

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

November 08, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington D.C. 20549**

**FORM 10-Q**

- þ** **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarter ended September 30, 2006**
- or**
- o** **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission File Number 1-14094**

**Meadowbrook Insurance Group, Inc.**  
*(Exact name of Registrant as specified in its charter)*

**Michigan**  
*(State of Incorporation)*

**38-2626206**  
*(IRS Employer Identification No.)*

**26255 American Drive, Southfield, Michigan 48034**  
*(Address, zip code of principal executive offices)*

**(248) 358-1100**  
*(Registrant's telephone number, including area code)*

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):  
Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate number of shares of the Registrant's Common Stock, \$.01 par value, outstanding on November 1, 2006 was 29,053,646.

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Table of Contents**PART 1 FINANCIAL INFORMATION****ITEM 1 Financial Statements****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF INCOME**

	<b>For the Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Unaudited)</b>	
	<b>(In thousands, except share data)</b>	
<b>Revenues</b>		
Premiums earned		
Gross	\$ 244,557	\$ 244,016
Ceded	(53,231)	(56,660)
Net earned premiums	191,326	187,356
Net commissions and fees	31,599	27,333
Net investment income	16,203	13,159
Net realized gains	46	31
Total revenues	239,174	227,879
<b>Expenses</b>		
Losses and loss adjustment expenses	160,066	179,669
Reinsurance recoveries	(49,748)	(66,338)
Net losses and loss adjustment expenses	110,318	113,331
Salaries and employee benefits	41,397	39,166
Policy acquisition and other underwriting expenses	37,663	33,740
Other administrative expenses	22,142	19,868
Interest expense	4,445	2,527
Total expenses	215,965	208,632
Income before taxes and equity earnings	23,209	19,247
Federal and state income tax expense	7,215	6,250
Equity earnings (loss) of affiliates	99	(12)
Net income	\$ 16,093	\$ 12,985

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Earnings Per Share			
Basic	\$	0.56	\$ 0.45
Diluted	\$	0.55	\$ 0.44
Weighted average number of common shares			
Basic		28,894,053	29,052,785
Diluted		29,509,892	29,363,045

The accompanying notes are an integral part of the Consolidated Financial Statements.

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF INCOME**

	<b>For the Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Unaudited)</b>	
	<b>(In thousands, except share data)</b>	
<b>Revenues</b>		
Premiums earned		
Gross	\$ 81,164	\$ 82,466
Ceded	(17,476)	(19,261)
Net earned premiums	63,688	63,205
Net commissions and fees	9,612	9,200
Net investment income	5,584	4,591
Net realized gains	28	41
Total revenues	78,912	77,037
<b>Expenses</b>		
Losses and loss adjustment expenses	52,247	61,805
Reinsurance recoveries	(16,118)	(23,336)
Net losses and loss adjustment expenses	36,129	38,469
Salaries and employee benefits	14,183	12,913
Policy acquisition and other underwriting expenses	13,059	11,947
Other administrative expenses	6,908	6,037
Interest expense	1,558	948
Total expenses	71,837	70,314
Income before taxes and equity earnings	7,075	6,723
Federal and state income tax expense	2,056	2,048
Equity earnings (loss) of affiliates	74	(13)
Net income	\$ 5,093	\$ 4,662
<b>Earnings Per Share</b>		
Basic	\$ 0.18	\$ 0.16
Diluted	\$ 0.17	\$ 0.16
Weighted average number of common shares		
Basic	28,884,578	28,957,369
Diluted	29,498,596	29,269,638

The accompanying notes are an integral part of the Consolidated Financial Statements.



Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

	<b>For the Nine Months Ended September 30, 2006                  2005 (Unaudited) (In thousands)</b>	
Net income	\$ 16,093	\$ 12,985
Other comprehensive income, net of tax:		
Unrealized gains (losses) on securities	488	(4,844)
Net deferred derivative gain    hedging activity	118	
Less: reclassification adjustment for losses included in net income	19	61
Other comprehensive income (loss), net of tax	625	(4,783)
Comprehensive income	\$ 16,718	\$ 8,202

The accompanying notes are an integral part of the Consolidated Financial Statements.

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

	<b>For the Three Months Ended September 30, 2006                  2005 (Unaudited) (In thousands)</b>	
Net income	\$ 5,093	\$ 4,662
Other comprehensive income, net of tax:		
Unrealized gains (losses) on securities	5,302	(3,633)
Net deferred derivative loss    hedging activity	(322)	
Less: reclassification adjustment for gains included in net income		(18)
Other comprehensive income (loss), net of tax	4,980	(3,651)
Comprehensive income	\$ 10,073	\$ 1,011

The accompanying notes are an integral part of the Consolidated Financial Statements.

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2006 (Unaudited)</b>	<b>December 31, 2005</b>
	<b>(In thousands, except share data)</b>	
<b>ASSETS</b>		
Investments		
Debt securities available for sale, at fair value (amortized cost of \$477,804 and \$403,947)	\$ 476,665	\$ 402,195
Cash and cash equivalents	24,745	58,038
Accrued investment income	5,691	4,953
Premiums and agent balances receivable, net	106,560	84,807
Reinsurance recoverable on:		
Paid losses	4,229	15,327
Unpaid losses	197,192	187,254
Prepaid reinsurance premiums	22,964	24,588
Deferred policy acquisition costs	27,118	26,371
Deferred federal income taxes	15,816	16,630
Goodwill	30,802	30,802
Other assets	52,323	50,379
<b>Total assets</b>	<b>\$ 964,105</b>	<b>\$ 901,344</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities		
Losses and loss adjustment expenses	\$ 493,641	\$ 458,677
Unearned premiums	145,531	140,990
Debt	9,700	7,000
Debtures	55,930	55,930
Accounts payable and accrued expenses	29,531	26,667
Reinsurance funds held and balances payable	20,426	15,240
Payable to insurance companies	3,846	6,684
Other liabilities	10,043	12,791
<b>Total liabilities</b>	<b>768,648</b>	<b>723,979</b>
Shareholders Equity		
Common stock, \$0.01 stated value; authorized 50,000,000 shares; 29,048,146 and 28,672,009 shares issued and outstanding	290	287
Additional paid-in capital	126,308	124,819

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Retained earnings	70,341	54,248
Note receivable from officer	(859)	(859)
Accumulated other comprehensive loss	(623)	(1,130)
Total shareholders' equity	195,457	177,365
Total liabilities and shareholders' equity	\$ 964,105	\$ 901,344

The accompanying notes are an integral part of the Consolidated Financial Statements.

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>For the Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(Unaudited)</b>	
	<b>(In thousands)</b>	
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 16,093	\$ 12,985
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of other intangible assets	448	277
Amortization of deferred debenture issuance costs	177	116
Depreciation of furniture, equipment, and building	1,761	1,853
Net accretion of discount and premiums on bonds	1,947	1,786
Loss on sale of investments, net	30	94
Gain on sale of fixed assets	(66)	(148)
Stock-based employee compensation	118	32
Incremental tax benefits from stock options exercised	(1,386)	
Long-term incentive plan expense	704	585
Deferred income tax expense	540	1,067
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Premiums and agent balances receivable	(21,753)	(21,721)
Reinsurance recoverable on paid and unpaid losses	1,160	(27,289)
Prepaid reinsurance premiums	1,623	1,332
Deferred policy acquisition costs	(747)	(1,427)
Other assets	(1,532)	6,172
Increase (decrease) in:		
Losses and loss adjustment expenses	34,963	65,137
Unearned premiums	4,541	9,010
Payable to insurance companies	(2,838)	(1,464)
Reinsurance funds held and balances payable	5,186	(2,444)
Other liabilities	2,008	2,746
Total adjustments	26,884	35,714
Net cash provided by operating activities	42,977	48,699
<b>Cash Flows From Investing Activities</b>		
Purchase of debt securities available for sale	(156,015)	(174,301)
Proceeds from sales and maturities of debt securities available for sale	80,182	115,196
Proceeds from sales of equity securities available for sale		8
Capital expenditures	(3,790)	(14,050)
Proceeds from sale of assets		633
Other investing activities	167	(2,284)

Net cash used in investing activities	(79,456)	(74,798)
<b>Cash Flows From Financing Activities</b>		
Proceeds from lines of credit	12,578	6,388
Payment of lines of credit	(9,878)	(16,234)
Net proceeds from debentures		19,400
Book overdraft	23	1,172
Issuance of common stock	(716)	995
Share repurchases of common stock		(3,404)
Incremental tax benefits from stock options exercised	1,386	
Other financing activities	(207)	(196)
Net cash provided by financing activities	3,186	8,121
Net decrease in cash and cash equivalents	(33,293)	(17,978)
Cash and cash equivalents, beginning of period	58,038	69,875
Cash and cash equivalents, end of period	\$ 24,745	\$ 51,897

The accompanying notes are an integral part of the Consolidated Financial Statements.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**Note 1 Summary of Significant Accounting Policies**

***Basis of Presentation and Management Representation***

The consolidated financial statements include accounts, after elimination of intercompany accounts and transactions, of Meadowbrook Insurance Group, Inc. (the Company), its wholly owned subsidiary Star Insurance Company (Star), and Star's wholly owned subsidiaries, Savers Property and Casualty Insurance Company, Williamsburg National Insurance Company, and Ameritrust Insurance Corporation (which are collectively referred to as the Insurance Company Subsidiaries), and Preferred Insurance Company, Ltd. The consolidated financial statements also include Meadowbrook, Inc., Crest Financial Corporation, and their subsidiaries.

Pursuant to Financial Accounting Standards Board Interpretation Number (FIN) 46(R), the Company does not consolidate its subsidiaries, Meadowbrook Capital Trust I and II (the Trusts), as they are not variable interest entities and the Company is not the primary beneficiary of the Trusts. The consolidated financial statements, however, include the equity earnings of the Trusts. In addition and in accordance with FIN 46(R), the Company does not consolidate its subsidiary American Indemnity Insurance Company, Ltd. (American Indemnity). While the Company and its subsidiary Star are the common shareholders, they are not the primary beneficiaries of American Indemnity. The consolidated financial statements, however, include the equity earnings of American Indemnity.

In the opinion of management, the consolidated financial statements reflect all normal recurring adjustments necessary to present a fair statement of the results for the interim period. Preparation of financial statements under generally accepted accounting principles requires management to make estimates. Actual results could differ from those estimates. The results of operations for the three months and nine months ended September 30, 2006, are not necessarily indicative of the results expected for the full year.

These financial statements and the notes thereto should be read in conjunction with the Company's audited financial statements and accompanying notes included in its annual report on Form 10-K, as filed with the United States Securities and Exchange Commission, for the year ended December 31, 2005.

Certain amounts in the 2005 financial statements and notes to the consolidated financial statements have been reclassified to conform to the 2006 presentation.

***Revenue Recognition***

Premiums written, which include direct, assumed, and ceded are recognized as earned on a pro rata basis over the life of the policy term. Unearned premiums represent the portion of premiums written that are applicable to the unexpired terms of policies in force. Provisions for unearned premiums on reinsurance assumed from others are made on the basis of ceding reports when received and actuarial estimates.

For the nine months ending September 30, 2006, total assumed written premiums were \$53.8 million, of which \$45.1 million, relates to assumed business the Company manages directly, and therefore, no estimation is involved. The remaining \$8.7 million of assumed written premiums includes \$7.7 million related to residual markets.

For the three months ending September 30, 2006, total assumed written premiums were \$19.1 million, of which \$17.6 million, relates to assumed business the Company manages directly. The remaining \$1.5 million of assumed written premiums includes \$1.1 million related to residual markets.

Assumed premium estimates are specifically related to the mandatory assumed pool business from the National Council on Compensation Insurance ( NCCI ), or residual market business. The pool cedes workers' compensation business to participating companies based upon the individual company's market share by state. The activity is reported from the NCCI to participating companies on a two quarter lag. To account for this lag, the Company estimates premium and loss activity based on historical and market based results. Historically, the Company has not experienced any material difficulties or disputes in collecting balances from NCCI; and therefore, no provision for doubtful accounts is recorded related to the assumed premium estimate.



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)**

In addition, certain premiums are subject to retrospective premium adjustments. Premium is recognized over the term of the insurance contract.

Fee income, which includes risk management consulting, loss control, and claims services, is recognized during the period the services are provided. Depending on the terms of the contract, claims processing fees are recognized as revenue over the estimated life of the claims, or the estimated life of the contract. For those contracts that provide services beyond the expiration or termination of the contract, fees are deferred in an amount equal to management's estimate of the Company's obligation to continue to provide services.

Commission income, which includes reinsurance placement, is recorded on the later of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of any sub-producer commission expense. Any commission adjustments that occur subsequent to the earnings process, are recognized upon notification from the insurance companies. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

The Company reviews, on an ongoing basis, the collectibility of its receivables and establishes an allowance for estimated uncollectible accounts.

Realized gains or losses on sale of investments are determined on the basis of specific costs of the investments. Dividend income is recognized when declared and interest income is recognized when earned. Discount or premium on debt securities purchased at other than par value is amortized using the effective yield method. Investments with other than temporary declines in fair value are written down to their estimated net fair value and the related realized losses are recognized in income.

