthetic coal (Syn/Coal) partnerships which owned and leased equipment that processed qualified fuel under IRC Section 29. Gallagher has an interest in five IRC Section 29-related Biomass limited partnerships and five IRC Section 29-related Syn/Coal limited partnerships or

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limited liability companies that generated tax benefits to Gallagher in the form of both tax deductions for operating losses and tax credits. At September 30, 2008, one of the IRC Section 29-related Syn/Coal limited partnerships was consolidated into Gallagher's financial statements due to Gallagher's percentage ownership in the partnership. The remainder of these investments were carried at amortized cost. Gallagher recognized the tax credits as a component of the provision for income taxes as they were allocated by the partnerships.

The law that provided for IRC Section 29-related tax credits expired on December 31, 2007. Effective December 31, 2007, all of the IRC Section 29-related Syn/Coal facilities were idled and the production of synthetic coal was stopped. Gallagher has been winding down its IRC Section 29 Syn/Coal partnerships since December 31, 2007 and management intends to liquidate these remaining investments by the end of 2008.

Four of the Biomass projects have been determined to be variable interest entities (VIEs), as defined by FASB Interpretation No. 46,

Consolidation of Variable Interest Entities, (FIN 46) but are not required to be consolidated. Gallagher is a limited partner in each investment. The investments were entered into by Gallagher between 1991 and 1998. At September 30, 2008, total assets and total debt of these investments were approximately \$5.0 million and \$3.0 million, respectively. Gallagher's maximum exposure to a potential loss from these VIEs was zero at September 30, 2008, which equaled the net aggregate carrying value of its investments.

IRC Section 29 Syn/Coal Production Net Receivables represent the net uncollected installment sale proceeds as of each balance sheet date related to Gallagher's sales of several IRC Section 29-related operations (Biomass and Syn/Coal) that have been either partially or completely sold to third parties.

In connection with the sales of certain interests in IRC Section 29-related Biomass and Syn/Coal partnerships, Gallagher provided indemnifications to the buyers for taxes that may arise as a result of incorrect representations. Gallagher obtained legal, tax, and other expert services and advice when making these representations, and for the Syn/Coal partnerships, also obtained private letter rulings (PLRs) from the Internal Revenue Service (IRS). At September 30, 2008, the maximum potential amount of future payments that Gallagher could be required to make under these indemnifications for the Biomass partnerships totaled approximately \$16.8 million, net of the applicable income tax benefit. Gallagher also has a maximum after-tax indemnification exposure of \$224.7 million at September 30, 2008 to the purchasers of certain Syn/Coal facilities, if it were to be found that Gallagher had misrepresented IRC Section 29 facts or had breached its representations or warranties provided in the respective sale agreements. At September 30, 2008, with respect to the Syn/Coal partnerships, Gallagher had exposure on \$179.9 million of tax credits earned through December 31, 2007, and has insurance policies in place, the scope of which would provide up to \$39.5 million of after-tax coverage in the event IRC Section 29-related Syn/Coal tax credits are disallowed. There can be no assurance that such coverage and/or the full amount of the policies would ultimately be available. These policies provide coverage on a claims-made basis through various dates up to December 31, 2009. Gallagher has not recorded any liability in its September 30, 2008 consolidated balance sheet for these potential indemnification obligations. See IRC Section 29-related Syn/Coal Matters below for a discussion of the potential exposures related to Syn/Coal at September 30, 2008.

IRC Section 29-related Syn/Coal Matters - Any future tax audits of the IRC Section 29-related Syn/Coal partnerships in which Gallagher has an ownership interest, or future administrative or judicial decisions, could adversely affect Gallagher's ability to claim IRC Section 29-related Syn/Coal tax credits on Gallagher's tax returns, or cause Gallagher to be subject to liability under indemnification obligations related to prior sales of interests in partnerships claiming IRC Section 29-related Syn/Coal tax credits.

Through December 31, 2007, IRC Section 29 had a phase-out provision that was triggered when the Market Wellhead Price of domestic crude oil reached certain Phase-out Prices, as determined by the IRS. The IRC Section 29 phase-out percentage for 2007 was 67% (33% for 2006).

During 2007, Gallagher had an arrangement with an unaffiliated third party which constituted call spreads on oil futures that created financial hedges designed to generate gains to Gallagher in the event of certain levels of increased oil prices. These hedges were not intended to be perfect hedges for accounting purposes, but were intended to mitigate a substantial portion of the negative impact to Gallagher of increased oil prices. Any hedging gains were designed to offset a portion of the expenses associated with operating Gallagher's IRC Section 29-Syn/Coal facilities in the event of a phase-out of IRC Section 29-related tax credits. In January 2007, Gallagher made an up-front payment of \$2.7 million to enter into these financial hedges, which were marked to market value each period throughout 2007 as part of the Financial Services and Corporate Segment operating

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results. In the nine-month period ended September 30, 2007, a \$4.6 million gain was recognized by Gallagher as a result of the market valuation of the financial hedges as of September 30, 2007. In November 2007, Gallagher sold this oil price derivative for \$17.2 million and realized a gain of \$14.5 million in fourth quarter 2007.

