

MERCURY GENERAL CORP  
Form 10-Q  
November 03, 2009

# 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, 2009

Commission File No. 001-12257

# MERCURY GENERAL CORPORATION

(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of  
incorporation or organization)

95-2211612  
(I.R.S. Employer  
Identification No.)

4484 Wilshire Boulevard, Los Angeles, California

90010

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(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (323) 937-1060

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

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

At October 31, 2009, the Registrant had issued and outstanding an aggregate of 54,770,238 shares of its Common Stock.

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## MERCURY GENERAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

|   | September 30,<br>2009<br>(unaudited) | December 31,<br>2008 |
|---|--------------------------------------|----------------------|
| <b>ASSETS</b>   |                                      |                      |
| Investments:  |                                      |                      |
| Fixed maturities trading, at fair value (amortized cost \$2,692,117; \$2,728,471)                     | \$ 2,728,815                         | \$ 2,481,673         |
| Equity securities trading, at fair value (cost \$321,911; \$403,773)                                  | 287,720                              | 247,391              |
| Short-term investments, at fair value (cost \$126,328; \$208,278)                                     | 126,172                              | 204,756              |
| Total investments   | 3,142,707                            | 2,933,820            |
| Cash  | 204,194                              | 35,396               |
| Receivables:  |                                      |                      |
| Premiums receivable   | 267,684                              | 268,227              |
| Premium notes   | 23,357                               | 25,699               |
| Accrued investment income   | 38,168                               | 36,540               |
| Other   | 9,835                                | 9,526                |
| Total receivables   | 339,044                              | 339,992              |
| Deferred policy acquisition costs   | 182,237                              | 200,005              |
| Fixed assets, net   | 200,930                              | 191,777              |
| Current income taxes  |                                      | 43,378               |
| Deferred income taxes   | 63,604                               | 171,025              |
| Goodwill  | 42,850                               | 5,206                |
| Other intangible assets   | 68,526                               |                      |
| Other assets  | 29,755                               | 29,596               |
| Total assets  | \$ 4,273,847                         | \$ 3,950,195         |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                                      |                      |
| Losses and loss adjustment expenses   | \$ 1,055,887                         | \$ 1,133,508         |
| Unearned premiums   | 871,698                              | 879,651              |
| Notes payable   | 272,690                              | 158,625              |
| Accounts payable and accrued expenses   | 133,954                              | 93,864               |
| Current income taxes  | 7,113                                |                      |
| Other liabilities   | 163,892                              | 190,496              |
| Total liabilities   | 2,505,234                            | 2,456,144            |
| Commitments and contingencies   |                                      |                      |
| Shareholders' equity:   |                                      |                      |
| Common stock without par value or stated value:   |                                      |                      |
| Authorized 70,000,000 shares; issued and outstanding 54,770,238 in 2009 and 54,763,713 shares in 2008 | 72,248                               | 71,428               |
| Accumulated other comprehensive loss  | (672)                                | (876)                |
| Retained earnings   | 1,697,037                            | 1,423,499            |

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|  |              |              |
|--|--------------|--------------|
| Total shareholders' equity                 | 1,768,613    | 1,494,051    |
| Total liabilities and shareholders' equity | \$ 4,273,847 | \$ 3,950,195 |

See accompanying Condensed Notes to Consolidated Financial Statements.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except share and per share data)

(unaudited)

|  | <b>Three Months Ended September 30,</b> |                     |
|--|---|---------------------|
|  | <b>2009</b>                             | <b>2008</b>         |
| <b>Revenues:</b>   |   |                     |
| Net premiums earned  | \$ 653,758                              | \$ 696,605          |
| Net investment income  | 35,208                                  | 38,086              |
| Net realized investment gains (losses)   | 171,373                                 | (276,973)           |
| Other  | 895                                     | 1,313               |
| <b>Total revenues</b>  | <b>861,234</b>                          | <b>459,031</b>      |
| <b>Expenses:</b>   |   |                     |
| Losses and loss adjustment expenses  | 446,436                                 | 511,806             |
| Policy acquisition costs   | 130,172                                 | 154,530             |
| Other operating expenses   | 53,766                                  | 44,350              |
| Interest   | 1,634                                   | 1,663               |
| <b>Total expenses</b>  | <b>632,008</b>                          | <b>712,349</b>      |
| <b>Income (loss) before income taxes</b>   | <b>229,226</b>                          | <b>(253,318)</b>    |
| Income tax expense (benefit)   | 71,489                                  | (112,779)           |
| <b>Net income (loss)</b>   | <b>\$ 157,737</b>                       | <b>\$ (140,539)</b> |
| Basic earnings per share (weighted average shares outstanding 54,769,799 in 2009 and 54,748,101 in 2008)   | \$ 2.88                                 | \$ (2.57)           |
| Diluted earnings per share (weighted average shares 55,312,825 as adjusted by 543,026 for the dilutive effect of options in 2009 and 54,748,101 in 2008) | \$ 2.85                                 | \$ (2.57)           |
| Dividends declared per share   | \$ 0.58                                 | \$ 0.58             |

