

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

November 07, 2005

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarter ended September 30, 2005

or

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

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, 2005 was 28,684,282.

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Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer, Pursuant to Rule 13a-14(a)

Certification of Robert S. Cubbin, Chief Executive Officer, Pursuant to Section 906

Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer, Pursuant to Section 906

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CONSOLIDATED STATEMENTS OF INCOME**

	For the Nine Months Ended September 30,	
	2005	2004
	(Unaudited) (In thousands, except share data)	
Revenues		
Premiums earned		
Gross	\$ 244,016	\$ 211,125
Ceded	(56,660)	(55,366)
Net earned premiums	187,356	155,759
Net commissions and fees	27,333	32,794
Net investment income	13,159	10,901
Net realized gains (losses)	31	(73)
Total revenues	227,879	199,381
Expenses		
Losses and loss adjustment expenses	179,669	158,467
Reinsurance recoveries	(66,338)	(61,303)
Net losses and loss adjustment expenses	113,331	97,164
Salaries and employee benefits	39,166	39,417
Policy acquisition and other underwriting expenses	33,740	24,585
Other administrative expenses	19,868	19,367
Interest expense	2,527	1,529
Total expenses	208,632	182,062
Income before taxes and equity earnings	19,247	17,319
Federal and state income tax expense	6,250	6,043
Equity (losses) earnings, of affiliates	(12)	28
Net income	\$ 12,985	\$ 11,304
Earnings Per Share		
Basic	\$ 0.45	\$ 0.39
Diluted	\$ 0.44	\$ 0.38
Weighted average number of common shares		
Basic	29,052,785	29,040,503

Diluted

29,363,045

29,420,049

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

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**MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF INCOME**

	For the Three Months Ended September 30,	
	2005	2004
	(Unaudited) (In thousands, except share data)	
Revenues		
Premiums earned		
Gross	\$ 82,466	\$ 75,025
Ceded	(19,261)	(22,062)
Net earned premiums	63,205	52,963
Net commissions and fees	9,200	12,669
Net investment income	4,591	3,757
Net realized gains	41	79
Total revenues	77,037	69,468
Expenses		
Losses and loss adjustment expenses	61,805	57,056
Reinsurance recoveries	(23,336)	(25,227)
Net losses and loss adjustment expenses	38,469	31,829
Salaries and employee benefits	12,913	14,284
Policy acquisition and other underwriting expenses	11,947	8,169
Other administrative expenses	6,037	6,802
Interest expense	948	686
Total expenses	70,314	61,770
Income before taxes and equity earnings	6,723	7,698
Federal and state income tax expense	2,048	2,509
Equity (losses) earnings, of affiliates	(13)	63
Net income	\$ 4,662	\$ 5,252
Earnings Per Share		
Basic	\$ 0.16	\$ 0.18
Diluted	\$ 0.16	\$ 0.18
Weighted average number of common shares		
Basic	28,957,369	29,059,626
Diluted	29,269,638	29,425,674

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

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MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	For the Nine Months Ended September 30,	
	2005	2004
	(Unaudited)	
	(In thousands)	
Net income	\$ 12,985	\$ 11,304
Other comprehensive income (loss), net of tax:		
Unrealized losses on securities	(4,844)	(1,386)
Less: reclassification adjustment for losses included in net income	61	41
Other comprehensive loss, net of tax	(4,783)	(1,345)
Comprehensive income	\$ 8,202	\$ 9,959

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

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MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	For the Three Months Ended September 30,	
	2005	2004
	(Unaudited) (In thousands)	
Net income	\$ 4,662	\$ 5,252
Other comprehensive income (loss), net of tax:		
Unrealized (losses) gains on securities	(3,633)	3,285
Less: reclassification adjustment for (gains) losses included in net income	(18)	(19)
Other comprehensive (loss) gain, net of tax	(3,651)	3,266
Comprehensive income	\$ 1,011	\$ 8,518

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

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**MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED BALANCE SHEETS**