In connection with its Headwaters licensing agreement, Gallagher recorded a \$0.2 million credit and \$10.9 million of expense in the nine-month periods ended September 30, 2008 and 2007, respectively, which were included in investment expenses of the Financial Services and Corporate Segment. The 2008 credit was the result of adjusting royalty expense accrued in 2007 for the actual phase-out percentage published by the IRS in April 2008.

Equity Interest in Biomass Projects and Pipeline consists of a Biomass parent company and related partnerships which own the rights to Biogas from landfills and the wells, infrastructure and a pipeline to capture, distribute and sell Biogas.

Clean Energy Related Ventures represent Gallagher's ownership interests in two privately-owned entities:

Chem-Mod LLC (Chem-Mod), a multi-pollutant reduction venture, possesses rights, information and technology for the reduction of unwanted emissions created during the combustion of coal. Chem-Mod has developed and is the exclusive licensee of a new proprietary emissions technology it refers to as The Chem-Mod Solution, which uses a dual injection sorbent system to reduce mercury, sulfur dioxide and other toxic emissions at coal-fired power plants. Although Chem-Mod is in the early stages of commercializing the technology, the principal potential market for The Chem-Mod Solution is coal-fired power plants owned by utility companies. On October 17, 2007, Chem-Mod signed its first commercial license agreement with a utility company for use of The Chem-Mod Solution. Gallagher, through a wholly-owned subsidiary, initially owned a 10% direct equity interest in Chem-Mod and had an option to acquire an additional 32% indirect equity interest in Chem-Mod. On December 28, 2007, Gallagher exercised one-half of its option for \$5.5 million to acquire an additional indirect ownership of 16% from existing owners of Chem-Mod. On May 23, 2008, Gallagher exercised a portion of its option for \$250,000 to acquire an additional indirect ownership of 0.7% from existing owners of Chem-Mod. On August 18, 2008, Gallagher exercised the remaining portion of its option for \$5.3 million to acquire an additional indirect ownership of 15.3% from existing owners of Chem-Mod and now holds a 42% direct and indirect interest in Chem-Mod. Effective August 18, 2008, Gallagher's ownership interests in Chem-Mod are consolidated into Gallagher's consolidated financial statements (see Consolidated Investments below). Prior to August 18, 2008, these direct and indirect interests in Chem-Mod were accounted for using equity method accounting. In addition, Gallagher, through a wholly-owned subsidiary, owns a 20% direct equity interest in Chem-Mod International LLC, the exclusive licensee of The Chem-Mod Solution on a global basis, excluding the U.S. and Canada (Gallagher's interests in Chem-Mod and Chem-Mod International LLC are collectively referred to herein as Chem-Mod Interests). Gallagher first began providing funding to Chem-Mod in June 2004. Gallagher also has additional funding commitments of approximately \$0.5 million. Chem-Mod continues to test and market its technology in an effort to secure more commercial licenses. While Gallagher currently believes that its Chem-Mod Interests may prove to have substantial value, there can be no assurance given as to timing or amount, if any, with respect to any realization on this investment.

On April 19, 2006, Gallagher funded \$4.7 million related to another clean energy venture formed by the founders of Chem-Mod, C-Quest Technologies LLC (C-Quest). C-Quest possesses rights, information and technology for the reduction of carbon dioxide emissions created by burning fossil fuels. Gallagher, through a wholly-owned subsidiary, currently owns a 5% direct equity interest in C-Quest and has an option to acquire an additional 22% direct interest in C-Quest. In addition, Gallagher, through a wholly-owned subsidiary, currently owns a 5% direct equity interest in C-Quest Technologies International LLC (C-Quest International), and has an option to acquire an additional 22% direct interest in C-Quest International, which possesses rights to use information and technology of C-Quest on a global basis, excluding the U.S. and Canada (the equity interest and option rights in C-Quest and C-Quest International are collectively referred to herein as C-Quest Interests). Currently, Gallagher's carrying value with respect to its C-Quest Interests is \$0.1 million. Gallagher's options to acquire the additional 22% direct interest in C-Quest and C-Quest International are exercisable at any time on or prior to April 18, 2010 at an exercise price of \$5.5 million for each option (\$11.0 million total). While Gallagher currently believes that its C-Quest Interests may prove to have substantial value, there can be no assurance given as to timing or amount, if any, with respect to any realization on this investment.