***Earnings Per Share***

Basic earnings per share are based on the weighted average number of common shares outstanding during the period, while diluted earnings per share includes the weighted average number of common shares and potential dilution from shares issuable pursuant to stock options using the treasury stock method.

Outstanding options of 125,221 and 619,092 for the nine months ended September 30, 2006 and 2005, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive. Shares available for issuance pursuant to stock options included in diluted earnings per share were 147,201 and 310,260 for the nine months ended September 30, 2006 and 2005, respectively. Restricted shares related to the Company's Long Term Incentive Plan (LTIP) included in diluted earnings per share were 468,636 for the nine months ended September 30, 2006. There were no shares related to the LTIP included in diluted earnings per share for the nine months ended September 30, 2005.

Outstanding options of 125,221 and 619,092 for the three months ended September 30, 2006 and 2005, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive. Shares available for issuance pursuant to stock options included in diluted earnings per share were 162,460 and 312,269 for the three months ended September 30, 2006 and 2005, respectively. Restricted shares related to the Company's LTIP included in diluted earnings per share were 451,559 for the three months ended September 30, 2006. There were no shares related to the LTIP included in diluted earnings per share for the three months ended September 30, 2005.

***Recent Accounting Pronouncements***

In February 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 155, *Accounting for Certain Hybrid Financial Instruments*. Under current generally accepted accounting principles, an entity that holds a financial instrument with an embedded derivative must bifurcate the financial instrument, resulting in the host and the embedded derivative being accounted for separately. SFAS No. 155 permits, but does not require, entities to account for financial instruments with an embedded derivative at fair value thus negating the need to bifurcate the instrument between its host and the

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)**

embedded derivative. SFAS No. 155 is effective for fiscal periods beginning after September 15, 2006. The adoption of SFAS No. 155 will not impact the Company's consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*. SFAS No. 156 amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to require that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. SFAS No. 156 permits, but does not require, the subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value. An entity that uses derivative instruments to mitigate the risks inherent in servicing assets and servicing liabilities is required to account for those derivative instruments at fair value. SFAS No. 156 is effective for fiscal periods beginning after September 15, 2006. The adoption of SFAS No. 156 will not impact the Company's consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* (FIN 48), which becomes effective for fiscal years beginning after December 15, 2006. FIN 48 clarifies the accounting and reporting for uncertainties in the income tax law. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition, measurement, and presentation of uncertain tax positions taken or expected to be taken in an income tax return. The Company will commence evaluation of the impact of FIN 48, but currently believes the adoption of FIN 48 will not have a material impact on its consolidated financial statements or disclosure requirements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which becomes effective for fiscal years beginning after November 15, 2007. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The Company will evaluate the impact of SFAS No. 157, but believes the adoption of SFAS No. 157 will not have a material impact on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. SFAS No. 158 requires the recognition, on a prospective basis, of the funded status of a company's defined benefit plan as an asset or liability. In addition, any unrecognized gains and losses or prior service costs shall be recognized as a component of accumulated other comprehensive income. SFAS No. 158 will also require additional disclosures in the notes to financial statements. SFAS No. 158 is effective for fiscal years ending after December 15, 2006, with early application encouraged. The Company will evaluate the impact of SFAS No. 158, but believes the adoption of SFAS No. 158 will not impact its consolidated financial statements.

**Note 2 Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan**

Effective January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment*, using the modified prospective application transition method. The Company previously adopted the requirements of recording stock options consistent with SFAS 123 and accounting for the change in accounting principle using the prospective method in accordance with SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123*. Under the prospective method, stock-based compensation expense was recognized for awards granted after the beginning of the fiscal year in which the change is made, or January 1, 2003. Upon implementation of SFAS No. 148 in 2003, the Company recognized stock-based compensation expense for awards granted after January 1, 2003.

Prior to the adoption of SFAS No. 148, the Company applied the intrinsic value-based provisions set forth in APB Opinion No. 25. Under the intrinsic value method, compensation expense is determined on the measurement date, which is the first date when both the number of shares the employee is entitled to receive, and the exercise price are known. Compensation expense for each quarter resulting from stock options granted by the Company was determined based upon the difference between the exercise price and the fair market value of the underlying common stock at the date of grant. The Company's Stock Option Plan requires the exercise price of the grants to be at the current fair market value of the underlying common stock.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)**

Upon adoption of SFAS No. 123(R) on January 1, 2006, the Company was required to recognize as an expense in the financial statements all share-based payments to employees based on their fair values. SFAS No. 123(R) requires forfeitures to be estimated in calculating the expense relating to the share-based payments, as opposed to recognizing any forfeitures and the corresponding reduction in expense as they occur. In addition, SFAS No. 123(R) requires any tax savings resulting from tax deductions in excess of compensation expense be reflected in the financial statements as a cash inflow from financing activities, rather than as an operating cash flow as in prior periods. The pro forma disclosures previously permitted under SFAS 123, are no longer an alternative to financial statement recognition. As indicated, the Company adopted the requirements of SFAS 123(R) using the modified prospective application transition method. The prospective method requires compensation expense to be recorded for all unvested stock options and restricted stock, based upon the previously disclosed SFAS 123 methodology and amounts.

The Company, through its 1995 and 2002 Amended and Restated Stock Option Plans (the Plans), may grant options to key executives and other members of management of the Company and its subsidiaries in amounts not to exceed 2,000,000 shares of the Company's common stock allocated for each plan. The Plans are administered by the Compensation Committee (the Committee) of the Board of Directors. Option shares may be exercised subject to the terms of the Plans and the terms prescribed by the Committee at the time of grant. Currently, the Plans' options have either five or ten-year terms and are exercisable and vest in equal increments over the option term.

The Company has not issued any new stock options to employees since 2003.

The following is a summary of the Company's stock option activity and related information for the nine months ended September 30, 2006:

	<b>Options</b>	<b>Weighted-Average Exercise Price</b>
Outstanding as of December 31, 2005	1,605,901	\$ 5.42
Granted		
Exercised	(731,366)	\$ 3.35
Forfeited	(408,955)	\$ 7.16
Outstanding as of September 30, 2006	465,580	\$ 7.15
Exercisable as of September 30, 2006	396,343	\$ 7.27

The following table summarizes information about stock options outstanding at September 30, 2006:

<b>Range of</b>	<b>Options Outstanding</b>		<b>Options Exercisable</b>
	<b>Weighted-Average Remaining</b>	<b>Weighted-Average Exercise</b>	<b>Weighted-Average Exercise</b>

<b>Exercise Prices</b>	<b>Options</b>	<b>Life (Years)</b>	<b>Price</b>	<b>Options</b>	<b>Price</b>
\$2.173 to \$3.066	321,859	1.6	\$ 2.69	272,979	\$ 2.61
\$3.507	17,000	1.2	\$ 3.51	17,000	\$ 3.51
\$6.48	1,500	3.7	\$ 6.48		\$ 6.48
\$10.91 to \$30.45	125,221	2.0	\$ 19.63	106,364	\$ 19.31
	465,580	1.7	\$ 7.15	396,343	\$ 7.27

Compensation expense of \$3,400 and \$118,000 has been recorded in the three months and nine months ended September 30, 2006 under SFAS 123(R), respectively. Compensation expense of \$32,000 and \$61,000 was recorded in the three months and nine months ended September 30, 2005 under SFAS 148, respectively.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)**

Results for the three months and nine months ended September 30, 2005 have not been restated. If compensation cost for stock option grants had been determined based on a fair value method, net income and earnings per share on a pro forma basis for the three months and nine months ending September 30, 2005 would be as follows (in thousands):

	<b>For the Nine Months Ended September 30, 2005</b>
Net income, as reported	\$ 12,985
Add: Stock-based employee compensation expense included in reported income, net of related tax effects	21
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(161)
Pro forma net income	\$ 12,845
Earnings per share:	
Basic as reported	\$ 0.45
Basic pro forma	\$ 0.44
Diluted as reported	\$ 0.44
Diluted pro forma	\$ 0.44
	<b>For the Three Months Ended September 30, 2005</b>
Net income, as reported	\$ 4,662
Add: Stock-based employee compensation expense included in reported income, net of related tax effects	6
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(40)
Pro forma net income	\$ 4,628
Earnings per share:	
Basic as reported	\$ 0.16
Basic pro forma	\$ 0.16
Diluted as reported	\$ 0.16
Diluted pro forma	\$ 0.16

In 2004, the Company approved the adoption of a Long Term Incentive Plan (the "LTIP"). The LTIP provides participants with the opportunity to earn cash and stock awards based upon the achievement of specified financial goals over a three-year performance period with the first performance period commencing January 1, 2004. At the end

of the three-year performance period, and if the performance target is achieved, the Compensation Committee of the Board of Directors shall determine the amount of LTIP awards that are payable to participants in the LTIP. One-half of any LTIP award will be payable in cash and one-half of the award will be payable in the form of a restricted stock award. If the Company achieves the three-year performance target, payment of the cash portion of the award would be made in three annual installments, with the first payment being paid as of the end of the performance period and the remaining two payments to be paid in the fourth and fifth year. Any unpaid portion of a cash award is subject to forfeiture if the participant voluntarily leaves the Company or is discharged for cause. The portion of the award to be paid in the form of stock will be issued as of the end of the performance period. The number of shares of Company's common stock subject to the restricted stock award shall equal the dollar amount of one-half of the LTIP award divided by the fair market value of Company's common stock on the first date of the



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performance period. The restricted stock awards shall be made subject to the terms and conditions of the LTIP and Plans. The Company accrues awards based upon the criteria set-forth and approved by the Compensation Committee of the Board of Directors, as included in the LTIP. At September 30, 2006, the Company had \$1.3 million and \$2.3 million accrued for the cash and restricted stock award, respectively, for a total accrual of \$3.6 million under the LTIP. At December 31, 2005, the Company had \$894,000 and \$1.6 million accrued for the cash and restricted stock award, respectively, for a total accrual of \$2.5 million under the LTIP. Accordingly, the Company included 451,559 and 468,636 shares in diluted earnings per share for the three months and nine months ended September 30, 2006, respectively. There were no shares included in diluted earnings per share for the three months and nine months ended September 30, 2005.

In May 2006, the Company adopted an Executive Nonqualified Excess Plan (the Excess Plan). The Excess Plan is intended to be a nonqualified deferred compensation plan that will comply with the provisions of Section 409A of the Internal Revenue Code. The Company adopted the Excess Plan to provide a means by which certain key management employees may elect to defer receipt of current compensation from the Company in order to provide retirement and other benefits, as provided for in the Excess Plan. The Excess Plan is intended to be an unfunded plan maintained primarily for the purpose of providing deferred compensation benefits for eligible employees. At September 30, 2006, the Company had \$130,000 accrued for deferred compensation.

**Note 3 Reinsurance**

The Insurance Company Subsidiaries cede insurance to reinsurers under pro-rata and excess-of-loss contracts. These reinsurance arrangements diversify the Company's business and minimize its exposure to large losses or from hazards of an unusual nature. The ceding of insurance does not discharge the original insurer from its primary liability to its policyholder. In the event that all or any of the reinsuring companies are unable to meet their obligations, the Insurance Company Subsidiaries would be liable for such defaulted amounts. Therefore, the Company is subject to credit risk with respect to the obligations of its reinsurers. In order to minimize its exposure to significant losses from reinsurer insolvencies, the Company evaluates the financial condition of its reinsurers and monitors the economic characteristics of the reinsurers on an ongoing basis. The Company also assumes insurance from other domestic insurers and reinsurers. Based upon management's evaluation, they have concluded the reinsurance agreements entered into by the Company transfer both significant timing and underwriting risk to the reinsurer and, accordingly, are accounted for as reinsurance under the provisions of SFAS No. 113 *Accounting and Reporting for Reinsurance for Short-Duration and Long-Duration Contracts*.

Intercompany pooling agreements are commonly entered into between affiliated insurance companies, so as to allow the companies to utilize the capital and surplus of all of the companies, rather than each individual company. Under pooling arrangements, companies share in the insurance business that is underwritten and allocate the combined premium, losses and related expenses between the companies within the pooling arrangement. The Insurance Company Subsidiaries entered into an Inter-Company Reinsurance Agreement (the Pooling Agreement). This Pooling Agreement includes Star, Ameritrust Insurance Corporation (Ameritrust), Savers Property and Casualty Insurance Company (Savers) and Williamsburg National Insurance Company (Williamsburg). Pursuant to the Pooling Agreement, Savers, Ameritrust and Williamsburg have agreed to cede to Star and Star has agreed to reinsure 100% of the liabilities and expenses of Savers, Ameritrust and Williamsburg, relating to all insurance and reinsurance policies issued by them. In return, Star agrees to cede and Savers, Ameritrust and Williamsburg have agreed to reinsure Star for their respective percentages of the liabilities and expenses of Star. Annually, the Company examines the Pooling Agreement for any changes to the ceded percentage for the liabilities and expenses. Any changes to the Pooling Agreement must be submitted to the applicable regulatory authorities for approval.

At September 30, 2006 and December 31, 2005, the Company had reinsurance recoverables for paid and unpaid losses of \$201.4 million and \$202.6 million, respectively. The Company manages its credit risk on reinsurance recoverables by reviewing the financial stability, A.M. Best rating, capitalization, and credit worthiness of prospective and existing risk-sharing partners. The Company customarily collateralizes reinsurance balances due

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from non-admitted reinsurers through funds withheld trusts or stand-by letters of credit issued by highly rated banks. The largest unsecured reinsurance recoverable is due from an admitted reinsurer with an A A.M. Best rating and accounts for 43.9% of the total recoverable for paid and unpaid losses.