	September 30, 2005	December 31, 2004
(Unaudited)		
(In thousands, except share data)		
ASSETS		
Investments		
Debt securities available for sale, at fair value (amortized cost of \$382,183 and \$324,966)	\$ 382,250	\$ 332,242
Equity securities available for sale, at fair value (cost of \$0)		39
Total investments	382,250	332,281
Cash and cash equivalents	51,897	69,875
Accrued investment income	4,631	4,331
Premiums and agent balances receivable, net	105,815	84,094
Reinsurance recoverable on:		
Paid losses	15,095	17,908
Unpaid losses	181,262	151,161
Prepaid reinsurance premiums	24,743	26,075
Deferred policy acquisition costs	26,594	25,167
Deferred federal income taxes	16,354	14,956
Goodwill	28,997	28,997
Other assets	44,168	46,851
Total assets	\$ 881,806	\$ 801,696
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities		
Losses and loss adjustment expenses	\$ 443,294	\$ 378,157
Unearned premiums	143,312	134,302
Debt	2,298	12,144
Debentures	55,930	35,310
Accounts payable and accrued expenses	28,997	38,837
Reinsurance funds held and balances payable	15,388	17,832
Payable to insurance companies	5,526	6,990
Other liabilities	13,107	10,614
Total liabilities	707,852	634,186
Commitments and contingencies (Note 6)		
Shareholders Equity		
Common stock, \$0.01 stated value; authorized 50,000,000 shares; 28,759,282 and 29,074,832 shares issued and outstanding	288	290

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Additional paid-in capital	124,968	126,085
Retained earnings	49,512	37,175
Note receivable from officer	(859)	(868)
Accumulated other comprehensive income	45	4,828
Total shareholders equity	173,954	167,510
Total liabilities and shareholders equity	\$ 881,806	\$ 801,696

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

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

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

2005 2004

**(Unaudited)
(In thousands)**

Cash Flows From Operating Activities

Net income	\$ 12,985	\$ 11,304
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of other intangible assets	277	284
Amortization of deferred debenture issuance costs	116	73
Depreciation of furniture, equipment, and building	1,853	1,087
Net accretion of discount and premiums on bonds	1,786	1,318
Loss on sale of investments, net	94	63
Gain on sale of fixed assets	(148)	(22)
Stock-based employee compensation	32	61
Long-term incentive plan expense	585	488
Deferred income tax expense	1,067	2,193
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Premiums and agent balances receivable	(21,721)	(22,572)
Reinsurance recoverable on paid and unpaid losses	(27,289)	(11,104)
Prepaid reinsurance premiums	1,332	(3,514)
Deferred policy acquisition costs	(1,427)	(3,918)
Other assets	6,172	4,244
Increase (decrease) in:		
Losses and loss adjustment expenses	65,137	32,677
Unearned premiums	9,010	20,035
Payable to insurance companies	(1,464)	(106)
Reinsurance funds held and balances payable	(2,444)	5,946
Other liabilities	2,746	4,807
Total adjustments	35,714	32,040
Net cash provided by operating activities	48,699	43,344

Cash Flows From Investing Activities

Purchase of debt securities available for sale	(174,301)	(87,022)
Proceeds from sales and maturities of debt securities available for sale	115,196	38,294
Proceeds from sales of equity securities available for sale	8	
Capital expenditures	(14,050)	(3,156)
Purchase of books of business	(342)	(361)
Proceeds from sale of assets	633	2,784
Deconsolidation of subsidiary		(4,218)

Other investing activities	(1,942)	2,398
Net cash used in investing activities	(74,798)	(51,281)
Cash Flows From Financing Activities		
Proceeds from lines of credit	6,388	9,829
Payment of lines of credit	(16,234)	(13,585)
Net proceeds from debentures	19,400	24,250
Book overdraft	1,172	(607)
Stock options exercised	995	125
Share repurchases of common stock	(3,404)	
Other financing activities	(196)	14
Net cash provided by financing activities	8,121	20,026
Net (decrease) increase in cash and cash equivalents	(17,978)	12,089
Cash and cash equivalents, beginning of period	69,875	50,647
Cash and cash equivalents, end of period	\$ 51,897	\$ 62,736

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. In addition, the consolidated financial statements include the equity earnings of the Company's wholly owned unconsolidated subsidiaries, American Indemnity Insurance Company, Ltd., Meadowbrook Capital Trust I, and Meadowbrook Capital Trust II.