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Real Estate and Venture Capital Investments - At September 30, 2008, Gallagher had ownership interests in twenty-one completed and certified low income housing developments with zero carrying value. Gallagher also had investments in three venture capital investment funds that invest in debt and equity of development-stage and turn-around companies, with an aggregate net carrying value of \$6.2 million, the largest of which was \$5.1 million. Eleven of the twenty-four investments discussed above have been determined to be VIEs, but are not required to be consolidated. These were originally invested in between 1997 and 2006. At September 30, 2008, total assets and total debt of these eleven investments were approximately \$64.0 million and \$66.0 million, respectively. Gallagher's maximum exposure to a potential loss related to these investments was zero at September 30, 2008, which equaled the net aggregate carrying value of these investments.

Consolidated Investments - Gallagher has an equity ownership interest of 99% in one IRC Section 29-related Syn/Coal facility, which is consolidated into Gallagher's consolidated financial statements. Following the expiration of IRC Section 29 on December 31, 2007, Gallagher intends to liquidate and dissolve its ownership interest in this operation by the end of 2008.

At September 30, 2008, Gallagher owned, directly and indirectly, 42% of Chem-Mod. This investment has been determined to be a variable interest entity. Gallagher is deemed to be the primary beneficiary, and therefore was required to consolidate this investment into its consolidated financial statements under FIN 46 rules during third quarter 2008. At September 30, 2008, total assets and total liabilities of this investment that were included in Gallagher's consolidated balance sheet were each less than \$0.3 million.

Impairment Reviews - Gallagher has a management investment committee that meets four to six times per year to review Gallagher's investments. For investments that do not have quoted market prices, Gallagher utilizes various valuation techniques to estimate fair value and proactively looks for indicators of impairment. Factors, among others, that may indicate that an impairment could exist include defaults on interest and/or principal payments, reductions or changes to dividend payments, sustained operating losses or a trend of poor operating performance, recent refinancings or recapitalizations, unfavorable press reports, untimely filing of financial information, significant customer or revenue loss, litigation, tax audits, losses by other companies in a similar industry, overall economic conditions, management and expert advisor changes and significant changes in strategy. In addition, in cases where the ultimate value of an investment is directly dependent on Gallagher for future financial support, Gallagher assesses its willingness and intent to provide future funding.

If an indicator of impairment exists, Gallagher compares the investment's carrying value to an estimate of its fair value. To estimate the fair value of its equity investments, Gallagher compares values established in recent recapitalizations or appraisals conducted by third parties. In some cases, no such recapitalizations or appraisals exist and Gallagher must perform its own valuations, which requires Gallagher to exercise significant judgment. Even if impairment indicators exist, no write-down may be required if the estimated fair value is not less than the current carrying value or if the decline in value is determined to be temporary and Gallagher has the ability and intent to hold the investment for a period of time sufficient for the value to recover. When Gallagher determines that the decline in fair value is other-than-temporary, and therefore that an impairment is required, the impairment is recorded as a realized loss against current period earnings.

Both the process to review for indicators of impairment and, if such indicators exist, the method to compute the amount of impairment, incorporate quantitative data and qualitative criteria, including the receipt of new information that can dramatically change the decision about the valuation of an investment in a short period of time. The determination of whether a decline in fair value is other-than-temporary is necessarily a matter of subjective judgment. The timing and amount of realized losses reported in earnings could vary if management's conclusions were different.

Due to the inherent risk of investments, Gallagher cannot give assurance that there will not be impairments in the future should economic and other conditions change.

Table of Contents**4. Business Combinations**

During the nine-month period ended September 30, 2008, Gallagher acquired substantially all of the net assets of the following brokerage firms in exchange for its common stock and/or cash. These acquisitions have been accounted for using the purchase accounting method for recording business combinations (in millions except share data):