The Company has historically maintained an allowance for the potential exposure to uncollectibility of certain reinsurance balances. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. The following table sets forth the Company's exposure to uncollectible reinsurance on paid and unpaid balances or losses and related allowances for the nine months ending September 30, 2006 and the year ended December 31, 2005 (in thousands):

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
Gross exposure	\$ 14,711	\$ 14,046
Collateral or other security	(3,477)	(2,749)
Allowance	(9,391)	(9,662)
Net exposure	\$ 1,843	\$ 1,635

While management believes the above allowances to be adequate, no assurance can be given, however, regarding the future ability of any of the Company's risk-sharing partners to meet their obligations.

The Company maintains an excess-of-loss reinsurance treaty designed to protect against large or unusual loss and loss adjustment expense activity. The Company determines the appropriate amount of reinsurance primarily based on the Company's evaluation of the risks accepted, but also considers analysis prepared by consultants and reinsurers and on market conditions including the availability and pricing of reinsurance. To date, there have been no material disputes with the Company's excess-of-loss reinsurers. No assurance can be given, however, regarding the future ability of any of the Company's excess-of-loss reinsurers to meet their obligations.

Under the workers' compensation reinsurance treaty, reinsurers are responsible for 100% of each loss in excess of \$350,000, up to \$5.0 million for each claimant, on losses occurring prior to April 1, 2005. The Company increased its retention from \$350,000 to \$750,000, for losses occurring on or after April 1, 2005 and to \$1.0 million for losses occurring on or after April 1, 2006. In addition, there is coverage for loss events involving more than one claimant up to \$50.0 million per occurrence. In a loss event involving more than one claimant, the per claimant coverage is \$10.0 million.

Under the core liability reinsurance treaty, the reinsurers are responsible for 100% of each loss in excess of \$350,000, up to \$2.0 million per occurrence on policies effective prior to June 1, 2005. The Company increased its retention from \$350,000 to \$500,000, for losses occurring on policies effective on or after June 1, 2005. The Company also purchased an additional \$3.0 million of reinsurance clash coverage in excess of the \$2.0 million to cover amounts that may be in excess of the \$2.0 million policy limit, such as expenses associated with the settlement of claims or awards in excess of policy limits. Reinsurance clash coverage reinsures a loss when two or more policies are involved in a common occurrence. Effective June 1, 2006, the Company purchased a \$5.0 million excess cover to support its

umbrella business. This business had previously been reinsured through various semi-automatic agreements and will now be protected by one common treaty. The Company has no retention when the umbrella limit is in excess of the primary limit, but does warrant it will maintain a minimum liability of \$1.0 million if the primary limit does not respond or is exhausted.

The Company has a separate treaty to cover liability specifically related to commercial trucking, where reinsurers are responsible for 100% of each loss in excess of \$350,000, up to \$1.0 million for losses occurring prior to December 1, 2005. The Company increased its retention from \$350,000 to \$500,000 for losses occurring on or after December 1, 2005. In addition, the Company purchased an additional \$1.0 million of reinsurance clash coverage. The Company established a separate treaty to cover liability related to chemical distributors and repackagers, where reinsurers are responsible for 100% of each loss in excess of \$500,000, up to \$1.0 million,

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applied separately to general liability and auto liability. This treaty was terminated on a run-off basis on August 1, 2006. The exposures are covered under the core casualty treaty for policies effective August 1, 2006 and after. Additionally, the Company has a separate treaty structure to cover liability related to agricultural business. The reinsurer is responsible for 100% of each loss in excess of \$500,000, up to \$1.0 million for casualty losses and up to \$5.0 million, for property losses occurring on or after May 1, 2006. This treaty also provides an additional \$1.0 million of reinsurance clash coverage for the casualty lines.

Under the property reinsurance treaty, reinsurers are responsible for 100% of the amount of each loss in excess of \$500,000, up to \$5.0 million per location for an occurrence. In addition, there is coverage for loss events involving multiple locations up to \$20.0 million after the Company has incurred \$750,000 in loss.

On February 1, 2006, the Company renewed its existing reinsurance agreement that provides reinsurance coverage for policies written in the Company's public entity excess liability program. The agreement provides reinsurance coverage of \$4.0 million in excess of \$1.0 million for each occurrence in excess of the policyholder's self-insured retention.

In addition, the Company purchased \$10.0 million in excess of \$5.0 million for each occurrence, which is above the underlying \$5.0 million of coverage for the Company's public entity excess liability program. Under this agreement, reinsurers are responsible for 100% of each loss in excess of \$5.0 million for all lines, except workers' compensation, which is covered by the Company's core catastrophic workers' compensation treaty structure up to \$50.0 million per occurrence.

Additionally, several small programs have separate reinsurance treaties in place, which limit the Company's exposure to \$350,000 or less.

Facultative reinsurance is purchased for property values in excess of \$5.0 million, casualty limits in excess of \$2.0 million, or for coverage not covered by a treaty.

**Note 4 Debt**

***Lines of Credit***

In November 2004, the Company entered into a revolving line of credit for up to \$25.0 million, which expires in November 2007. The Company uses the revolving line of credit to meet short-term working capital needs. Under the revolving line of credit, the Company and certain of its non-regulated subsidiaries pledged security interests in certain property and assets of the Company and named subsidiaries.

At September 30, 2006 and December 31, 2005, the Company had an outstanding balance of \$9.7 million and \$5.0 million on the revolving line of credit, respectively.

The revolving line of credit provides for interest at a variable rate based, at the Company's option, upon either a prime based rate or LIBOR-based rate. In addition, the revolving line of credit also provides for an unused facility fee. On prime based borrowings, the applicable margin ranges from 75 to 25 basis points below prime. On LIBOR-based borrowings, the applicable margin ranges from 125 to 175 basis points above LIBOR. The margin for all loans is dependent on the sum of non-regulated earnings before interest, taxes, depreciation, amortization, and non-cash impairment charges related to intangible assets for the preceding four quarters, plus dividends paid or payable to the Company from subsidiaries during such period ( Adjusted EBITDA ). At September 30, 2006, the weighted average

interest rate for LIBOR-based borrowings outstanding was 6.7%.

Debt covenants consist of: (1) maintenance of the ratio of Adjusted EBITDA to interest expense of 2.0 to 1.0, (2) minimum net worth of \$130.0 million and increasing annually commencing June 30, 2005, by fifty percent of the prior year's positive net income, (3) minimum A.M. Best rating of B+, and (4) minimum Risk Based Capital Ratio for Star of 1.75 to 1.00. As of September 30, 2006, the Company was in compliance with these covenants.

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Previously, a non-insurance premium finance subsidiary of the Company maintained a line of credit with a bank. At December 31, 2005, this line of credit had an outstanding balance of \$2.0 million. In May 2006, the balance of this loan was paid in full by the subsidiary and the terms of the line of credit were not renewed.

***Senior Debentures***

In April 2004, the Company issued senior debentures in the amount of \$13.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.0%, which is non-deferrable. At September 30, 2006, the interest rate was 9.41%. The senior debentures are callable by the Company at par after five years from the date of issuance. Associated with this transaction, the Company incurred \$390,000 of commissions paid to the placement agents. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

In May 2004, the Company issued senior debentures in the amount of \$12.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.2%, which is non-deferrable. At September 30, 2006, the interest rate was 9.60%. The senior debentures are callable by the Company at par after five years from the date of issuance. Associated with this transaction, the Company incurred \$360,000 of commissions paid to the placement agents. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

The Company contributed \$9.9 million of the proceeds to its Insurance Company Subsidiaries in December 2004. The remaining proceeds from the issuance of the senior debentures were used for general corporate purposes.

***Junior Subordinated Debentures***

In September 2005, Meadowbrook Capital Trust II (the Trust II), an unconsolidated subsidiary trust of the Company, issued \$20.0 million of mandatorily redeemable trust preferred securities (TPS) to a trust formed by an institutional investor. Contemporaneously, the Company issued \$20.6 million in junior subordinated debentures, which includes the Company's investment in the trust of \$620,000. These debentures have financial terms similar to those of the TPS, which includes the deferral of interest payments at any time, or from time-to-time, for a period not exceeding five years, provided there is no event of default. These debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 3.58%. At September 30, 2006, the interest rate was 8.97%. These debentures are callable by the Company at par beginning in October 2010.

The Company received \$19.4 million in net proceeds, after the deduction of approximately \$600,000 of commissions paid to the placement agents in the transaction. These issuance costs have been capitalized and are included in other assets on the balance sheet, which will be amortized over seven years as a component of interest expense.

The Company contributed \$10.0 million of the proceeds from the issuance of these debentures to its Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes.

In September 2003, Meadowbrook Capital Trust (the Trust), an unconsolidated subsidiary trust of the Company, issued \$10.0 million of mandatorily redeemable TPS to a trust formed by an institutional investor. Contemporaneously, the Company issued \$10.3 million in junior subordinated debentures, which includes the Company's investment in the trust of \$310,000. These debentures have financial terms similar to those of the TPS, which includes the deferral of interest payments at any time, or from time-to-time, for a period not exceeding five

years, provided there is no event of default. These debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.05%. At September 30, 2006, the interest rate was 9.55%. These debentures are callable by the Company at par beginning in October 2008.

The Company received \$9.7 million in net proceeds, after the deduction of approximately \$300,000 of commissions paid to the placement agents in the transaction. These issuance costs have been capitalized and are



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included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

The Company contributed \$6.3 million of the proceeds from the issuance of these debentures to its Insurance Company Subsidiaries and the remaining balance has been used for general corporate purposes.

The junior subordinated debentures are unsecured obligations of the Company and are junior to the right of payment to all senior indebtedness of the Company. The Company has guaranteed that the payments made to both Trusts will be distributed by the Trusts to the holders of the TPS.

The Company estimates the fair value of the above mentioned junior subordinated debentures and senior debentures issued approximate the gross proceeds of cash received at the time of issuance.

The seven year amortization period in regard to the issuance costs represents management's best estimate of the estimated useful life of the bonds related to both the senior debentures and junior subordinated debentures described above.

**Note 5 Derivative Instruments**

In October 2005, the Company entered into two interest rate swap transactions with LaSalle Bank ( LaSalle ) to mitigate its interest rate risk on \$5.0 million and \$20.0 million of the Company's senior debentures and trust preferred securities, respectively. The Company has recognized these transactions in accordance with SFAS No. 133

*Accounting for Derivative Instruments and Hedging Activities*, as subsequently amended. These interest rate swap transactions have been designated as a cash flow hedge and are deemed a highly effective transaction under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and any changes in their fair value are accounted for within other comprehensive income. The interest differential to be paid or received is being accrued and is being recognized as an adjustment to interest expense.

The first interest rate swap transaction, which relates to \$5.0 million of the Company's \$12.0 million issuance of senior debentures, has an effective date of October 6, 2005 and an ending date of May 24, 2009. The Company is required to make certain quarterly fixed rate payments to LaSalle calculated on a notional amount of \$5.0 million, non-amortizing, based on a fixed annual interest rate of 8.925%. LaSalle is obligated to make quarterly floating rate payments to the Company referencing the same notional amount, based on the three-month LIBOR, plus 4.20%.

The second interest rate swap transaction, which relates to \$20.0 million of the Company's \$20.0 million issuance of trust preferred securities, has an effective date of October 6, 2005 and an ending date of September 16, 2010. The Company is required to make quarterly fixed rate payments to LaSalle calculated on a notional amount of \$20.0 million, non-amortizing, based on a fixed annual interest rate of 8.34%. LaSalle is obligated to make quarterly floating rate payments to the Company referencing the same notional amount, based on the three-month LIBOR, plus 3.58%.

In relation to the above interest rate swaps, the net interest income received for the nine months ended September 30, 2006, was approximately \$27,000. For the three months ended September 30, 2006, the net interest income received was approximately \$36,000. The total fair value of the interest rate swaps as of September 30, 2006, and December 31, 2005, was approximately \$182,000 and \$14,000, respectively. Accumulated other comprehensive

income at September 30, 2006 and December 31, 2005, included the accumulated income on the cash flow hedge, net of taxes, of \$118,000 and \$9,100, respectively.

In July 2005, the Company made a \$2.5 million loan, at an effective interest rate equal to the three-month LIBOR, plus 5.2%, to an unaffiliated insurance agency. In December 2005, the Company loaned an additional \$3.5 million to the unaffiliated insurance agency. The original \$2.5 million demand note was replaced with a \$6.0 million convertible note. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This agency has been a producer for the Company for over ten years. As

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security for the loan, the borrower granted the Company a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible at the option of the Company based upon a pre-determined formula, beginning in 2008. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At September 30, 2006, the estimated fair value of the derivative was zero.

**Note 6 Shareholders Equity**

At September 30, 2006, shareholders equity was \$195.5 million, or a book value of \$6.73 per common share, compared to \$177.4 million, or a book value of \$6.19 per common share, at December 31, 2005.