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, 2005, 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, 2004.

Certain amounts in the 2004 financial statements and notes to consolidated financial statements have been reclassified to conform to the 2005 presentation. These amounts specifically relate to state income tax expense, the allocation of corporate overhead, and a reclassification of revenue and net income related to a specific subsidiary. State income tax expense has been reclassified from total expenses to federal and state income tax expense. The Company's segment information has been reclassified to include an allocation of corporate overhead from the specialty risk management operations segment to the agency operations segment. This reclassification for the allocation of corporate overhead more accurately presents the Company's segments as a result of improved cost allocation information. Previously, 100% of corporate overhead was allocated to specialty risk management operations. In addition, the Company reclassified revenues and the overall net income related to a specific subsidiary from the agency operations segment to the specialty risk management operations segment. Refer to Note 7 *Segment Information* for additional information.

Revenue Recognition

Premiums written 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. Certain premiums are subject to retrospective premium adjustments. Premiums are recognized over the term of the insurance policy.

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 are earned. Commission income is reported net of sub-producer commission expense. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

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

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 619,092 and 976,020 for the nine months ended September 30, 2005 and 2004, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive. Shares issuable pursuant to stock options included in diluted earnings per share were 310,260 and 307,386 for the nine months ended September 30, 2005 and 2004, respectively. In addition, shares issuable pursuant to outstanding warrants included in diluted earnings per share were 72,160 for the nine months ended September 30, 2004. There were no outstanding warrants as of September 30, 2005.

Outstanding options of 619,092 and 976,020 for the three months ended September 30, 2005 and 2004, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive. Shares issuable pursuant to stock options included in diluted earnings per share were 312,269 and 296,481 for the three months ended September 30, 2005 and 2004, respectively. In addition, shares issuable pursuant to outstanding warrants included in diluted earnings per share were 69,567 for the three months ended September 30, 2004. There were no outstanding warrants as of September 30, 2005.

Stock Options

Effective January 1, 2003, the Company adopted the requirements of Statement of Financial Accounting Standards (SFAS) No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123*, utilizing the prospective method. Under the prospective method, stock-based compensation expense is recognized for awards granted after the beginning of the fiscal year in which the change is made. Upon implementation of SFAS No. 148 in 2003, the Company is recognizing 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, if any, resulting from stock options granted by the Company is 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.

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.

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

In 2004, the Company's Board of Directors 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 Committee 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 award would be made in three annual installments. 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 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 Committee, as included in the LTIP. At September 30, 2005 and December 31, 2004, the Company had \$2.5 million and \$1.3 million accrued under the LTIP, respectively.

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 periods ending September 30, 2005 and 2004 would be as follows (in thousands):

	For the Nine Months Ended September 30,	
	2005	2004
Net income, as reported	\$ 12,985	\$ 11,304
Stock-based employee compensation expense included in reported income, net of related tax effects	21	40
Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(161)	(344)
Pro forma net income	\$ 12,845	\$ 11,000
Earnings per share:		
Basic as reported	\$ 0.45	\$ 0.39
Basic pro forma	\$ 0.44	\$ 0.38
Diluted as reported	\$ 0.44	\$ 0.38
Diluted pro forma	\$ 0.44	\$ 0.37

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

	For the Three Months Ended September 30,	
	2005	2004
Net income, as reported	\$ 4,662	\$ 5,252
Stock-based employee compensation expense included in reported income, net of related tax effects	6	11
Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(40)	(93)
Pro forma net income	\$ 4,628	\$ 5,170
Earnings per share:		
Basic as reported	\$ 0.16	\$ 0.18
Basic pro forma	\$ 0.16	\$ 0.18
Diluted as reported	\$ 0.16	\$ 0.18
Diluted pro forma	\$ 0.16	\$ 0.18

No options were granted during the nine months and three months ending September 30, 2005 or 2004.