See accompanying Condensed Notes to Consolidated Financial Statements.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except share and per share data)

(unaudited)

|  | <b>Nine Months Ended September 30,</b> |                    |
|--|--|--------------------|
|  | <b>2009</b>                            | <b>2008</b>        |
| <b>Revenues:</b>   |  |                    |
| Net premiums earned  | \$ 1,979,032                           | \$ 2,128,725       |
| Net investment income  | 109,334                                | 116,380            |
| Net realized investment gains (losses)   | 352,549                                | (332,614)          |
| Other  | 3,256                                  | 3,809              |
| <b>Total revenues</b>  | <b>2,444,171</b>                       | <b>1,916,300</b>   |
| <b>Expenses:</b>   |  |                    |
| Losses and loss adjustment expenses  | 1,336,191                              | 1,484,824          |
| Policy acquisition costs   | 414,062                                | 472,112            |
| Other operating expenses   | 158,616                                | 131,834            |
| Interest   | 5,059                                  | 3,659              |
| <b>Total expenses</b>  | <b>1,913,928</b>                       | <b>2,092,429</b>   |
| <b>Income (loss) before income taxes</b>   | <b>530,243</b>                         | <b>(176,129)</b>   |
| Income tax expense (benefit)   | 161,406                                | (102,355)          |
| <b>Net income (loss)</b>   | <b>\$ 368,837</b>                      | <b>\$ (73,774)</b> |
| Basic earnings per share (weighted average shares outstanding 54,768,951 in 2009 and 54,737,337 in 2008)   | \$ 6.73                                | \$ (1.35)          |
| Diluted earnings per share (weighted average shares 55,080,542 as adjusted by 311,591 for the dilutive effect of options in 2009 and 54,737,337 in 2008) | \$ 6.70                                | \$ (1.35)          |
| Dividends declared per share   | \$ 1.74                                | \$ 1.74            |

See accompanying Condensed Notes to Consolidated Financial Statements.

**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(in thousands)

(unaudited)

|  | <b>Three Months Ended September 30,</b> |              | <b>Nine Months Ended September 30,</b> |             |
|--|---|--------------|--|-------------|
|  | <b>2009</b>                             | <b>2008</b>  | <b>2009</b>                            | <b>2008</b> |
| Net income (loss)  | \$ 157,737                              | \$ (140,539) | \$ 368,837                             | \$ (73,774) |
| Other comprehensive (loss) income, before tax:                               |   |              |  |             |
| (Losses) gains on hedging instrument   | (187)                                   | (186)        | 315                                    | 83          |
| Other comprehensive (loss) income, before tax                                | (187)                                   | (186)        | 315                                    | 83          |
| Income tax (benefit) expense related to (losses) gains on hedging instrument | (65)                                    | (65)         | 111                                    | 29          |
| Comprehensive income (loss), net of tax                                      | \$ 157,615                              | \$ (140,660) | \$ 369,041                             | \$ (73,720) |

See accompanying Condensed Notes to Consolidated Financial Statements.