On October 28, 2005, the Company's Board of Directors authorized management to purchase up to 1,000,000 shares of its common stock in market transactions for a period not to exceed twenty-four months. For the nine months ended September 30, 2006, the Company did not repurchase any common stock. For the year ended December 31, 2005, the Company purchased and retired 772,900 shares of common stock for a total cost of approximately \$4.2 million. Of these shares, 63,000 shares for a total cost of approximately \$372,000 related to the current share repurchase plan. As of September 30, 2006, the cumulative amount the Company repurchased and retired under the current share repurchase plan was 63,000 shares of common stock for a total cost of approximately \$372,000. As of September 30, 2006, the Company has available up to 937,000 shares remaining to be purchased.

**Note 7 Regulatory Matters and Rating Agencies**

A significant portion of the Company's consolidated assets represent assets of the Insurance Company Subsidiaries. The State of Michigan Office of Financial and Insurance Services ( OFIS ), restricts the amount of funds that may be transferred to the holding company in the form of dividends, loans or advances. These restrictions in general, are as follows: the maximum discretionary dividend that may be declared, based on data from the preceding calendar year, is the greater of each insurance company's net income (excluding realized capital gains) or ten percent of the insurance company's surplus (excluding unrealized gains). These dividends are further limited by a clause in the Michigan law that prohibits an insurer from declaring dividends, except from surplus earnings of the company. Earned surplus balances are calculated on a quarterly basis. Since Star is the parent insurance company, its maximum dividend calculation represents the combined Insurance Company Subsidiaries' surplus. At September 30, 2006, Star's earned surplus position was positive \$10.5 million. At December 31, 2005, Star had negative earned surplus of \$7.2 million. Based upon the September 30, 2006 statutory financial statements, Star may pay a dividend of up to \$10.5 million to the Company without the prior approval of OFIS. No statutory dividends were paid in 2005 or during the nine months ended September 30, 2006.

Insurance operations are subject to various leverage tests (e.g. premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. The Company's targets for gross and net written premium to statutory surplus are 2.8 to 1.0 and 2.25 to 1.0, respectively. As of September 30, 2006, on a statutory combined basis, the gross and net premium leverage ratios were 2.0 to 1.0 and 1.6 to 1.0, respectively.

The National Association of Insurance Commissioners ( NAIC ) has adopted a risk-based capital ( RBC ) formula to be applied to all property and casualty insurance companies. The formula measures required capital and surplus based on an insurance company's products and investment portfolio and is used as a tool to evaluate the capital of regulated companies. The RBC formula is used by state insurance regulators to monitor trends in statutory capital and surplus

for the purpose of initiating regulatory action. In general, an insurance company must submit a calculation of its RBC formula to the insurance department of its state of domicile as of the end of the previous calendar year. These laws require increasing degrees of regulatory oversight and intervention as an insurance company's RBC declines. The level of regulatory oversight ranges from requiring the insurance company to inform and obtain approval from the domiciliary insurance commissioner of a comprehensive financial plan for increasing

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its RBC to mandatory regulatory intervention requiring an insurance company to be placed under regulatory control in a rehabilitation or liquidation proceeding.

At December 31, 2005, all of the Insurance Company Subsidiaries were in compliance with RBC requirements. Star reported statutory surplus of \$141.1 million at December 31, 2005, compared to the threshold requiring the minimum regulatory involvement of \$74.5 million in 2005. At September 30, 2006, Star's statutory surplus was \$160.9 million.

In May 2006, the Company announced the affirmation of A.M. Best Company's financial strength rating of B++ (Very Good) for three of its insurance company subsidiaries: Star Insurance Company (Star), Savers Property & Casualty Insurance Company, and Williamsburg National Insurance Company. Concurrently, A.M. Best upgraded the rating of its other insurance company subsidiary, Ameritrust Insurance Corporation, to B++ (Very Good), from B+ (Very Good). Additionally, A.M. Best upgraded the outlook for all the ratings from stable to positive. A positive outlook is placed on a company's rating if its financial and market trends are favorable, relative to its current rating level.

**Note 8 Segment Information**

The Company defines its operations as specialty risk management operations and agency operations based upon differences in products and services. The separate financial information of these segments is consistent with the way results are regularly evaluated by management in deciding how to allocate resources and in assessing performance. Intersegment revenue is eliminated upon consolidation. It would be impracticable for the Company to determine the allocation of assets between the two segments.

***Specialty Risk Management Operations***

The specialty risk management operations segment focuses on specialty or niche insurance business in which it provides various services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention, and reinsurance placement, along with various types of property and casualty insurance coverage, including workers' compensation, commercial multiple peril, general liability, commercial auto liability, and inland marine. Insurance coverage is provided primarily to associations or similar groups of members and to specified classes of business of the Company's agent-partners. The Company recognizes revenue related to the services and coverages the specialty risk management operations provides within seven categories: net earned premiums, management fees, claims fees, loss control fees, reinsurance placement, investment income, and net realized gains (losses).

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**(Unaudited)*****Agency Operations***

The Company earns commissions through the operation of its retail property and casualty insurance agency, which was formed in 1955. The agency is one of the largest agencies in Michigan and, with acquisitions, has expanded into California and Florida. The agency operations produce commercial, personal lines, life, and accident and health insurance, for more than fifty unaffiliated insurance carriers. The agency produces an immaterial amount of business for its affiliated Insurance Company Subsidiaries.

The following tables set forth the segment results (in thousands):

	<b>For the Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Revenues		
Net earned premiums	\$ 191,326	\$ 187,356
Management fees	14,320	12,624
Claims fees	6,746	5,317
Loss control fees	1,683	1,739
Reinsurance placement	640	563
Investment income	15,492	13,012
Net realized gains (losses)	46	(52)
Specialty risk management	230,253	220,559
Agency operations	9,540	8,859
Miscellaneous income(2)	711	230
Intersegment revenue	(1,330)	(1,769)
Consolidated revenue	\$ 239,174	\$ 227,879
Pre-tax income:		
Specialty risk management	\$ 27,977	\$ 21,942
Agency operations(1)	2,462	2,669
Non-allocated expenses	(7,230)	(5,364)
Consolidated pre-tax income	\$ 23,209	\$ 19,247

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	<b>For the Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Revenues		
Net earned premiums	\$ 63,688	\$ 63,205
Management fees	4,699	4,328
Claims fees	2,295	1,799
Loss control fees	552	611
Reinsurance placement	79	124
Investment income	5,322	4,458
Net realized gains	28	40
Specialty risk management	76,663	74,565
Agency operations	2,401	2,917
Miscellaneous income(2)	262	134
Intersegment revenue	(414)	(579)
Consolidated revenue	\$ 78,912	\$ 77,037
Pre-tax income:		
Specialty risk management	\$ 9,345	\$ 7,959
Agency operations(1)	197	687
Non-allocated expenses	(2,467)	(1,923)
Consolidated pre-tax income	\$ 7,075	\$ 6,723

(1) The Company's agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate overhead allocation excludes those expenses specific to the holding company. For the nine months ended September 30, 2006 and 2005, the allocation of corporate overhead to the agency operations segment was \$2.3 million and \$2.3 million, respectively. For the three months ended September 30, 2006 and 2005, the allocation of corporate overhead to the agency operations segment was \$740,000 and \$609,000, respectively.

(2) The miscellaneous income included in the revenue relates to miscellaneous interest income within the holding company.

The following table sets forth the non-allocated expenses included in pre-tax income (in thousands):

**For the Nine Months  
Ended September 30,**  
**2006**      **2005**

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Holding company expenses	\$ (2,337)	\$ (2,560)
Amortization	(448)	(277)
Interest expense	(4,445)	(2,527)
	\$ (7,230)	\$ (5,364)

**For the Three Months  
Ended September 30,  
2006                      2005**

Holding company expenses	\$ (768)	\$ (882)
Amortization	(141)	(93)
Interest expense	(1,558)	(948)
	\$ (2,467)	\$ (1,923)



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**(Unaudited)**

**Note 9 Commitments and Contingencies**

The Company, and its subsidiaries, are subject at times to various claims, lawsuits and proceedings relating principally to alleged errors or omissions in the placement of insurance, claims administration, consulting services and other business transactions arising in the ordinary course of business. Where appropriate, the Company vigorously defends such claims, lawsuits and proceedings. Some of these claims, lawsuits and proceedings seek damages, including consequential, exemplary or punitive damages, in amounts that could, if awarded, be significant. Most of the claims, lawsuits and proceedings arising in the ordinary course of business are covered by errors and omissions insurance or other appropriate insurance. In terms of deductibles associated with such insurance, the Company has established provisions against these items, which are believed to be adequate in light of current information and legal advice. In accordance with SFAS No. 5, *Accounting for Contingencies*, if it is probable that an asset has been impaired or a liability has been incurred as of the date of the financial statements and the amount of loss is estimable; an accrual for the costs to resolve these claims is recorded by the Company in its consolidated balance sheets. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. Management, with the assistance of outside counsel, adjusts such provisions according to new developments or changes in the strategy in dealing with such matters. On the basis of current information, the Company does not expect the outcome of the claims, lawsuits and proceedings to which the Company is subject to, either individually, or in the aggregate, will have a material adverse effect on the Company's financial condition. However, it is possible that future results of operations or cash flows for any particular quarter or annual period could be materially affected by an unfavorable resolution of any such matters.

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**ITEM 2**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS OF**  
**FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**For the Periods ended September 30, 2006 and 2005**

***Forward-Looking Statements***

*This quarterly report may provide information including certain statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These include statements regarding the intent, belief, or current expectations of management, including, but not limited to, those statements that use the words believes, expects, anticipates, estimates, or similar expressions. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties, and results could differ materially from those indicated by such forward-looking statements. Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements are: the frequency and severity of claims; uncertainties inherent in reserve estimates; catastrophic events; a change in the demand for, pricing of, availability or collectibility of reinsurance; increased rate pressure on premiums; obtainment of certain rate increases in current market conditions; investment rate of return; changes in and adherence to insurance regulation; actions taken by regulators, rating agencies or lenders; obtainment of certain processing efficiencies; changing rates of inflation; general economic conditions and other risks identified in our reports and registration statements filed with the Securities and Exchange Commission. We are not under any obligation to (and expressly disclaim any such obligation to) update or alter our forward-looking statements whether as a result of new information, future events or otherwise.*

**Description of Business**

We are a publicly traded specialty risk management company, with an emphasis on alternative market insurance and risk management solutions for agents, professional and trade associations, and small to medium-sized insureds. The alternative market includes a wide range of approaches to financing and managing risk exposures, such as captives, rent-a-captives, risk retention and risk purchasing groups, governmental pools and trusts, and self-insurance plans. The alternative market developed as a result of the historical volatility in the cost and availability of traditional commercial insurance coverages, and usually involves some form of self-insurance or risk-sharing on the part of the client. We develop and manage alternative risk management programs for defined client groups and their members. We also operate as an insurance agency representing unaffiliated insurance companies in placing insurance coverages for policyholders. We define our business segments as specialty risk management operations and agency operations.

**Critical Accounting Estimates**

In certain circumstances, we are required to make estimates and assumptions that affect amounts reported in our consolidated financial statements and related footnotes. We evaluate these estimates and assumptions on an on-going basis based on a variety of factors. There can be no assurance, however, that actual results will not be materially different than our estimates and assumptions, and that reported results of operation will not be affected by accounting adjustments needed to reflect changes in these estimates and assumptions. The accounting estimates and related risks described in our annual report on Form 10-K as filed with the United States Securities and Exchange Commission on March 14, 2006, are those that we consider to be our critical accounting estimates. As of the three months and nine months ended September 30, 2006, there have been no material changes in regard to any of our critical accounting estimates.

**RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005**

*Executive Overview*

Our overall results for the nine months ended September 30, 2006, continued to show improvement in comparison to 2005. These results are a continued demonstration of our commitment to strong underwriting

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discipline and improved profitability of our specialty insurance and fee-for-service programs. The improvement in net income in comparison to 2005 is indicative of our selective growth consistent with our corporate underwriting guidelines and controls over price adequacy. As a result, our generally accepted accounting principles ( GAAP ) combined ratio improved 1.9 percentage points to 96.9% in the nine months ended September 30, 2006, from 98.8% in the comparable period in 2005.

In May 2006, we announced the affirmation of A.M. Best Company's financial strength rating of B++ (Very Good) for three of our insurance company subsidiaries: Star Insurance Company ( Star ), Savers Property & Casualty Insurance Company, and Williamsburg National Insurance Company. Concurrently, A.M. Best upgraded the rating of our other insurance company subsidiary, Ameritrust Insurance Corporation, to B++ (Very Good), from B+ (Very Good). Additionally, A.M. Best upgraded the outlook for all the ratings from stable to positive. A positive outlook is placed on a company's rating if its financial and market trends are favorable, relative to its current rating level.

Gross written premium was down slightly in comparison to 2005. This slight decrease was primarily the result of exiting a limited number of small programs that no longer met our pricing standards, therefore reducing premium volume in certain limited programs in which pricing competition dictates that we write less volume. In addition, this decrease was the result of a reduction in audit related premiums. We continue to follow pricing guidelines mandated by our corporate underwriting guidelines. Overall, our year-to-date rate change was a small decrease of 2.5%. There have been anticipated mandatory rate decreases in workers' compensation in some states, but for the most part those were offset by benefit changes that should lower incurred losses. We have several new programs where we have completed our due diligence process and have commenced writing policies, or will commence writing policies sometime during the remainder of this year.