Name and Effective Date of Acquisition	Common Shares Issued (000s)	Common Share Value	Cash Paid	Accrued Liability	Escrow Deposited	Recorded Purchase Price	Potential Earnout Payable
Crist Elliott Machette Insurance Services, Inc. January 1, 2008	82	\$ 1.1	\$ 7.4	\$	\$ 1.0	\$ 9.5	\$ 2.0
Petty Burton Associates, Inc. January 1, 2008			1.8		0.2	2.0	0.5
Yanni Partners, Inc. January 31, 2008			7.6		0.5	8.1	3.4
The Commonwealth Consulting Group, Inc. February 1, 2008	9	0.1	4.1		0.1	4.3	1.4
Doeren Mayhew Risk Management, LLC February 1, 2008			5.2			5.2	
Leicht General Agency (LGA) February 1, 2008	20		10.3		1.2	11.5	2.5
The Splinter Group, Inc. February 1, 2008	19		1.4		0.5	1.9	1.1
Taylor Benefits February 1, 2008	35	0.6	4.1		0.2	4.9	3.1
Bankers Financial Benefits March 1, 2008			2.4		0.1	2.5	1.1
Healthcare Risk Solutions, LLC March 1, 2008	115	2.0	7.3		0.7	10.0	3.5
Providium Consulting Group, LLC (PCG) March 1, 2008			13.5		0.5	14.0	8.0
Life Insurance Strategies April 1, 2008			5.1		0.1	5.2	5.5
Reimbursement Services, Inc. (RSI) May 1, 2008	204	4.0	31.2		1.0	36.2	17.6
Specialty Risk, Inc. May 1, 2008			2.2		0.2	2.4	2.0
The Lance Group Employee Benefits Specialist, LLC June 1, 2008			2.5		0.5	3.0	2.9
Voluntary Benefits Solutions, LLC June 1, 2008			7.1		0.5	7.6	11.4
Gale Smith & Company, Inc. July 1, 2008	262	5.9			0.7	6.6	3.5
WM. W. George & Associates Inc. (WGA) August 1, 2008	327	7.9	11.9		0.7	20.5	5.5

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Name and Effective Date of Acquisition	Common Shares Issued (000s)	Common Share Value	Cash Paid	Accrued Liability	Escrow Deposited	Recorded Purchase Price	Potential Earnout Payable
California Insurance Center, Inc. (CIC) September 1, 2008	360	\$ 7.6	\$ 29.3	\$	\$ 1.9	\$ 38.8	\$ 9.0
Summit Insurance Group, Inc. (SIG) September 1, 2008			11.5		0.4	11.9	19.0
Oxygen Insurance Managers, Ltd (OIM) September 15, 2008			11.4			11.4	13.5
Seven other acquisitions completed in 2008	94	2.2	9.1	0.9	0.5	12.7	3.0
	1,527	\$ 31.4	\$ 186.4	\$ 0.9	\$ 11.5	\$ 230.2	\$ 119.5

Common shares issued in connection with acquisitions are valued at closing market prices as of the effective date of the respective acquisition. Escrow deposits that are returned to Gallagher as a result of adjustments to net assets acquired are recorded as reductions of goodwill when the escrows are settled. The potential earnout payables disclosed in the foregoing table represent the maximum amount of additional consideration that could be paid pursuant to the terms of the respective purchase agreement related to each applicable acquisition. These potential earnout obligations are primarily based upon future earnings of the acquired entities and were not included in the purchase price that was recorded for each applicable acquisition at its acquisition date because such obligations are not fixed and determinable. Future payments made under these arrangements, if any, will generally be recorded as additional goodwill when the earnouts are settled. The aggregate amount of unrecorded earnout payables outstanding as of September 30, 2008 was \$242.9 million related to acquisitions made by Gallagher during the period from 2004 to 2008.

The following is a summary of the estimated fair values of the assets acquired at the date of each acquisition based on preliminary purchase price allocations (in millions):

	LGA	PCG	RSI	WGA	CIC	SIG	OIM	Twenty One Other Acquisitions	Total
Current assets	\$3.7	\$0.2	\$ 0.5	\$ 2.6	\$ 9.8	\$ 1.0	\$ 1.8	\$ 13.5	\$ 33.1
Fixed assets		0.2	0.4		0.3			0.5	1.4
Goodwill	5.8	3.4	10.2	9.3	18.0	3.2	1.8	30.0	81.7
Expiration lists	5.2	10.3	25.0	10.5	19.2	8.5	9.4	54.4	142.5
Non-compete agreements	0.2	0.2	0.4	0.2	0.3	0.1	0.7	0.9	3.0
Total assets acquired	14.9	14.3	36.5	22.6	47.6	12.8	13.7	99.3	261.7
Current liabilities	3.4		0.3	2.1	8.8	0.9	0.2	13.4	29.1
Noncurrent liabilities		0.3					2.1		2.4
Total liabilities assumed	3.4	0.3	0.3	2.1	8.8	0.9	2.3	13.4	31.5
Total net assets acquired	\$ 11.5	\$ 14.0	\$ 36.2	\$ 20.5	\$ 38.8	\$ 11.9	\$ 11.4	\$ 85.9	\$ 230.2

These acquisitions allow Gallagher to expand into desirable geographic locations, further extend its presence in the retail and wholesale insurance brokerage services industries and increase the volume of general services currently provided. The excess of the purchase price over the estimated fair value of the tangible net assets acquired at the acquisition date was allocated within the Brokerage Segment to goodwill, expiration lists and non-compete agreements in the amounts of \$81.7 million, \$142.5 million and \$3.0 million, respectively. Purchase price allocations are preliminarily established at the time of the acquisition and are subsequently reviewed within the first year of operations to determine the necessity for allocation adjustments.