## MERCURY GENERAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

|  | Nine Months Ended September 30, |             |
|--|---------------------------------|-------------|
|  | 2009                            | 2008        |
| Cash flows from operating activities:  |                                 |             |
| Net income (loss)  | \$ 368,837                      | \$ (73,774) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                 |             |
| Depreciation and amortization  | 26,315                          | 19,918      |
| Net realized investment (gains) losses   | (352,549)                       | 332,614     |
| Bond amortization, net   | 4,760                           | 5,711       |
| Excess tax benefit from exercise of stock options  | (5)                             | (133)       |
| Decrease in premiums receivable  | 543                             | 10,098      |
| Decrease (increase) in premiums notes receivable   | 2,342                           | (1,346)     |
| Decrease in deferred policy acquisition costs  | 17,768                          | 4,037       |
| Decrease in unpaid losses and loss adjustment expenses                                   | (77,621)                        | (54,674)    |
| Decrease in unearned premiums  | (7,953)                         | (20,229)    |
| Decrease (increase) in income taxes  | 157,806                         | (139,535)   |
| Increase in accounts payable and accrued expenses  | 37,751                          | 3,477       |
| Decrease in trading securities in nature, net of realized gains and losses               | 3,209                           | 2,042       |
| Share-based compensation   | 571                             | 489         |
| Decrease in other payables   | (14,859)                        | (11,867)    |
| Other, net   | (10,455)                        | (4,216)     |
| Net cash provided by operating activities  | 156,460                         | 72,612      |
| Cash flows from investing activities:  |                                 |             |
| Fixed maturities available for sale in nature:   |                                 |             |
| Purchases  | (364,866)                       | (521,102)   |
| Sales  | 226,184                         | 423,031     |
| Calls or maturities  | 165,159                         | 184,913     |
| Equity securities available for sale in nature:  |                                 |             |
| Purchases  | (218,038)                       | (336,636)   |
| Sales  | 242,392                         | 247,545     |
| Net increase in payable for securities   | 1,713                           | 2,973       |
| Net decrease in short-term investments   | 78,756                          | 19,818      |
| Purchase of fixed assets   | (30,215)                        | (37,787)    |
| Sale and write off of fixed assets   | 345                             | 1,115       |
| Business acquisition, net of cash acquired   | (115,488)                       |             |
| Other, net   | 1,446                           | 5,029       |
| Net cash used in investing activities  | (12,612)                        | (11,101)    |
| Cash flows from financing activities:  |                                 |             |
| Dividends paid to shareholders   | (95,299)                        | (95,248)    |
| Excess tax benefit from exercise of stock options  | 5                               | 133         |
| Proceeds from stock options exercised  | 244                             | 1,120       |
| Proceeds from bank loan  | 120,000                         | 18,000      |
| Net cash provided by (used in) financing activities                                      | 24,950                          | (75,995)    |
| Net increase (decrease) in cash  | 168,798                         | (14,484)    |
| Cash:  |                                 |             |



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|  |  |             |    |        |
|--|--|-------------|----|--------|
| Beginning of the period                              |  | 35,396      |    | 48,245 |
| End of the period                                    |  | \$ 204,194  | \$ | 33,761 |
| Supplemental disclosures of cash flow information:   |  |             |    |        |
| Interest paid during the period                      |  | \$ 6,077    | \$ | 5,595  |
| Income taxes paid during the period                  |  | \$ 3,594    | \$ | 36,823 |
| Net realized (losses) gains from sale of investments |  | \$ (62,744) | \$ | 10,197 |

See accompanying Condensed Notes to Consolidated Financial Statements.

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**MERCURY GENERAL CORPORATION AND SUBSIDIARIES**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(unaudited)

**1. Basis of Presentation**

The condensed consolidated financial statements include the accounts of Mercury General Corporation ( Mercury General ) and its directly and indirectly wholly owned insurance and non-insurance subsidiaries (collectively, the Company ). The insurance subsidiaries are: Mercury Casualty Company ( MCC ), Mercury Insurance Company, California Automobile Insurance Company, California General Underwriters Insurance Company, Mercury Insurance Company of Illinois, Mercury Insurance Company of Georgia, Mercury Indemnity Company of Georgia, Mercury National Insurance Company, American Mercury Insurance Company, American Mercury Lloyds Insurance Company ( AML ), Mercury County Mutual Insurance Company ( MCM ), Mercury Insurance Company of Florida and Mercury Indemnity Company of America. The non-insurance subsidiaries are: Mercury Select Management Company, Inc. ( MSMC ), American Mercury MGA, Inc., Concord Insurance Services, Inc., Mercury Insurance Services, LLC, Mercury Group, Inc., AIS Management LLC, Auto Insurance Specialists, LLC ( AIS ) and PoliSeek AIS Insurance Solutions, Inc. ( PoliSeek ). AML is not owned by the Company, but is controlled by the Company through its attorney-in-fact, MSMC. MCM is not owned by the Company, but is controlled through a management contract and therefore its results are included in the condensed consolidated financial statements. The condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles ( GAAP ), which differ in some respects from those filed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates and assumptions in the preparation of these condensed consolidated financial statements relate to losses and loss adjustment expenses and evaluation of the recoverability of deferred tax assets. Actual results could differ materially from those estimates (See Note 1 Significant Accounting Policies of Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2008).