***Results of Operations***

Net income for the nine months ended September 30, 2006, was \$16.1 million, or \$0.55 per dilutive share, compared to net income of \$13.0 million, or \$0.44 per dilutive share, for the comparable period of 2005. As previously indicated, this improvement is primarily the result of our selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy. In addition, during 2005 we increased our retention levels on certain reinsurance treaties, which favorably impacted net earned premiums and net income for the nine months ended September 30, 2006, compared to the same period in 2005. Growth in our fee-for-service programs also contributed to the overall improvement in net income in comparison to 2005.

Revenues for the nine months ended September 30, 2006, increased \$11.3 million, or 5.0%, to \$239.2 million, from \$227.9 million for the comparable period in 2005. This increase reflects a \$4.0 million, or 2.1%, increase in net earned premiums. The increase in net earned premiums is the result of our selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy, as well as the favorable impact from an increase in our retention levels on certain reinsurance treaties effective in 2005. Offsetting the overall increase in net earned premiums for the nine months ended September 30, 2006, was a reduction in audit related premiums in comparison to 2005. The increase in revenue was also the result of an overall increase in fee-for-service revenue, primarily as a result of new managed programs. In addition, the increase in revenue reflects a \$3.0 million increase in investment income, primarily due to an increase in average invested assets as a result of improved cashflow from favorable underwriting results and proceeds from the junior subordinated debentures issued in the third quarter of 2005. The increase in investment income is also the result of a slight increase in yield.

**Table of Contents****Specialty Risk Management Operations**

The following table sets forth the revenues and results from operations for our specialty risk management operations (in thousands):

	<b>For the Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Revenue:		
Net earned premiums	\$ 191,326	\$ 187,356
Management fees	14,320	12,624
Claims fees	6,746	5,317
Loss control fees	1,683	1,739
Reinsurance placement	640	563
Investment income	15,492	13,012
Net realized gains (losses)	46	(52)
Total revenue	\$ 230,253	\$ 220,559
Pre-tax income		
Specialty risk management operations	\$ 27,977	\$ 21,942

Revenues from specialty risk management operations increased \$9.7 million, or 4.4%, to \$230.3 million for the nine months ended September 30, 2006, from \$220.6 million for the comparable period in 2005.

Net earned premiums increased \$4.0 million, or 2.1%, to \$191.3 million in the nine months ended September 30, 2006, from \$187.3 million in the comparable period in 2005. This increase is primarily the result of selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy, as well as the favorable impact from an increase in our retention levels on certain reinsurance treaties. Offsetting these increases was an overall decrease in audit related premiums in comparison to 2005.

Management fees increased \$1.7 million, or 13.4%, to \$14.3 million for the nine months ended September 30, 2006, from \$12.6 million for the comparable period in 2005. This increase is primarily the result of a Florida-based program implemented in the second quarter of 2005. In addition, this increase is the result of growth in a specific New England-based program. Also contributing to the overall increase in management fees was the recognition of \$250,000 from a profit-based revenue sharing payment related to a specific managed program.

Claim fees increased \$1.4 million, or 26.9%, to \$6.7 million, from \$5.3 million for the comparable period in 2005. This increase is primarily the result of our 2006 entry into the self-insured workers compensation market in Nevada. In addition, this increase is the result of increases in revenue related to a specific Minnesota-based program, as well as a Florida-based program, which was implemented in the second quarter of 2005.

Net investment income increased \$2.5 million, or 19.1%, to \$15.5 million in 2006, from \$13.0 million in 2005. Average invested assets increased \$70.8 million, or 17.3%, to \$480.8 million in 2006, from \$410.0 million in 2005. The increase in average invested assets reflects cash flows from underwriting activities primarily from favorable underwriting results and an increase in the duration of our reserves. The increase in the duration of our reserves reflects the impact of our public entity excess program, which was implemented at the end of 2003. This program has

a longer duration than the average reserves on our remaining programs and is a larger proportion of reserves. In addition, the \$19.4 million in net proceeds received from capital raised in 2005 through the issuances of debentures increased average invested assets. The average investment yield for September 30, 2006, was 4.5%, compared to 4.3% for the comparable period in 2005. The current pre-tax book yield was 4.3%. The current after-tax book yield for the nine months ended September 30, 2006 was 3.3%, compared to 3.0% for the comparable period in 2005. This increase is primarily the result of the shift in our investment portfolio to tax-exempt investments. The duration of the investment portfolio is 3.86 years.

Specialty risk management operations generated pre-tax income of \$28.0 million for the nine months ended September 30, 2006, compared to pre-tax income of \$21.9 million for the comparable period in 2005. This increase

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in pre-tax income demonstrates a continued improvement in underwriting results as a result of our controlled growth in premium volume and our continued focus on leveraging of fixed costs. The GAAP combined ratio was 96.9% for the nine months ended September 30, 2006, compared to 98.8% for the same period in 2005.

Net loss and loss adjustment expenses ( LAE ) decreased \$3.0 million, or 2.7%, to \$110.3 million for the nine months ended September 30, 2006, from \$113.3 million for the same period in 2005. Our loss and LAE ratio improved 2.6 percentage points to 62.6% for the nine months ended September 30, 2006, from 65.2% for the same period in 2005. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. The improvement in the loss and LAE ratio reflects a 3.2 percentage point decrease in the change in net ultimate loss estimates for prior accident years in 2006 as compared to 2005. Development on prior accident year reserves was a favorable \$1.4 million, or a 0.8 percentage point reduction, to net loss and LAE in 2006, compared to an unfavorable \$4.5 million, or an additional 2.4 percentage points in 2005. The improvement in the loss ratio for 2006 in comparison to 2005 primarily reflects improved results within the workers' compensation and professional liability lines of business, partially offset by a single property claim within a California-based agricultural program. Additional discussion of our reserve activity is described below within the *Other Items - Reserves* section.

Our expense ratio for the nine months ended September 30, 2006 was 34.3%, compared to 33.6% for the same period in 2005. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. The increase in our expense ratio in comparison to 2005 reflects a slight increase in gross external commissions as a result of a shift in our mix of business and a reduction in an accrual for estimated profit-based ceding commissions on an excess reinsurance treaty for a specific commercial transportation program. This decrease was the result of unfavorable loss development on a limited number of excess of loss claims from prior accident years and added \$1.6 million to our expenses, or 0.9 percentage points to our expense ratio in the period. As of September 30, 2006, the remaining accrual was less than \$100,000; therefore, we do not anticipate any further unfavorable adjustments. Offsetting these increases was a reduction in insurance related assessments primarily related to the guaranty fund in Florida and Nevada.

**Agency Operations**

The following table sets forth the revenues and results from operations for our agency operations (in thousands):

	<b>For the Nine Months Ended September 30, 2006            2005</b>	
Net commission	\$ 9,540	\$ 8,859
Pre-tax income(1)	\$ 2,462	\$ 2,669

- (1) Our agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate overhead allocation excludes those expenses specific to the holding company. For the nine months ended September 30, 2006 and 2005, the allocation of corporate overhead to the agency operations segment was \$2.3 million and \$2.3 million, respectively.

Revenue from agency operations, which consists primarily of agency commission revenue, increased \$681,000, or 7.7%, to \$9.5 million for the nine months ended September 30, 2006, from \$8.8 million for the comparable period in

2005. This increase is primarily the result of the November 2005 acquisition of a Florida-based retail agency and an increase in profit sharing commissions in comparison to 2005. Offsetting these increases was a decrease in commission revenue as a result of a reduction in premium on client renewals.

Agency operations generated pre-tax income, after the allocation of corporate overhead, of \$2.5 million for the nine months ended September 30, 2006, compared to \$2.7 million for the comparable period in 2005. This slight decrease in pre-tax income in comparison to 2005 is primarily the result of a slight increase in operating expenses coupled with the decrease in commission revenue noted above as a result of the reduction in premium on client renewals, offset by the favorable impact from the Florida-based retail agency acquisition.



**Table of Contents****Other Items*****Reserves***

At September 30, 2006, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was \$296.4 million. We established a reasonable range of reserves of approximately \$275.5 million to \$313.2 million. This range was established primarily by considering the various indications derived from standard actuarial techniques and other appropriate reserve considerations. The following table sets forth this range by line of business (in thousands):

<b>Line of Business</b>	<b>Minimum Reserve Range</b>	<b>Maximum Reserve Range</b>	<b>Selected Reserves</b>
Workers Compensation(1)	\$ 150,483	\$ 168,748	\$ 160,293
Commercial Multiple Peril/General Liability	54,314	63,000	58,677
Commercial Automobile	50,292	57,164	54,792
Other	20,387	24,257	22,687
Total Net Reserves	\$ 275,476	\$ 313,169	\$ 296,449

(1) Includes Residual Markets

Reserves are reviewed by internal and independent actuaries for adequacy on a quarterly basis. When reviewing reserves, we analyze historical data and estimate the impact of numerous factors such as (1) per claim information; (2) industry and our historical loss experience; (3) legislative enactments, judicial decisions, legal developments in the imposition of damages, and changes in political attitudes; and (4) trends in general economic conditions, including the effects of inflation. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of reserves, because the eventual deficiency or redundancy is affected by multiple factors.

The key assumptions used in our selection of ultimate reserves included the underlying actuarial methodologies, a review of current pricing and underwriting initiatives, an evaluation of reinsurance costs and retention levels, and a detailed claims analysis with an emphasis on how aggressive claims handling may be impacting the paid and incurred loss data trends embedded in the traditional actuarial methods. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the nine months ended September 30, 2006 and the year ended December 31, 2005.

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For the nine months ended September 30, 2006, we reported a decrease in net ultimate loss estimates for accident years 2005 and prior of \$1.4 million, or 0.5% of \$271.4 million of net loss and LAE reserves at December 31, 2005. The decrease in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2006 that differed from the projected activity. There were no significant changes in the key assumptions utilized in the analysis and calculations of our reserves during 2006 and 2005. The major components of this change in ultimate loss estimates are as follows (in thousands):

Line of Business	Reserves	Incurred Losses			Paid Losses			Reserves
	at December 31, 2005	Current Year	Prior Years	Total Incurred	Current Year	Prior Years	Total Paid	at September 30, 2006
Workers Compensation	\$ 128,802	\$ 43,302	\$ (803)	\$ 42,499	\$ 4,374	\$ 32,465	\$ 36,839	\$ 134,462
Residual Markets	24,440	8,131	(502)	7,629	3,136	3,102	6,238	25,831
Commercial Multiple Peril/General Liability	52,506	17,607	(989)	16,618	1,111	9,336	10,447	58,677
Commercial Automobile	44,382	29,097	1,397	30,494	5,432	14,652	20,084	54,792
Other	21,293	13,620	(542)	13,078	4,642	7,042	11,684	22,687
Net Reserves	271,423	\$ 111,757	\$ (1,439)	\$ 110,318	\$ 18,695	\$ 66,597	\$ 85,292	296,449
Reinsurance Recoverable	187,254							197,192
Consolidated	\$ 458,677							\$ 493,641

Line of Business	Reserves at	Re-Estimated	Development
	December 31, 2005	Reserves at September 30, 2006 on Prior Years	as a Percentage of Prior Year Reserves
Workers Compensation	\$ 128,802	\$ 127,999	(0.6)%
Commercial Multiple Peril/General Liability	52,506	51,517	(1.9)%
Commercial Automobile	44,382	45,779	3.1%
Other	21,293	20,751	(2.5)%
Sub-total	246,983	246,046	(0.4)%
Residual Markets	24,440	23,938	(2.1)%
Total Net Reserves	\$ 271,423	\$ 269,984	(0.5)%

**Workers Compensation Excluding Residual Markets**

The projected net ultimate loss estimate for the workers' compensation line of business, excluding residual markets, decreased \$803,000, or 0.6% of net workers' compensation reserves. This net overall decrease reflects decreases of \$805,000, \$1.4 million, and \$339,000 in accident years 2005, 2004, and 2001, respectively. These decreases reflect better than expected experience for many of our workers' compensation programs, including a Florida program, a Tennessee program, an Alabama program, and a Nevada program. Average severity on reported claims did not increase as much as anticipated in the prior actuarial projections so ultimate loss estimates were reduced. These decreases were offset by increases of \$348,000, \$659,000, \$616,000, and \$338,000 in the ultimate loss estimate for accident years 2003, 2002, 1998, and 1996, respectively. These increases reflect some large claim activity and case reserve strengthening primarily related to a Massachusetts program. The change in ultimate loss estimates for all other accident years was insignificant.

### **Commercial Multiple Peril/General Liability**

The commercial multiple peril line and general liability line of business had a decrease in net ultimate loss estimates of \$989,000, or 1.9% of net commercial multiple peril and general liability reserves. The net decrease reflects reductions of \$1.3 million, \$414,000, and \$329,000 in the ultimate loss estimates for accident years 2005, 2004, and 2003, respectively. These decreases reflect better than expected claim emergence within a California program and a Missouri program. These decreases were offset by an increase of \$347,000 in accident year 2002.

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This increase reflects greater than expected claim activity within a Missouri program. The change in ultimate loss estimates for all other accident years was insignificant.