Compensation expense of \$32,000 and \$61,000 has been recorded in the nine months ended September 30, 2005 and 2004, respectively, under SFAS 148. Compensation expense of \$9,000 and \$17,000 has been recorded in the three months ended September 30, 2005 and 2004, respectively.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), which replaces SFAS No. 123, *Accounting for Stock Issued to Employees*. SFAS 123(R) requires all share-based payments to employees to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123, will no longer be an alternative to financial statement recognition. Commencing in the first quarter of 2003, the Company began expensing the fair value of all stock options granted since January 1, 2003 under the prospective method. Under SFAS 123(R), the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded at the beginning of the first quarter of adoption of SFAS 123(R) for all unvested stock options and restricted stock based upon the previously disclosed SFAS 123 methodology and amounts. The retroactive methods would record compensation expense beginning with the first period restated for all unvested stock options and restricted stock. On April 14, 2005, the Securities and Exchange Commission adopted a new rule that delays the compliance dates for SFAS 123(R). Under the new rule, SFAS 123(R) is effective for public companies for annual, rather than interim periods, that begin after June 15, 2005. Therefore, the Company is required to adopt SFAS 123(R) in the first quarter of 2006, or beginning January 1, 2006. The Company has evaluated the requirements of SFAS 123(R) and has determined the impact on its financial statements related to existing stock options is immaterial.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS No. 154 replaces the mentioned pronouncements and changes the

requirements for the accounting and reporting of a change in an accounting principle. This Statement applies to all voluntary changes in accounting principle, as well as changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. However, when a pronouncement includes specific transition provisions, those provisions

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(Unaudited)**

should be followed. SFAS No. 154 requires retrospective application to prior period financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle should be recognized in the period of the accounting change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. However, early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement was issued. The Company is required to adopt the provisions of SFAS No. 154, as applicable, beginning in 2006. Management believes the adoption of SFAS No. 154 will not have a material impact on its consolidated financial statements.

In July 2005, the FASB issued an exposure draft of a proposed interpretation on accounting for uncertain tax positions under SFAS No. 109 *Accounting for Income Taxes*. If adopted as proposed, the pronouncement will be effective December 31, 2005 and only those tax benefits that meet the probable recognition threshold may be recognized or continue to be recognized as of the effective date. The Company has evaluated the impact this proposed interpretation will have on its financial statements and does not expect it to have a material impact.

Note 2 Reinsurance

The Insurance Company Subsidiaries cede insurance to other insurers 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 insurers and reinsurers, both domestic and foreign, under pro-rata and excess-of-loss contracts. 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. Effective January 1, 2005, 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. The Pooling Agreement was filed with the applicable regulatory authorities. Any changes to the Pooling Agreement must be submitted to the applicable regulatory authorities.

At September 30, 2005, the Company had reinsurance recoverables for paid and unpaid losses of \$196.4 million. The Company customarily collateralizes reinsurance balances due from non-admitted reinsurers through funds withheld trusts or letters of credit. The largest unsecured reinsurance recoverable is

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

due from an admitted reinsurer with an A A.M. Best rating and accounts for 37.0%, or \$72.6 million, of the total recoverable for paid and unpaid losses.

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. 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.

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. In addition, the Company purchased an additional \$1.0 million of reinsurance clash coverage. The Company also 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, applied separately to general liability and auto liability.

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.

Under the semi-automatic facultative reinsurance treaties, covering the Company's umbrella policies, the reinsurers are responsible for a minimum of 85% of the first million in coverage and 100% of each of the second through fifth million of coverage, up to \$5.0 million. The reinsurers pay a ceding commission to reimburse the Company for its expenses associated with the treaties.

Effective September 30, 2004, the Company amended an existing reinsurance agreement that provided reinsurance coverage for policies with effective dates from August 1, 2003 to July 31, 2004, which were written in the Company's public entity excess liability program. This reinsurance agreement provided coverage on an excess-of-loss basis for each occurrence in excess of the policyholder's self-insured and the Company's retained limit. This reinsurance agreement was amended by revising premium rate and loss coverage terms, which effected the transfer of risk to the reinsurer and reduced the net estimated costs of reinsurance to the Company. The amended reinsurance cost for this coverage is a flat percentage of premium subject to this treaty and 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. These amended terms were applicable to the renewal of this reinsurance agreement for the period August 1, 2004 to January 31, 2006.