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Expiration lists and non-compete agreements related to these acquisitions are currently being amortized on a straight-line basis over useful lives of five to fifteen years and five years, respectively. Goodwill is not amortized, but is subject to periodic reviews for impairment. Gallagher reviews its intangible assets for impairment periodically (at least annually) and whenever events or changes in business circumstances indicate that the carrying value of the assets may not be recoverable. In reviewing intangible assets, if the fair value is less than the carrying amount of the respective (or underlying) asset, an indicator of impairment would exist and further analysis would be required to determine whether or not a loss would need to be charged against current period earnings. No such indicators were noted in the nine-month periods ended September 30, 2008 and 2007 related to continuing operations. See Note 5 to the consolidated financial statements for a discussion on discontinued operations. Of the \$142.5 million of expiration lists and \$3.0 million of non-compete agreements related to the 2008 acquisitions, \$14.1 million and \$0.8 million are not expected to be deductible for income tax purposes. Accordingly, Gallagher recorded a deferred tax liability of \$4.8 million, and a corresponding amount of goodwill, in 2008 related to the nondeductible amortizable intangible assets. This amount has not been included in the above table.

During the nine-month period ended September 30, 2008, Gallagher issued 18,000 shares of its common stock, paid \$6.8 million in cash and accrued \$1.5 million in current liabilities related to earnout obligations for acquisitions made prior to 2008 and recorded additional goodwill of \$6.5 million. During the nine-month period ended September 30, 2007, Gallagher issued 322,000 shares of its common stock, paid \$12.8 million in cash and accrued \$9.3 million in current liabilities related to earnout obligations for acquisitions made prior to 2007 and recorded additional goodwill of \$25.0 million.

Gallagher's consolidated financial statements for the nine-month period ended September 30, 2008 include the operations of the entities acquired from the dates of their respective acquisitions. The following is a summary of the unaudited pro forma historical results, as if these purchased entities had been acquired at January 1, 2007 (in millions, except per share data):

	Three-month period ended		Nine-month period ended	
	September 30, 2008	September 30, 2007	September 30, 2008	September 30, 2007
Total revenues	\$ 433.2	\$ 434.5	\$ 1,273.3	\$ 1,291.8
Earnings from continuing operations	41.8	52.9	102.4	125.7
Basic earnings from continuing operations per share	0.44	0.56	1.09	1.28
Diluted earnings from continuing operations per share	0.44	0.54	1.08	1.26

The unaudited pro forma results above have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which actually would have resulted had these acquisitions occurred at January 1, 2007, nor are they necessarily indicative of future operating results. Annualized revenues of the entities acquired during the nine-month period ended September 30, 2008 totaled approximately \$99.0 million.

Table of Contents**5. Discontinued Operations**

In fourth quarter 2007, Gallagher made a determination to exit its global reinsurance operations and its Irish wholesale brokerage operation. In first quarter 2008, Gallagher signed definitive agreements to sell substantially all of its on-going reinsurance brokerage business. Under the agreements, Gallagher received initial proceeds of \$31.8 million in cash and a \$1.3 million note receivable to be paid by December 31, 2008 and potential additional contingent proceeds of up to \$14.6 million that are based on revenues generated in the twelve months subsequent to March 2008. In third quarter 2008, Gallagher abandoned its efforts to sell its small Irish wholesale brokerage operation and ceased those operations.

In the accompanying consolidated statement of earnings, the revenues and expenses of these operations have been reclassified from continuing operations to discontinued operations for all periods presented. In Gallagher's previously reported financial information, the operating results for these discontinued operations were included in the Brokerage Segment.

For the nine-month period ended September 30, 2008, Gallagher recorded the following related to its discontinued operations (in millions):

Gain on Disposal of Operations	
Cash proceeds from sale	\$ 31.8
Estimated additional sale proceeds to be received	6.3
Book value of net assets sold, principally goodwill and other intangible assets	(20.0)
Severance and other compensation costs	(5.9)
 Gain on disposal of operations	 12.2
Loss from Discontinued Operations Before Income Taxes	
Write-off of goodwill related to Irish wholesale brokerage operation	(13.0)
Severance and other compensation costs	(14.3)
Accrual of service obligations costs for accounts not sold	(4.9)
Write-off of fixed assets and lease costs	(4.5)
Other	0.4
 Loss from discontinued operations before income taxes	 (36.3)
Provision for income taxes	3.0
 Loss from discontinued operations	 \$ (27.1)

In third quarter 2008, Gallagher recorded \$1.0 million in lease termination and other real estate costs related to its reinsurance brokerage operations. Gallagher expects to record approximately \$8.0 million in additional lease termination costs in fourth quarter 2008 when it winds down the leased facilities of its reinsurance brokerage operations. In addition, at September 30, 2008, Gallagher had restricted cash, receivables and payables recorded in its consolidated balance sheet related to obligations to provide future claims handling and certain administrative services for client accounts not sold in these transactions and to other reinsurance clients. Gallagher also had a claims handling obligation liability accrued at September 30, 2008 in the accompanying consolidated balance sheet that is based on the estimated costs to provide future services to these former reinsurance clients. This liability is based on estimates and assumptions using historical data to project future experience. Gallagher is currently evaluating alternatives with respect to how these obligations will be handled in the future, which includes the potential sale of this run-off obligation to an independent party.