### **Commercial Automobile**

The projected net ultimate loss estimate for the commercial automobile line of business increased \$1.4 million, or 3.1% of net commercial automobile reserves. This net overall increase reflects increases of \$1.1 million, \$509,000, and \$258,000 in accident years 2005, 2003, and 2001, respectively. These increases reflect higher than expected emergence of claim activity within two California-based programs. These increases were offset by a decrease of \$947,000 in accident year 2004. This decrease reflects better than expected claim emergence within a California-based program. The change in ultimate loss estimates for all other accident years was insignificant.

### **Other**

The projected net ultimate loss estimate for the other lines of business decreased \$542,000, or 2.5% of net reserves. This net decrease reflects a reduction of \$1.2 million in accident year 2004. This decrease is due to better than expected case reserve development in a medical malpractice program, offset by an increase of \$1.0 million in accident year 2005. The increase in accident year 2005 is the result of a claim within a specific California-based program. The change in ultimate loss estimates for all other accident years was insignificant.

### **Residual Markets**

The workers' compensation residual market line of business had a decrease in net ultimate loss estimates of \$502,000, or 2.1% of net reserves. This decrease reflects decreases of \$923,000, \$381,000, and \$285,000 in accident years 2004, 2003 and 2002, respectively. Offsetting these decreases was an increase of \$995,000 in accident year 2005. We record loss reserves as reported by the National Council on Compensation Insurance (NCCI), plus a provision for the reserves incurred but not yet analyzed and reported to us due to a two quarter lag in reporting. These changes reflect a difference between our estimate of the lag incurred but not reported and the amounts reported by the NCCI in the quarter. The change in ultimate loss estimates for all other accident years was insignificant.

### **Salary and Employee Benefits and Other Administrative Expenses**

Salary and employee benefits for the nine months ended September 30, 2006, increased \$2.2 million, or 5.7%, to \$41.4 million, from \$39.2 million for the comparable period in 2005. This increase primarily reflects an increase in variable compensation. In addition, this increase is the result of an increase in staffing levels, primarily as a result of the recent additions of our Florida-based retail agency and our entry into the self-insured workers' compensation market in Nevada. Excluding those additions, overall staffing levels for 2006 were slightly higher in comparison to 2005.

Other administrative expenses increased \$2.2 million, or 11.5%, to \$22.1 million, from \$19.9 million for the comparable period in 2005. A portion of this increase is the result of the expenses associated with the additions of our Florida-based agency and our entry into the self-insured workers' compensation market in Nevada. As revenues increase in these two locations we expect to see margins improve. In addition, the increase in other administrative expenses is the result of information technology enhancements and various increases in other general operating expenses in comparison to 2005.

Salary and employee benefits and other administrative expenses include both corporate overhead and the holding company expenses included in the non-allocated expenses of our segment information.

### **Interest Expense**

Interest expense for the nine months ended September 30, 2006, increased \$1.9 million, or 75.9%, to \$4.4 million, from \$2.5 million for the comparable period in 2005. Interest expense is primarily attributable to our debentures, which are described within the *Liquidity and Capital Resources* section of Management's Discussion and Analysis, as well as our current lines of credit. The increase in interest expense was related to the issuance of the

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junior subordinated debentures in the third quarter of 2005, as well as an overall increase in the average interest rates. The average outstanding balance on our lines of credit during the nine months ending September 30, 2006, was \$10.6 million, compared to \$10.4 million for the same period in 2005. The average interest rate, excluding our debentures, increased in 2006 to 6.8%, compared to 4.6% in 2005 as a result of increases in the underlying eurocurrency based rate.

**Income Taxes**

Income tax expense, which includes both federal and state taxes, for the nine months ended September 30, 2006, was \$7.2 million, or 31.1% of income before taxes. For the same period last year, we reflected an income tax expense of \$6.3 million, or 32.5% of income before taxes. Our effective tax rate differs from the 35% statutory rate primarily due to a shift towards increasing investments in tax-exempt securities in an effort to maximize after-tax investment yields. Our current and deferred taxes are calculated using a 35% statutory rate.

**Other than Temporary Impairments**

Our policy for the valuation of temporarily impaired securities is to determine impairment based on analysis of the following factors: (1) rating downgrade or other credit event (e.g., failure to pay interest when due); (2) financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment; (3) prospects for the issuer's industry segment; and (4) our intent and ability to retain the investment for a period of time sufficient to allow for anticipated recovery in market value. We evaluate our investments in securities to determine other than temporary impairment, no less than quarterly. Investments that are deemed other than temporarily impaired are written down to their estimated net fair value and the related losses recognized in operations.

At September 30, 2006, we had 276 securities that were in an unrealized loss position. These investments all had unrealized losses of less than ten percent. At September 30, 2006, 132 of those investments, with an aggregate \$130.0 million and \$3.1 million fair value and unrealized loss, respectively, have been in an unrealized loss position for more than eighteen months. Positive evidence considered in reaching our conclusion that the investments in an unrealized loss position are not other than temporarily impaired consisted of: 1) there were no specific events which caused concerns; 2) there were no past due interest payments; 3) there has been a rise in market prices; 4) our ability and intent to retain the investment for a sufficient amount of time to allow an anticipated recovery in value; and 5) changes in market value considered normal in relation to overall fluctuations in interest rates.

The fair value and amount of unrealized losses segregated by the time period the investment has been in an unrealized loss position is as follows (in thousands):

		September 30, 2006				Total	
		Less than 12 months		Greater than 12 months			
Fair Value	Gross	Fair Value	Gross	Fair Value	Gross		
of	Unrealized	of	Unrealized	of	Unrealized	of	Unrealized
Investments	Losses	Investments	Losses	Investments	Losses	Investments	Losses
with	Losses	with	Losses	with	Losses	with	Losses
Unrealized	Losses	Unrealized	Losses	Unrealized	Losses	Unrealized	Losses

**Debt Securities:**

\$	6,252	\$	(21)	\$	27,717	\$	(555)	\$	33,969	\$	(576)
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Debt securities issued by U.S. government and agencies							
Obligations of states and political subdivisions	17,469	(71)	76,304	(1,163)	93,773	(1,234)	
Corporate securities	7,753	(88)	54,995	(1,461)	62,748	(1,549)	
Mortgage and asset backed securities	18,112	(76)	64,104	(1,564)	82,216	(1,640)	
Totals	\$ 49,586	\$ (256)	\$ 223,120	\$ (4,743)	\$ 272,706	\$ (4,999)	

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	Less than 12 months		December 31, 2005 Greater than 12 months		Total	
	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses
<b>Debt Securities:</b>						
Debt securities issued by U.S. government and agencies	\$ 10,627	\$ (155)	\$ 24,328	\$ (565)	\$ 34,955	\$ (720)
Obligations of states and political subdivisions	64,559	(877)	24,818	(616)	89,377	(1,493)
Corporate securities	33,820	(769)	29,586	(953)	63,406	(1,722)
Mortgage and asset backed securities	58,048	(953)	20,667	(649)	78,715	(1,602)
Totals	\$ 167,053	\$ (2,754)	\$ 99,399	\$ (2,783)	\$ 266,452	\$ (5,537)

As of September 30, 2006, gross unrealized gains and (losses) on securities were \$3.9 million and (\$5.0 million), respectively. As of December 31, 2005, gross unrealized gains and (losses) on securities were \$3.8 million and (\$5.5 million), respectively.

**RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005*****Results of Operations***

Net income for the three months ended September 30, 2006, was \$5.1 million, or \$0.17 per dilutive share, compared to net income of \$4.7 million, or \$0.16 per dilutive share, for the comparable period of 2005. This improvement primarily reflects our selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy. Growth in our fee-for-service programs also contributed to the overall improvement in net income in comparison to 2005.

Revenues for the three months ended September 30, 2006, increased \$1.9 million, or 2.4%, to \$78.9 million, from \$77.0 million for the comparable period in 2005. This increase reflects a \$483,000 increase in net earned premiums. The increase in net earned premiums is the result of our selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy. The increase in revenue was also the result of an overall increase in fee-for-service revenue, primarily as a result of new managed programs. In addition, the increase in revenue reflects a \$993,000 increase in investment income, primarily due to an increase in average invested assets as a result of improved cashflow from favorable underwriting results and proceeds from the junior subordinated debentures issued in the third quarter of 2005. The increase in investment income is also the result of a slight increase in yield.



**Table of Contents****Specialty Risk Management Operations**

The following table sets forth the revenues and results from operations for our specialty risk management operations (in thousands):

	<b>For the Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Revenue:		
Net earned premiums	\$ 63,688	\$ 63,205
Management fees	4,699	4,328
Claims fees	2,295	1,799
Loss control fees	552	611
Reinsurance placement	79	124
Investment income	5,322	4,458
Net realized gains	28	40
Total revenue	\$ 76,663	\$ 74,565
Pre-tax income		
Specialty risk management operations	\$ 9,345	\$ 7,959

Revenues from specialty risk management operations increased \$2.1 million, or 2.8%, to \$76.7 million for the three months ended September 30, 2006, from \$74.6 million for the comparable period in 2005.

Net earned premiums increased \$483,000 to \$63.7 million in the three months ended September 30, 2006, from \$63.2 million in the comparable period in 2005.

Management fees increased \$371,000, or 8.6%, to \$4.7 million for the three months ended September 30, 2006, from \$4.3 million for the comparable period in 2005. This increase is primarily the result of growth in a specific New England based program.

Claim fees increased \$496,000, or 27.6%, to \$2.3 million, from \$1.8 million for the comparable period in 2005. This increase is primarily the result of our 2006 entry into the self-insured workers compensation market in Nevada. In addition, this increase is partially the result of an increase in revenue related to a specific Minnesota-based program.

Net investment income increased \$864,000, or 19.4%, to \$5.3 million in 2006, from \$4.5 million in 2005. Average invested assets increased \$73.4 million, or 17.8%, to \$486.1 million in 2006, from \$412.7 million in 2005. The increase in average invested assets reflects cash flows from underwriting activities primarily from underwriting results and an increase in the duration of our reserves. The increase in the duration of our reserves reflects the impact of our public entity excess program, which was implemented at the end of 2003. This program has a longer duration than the average reserves on our remaining programs and is a larger proportion of reserves. In addition, the \$19.4 million in net proceeds received from capital raised in 2005 through the issuances of debentures increased average invested assets. The average investment yield for September 30, 2006, was 4.6%, compared to 4.5% for the comparable period in 2005. The current pre-tax book yield was 4.3%. The current after-tax book yield for the three months ended September 30, 2006 was 3.3%, compared to 3.0% for the comparable period in 2005. This increase is primarily the result of the shift in our investment portfolio to tax-exempt investments. The duration of the investment portfolio is

3.86 years.

Specialty risk management operations generated pre-tax income of \$9.3 million for the three months ended September 30, 2006, compared to pre-tax income of \$8.0 million for the comparable period in 2005. This increase in pre-tax income demonstrates a continued improvement in underwriting results as a result of our controlled growth in premium volume and our continued focus on leveraging of fixed costs. The GAAP combined ratio was 97.2% for the three months ended September 30, 2006, compared to 99.8% for the same period in 2005.

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Net loss and loss adjustment expenses decreased \$2.3 million, or 6.1%, to \$36.1 million for the three months ended September 30, 2006, from \$38.4 million for the same period in 2005. Our loss and LAE ratio improved 3.8 percentage points to 61.7% for the three months ended September 30, 2006, from 65.5% for the same period in 2005. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. The improvement in the loss and LAE ratio reflects a 5.0 percentage point decrease in the change in net ultimate loss estimates for prior accident years in 2006 as compared to 2005. Development on prior accident year reserves was a favorable \$726,000, or a 1.1 percentage point reduction, to net loss and LAE in 2006, compared to an unfavorable \$2.5 million, or an additional 3.9 percentage points in 2005. The improvement in the loss ratio for 2006 in comparison to 2005 primarily reflects improved results within the workers' compensation and professional liability lines of business, partially offset by the non-reinsured portion of a single property claim within a California-based agricultural program.

Our expense ratio increased 1.2 percentage points to 35.5% for the three months ended September 30, 2006, from 34.3% for the same period in 2005. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. The increase in the expense ratio in comparison to 2005 reflects a slight increase in gross external commissions as a result of a shift in our mix of business and a reduction in an accrual for estimated profit-based ceding commissions on an excess reinsurance treaty for a specific commercial transportation program. This decrease was the result of unfavorable loss development on a limited number of excess of loss claims from prior accident years and added \$794,000 to our expenses, or 1.3 percentage points to our expense ratio in the period. As of September 30, 2006, the remaining accrual was less than \$100,000; therefore, we do not anticipate any further unfavorable adjustments.

**Agency Operations**

The following table sets forth the revenues and results from operations for our agency operations (in thousands):

	<b>For the Three Months Ended September 30, 2006                  2005</b>	
Net commission	\$ 2,401	\$ 2,917
Pre-tax income(1)	\$ 197	\$ 687

- (1) Our agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate overhead allocation excludes those expenses specific to the holding company. For the three months ended September 30, 2006 and 2005, the allocation of corporate overhead to the agency operations segment was \$740,000 and \$609,000, respectively.