The financial data of the Company included herein has been prepared without audit. In the opinion of management, all material adjustments of a normal recurring nature necessary to present fairly the Company s financial position at September 30, 2009 and the results of operations, comprehensive income and cash flows for the periods presented have been made. Operating results and cash flows for the nine-month period ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

Certain reclassifications have been made to the prior-period balances to conform to the current-period presentation.

**2. Recently Adopted Accounting Standards**

In June 2009, the Financial Accounting Standards Board ( FASB ) issued a new standard related to accounting standards codification and the hierarchy of generally accepted accounting principles. The new standard establishes the FASB Accounting Standards Codification <sup>TM</sup> as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. Rules and interpretive releases of the Securities and Exchange Commission under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. The new standard is effective for the interim reporting period ended September 30, 2009. The adoption of the new standard did not have a material impact on the Company s condensed consolidated financial statements.

Effective January 1, 2009, the FASB issued a new accounting standard related to business combinations wherein an acquirer is required to use the acquisition method, previously referred to as the purchase method, for all business combinations and, further, for an acquirer to be identified for each business combination. This new standard significantly changes the accounting for business combinations in a number of areas including the treatment of contingent consideration, contingencies, and acquisition costs. It requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date. Costs incurred to effect the acquisition are required to be recognized separately from the acquisition rather than included in the cost allocated to the assets acquired and liabilities assumed. The acquirer is required to recognize goodwill as of the acquisition date, measured as a residual, which in most types of business combinations will result in measuring goodwill as the excess of the consideration transferred plus the fair value of any noncontrolling interest in the acquiree at the acquisition date over the fair values of the identifiable net assets acquired. The standard also provides that changes in deferred tax asset valuation allowances and acquired income tax uncertainties that occur after the measurement period impact income tax expense.



Effective January 1, 2009, MCC acquired all of the membership interests of AIS Management LLC, a California limited liability company, which is the parent company of AIS and PoliSeek. The acquisition was accounted for in accordance with the new standard and its adoption did not have a material impact on the Company's condensed consolidated financial statements.

In March 2008, the FASB issued a new accounting standard to expand disclosures related to derivative instruments and hedging activities. The new standard requires increased qualitative disclosures such as how and why an entity is using a derivative instrument; how the entity is accounting for its derivative instrument and hedged item; and how the instrument affects the entity's financial position, financial performance, and cash flows. Quantitative disclosures should include information about the fair value of the derivative instrument, including gains and losses, and should contain more detailed information about the location of the derivative instrument in the entity's financial statements. Credit-risk disclosures should include information about the existence and nature of credit-risk-related contingent features included in derivative instruments. Credit-risk-related contingent features can be defined as those that require entities, upon the occurrence of a credit event such as a credit rating downgrade, to settle derivative instruments or post collateral. Existing financial accounting requirements for derivative instruments and hedging activities were not changed. The Company adopted the new standard on January 1, 2009 and its adoption did not have a material impact on the Company's condensed consolidated financial statements.

In April 2008, the FASB issued a new accounting standard related to the determination of the useful life of intangible assets. This standard amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset and it is effective for fiscal years beginning after December 15, 2008. The Company adopted the new standard on January 1, 2009 and its adoption did not have a material impact on the Company's condensed consolidated financial statements.

In April 2009, the FASB issued a new accounting standard related to accounting for contingencies in a business combination. Under the new standard, an acquirer is required to recognize assets or liabilities arising from contingencies provided that the acquisition-date fair value of that asset or liability can be determined during the measurement period. The Company adopted the new standard effective January 1, 2009 and its adoption did not have a material impact on the Company's condensed consolidated financial statements.