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

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

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.

In its risk-sharing programs, the Company is also subject to credit risk with respect to the payment of claims by its clients' captive, rent-a-captive, large deductible programs, indemnification agreements, and on the portion of risk exposure either ceded to the captives, or retained by the clients. The capitalization and credit worthiness of prospective risk-sharing partners is one of the factors considered by the Company in entering into and renewing risk-sharing programs. The Company collateralizes balances due from its risk-sharing partners through funds withheld trusts or letters of credit. At September 30, 2005, the Company had risk exposure in excess of collateral in the amount of \$10.6 million on these programs, of which the Company has an allowance of \$8.5 million, related to these exposures. At June 30, 2005, the Company increased its exposure allowance related to reinsurance recoverables for a specific discontinued surety program. The Company had received an updated financial report from the liquidator of the defunct reinsurer on that program. Based upon this information, the Company increased the allowance in relation to this program to 100% of the uncollateralized exposure as of June 30, 2005. The Company's total net exposure, after collateral and allowances, for uncollectible reinsurance at September 30, 2005, was \$2.1 million, up from \$1.9 million at June 30, 2005.

The Company has historically maintained an allowance for the potential uncollectibility of certain reinsurance balances due from some risk-sharing partners, some of which are in litigation with the Company. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. As of September 30, 2005, management believes that this allowance is adequate. No assurance can be given, however, regarding the future ability of any of the Company's risk-sharing partners to meet their obligations.

Note 3 Debt

Lines of Credit

In November 2004, the Company entered into a revolving line of credit for up to \$25.0 million. The revolving line of credit replaced the Company's former term loan and line of credit and expires in November 2007. The Company had drawn approximately \$9.0 million on this new revolving line of credit to pay off its former term loan. The Company used 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, 2005, there was no outstanding balance on the revolving line of credit. On December 31, 2004, the Company had an outstanding balance of \$9.0 million on the revolving line of credit.

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. 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). For the three month period ending September 30, 2005, the average interest rate for LIBOR-based borrowings was 4.7%.

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

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, 2005, the Company was in compliance with these covenants.

In addition, a non-insurance premium finance subsidiary of the Company maintains a line of credit with a bank, which permits borrowings up to 75% of the accounts receivable, which collateralize the line of credit. At September 30, 2005, this line of credit had an outstanding balance of \$2.3 million. On April 26, 2005, the terms of this line of credit were modified. The modifications included a decrease in the line of credit from \$8.0 million to \$6.0 million. The interest terms of this line of credit provide for interest at the prime rate minus 0.5%, or a LIBOR-based rate, plus 2.0%. At September 30, 2005, the LIBOR-based option was 5.6% and the average interest rate was 5.6%.

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. 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. 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 may be used to support future premium growth through further contributions to the Insurance Company Subsidiaries and 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%. 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 will be used for general corporate purposes.

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

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%. 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 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 that 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 4 Shareholders Equity

At September 30, 2005, shareholders' equity was \$174.0 million, or a book value of \$6.05 per common share, compared to \$167.5 million, or a book value of \$5.76 per common share, at December 31, 2004.

In November 2004, 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 nine months and three months ended September 30, 2005, the Company purchased and retired 634,900 and 426,110 shares of common stock for a total cost of approximately \$3.4 million and \$2.3 million, respectively. The Company did not repurchase any common stock during 2004. As of September 30, 2005, the cumulative amount the Company repurchased and retired under the current share repurchase plan was 634,900 shares of common stock for a total cost of approximately \$3.4 million.

At the Company's regularly scheduled board meeting on October 28, 2005, the Company's Board of Directors authorized management to purchase up to 1,000,000 shares, or approximately 3%, of the Company's common stock in market transactions for a period not to exceed twenty-four months.