Revenue from agency operations, which consists primarily of agency commission revenue, decreased \$516,000, or 17.7%, to \$2.4 million for the three months ended September 30, 2006, from \$2.9 million for the comparable period in 2005. This decrease is primarily the result of a reduction in premium on client renewals. Offsetting this decrease is an increase in agency commission revenue as a result of the November 2005 acquisition of a Florida-based retail agency.

Agency operations generated pre-tax income, after the allocation of corporate overhead, of \$197,000 for the three months ended September 30, 2006, compared to \$687,000 for the comparable period in 2005. This decrease in pre-tax income in comparison to 2005 is primarily the result of the decrease in commission revenue noted above as a result of the reduction in premium on client renewals, offset by the favorable impact from the Florida-based retail agency

acquisition.

**Other Items**

*Reserves*

For the three months ended September 30, 2006, we reported a decrease in net ultimate loss estimates for accident years 2005 and prior of \$726,000, or 0.3% of \$271.4 million of net loss and LAE reserves at December 31,

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2005. There were no significant changes in the key assumptions utilized in the analysis and calculations of our reserves during 2006 and 2005.

### **Salary and Employee Benefits and Other Administrative Expenses**

Salary and employee benefits for the three months ended September 30, 2006, increased \$1.3 million, or 9.8%, to \$14.2 million, from \$12.9 million for the comparable period in 2005. This increase is primarily the result of the recent additions of our Florida-based retail agency and our entry into the self-insured workers' compensation market in Nevada. Excluding those additions, overall staffing levels in 2006 were slightly higher in comparison to 2005. In addition, this increase is the result of a slight increase in variable compensation in comparison to 2005.

Other administrative expenses increased \$871,000, or 14.4%, to \$6.9 million, from \$6.0 million for the comparable period in 2005. This increase is primarily the result of various increases in other general operating expenses in comparison to 2005, primarily as a result of the recent additions of our Florida-based retail agency and our entry into the self-insured workers' compensation market in Nevada. As revenues increase in these two locations we expect to see margins improve. In addition, this increase in other administrative expenses is the result of information technology enhancements.

Salary and employee benefits and other administrative expenses include both corporate overhead and the holding company expenses included in the non-allocated expenses of our segment information.

### **Interest Expense**

Interest expense for the three months ended September 30, 2006, increased \$610,000, or 64.4%, to \$1.6 million, from \$948,000 for the comparable period in 2005. Interest expense is primarily attributable to our debentures, which are described within the *Liquidity and Capital Resources* section of Management's Discussion and Analysis, as well as our current lines of credit. The increase in interest expense was related to the issuance of the junior subordinated debentures in the third quarter of 2005, as well as an overall increase in the average interest rates. The average outstanding balance on our lines of credit during the three months ending September 30, 2006, was \$10.1 million, compared to \$9.8 million for the same period in 2005. The average interest rate, excluding our debentures, increased in 2006 to 6.6%, compared to 4.9% in 2005 as a result of increases in the underlying eurocurrency based rate.

### **Income Taxes**

Income tax expense, which includes both federal and state taxes, for the three months ended September 30, 2006, was \$2.1 million, or 29.1% of income before taxes. For the same period last year, we reflected an income tax expense of \$2.0 million, or 30.5% of income before taxes. Our effective tax rate differs from the 35% statutory rate primarily due to a shift towards increasing investments in tax-exempt securities in an effort to maximize after-tax investment yields. Our current and deferred taxes are calculated using a 35% statutory rate.

**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

Our principal sources of funds, which include both regulated and non-regulated cash flows, are insurance premiums, investment income, proceeds from the maturity and sale of invested assets, risk management fees, and agency commissions. Funds are primarily used for the payment of claims, commissions, salaries and employee benefits, other operating expenses, shareholders' dividends, share repurchases, and debt service. Our regulated sources of funds are insurance premiums, investment income, and proceeds from the maturity and sale of invested assets. These regulated funds are used for the payment of claims, policy acquisition and other underwriting expenses, and taxes relating to the regulated portion of net income. Our non-regulated sources of funds are in the form of commission revenue, outside management fees, and intercompany management fees. These non-regulated sources of funds are used to service debt, shareholders' dividends, share repurchases, and other operating expenses of the holding company and non-regulated subsidiaries. The following table illustrates net income, excluding interest, depreciation, and amortization, between our regulated and non-regulated subsidiaries, which reconciles to our consolidated statement of income and statement of cash flows (in thousands):

	<b>For the Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Net income	\$ 16,093	\$ 12,985
Regulated Subsidiaries:		
Net income	\$ 14,501	\$ 9,463
Adjustments to reconcile net income to net cash provided by operating activities	2,440	2,634
Changes in operating assets and liabilities	26,292	34,464
Total adjustments	28,732	37,098
Net cash provided by operating activities	\$ 43,233	\$ 46,561
Non-regulated Subsidiaries:		
Net income	\$ 1,592	\$ 3,522
Depreciation and amortization	2,209	2,129
Interest	4,445	2,527
Net income, excluding interest, depreciation, and amortization	8,247	8,178
Adjustments to reconcile net income to net cash (used in) provided by operating activities	1,832	3,027
Changes in operating assets and liabilities	(3,681)	(4,411)
Total adjustments	(1,848)	(1,384)
Depreciation and amortization	(2,209)	(2,129)
Interest	(4,445)	(2,527)
Net cash (used in) provided by operating activities	\$ (256)	\$ 2,138
Consolidated total adjustments	26,884	35,714

Consolidated net cash provided by operating activities	\$ 42,977	\$ 48,699
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	<b>For the Three Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Net income	\$ 5,093	\$ 4,662
Regulated Subsidiaries:		
Net income	\$ 4,966	\$ 3,093
Adjustments to reconcile net income to net cash provided by operating activities	1,383	1,141
Changes in operating assets and liabilities	17,596	15,981
Total adjustments	18,979	17,122
Net cash provided by operating activities	\$ 23,945	\$ 20,215
Non-regulated Subsidiaries:		
Net income	\$ 127	\$ 1,569
Depreciation and amortization	781	697
Interest	1,558	948
Net income, excluding interest, depreciation, and amortization	2,466	3,214
Adjustments to reconcile net income to net cash provided by operating activities	203	1,073
Changes in operating assets and liabilities	1,652	2,821
Total adjustments	1,855	3,894
Depreciation and amortization	(781)	(697)
Interest	(1,558)	(948)
Net cash provided by operating activities	\$ 1,982	\$ 5,463
Consolidated total adjustments	20,834	21,016
Consolidated net cash provided by operating activities	\$ 25,927	\$ 25,678

Consolidated cash flow provided by operations for the nine months ended September 30, 2006, was \$42.9 million, compared to consolidated cash flow provided by operations of \$48.7 million for the comparable period in 2005.

Regulated subsidiaries cash flow provided by operations for the nine months ended September 30, 2006, was \$43.2 million, compared to \$46.6 million for the comparable period in 2005. This decrease was primarily the result of timing in relation to reinsurance payments. This decrease was slightly offset as a result of improved underwriting results, lower paid losses in proportion to incurred losses, and an increase in investment income.

Non-regulated subsidiaries cash flow used in operations for the nine months ended September 30, 2006, was \$256,000, compared to cash flow provided by operations of \$2.1 million for the comparable period in 2005. This decrease in cash flow was primarily the result of intercompany tax payments made in 2006 to the holding company



from the regulated subsidiaries in accordance with a tax sharing agreement. There were no payments made in 2005 from the regulated subsidiaries to the holding company because of the utilization of the net operating loss carryforward in 2004.

We anticipate a temporary increase in cash outflows related to our continued investments in technology as we enhance our operating systems and controls. We believe these temporary increases will not affect our liquidity, debt covenants, or other key financial measures.

#### **Other Items**

In September 2003, an unconsolidated subsidiary trust issued \$10.0 million of mandatory redeemable trust preferred securities to a trust formed by an institutional investor. Contemporaneously, we issued \$10.3 million in junior subordinated debentures, which includes our \$310,000 investment in the trust. We received a total of

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\$9.7 million in net proceeds, after the deduction of approximately \$300,000 of commissions paid to the placement agents in the transaction. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense. We contributed \$6.3 million of the proceeds to our Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes. The debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.05%. As of September 30, 2006, the average interest rate was 9.06%.

In April 2004, we issued senior debentures in the amount of \$13.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.0%, which is non-deferrable. As of September 30, 2006, the average interest rate was 8.93%. The senior debentures are callable at par after five years from the date of issuance. Associated with this transaction, we incurred \$390,000 of commissions paid to the placement agents. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

In May 2004, we issued senior debentures in the amount of \$12.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.2%, which is non-deferrable. As of September 30, 2006, the average interest rate was 9.13%. The senior debentures are callable at par after five years from the date of issuance. Associated with this transaction, we incurred \$360,000 of commissions paid to the placement agents. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

We contributed \$9.9 million of the proceeds from the senior debentures to our Insurance Company Subsidiaries in December 2004. The remaining proceeds from the issuance of the senior debentures were used for general corporate purposes.

In September 2005, an unconsolidated subsidiary trust issued \$20.0 million of mandatory redeemable trust preferred securities to a trust formed by an institutional investor. Contemporaneously, we issued \$20.6 million in junior subordinated debentures, which includes our \$620,000 investment in the trust. We received a total of \$19.4 million in net proceeds, after the deduction of approximately \$600,000 of commissions paid to the placement agents in the transaction. These issuance costs have been capitalized and are included in other assets on the balance sheet, which will be amortized over seven years as a component of interest expense. We contributed \$10.0 million of the proceeds to our Insurance Company Subsidiaries and the remaining balance will be used for general corporate purposes. The debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 3.58%. As of September 30, 2006, the average interest rate was 8.54%.

The seven year amortization period in regard to the issuance costs represents our best estimate of the estimated useful life of the bonds related to both the senior debentures and junior subordinated debentures described above.

In October 2005, we entered into two interest rate swap transactions with LaSalle Bank ( LaSalle ) to mitigate our interest rate risk on \$5.0 million and \$20.0 million of our senior debentures and trust preferred securities, respectively. In accordance with Statement of Financial Accounting Standards ( SFAS ) No. 133 *Accounting for Derivative Instruments and Hedging Activities*, these interest rate swap transactions were recorded at fair value on the balance sheet and any changes in their fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and is recognized as an adjustment to interest expense.

The first interest rate swap transaction, which relates to \$5.0 million of our \$12.0 million issuance of senior debentures, has an effective date of October 6, 2005 and an ending date of May 24, 2009. We are required to make certain quarterly fixed rate payments to LaSalle calculated on a notional amount of \$5.0 million, non-amortizing, based on a fixed annual interest rate of 8.925%. LaSalle is obligated to make quarterly floating rate payments to us

referencing the same notional amount, based on the three-month LIBOR, plus 4.20%.

The second interest rate swap transaction, which relates to \$20.0 million of our \$20.0 million issuance of trust preferred securities, has an effective date of October 6, 2005 and an ending date of September 16, 2010. We are required to make quarterly fixed rate payments to LaSalle calculated on a notional amount of \$20.0 million, non-amortizing, based on a fixed annual interest rate of 8.34%. LaSalle is obligated to make quarterly floating rate payments to us referencing the same notional amount, based on the three-month LIBOR, plus 3.58%.

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In relation to the above interest rate swaps, the net interest income received for the nine months ended September 30, 2006, was approximately \$27,000. For the three months ended September 30, 2006, the net interest income received was approximately \$36,000. The total fair value of the interest rate swaps as of September 30, 2006 and December 31, 2005, was approximately \$182,000 and \$14,000, respectively. Accumulated other comprehensive income at September 30, 2006 and December 31, 2005, included the accumulated income on the cash flow hedge, net of taxes, of \$118,000 and \$9,100, respectively

In November 2004, we entered into a revolving line of credit for up to \$25.0 million, which expires in November 2007. We use the revolving line of credit to meet short-term working capital needs. Under the revolving line of credit, we and certain of our non-regulated subsidiaries pledged security interests in certain property and assets of named subsidiaries.

At September 30, 2006 and December 31, 2005, we had an outstanding balance of \$9.7 million and \$5.0 million on the new revolving line of credit, respectively.

The revolving line of credit provides for interest at a variable rate based, at our option, upon either a prime based rate or LIBOR-based rate. In addition, the revolving line of credit also provides for an unused facility fee. On prime based borrowings, the applicable margin ranges from 75 to 25 basis points below prime. On LIBOR-based borrowings, the applicable margin ranges from 125 to 175 basis points above LIBOR. The margin for all loans is dependent on the sum of non-regulated earnings before interest, taxes, depreciation, amortization, and non-cash impairment charges related to intangible assets for the preceding four quarters, plus dividends paid or payable to us from subsidiaries during such period ( Adjusted EBITDA ). As of September 30, 2006, the average interest rate for LIBOR-based borrowings was 6.7%.

Debt covenants consist of: (1) maintenance of the ratio of Adjusted EBITDA to interest expense of 2.0 to 1.0, (2) minimum net worth of \$130.0 million and increasing annually, commencing June 30, 2005, by fifty percent of the prior year's positive net income, (3) minimum A.M. Best rating of B , and (4) on an annual basis, a minimum Risk Based Capital Ratio for Star of 1.75 to 1.00. As of September 30, 2006, we were in compliance with these covenants.