The Company adopted the new FASB standard related to determining fair value when the volume and level of activity for an asset or liability have significantly decreased and identifying transactions that are not orderly. The new standard relates to selected transactions in disrupted markets and adopts guidelines related to a significant decrease in the volume and level of activity for an asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for an asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with earlier FASB standards related to fair value measurements. The new accounting standard became effective for the interim reporting period ended June 30, 2009 and its adoption did not have a material impact on the Company's condensed consolidated financial statements.

The Company adopted the new FASB standard related to interim disclosures about fair value of financial instruments which amends the earlier FASB standard related to such disclosures. The new standard requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies, in addition to disclosures previously required in annual financial statements. The new standard also amends the original standard related to interim financial reporting of fair value disclosures, and now requires related disclosures to be presented in a summarized form at interim reporting periods. The new accounting standard became effective for the interim reporting period ended June 30, 2009 and its adoption did not have a material impact on the Company's condensed consolidated financial statements.

The Company adopted the new FASB standard related to subsequent events. The new standard establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. The new accounting standard became effective for the interim reporting period ended June 30, 2009 and its adoption did not have a material impact on the Company's condensed consolidated financial statements.

### 3. Financial Instruments

The financial instruments recorded in the consolidated balance sheet include investments, receivables, interest rate swap agreements, accounts payable, equity contracts, and secured and unsecured notes payable. Due to their short-term maturity, the carrying amounts of receivables and accounts payable approximate their fair market values. The following table sets forth the carrying amounts and estimated fair values of other financial instruments at September 30, 2009 and December 31, 2008.

|                               | September 30, 2009 |              | December 31, 2008 |              |
|-------------------------------|--------------------|--------------|-------------------|--------------|
|                               | Carrying Value     | Fair Value   | Carrying Value    | Fair Value   |
| (Amounts in thousands)        |                    |              |                   |              |
| <b>Assets</b>                 |                    |              |                   |              |
| Investments                   | \$ 3,142,707       | \$ 3,142,707 | \$ 2,933,820      | \$ 2,933,820 |
| Interest rate swap agreements | \$ 9,776           | \$ 9,776     | \$ 14,394         | \$ 14,394    |
| <b>Liabilities</b>            |                    |              |                   |              |
| Interest rate swap agreements | \$ 2,562           | \$ 2,562     | \$ 1,348          | \$ 1,348     |
| Equity contracts              | \$ 2,126           | \$ 2,126     | \$ 2,803          | \$ 2,803     |
| Secured notes                 | \$ 138,000         | \$ 137,315   | \$                | \$           |
| Unsecured note                | \$ 134,690         | \$ 130,500   | \$ 158,625        | \$ 146,758   |

Methods and assumptions used in estimating fair values are as follows:

#### *Investments*

Effective January 1, 2008, the Company elected to apply the fair value option to all available-for-sale, fixed maturity and equity securities, and short-term investments existing at the time of adoption and similar securities acquired subsequently. The election included all hybrid securities held by the Company and similar securities acquired subsequently. Therefore, these securities are carried at fair value. For additional disclosures regarding methods and assumptions used in estimating fair values of these securities, see Note 5 of Condensed Notes to Consolidated Financial Statements.

#### *Interest rate swap agreements*

The fair value of interest rate swap agreements reflects the estimated amounts that the Company would pay or receive at September 30, 2009 and December 31, 2008 in order to terminate the contracts based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract. For additional disclosures regarding methods and assumptions used in estimating fair values of interest rate swap agreements, see Note 5 of Condensed Notes to Consolidated Financial Statements.

#### *Equity contracts*

The fair value of equity contracts is based on quoted prices for identical instruments in active markets. For additional disclosures regarding methods and assumptions used in estimating fair values of equity contracts, see Note 5 of Condensed Notes to Consolidated Financial Statements.

#### *Secured notes*

The fair value of the Company's \$120 million and \$18 million secured notes is estimated based on assumptions and inputs, such as reset rates, for similar termed notes that are observable in the market.

#### *Unsecured note*

The fair value of the Company's publicly traded \$125 million unsecured note is based on the unadjusted quoted price for similar notes in active markets.