Total revenues reclassified to discontinued operations related to Gallagher's reinsurance brokerage and Irish wholesale brokerage businesses for the three-month periods ended September 30, 2008 and 2007 were \$0.3 million and \$13.4 million, respectively. Total revenues reclassified to discontinued operations related to Gallagher's reinsurance brokerage and Irish wholesale brokerage businesses for the nine-month periods ended September 30, 2008 and 2007 were \$9.7 million and \$39.8 million, respectively.

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The assets and liabilities included in the accompanying September 30, 2008 and December 31, 2007 consolidated balance sheets related to these discontinued operations were as follows (in millions):

	September 30, 2008	December 31, 2007
Restricted cash	\$ 20.9	\$ 39.5
Premiums and fees receivables	165.9	587.2
Other current assets		3.2
Fixed assets - net	1.3	2.8
Other noncurrent assets	5.2	5.8
Goodwill - net		25.8
Amortizable intangible assets - net		4.3
 Total assets	 \$ 193.3	 \$ 668.6
Premiums payable to insurance and reinsurance companies	\$ 180.6	\$ 622.2
Other current liabilities	1.5	2.5
Noncurrent liabilities	14.3	9.7
 Total liabilities	 \$ 196.4	 \$ 634.4

6. Credit and Other Debt Agreements

Note Purchase Agreement - On August 3, 2007, Gallagher entered into a Note Purchase Agreement, as amended and restated (Note Purchase Agreement), with certain accredited institutional investors (the Purchasers), pursuant to which Gallagher issued and sold to the Purchasers \$100.0 million in aggregate principal amount of Gallagher's 6.26% Senior Notes, Series A, due August 3, 2014 (the Series A Notes) and \$300.0 million in aggregate principal amount of Gallagher's 6.44% Senior Notes, Series B, due August 3, 2017 (the Series B Notes and, together with the Series A Notes, the Notes), in a private placement. In connection with entering into the Note Purchase Agreement, Gallagher incurred approximately \$1.3 million of debt acquisition costs that were capitalized and are being amortized on a pro rata basis over a seven-year period.

Under the terms of the Note Purchase Agreement, the Notes are redeemable by Gallagher at any time, in whole or in part, at 100% of the principal amount of such Notes being redeemed, together with accrued and unpaid interest and a make-whole amount. The make-whole amount is derived from a net present value computation of the remaining scheduled payments of principal and interest using a discount rate based on U.S. Treasury yields plus 0.5% and is designed to compensate the Purchasers for their investment risk in the event prevailing interest rates at the time of prepayment are less favorable than the interest rates under the Notes. Gallagher currently has no intention of prepaying the Notes.

The Note Purchase Agreement contains customary provisions for transactions of this type, including representations and warranties regarding Gallagher and its subsidiaries and various covenants, including covenants that require Gallagher to maintain specified financial ratios. Gallagher was in compliance with these covenants at September 30, 2008. The Note Purchase Agreement provides customary events of default, generally with corresponding grace periods, including, without limitation, payment defaults with respect to the Notes, covenant defaults, cross-defaults to other agreements evidencing indebtedness of Gallagher or its subsidiaries, certain judgments against Gallagher or its subsidiaries and events of bankruptcy involving Gallagher or its material subsidiaries.

The Notes are senior unsecured obligations of Gallagher and rank equal in right of payment with Gallagher's unsecured multicurrency credit agreement.

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Credit Agreement - On October 5, 2005, Gallagher entered into an unsecured multicurrency credit agreement, as amended and restated (Credit Agreement), which expires on October 4, 2010, with a group of ten financial institutions. The Credit Agreement provides for a revolving credit commitment of up to \$450.0 million, of which up to \$125.0 million may be used for issuances of standby or commercial LOCs and up to \$30.0 million may be used for the making of swing loans. Gallagher may from time-to-time request, subject to certain conditions, an increase in the revolving credit commitment up to a maximum aggregate revolving credit commitment of \$550.0 million.