Previously, our non-insurance premium finance subsidiary maintained a line of credit with a bank. At December 31, 2005, this line of credit had an outstanding balance of \$2.0 million. In May 2006, the balance of this loan was paid in full and the terms of the line of credit were not renewed.

At September 30, 2006, shareholders' equity was \$195.5 million, or \$6.73 per common share, compared to \$177.4 million, or \$6.19 per common share, at December 31, 2005.

On October 28, 2005, our Board of Directors authorized management to purchase up to 1,000,000 shares of our common stock in market transactions for a period not to exceed twenty-four months. For the three months and nine months ended September 30, 2006, we did not repurchase any common stock. For the year ended December 31, 2005, we purchased and retired a total of 772,900 shares of common stock for a total cost of approximately \$4.2 million. Of these shares, 63,000 shares for a total cost of approximately \$372,000 related to the current share repurchase plan. As of September 30, 2006, the cumulative amount we repurchased and retired under our current share repurchase plan was 63,000 shares of common stock for a total cost of approximately \$372,000. As of September 30, 2006, we have available up to 937,000 shares remaining to be purchased.

A significant portion of our consolidated assets represent assets of our Insurance Company Subsidiaries. The State of Michigan Office of Financial and Insurance Services ( OFIS ), restricts the amount of funds that may be transferred to us in the form of dividends, loans or advances. These restrictions in general, are as follows: the maximum discretionary dividend that may be declared, based on data from the preceding calendar year, is the greater of each

insurance company's net income (excluding realized capital gains) or ten percent of the insurance company's surplus (excluding unrealized gains). These dividends are further limited by a clause in the Michigan law that prohibits an insurer from declaring dividends except out of surplus earnings of the company. Earned surplus balances are calculated on a quarterly basis. Since Star is the parent insurance company, its maximum dividend calculation represents the combined Insurance Company Subsidiaries' surplus. At September 30, 2006, Star's earned surplus position was positive \$10.5 million. At December 31, 2005, Star had negative earned surplus of \$7.2 million. Based upon the September 30, 2006 statutory financial statements, Star may pay a dividend of up to

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\$10.5 million without the prior approval of OFIS. No statutory dividends were paid in 2005 or during the nine months ended September 30, 2006.

## **Contractual Obligations and Commitments**

There were no material changes outside the ordinary course of our business in relation to our contractual obligations and commitments for the three months and nine months ended September 30, 2006.

## **Regulatory and Rating Issues**

The National Association of Insurance Commissioners ( NAIC ) has adopted a risk-based capital ( RBC ) formula to be applied to all property and casualty insurance companies. The formula measures required capital and surplus based on an insurance company's products and investment portfolio and is used as a tool to evaluate the capital of regulated companies. The RBC formula is used by state insurance regulators to monitor trends in statutory capital and surplus for the purpose of initiating regulatory action. In general, an insurance company must submit a calculation of its RBC formula to the insurance department of its state of domicile as of the end of the previous calendar year. These laws require increasing degrees of regulatory oversight and intervention as an insurance company's RBC declines. The level of regulatory oversight ranges from requiring the insurance company to inform and obtain approval from the domiciliary insurance commissioner of a comprehensive financial plan for increasing its RBC to mandatory regulatory intervention requiring an insurance company to be placed under regulatory control in a rehabilitation or liquidation proceeding.

At December 31, 2005, all of our Insurance Company Subsidiaries were in compliance with RBC requirements. Star reported statutory surplus of \$141.1 million at December 31, 2005, compared to the threshold requiring the minimum regulatory involvement of \$74.5 million in 2005. At September 30, 2006, Star's statutory surplus increased \$19.8 million to \$160.9 million.

Insurance operations are subject to various leverage tests (e.g. premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. Our targets for gross and net written premium to statutory surplus are 2.8 to 1.0 and 2.25 to 1.0, respectively. As of September 30, 2006, on a statutory consolidated basis, gross and net premium leverage ratios were 2.0 to 1.0 and 1.6 to 1.0, respectively.

## **Reinsurance**

Intercompany pooling agreements are commonly entered into between affiliated insurance companies, so as to allow the companies to utilize the capital and surplus of all of the companies, rather than each individual company. Under pooling arrangements, companies share in the insurance business that is underwritten and allocate the combined premium, losses and related expenses between the companies within the pooling arrangement. The Insurance Company Subsidiaries entered into an Inter-Company Reinsurance Agreement (the Pooling Agreement ). This Pooling Agreement includes Star, Ameritrust Insurance Corporation ( Ameritrust ), Savers Property and Casualty Insurance Company ( Savers ) and Williamsburg National Insurance Company ( Williamsburg ). Pursuant to the Pooling Agreement, Savers, Ameritrust and Williamsburg have agreed to cede to Star and Star has agreed to reinsure 100% of the liabilities and expenses of Savers, Ameritrust and Williamsburg, relating to all insurance and reinsurance policies issued by them. In return, Star agrees to cede and Savers, Ameritrust and Williamsburg have agreed to reinsure Star for their respective percentages of the liabilities and expenses of Star. Annually, we examine the Pooling Agreement for any changes to the ceded percentage for the liabilities and expenses. Any changes to the Pooling Agreement must be submitted to the applicable regulatory authorities for approval.

## **Convertible Note**

In July 2005, we made a \$2.5 million loan, at an effective interest rate equal to the three-month LIBOR, plus 5.2%, to an unaffiliated insurance agency. In December 2005, we loaned an additional \$3.5 million to the unaffiliated insurance agency. The original \$2.5 million demand note was replaced with a \$6.0 million convertible note. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This agency has been a producer for us for over ten years. As security for the loan, the borrower

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granted us a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible upon our option based upon a pre-determined formula, beginning in 2008. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At September 30, 2006, the estimated fair value of the derivative was zero.

## **Recent Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*. Under current generally accepted accounting principles, an entity that holds a financial instrument with an embedded derivative must bifurcate the financial instrument, resulting in the host and the embedded derivative being accounted for separately. SFAS No. 155 permits, but does not require, entities to account for financial instruments with an embedded derivative at fair value thus negating the need to bifurcate the instrument between its host and the embedded derivative. SFAS No. 155 is effective for fiscal periods beginning after September 15, 2006. The adoption of SFAS No. 155 will not impact our consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*. SFAS No. 156 amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to require that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. SFAS No. 156 permits, but does not require, the subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value. An entity that uses derivative instruments to mitigate the risks inherent in servicing assets and servicing liabilities is required to account for those derivative instruments at fair value. SFAS No. 156 is effective for fiscal periods beginning after September 15, 2006. The adoption of SFAS No. 156 will not impact our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* ( FIN 48 ), which becomes effective for fiscal years beginning after December 15, 2006. FIN 48 clarifies the accounting and reporting for uncertainties in the income tax law. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition, measurement, and presentation of uncertain tax positions taken or expected to be taken in an income tax return. We will commence evaluation of the impact of FIN 48, but we currently believe the adoption of FIN 48 will not have a material impact on our consolidated financial statements or disclosure requirements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which becomes effective for fiscal years beginning after November 15, 2007. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. We will evaluate the impact of SFAS No. 157, but believe the adoption of SFAS No. 157 will not have a material impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. SFAS No. 158 requires the recognition, on a prospective basis, of the funded status of a company's defined benefit plan as an asset or liability. In addition, any unrecognized gains and losses or prior service costs shall be recognized as a component of accumulated other comprehensive income. SFAS No. 158 will also require additional disclosures in the notes to financial statements. SFAS No. 158 is effective for fiscal years ending after December 15, 2006, with early application encouraged. We will evaluate the impact of SFAS No. 158, but believe the adoption of SFAS No. 158 will not impact our consolidated financial statements.



**Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates as well as other relevant market rate or price changes. The volatility and liquidity in the markets in which the underlying assets are traded directly influence market risk. The following is a discussion of our primary risk exposures and how those exposures are currently managed as of September 30, 2006. Our market risk sensitive

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instruments are primarily related to fixed income securities, which are available for sale and not held for trading purposes.

Interest rate risk is managed within the context of an asset and liability management strategy where the target duration for the fixed income portfolio is based on the estimate of the liability duration and takes into consideration our surplus. The investment policy guidelines provide for a fixed income portfolio duration of between three and a half and five and a half years. At September 30, 2006, our fixed income portfolio had a modified duration of 3.86, compared to 3.38 at December 31, 2005.

At September 30, 2006, the fair value of our investment portfolio was \$476.7 million. Our market risk to the investment portfolio is interest rate risk associated with debt securities. Our exposure to equity price risk is not significant. Our investment philosophy is one of maximizing after-tax earnings and has historically included significant investments in tax-exempt bonds. During 2005 and 2006, we continued to increase our holdings of tax-exempt securities based on our return to profitability and our desire to maximize after-tax investment income. For our investment portfolio, there were no significant changes in our primary market risk exposures or in how those exposures are managed compared to the year ended December 31, 2005. We do not anticipate significant changes in our primary market risk exposures or in how those exposures are managed in future reporting periods based upon what is known or expected to be in effect.

A sensitivity analysis is defined as the measurement of potential loss in future earnings, fair values, or cash flows of market sensitive instruments resulting from one or more selected hypothetical changes in interest rates and other market rates or prices over a selected period. In our sensitivity analysis model, a hypothetical change in market rates is selected that is expected to reflect reasonable possible near-term changes in those rates. Near term means a period of up to one year from the date of the consolidated financial statements. In our sensitivity model, we use fair values to measure our potential loss in fair value of debt securities assuming an upward parallel shift in interest rates to measure the hypothetical change in fair values. The table below presents our model's estimate of changes in fair values given a change in interest rates. Dollar values are rounded and in thousands.

	<b>Rates Down 100bps</b>	<b>Rates Unchanged</b>	<b>Rates Up 100bps</b>
Market Value	\$ 495,530	\$ 476,665	\$ 457,759
Yield to Maturity or Call	3.53%	4.53%	5.53%
Effective Duration	3.80	3.92	3.91

The other financial instruments, which include cash and cash equivalents, equity securities, premium receivables, reinsurance recoverables, line of credit and other assets and liabilities, when included in the sensitivity model, do not produce a material loss in fair values.

Our debentures are subject to variable interest rates. Thus, our interest expense on these debentures is directly correlated to market interest rates. At September 30, 2006 and December 31, 2005, we had debentures of \$55.9 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$559,000.

In October 2005, we entered into two interest rate swap transactions with LaSalle Bank to mitigate our interest rate risk on \$5.0 million and \$20.0 million of our senior debentures and trust preferred securities, respectively. We recognized these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities*, as subsequently amended. These interest rate swap transactions have been designated as a cash flow hedge

and are deemed a highly effective transaction under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and any changes in their fair value are accounted for within other comprehensive income. The interest differential to be paid or received is being accrued and is being recognized as an adjustment to interest expense.

In addition, our revolving line of credit under which we can borrow up to \$25.0 million is subject to variable interest rates. Thus, our interest expense on the revolving line of credit is directly correlated to market interest rates. At September 30, 2006, we had \$9.7 million outstanding on this revolving line of credit. At this level, a 100 basis point (1%) change in market rates would have changed interest expense by \$97,000. At December 31, 2005, we had

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\$5.0 million outstanding. At this level, a 100 basis point (1%) change in market rates would have changed interest expense by \$50,000.

### **Item 4. *Controls and Procedures***

#### **Evaluation of Disclosure Controls and Procedures.**

Our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, the Exchange Act ), which we refer to as disclosure controls, are controls and procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Exchange Act, such as this Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any control system. A control system, no matter how well conceived and operated, can provide only reasonable assurance that its objectives are met. No evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

As of September 30, 2006, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of disclosure controls. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls were effective in recording, processing, summarizing, and reporting, on a timely basis, material information required to be disclosed in the reports we file under the Exchange Act and is accumulated and communicated, as appropriate to allow timely decisions regarding required disclosure.

#### **Changes in Internal Control over Financial Reporting**

There were no significant changes in our internal control over financial reporting during the three month period ended September 30, 2006, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1. *Legal Proceedings***

The information required by this item is included under Note 9 *Commitments and Contingencies* of the Notes to the Consolidated Financial Statements of the Company's Form 10-Q for the nine months ended September 30, 2006, which is hereby incorporated by reference.

#### **Item 1A. *Risk Factors***

There have been no material changes to the Risk Factors previously disclosed in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

### **Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds***

In October 2005, the Company's Board of Directors authorized management to repurchase up to 1,000,000 shares of its common stock in market transactions for a period not to exceed twenty-four months.

For the three months ended September 30, 2006, the Company did not purchase and retire any shares of common stock. The maximum number of shares that may yet be repurchased under the Company's current share repurchase plan is 937,000 shares, as reported in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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**Item 6. Exhibits**

The following documents are filed as part of this Report:

**Exhibit**

**No.**

**Description**

- |      |   |
|------|---|
| 31.1 | Certification of Robert S. Cubbin, Chief Executive Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).  |
| 31.2 | Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).  |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Robert S. Cubbin, Chief Executive Officer of the Corporation.                         |
| 32.2 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation. |

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**SIGNATURES**

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Meadowbrook Insurance Group, Inc.

By: *Senior Vice President and  
Chief Financial Officer* /s/ Karen M. Spaun

Dated: November 8, 2006

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