#### 4. Fair Value of Financial Instruments

Gains and losses due to changes in fair value for items measured at fair value pursuant to election of the fair value option are included in net realized investment gains (losses) in the Company's consolidated statements of operations, while interest and dividend income on the investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income in the Company's consolidated statements of operations. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as expansion of use of fair value measurement consistent with the long-term measurement objectives of the FASB for accounting for financial instruments. The following table reflects gains (losses) due to changes in fair value for items measured at fair value pursuant to election of the fair value option:

|                           | Three Months ended September 30,<br>2009 | 2008         | Nine Months ended September 30,<br>2009 | 2008         |
|---------------------------|--|--------------|---|--------------|
|                           | (Amounts in thousands)                   |              |   |              |
| Fixed maturity securities | \$ 136,062                               | \$ (121,852) | \$ 283,496                              | \$ (191,709) |
| Equity securities         | 55,281                                   | (129,238)    | 122,200                                 | (129,781)    |
| Short-term investments    | (84)                                     | (3,031)      | (87)                                    | (3,344)      |
| Total                     | \$ 191,259                               | \$ (254,121) | \$ 405,609                              | \$ (324,834) |

#### 5. Fair Value Measurement

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the exit price). Accordingly, when market observable data is not readily available, the Company's own assumptions are set to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Financial assets and financial liabilities recorded on the consolidated balance sheets at fair value are categorized based on the reliability of inputs to the valuation techniques as follows:

*Level 1* Financial assets and financial liabilities whose values are based on unadjusted quoted prices for identical assets or liabilities in active markets that the Company can access.

*Level 2* Financial assets and financial liabilities whose values are based on the following:

- a) Quoted prices for similar assets or liabilities in active markets;
- b) Quoted prices for identical or similar assets or liabilities in non-active markets; or
- c) Valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability.

*Level 3* Financial assets and financial liabilities whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect the Company's estimates of the assumptions that market participants would use in valuing the financial assets and financial liabilities.

The availability of observable inputs varies by instrument. In situations where fair value is based on internally developed pricing models or inputs that are unobservable in the market, the determination of fair value requires more judgment. The degree of judgment exercised by the Company in determining fair value is typically greatest for instruments categorized in Level 3. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3.



### Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company obtained unadjusted fair values on approximately 98% of its portfolio from an independent pricing service. For less than 2% of its portfolio, the Company obtained specific unadjusted broker quotes generally from one knowledgeable outside security broker to determine the fair value of each security. For approximately 0.1% of its portfolio, where the Company was not able to obtain fair values from the independent pricing service or outside security brokers, management performed discounted cash flow price modeling.

**Level 1 Measurements** - Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure realistic fair values are used in pricing the investment portfolio.

U.S. government bonds and agencies: Priced using unadjusted quoted market prices for identical assets in active markets.

Common stock; Other: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets.

Equity contracts: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on quoted prices for identical instruments in active markets.

**Level 2 Measurements** - Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

Municipal securities: Valued based on models or matrices using inputs including quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by residential mortgage loans. Valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. At September 30, 2009 and December 31, 2008, the Company had no holdings in commercial mortgage-backed securities.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Collateralized debt obligations: Valued based on observable inputs, such as underlying debt instruments and their appropriate benchmark spread, for identical or similar assets in active markets.

Redeemable and Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Interest rate swap agreements: Valued based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract.

**Level 3 Measurements** - Fair values of financial assets are based on discounted cash flow price modeling performed by management with inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

Municipal securities: Comprised of certain distressed municipal securities for which valuation is based on models that are widely accepted in the financial services industry and require projections of future cash flows that are not market observable. Included in this category are \$3.0 million of auction rate securities ( ARS ). ARS are valued based on a discounted cash flow model with certain inputs that are significant to the valuation, but are not market observable.

The Company's total financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment gains (losses) in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.