The Credit Agreement provides that Gallagher may elect that each borrowing in U.S. dollars be either base rate loans or Eurocurrency loans, as defined in the Credit Agreement. All loans denominated in currencies other than U.S. dollars shall be Eurocurrency loans. Interest rates on base rate loans and outstanding drawings on LOCs in U.S. dollars under the Credit Agreement are based on the base rate, as defined in the Credit Agreement. Interest rates on Eurocurrency loans or outstanding drawings on LOCs in currencies other than U.S. dollars under the Credit Agreement are based on adjusted LIBOR, as defined in the Credit Agreement, plus a margin of .400%, .500%, .600% or .800%, depending on the financial leverage ratio maintained by Gallagher. Interest rates on swing loans are based, at the election of Gallagher, on either the base rate, as defined in the Credit Agreement, or such alternate rate as may be quoted by the lead lender. The annual facility fee related to the Credit Agreement is either .100%, .125%, .150% or .200% of the used and unused portions of the revolving credit commitment, depending on the financial leverage ratio maintained by Gallagher. In connection with entering into the Credit Agreement, Gallagher incurred approximately \$1.4 million of debt acquisition costs that were capitalized and are being amortized on a pro rata basis over the term of the Credit Agreement.

The terms of the Credit Agreement include various covenants, including covenants that require Gallagher to maintain specified levels of net worth and financial leverage ratios. Gallagher was in compliance with these covenants at September 30, 2008. The Credit Agreement also includes customary events of default, with corresponding grace periods, including, without limitation, payment defaults, cross-defaults to other agreements evidencing indebtedness and bankruptcy-related defaults.

At September 30, 2008, \$12.6 million of LOCs (for which Gallagher had \$5.6 million of liabilities recorded at September 30, 2008) were outstanding under the Credit Agreement. There were \$118.0 million of borrowings outstanding under the revolving credit commitment at September 30, 2008. Accordingly, as of September 30, 2008, \$319.4 million remained available for potential borrowings, of which \$112.4 million may be in the form of additional LOCs. The weighted average interest rate on \$118.0 million of outstanding borrowings, which is based on a spread over short-term LIBOR, was 3.54%. The interest rate at October 27, 2008 for a sixty day borrowing was 3.87%.

The following is a summary of Gallagher's corporate debt (in millions):

	September 30, 2008	December 31, 2007
Corporate related borrowings:		
Note Purchase Agreement:		
Semi-annual payments of interest, fixed rate of 6.26%, balloon due 2014	\$ 100.0	\$ 100.0
Semi-annual payments of interest, fixed rate of 6.44%, balloon due 2017	300.0	300.0
Total Note Purchase Agreement	400.0	400.0
Credit Agreement:		
Periodic payments of interest and principal, prime or LIBOR plus up to 0.80%, expires 2010	118.0	
	\$ 518.0	\$ 400.0

See Note 13 to the consolidated financial statements for additional discussion on commitments and contingencies.

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

	Three-month period ended September 30,		Nine-month period ended September 30,	
	2008	2007	2008	2007
Earnings from continuing operations	\$ 41.7	\$ 52.4	\$ 99.7	\$ 119.5
Loss from discontinued operations	(3.9)	(0.6)	(27.1)	(4.1)
Net earnings	\$ 37.8	\$ 51.8	\$ 72.6	\$ 115.4
Weighted average number of common shares outstanding	94.1	94.5	93.2	96.9
Dilutive effect of stock options using the treasury stock method	0.5	1.3	0.4	1.3
Weighted average number of common and common equivalent shares outstanding	94.6	95.8	93.6	98.2
Basic net earnings (loss) per share:				
Earnings from continuing operations	\$ 0.44	\$ 0.56	\$ 1.07	\$ 1.23
Loss from discontinued operations	(0.04)	(0.01)	(0.29)	(0.04)
Net earnings	\$ 0.40	\$ 0.55	\$ 0.78	\$ 1.19
Diluted net earnings (loss) per share:				
Earnings from continuing operations	\$ 0.44	\$ 0.54	\$ 1.07	\$ 1.22
Loss from discontinued operations	(0.04)		(0.29)	(0.04)
Net earnings	\$ 0.40	\$ 0.54	\$ 0.78	\$ 1.18

Options to purchase 10.7 million and 6.6 million shares of common stock were outstanding at September 30, 2008 and 2007, respectively, but were not included in the computation of the dilutive effect of stock options for the three-month periods then ended. Options to purchase 11.0 million and 6.7 million shares of common stock were outstanding at September 30, 2008 and 2007, respectively, but were not included in the computation of the dilutive effect of stock options for the nine-month periods then ended. In each case, these options were excluded from the computation because the options' exercise prices were greater than the average market price of Gallagher's common shares during the respective periods, and therefore would be antidilutive to earnings per share under the treasury stock method.