Note 5 Regulatory Matters and Rating Agencies

A significant portion of the Company's consolidated assets represent assets of the Insurance Company Subsidiaries that at this time, without prior approval of the State of Michigan Office of Financial and Insurance Services (OFIS), cannot be transferred to the holding company in the form of dividends, loans or advances. The restriction on the transferability to the holding company from its Insurance Company Subsidiaries is regulated by Michigan insurance regulatory statutes which, 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

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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. Based upon the 2004 statutory financial statements, Star may only pay dividends to the Company during 2005 with the prior approval of OFIS. Star's earned surplus position at December 31, 2004 was negative \$13.7 million. At September 30, 2005, earned surplus was negative \$7.1 million. No statutory dividends were paid in 2004 or 2005.

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 3.0 to 1.0 and 2.5 to 1.0, respectively. As of September 30, 2005, on a statutory combined basis, the gross and net premium leverage ratios were 2.4 to 1.0 and 1.9 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 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, 2004, all of the Insurance Company Subsidiaries were in compliance with RBC requirements. Star reported statutory surplus of \$120.7 million at December 31, 2004, compared to the minimum threshold requiring regulatory involvement of \$56.9 million in 2004. At September 30, 2005, Star's statutory surplus was \$138.9 million.

Note 6 Commitments and Contingencies

In June 2003, the Company entered into a guaranty agreement with a bank. The Company is guaranteeing payment of a \$1.5 million term loan issued by the bank to an unaffiliated insurance agency. In the event of default on the term loan by the insurance agency, the Company is obligated to pay any outstanding principal (up to a maximum of \$1.5 million), as well as any accrued interest on the loan, and any costs incurred by the bank in the collection process. In exchange for the Company's guaranty, the president and member of the unaffiliated insurance agency pledged 100% of the common stock of two insurance agencies that he wholly owns. In the event of default of the term loan by the unaffiliated insurance agency, the Company has the right to sell all or a portion of the pledged assets (the common stock of the two insurance agencies) and use the proceeds from the sale to recover any amounts paid under the guaranty agreement. Any excess proceeds would be paid to the shareholder. As of September 30, 2005, no liability has been recorded with respect to the Company's obligations under the guaranty agreement, since the collateral is in excess of the guaranteed amount.

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. This agency has been a producer for the Company for over ten years. Under the terms of the agreement, the Company may demand repayment of the principal, plus accrued interest at any time. As security for the loan, the shareholder has pledged 100% of the

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

common shares of the unaffiliated insurance agency and three other insurance agencies, and has executed a personal guaranty.

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.

Note 7 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).

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. The agency operations produce commercial, personal lines, life, and accident and health insurance, for more than fifty unaffiliated insurance carriers.

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(Unaudited)

The following table sets forth the segment results (in thousands):

	For the Nine Months Ended September 30,	
	2005	2004
Revenues		
Net earned premiums	\$ 187,356	\$ 155,759
Management fees	12,624	12,557
Claims fees	5,317	11,427
Loss control fees	1,739	1,629
Reinsurance placement	563	301
Investment income	13,012	10,884
Net realized losses	(52)	(73)
Specialty risk management	220,559	192,484
Agency operations(2)	8,859	7,646
Reconciling items(3)	230	17
Intersegment revenue(2)	(1,769)	(766)
Consolidated revenue	\$ 227,879	\$ 199,381
Pre-tax income:		
Specialty risk management(1) & (2)	\$ 21,942	\$ 19,182
Agency operations(1) & (2)	2,669	1,841
Other corporate	(5,364)	(3,704)
Consolidated pre-tax income	\$ 19,247	\$ 17,319

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(Unaudited)

	For the Three Months Ended September 30,	
	2005	2004
Revenues		
Net earned premiums	\$ 63,205	\$ 52,963
Management fees	4,328	3,948
Claims fees	1,799	5,998
Loss control fees	611	552
Reinsurance placement	124	184
Investment income	4,458	3,751
Net realized gains	40	79
Specialty risk management	74,565	67,475
Agency operations(2)	2,917	2,657
Reconciling items	134	6
Intersegment revenue(2)	(579)	(670)
Consolidated revenue	\$ 77,037	\$ 69,468
Pre-tax income:		
Specialty risk management(1) & (2)	\$ 7,959	\$ 8,799
Agency operations(1) & (2)	687	239
Other corporate	(1,923)	(1,340)
Consolidated pre-tax income	\$ 6,723	\$ 7,698