**Assets Measured at Fair Value**

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2009 and December 31, 2008, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

|  | September 30, 2009   |   |   |                                     |
|--|--|---|---|-------------------------------------|
|  | Quoted Prices in<br>Active Markets for<br>Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) | Balance as of<br>September 30, 2009 |
|  | (Amounts in thousands)   |   |   |                                     |
| <b>Assets</b>                          |  |   |   |                                     |
| Fixed maturity securities:             |  |   |   |                                     |
| U.S. government bonds and agencies     | \$ 9,128   | \$  | \$  | \$ 9,128                            |
| Municipal securities                   |  | 2,459,340   | 3,007   | 2,462,347                           |
| Mortgage-backed securities             |  | 125,773   |   | 125,773                             |
| Corporate securities                   |  | 88,932  |   | 88,932                              |
| Collateralized debt obligations        |  | 42,185  |   | 42,185                              |
| Redeemable preferred stock             |  | 450   |   | 450                                 |
| Equity securities:                     |  |   |   |                                     |
| Common stock:                          |  |   |   |                                     |
| Public utilities                       | 33,715   |   |   | 33,715                              |
| Banks, trusts and insurance companies  | 14,396   |   |   | 14,396                              |
| Industrial and other                   | 227,114  |   |   | 227,114                             |
| Non-redeemable preferred stock         |  | 12,495  |   | 12,495                              |
| Short-term bonds/Money market accounts | 117,064  | 8,916   |   | 125,980                             |
| Equity contracts                       | 192  |   |   | 192                                 |
| Interest rate swap agreements          |  | 9,776   |   | 9,776                               |
| <b>Total assets at fair value</b>      | <b>\$ 401,609</b>  | <b>\$ 2,747,867</b>                                 | <b>\$ 3,007</b>                                 | <b>\$ 3,152,483</b>                 |
| <b>Liabilities</b>                     |  |   |   |                                     |
| Equity contracts                       | \$ 2,126   | \$  | \$  | \$ 2,126                            |
| Interest rate swap agreements          |  | 2,562   |   | 2,562                               |
| <b>Total liabilities at fair value</b> | <b>\$ 2,126</b>  | <b>\$ 2,562</b>                                     | <b>\$</b>                                       | <b>\$ 4,688</b>                     |

|                                    | December 31, 2008  |   |   |                                    |
|------------------------------------|--|---|---|------------------------------------|
|                                    | Quoted Prices in<br>Active Markets for<br>Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) | Balance as of<br>December 31, 2008 |
|                                    | (Amounts in thousands)   |   |   |                                    |
| <b>Assets</b>                      |  |   |   |                                    |
| Fixed maturity securities:         |  |   |   |                                    |
| U.S. government bonds and agencies | \$ 9,898   | \$  | \$  | \$ 9,898                           |
| Municipal securities               |  | 2,184,684   | 2,984   | 2,187,668                          |
| Mortgage-backed securities         |  | 202,326   |   | 202,326                            |
| Corporate securities               |  | 65,727  |   | 65,727                             |
| Collateralized debt obligations    |  | 13,120  |   | 13,120                             |
| Redeemable preferred stock         |  | 2,934   |   | 2,934                              |
| Equity securities:                 |  |   |   |                                    |
| Common stock:                      |  |   |   |                                    |

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|  |                   |                     |                 |                     |
|--|-------------------|---------------------|-----------------|---------------------|
| Public utilities                       | 39,148            |                     |                 | 39,148              |
| Banks, trusts and insurance companies  | 11,328            |                     |                 | 11,328              |
| Industrial and other                   | 186,294           |                     |                 | 186,294             |
| Non-redeemable preferred stock         |                   | 10,621              |                 | 10,621              |
| Short-term bonds/Money market accounts | 202,475           | 2,203               |                 | 204,678             |
| Equity contracts                       | 78                |                     |                 | 78                  |
| Interest rate swap agreements          |                   | 14,394              |                 | 14,394              |
| <b>Total assets at fair value</b>      | <b>\$ 449,221</b> | <b>\$ 2,496,009</b> | <b>\$ 2,984</b> | <b>\$ 2,948,214</b> |
| <b>Liabilities</b>                     |                   |                     |                 |                     |
| Equity contracts                       | \$ 2,803          |                     |                 | \$ 2,803            |
| Interest rate swap agreements          |                   | 1,348               |                 | 1,348               |
| Other                                  | 2,492             |                     |                 | 2,492               |
| <b>Total liabilities at fair value</b> | <b>\$ 5,295</b>   | <b>\$ 1,348</b>     | <b>\$</b>       | <b>\$ 6,643</b>     |

When the inputs used to measure fair value fall within different levels of the hierarchy, the level within which the fair value measurement is categorized is based on the lowest level input that is significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3).