8. Stock Option Plans

Gallagher has four stock option-based employee compensation plans. In May 2008, all of these plans expired and thus Gallagher can no longer grant any new stock options under these plans. All remaining shares that were available for grant under these plans at the date of expiration (3.7 million shares) have expired.

Under the expired plans, Gallagher granted both incentive and nonqualified stock options to officers and key employees of Gallagher and its subsidiaries. Most options granted under the incentive plan prior to 2007 become exercisable at the rate of 10% per year beginning the calendar year after the date of grant. Most options granted under the nonqualified plan prior to 2007 become exercisable at the rate of 10% per year beginning the calendar year after the date of grant or earlier in the event of death, disability or retirement (if the retirement eligible age requirement is met). On March 5, 2008, the Compensation Committee granted 653,000 options to officers and key employees of Gallagher that become exercisable at the rate of 20% per year on the anniversary date of the grant. On May 13, 2008, the Compensation Committee granted 265,000 options to officers and key employees of Gallagher that become exercisable at the rate of 10% per year beginning the calendar year after the date of grant. Options expire ten years from the date of grant, or earlier in the event of termination of the employee (if the retirement eligible age requirement is not met). Stock options granted after May 15, 2007 do not provide for accelerated vesting upon retirement.

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In addition to the employee plans discussed above, Gallagher has a non-employee directors' stock option plan, under which, in 2007 and prior years, discretionary options were granted at the direction of the Compensation Committee and retainer options were granted in lieu of the directors' annual retainer. Discretionary options are exercisable at such rates as shall be determined by the Compensation Committee on the date of grant. Retainer options are cumulatively exercisable at the rate of 25% of the total retainer option at the end of each full fiscal quarter following the date of grant. Options granted under the non-employee directors' plan contain provisions where the vesting of the stock options accelerates to 100% on the termination of the director.

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

During the three-month periods ended September 30, 2008 and 2007, Gallagher recognized \$2.4 million and \$3.0 million, respectively, of compensation expense related to its stock option grants. During the nine-month periods ended September 30, 2008 and 2007, Gallagher recognized \$7.1 million and \$8.2 million, respectively of compensation expense related to its stock option grants.

For purposes of expense recognition in 2008 and 2007, the estimated fair values of the stock option grants are amortized to expense over the options' expected lives. The fair value of stock options at the date of grant was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

	2008	2007
Expected dividend yield	4.0%	4.0%
Expected risk-free interest rate	3.0%	4.4%
Volatility	25.7%	25.7%
Expected life (in years)	5.6	5.1

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because Gallagher's employee and director stock options have characteristics significantly different from those of traded options, and because changes in the selective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee and director stock options. The weighted average fair value per option for all options granted during the nine-month periods ended September 30, 2008 and 2007, as determined on the grant date using the Black-Scholes option valuation model, was \$4.24 and \$5.47, respectively.

The following is a summary of Gallagher's stock option activity and related information for 2008 (in millions, except exercise price and years data):

	Nine-month period ended September 30, 2008			
	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Beginning balance	14.7	\$ 25.36		
Granted	0.9	24.43		
Exercised	(1.1)	12.88		
Forfeited or canceled	(0.7)	26.92		
Ending balance	13.8	\$ 26.18	5.27	\$ 15.5
Exercisable at end of period	7.4	\$ 25.87	4.37	\$ 10.8
Ending vested and expected to vest	13.7	\$ 26.17	5.25	\$ 15.5

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Options with respect to 0.3 million shares were available for grant under the non-employee directors' stock option plan at September 30, 2008.

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The total intrinsic value of options exercised during the nine-month periods ended September 30, 2008 and 2007 amounted to \$13.5 million and \$8.9 million, respectively. As of September 30, 2008, there was approximately \$40.2 million of total unrecognized compensation cost related to nonvested options. That cost is expected to be recognized over a weighted average period of approximately five years.

Other information regarding stock options outstanding and exercisable at September 30, 2008 is summarized as follows (in millions, except exercise price and years data):

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 1.11 - \$ 22.70	2.4	2.84	\$ 20.46	1.8	\$ 20.09
23.72 - 24.90	2.6	5.78	24.55	1.1	24.77
24.99 - 27.03	2.3	4.34	26.32	1.5	26.31
27.06 - 27.25	2.4	6.72	27.23	1.0	27.21
27.35 - 29.42	3.0	6.51	29.08	1.2	29.16
29.45 - 36.94	1.1	4.79	32.16	0.8	32.26
\$ 1.11 - \$ 36.94	13.8	5.27	\$ 26.18	7.4	\$ 25.87

9. Deferred Compensation

Gallagher has a Deferred Equity Participation Plan, which is a non-qualified plan that provides for distributions to certain key executives of Gallagher when they attain age 62 or upon or after their actual retirement. Under the provisions of the plan, Gallagher contributes shares of its common stock or cash, in an am