(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. Prior to January 1, 2005, corporate overhead was only reflected in the specialty risk management operations segment. This reclassification for the allocation of corporate overhead more accurately presents the Company's segments as a result of improved cost allocation information. As a result, the segment information for the periods ended September 30, 2004, have been adjusted to reflect this allocation. For the nine months ended September 30, 2005 and 2004, the allocation of corporate overhead to the agency operations segment was \$2.3 million and \$2.6 million, respectively. For the three months ended September 30, 2005 and 2004, the allocation of corporate overhead to the agency operations segment was \$609,000 and \$948,000, respectively.

(2) In addition to the reclassification for the allocation of corporate overhead as described above, the Company also reclassified 2004 revenues related to the conversion of a west-coast commercial transportation program, which was converted to a specialty risk program with one of its subsidiaries, from the agency operations segment to the specialty risk management operations segment. Accordingly, the agency operations revenue and intersegment

revenue have been reclassified. As a result, \$5.6 million and \$1.8 million was reclassified within the agency operations segment and the intersegment revenue for the nine months and three months ended September 30, 2004, respectively. In addition, the overall net income related to this subsidiary was reclassified from the agency operations to the specialty risk management operations segment. As a result, pre-tax net income of \$2.3 million and \$951,000 related to this subsidiary was reclassified to the specialty risk management operations pre-tax income from the agency operations segment for the nine months and three months ended September 30, 2004, respectively.

- (3) On December 4, 2003, the Company entered into a Purchase and Sale Agreement with an unaffiliated third party for the sale of land. In July 2004, a land contract was executed and the transaction closed in escrow subject to the conveyance of certain land by the city to both parties. On May 18, 2005, the settlement of the land contract was completed. The sale of this land resulted in a total gain of approximately \$464,000. In accordance with SFAS No. 66 *Accounting for Sales of Real Estate*, the Company recorded this transaction based on the installment method of accounting. Accordingly, the Company recorded a gain of \$82,000, as of June 30, 2005, which reflects a portion of the total gain allocated proportionately based on the down payment to the total purchase price. The remaining \$382,000 will be deferred until the land contract is paid in full, or as principal payments are received.

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(Unaudited)

The reconciling item included in the revenue relates to interest income and the above mentioned gain in the holding company. The following table sets forth the components of other corporate pre-tax income (loss) (in thousands):

	For the Nine Months Ended September 30,	
	2005	2004
Holding company expenses	\$ (2,560)	\$ (1,891)
Amortization	(277)	(284)
Interest expense	(2,527)	(1,529)
	\$ (5,364)	\$ (3,704)

	For the Three Months Ended September 30,	
	2005	2004
Holding company expenses	\$ (882)	\$ (562)
Amortization	(93)	(92)
Interest expense	(948)	(686)
	\$ (1,923)	\$ (1,340)

Note 8 Subsequent Events

On October 4, 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 will recognize 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 will be recorded at fair value on the balance sheet and any changes in their fair value will be accounted for within other comprehensive income. The interest differential to be paid or received will be accrued and will be 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 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 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%.

On November 1, 2005, the Company purchased the net assets of a Florida-based insurance agency. In accordance with SFAS No. 141 *Business Combinations*, the Company will allocate the costs of the acquired business to the assets acquired, including intangible assets and liabilities assumed, based on their estimated fair value at the acquisition date. Any costs in excess of the amount specifically assigned to the assets acquired and liabilities assumed, will be recorded as goodwill. Subsequent to the acquisition, the goodwill and other intangible assets will be accounted for in accordance with SFAS No. 142 *Goodwill and Other Intangible Assets*.

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ITEM 2
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
For the Periods ended September 30, 2005 and 2004

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 insureds of all sizes. 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 th