The following table provides a summary of changes in fair value of Level 3 financial assets and financial liabilities held at fair value at September 30, 2009. There were no Level 3 financial assets and financial liabilities held at September 30, 2008.

|   | <b>Three Months Ended<br/>September 30, 2009<br/>Fixed Maturities<br/>(Amounts in thousands)</b> |
|---|--|
| Fair value at June 30, 2009   | \$ 2,856   |
| Realized gains included in net realized investment gains  | 151  |
| <b>Fair value at September 30, 2009</b>   | <b>\$ 3,007</b>  |
| The amount of total gains for the period included in earnings attributable to assets held at September 30, 2009 | \$ 151   |
|   | <b>Nine Months Ended<br/>September 30, 2009<br/>Fixed Maturities<br/>(Amounts in thousands)</b>  |
| Fair value at December 31, 2008   | \$ 2,984   |
| Realized gains included in net realized investment gains  | 23   |
| <b>Fair value at September 30, 2009</b>   | <b>\$ 3,007</b>  |
| The amount of total gains for the period included in earnings attributable to assets held at September 30, 2009 | \$ 23  |

At September 30, 2009, the Company did not have any nonrecurring measurements of nonfinancial assets or nonfinancial liabilities.

## 6. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are equity price risk and interest rate risk. Equity contracts on various equity securities are entered into to manage the price risk associated with forecasted purchases or sales of such securities. Interest rate swaps are entered into to manage interest rate risk associated with the Company's loans with fixed or floating rates.

**Fair value hedge**

Effective January 2, 2002, the Company entered into an interest rate swap of a 7.25% fixed rate obligation on a \$125 million senior note for a floating rate of LIBOR plus 107 basis points. The swap is designated as a fair value hedge and qualifies for the shortcut method wherein the gain or loss on the derivative, and the offsetting loss or gain on the hedged item attributable to the hedged risk, are recognized in current earnings. The Company includes the gain or loss on the hedged item in the same line item, other revenue, as the offsetting loss or gain on the related interest rate swaps as follows:

| Income Statement Classification | Three Months Ended<br>September 30, 2009 |                           | Nine Months Ended<br>September 30, 2009 |                           |
|---------------------------------|--|---------------------------|---|---------------------------|
|                                 | Gains/(Losses)<br>on<br>Swap             | Gains/(Losses)<br>on Loan | Gains/(Losses)<br>on Swap               | Gains/(Losses)<br>on Loan |
| Other revenue                   | \$ (747)                                 | \$ 747                    | \$ (4,618)                              | \$ 4,618                  |

As of September 30, 2009, the total fair market value of the Company's interest rate swap designated as a fair value hedge was \$9.8 million.

**Cash flow hedge**

On March 3, 2008, the Company entered into an interest rate swap of a floating LIBOR rate on an \$18 million bank loan for a fixed rate of 3.75%. The swap is designated as a cash flow hedge and qualifies for the shortcut method wherein the effective portion of the gain or loss on the derivative is reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings.

As of September 30, 2009, the total fair market value of the Company's interest rate swap designated as a cash flow hedge was \$(1.0) million.

**Fair value amounts, and gains and losses on derivative instruments**

The following tables provide the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains and losses in the consolidated statements of operations:

**Fair Values of Derivative Instruments**

|   | Asset Derivatives  |                   | Liability Derivatives |                   |
|---|--------------------|-------------------|-----------------------|-------------------|
|   | September 30, 2009 | December 31, 2008 | September 30, 2009    | December 31, 2008 |
| <b>Hedging derivatives</b>                                    |                    |                   |                       |                   |
| Interest rate contracts - Other assets (liabilities)          | \$ 9,776           | \$ 14,394         | \$ (1,034)            | \$ (1,348)        |
| <b>Non-hedging derivatives</b>                                |                    |                   |                       |                   |
| Interest rate contracts - Other liabilities                   |                    |                   | \$ (1,528)            |                   |
| Equity contracts - Short-term investments (Other liabilities) | \$ 192             | \$ 78             | (2,126)               | \$ (2,803)        |
| <b>Total non-hedging derivatives</b>                          | \$ 192             | \$ 78             | \$ (3,654)            | \$ (2,803)        |
| <b>Total derivatives</b>                                      | \$ 9,968           | \$ 14,472         | \$ (4,688)            | \$ (4,151)        |

**The Effect of Derivative Instruments on the Statements of Operations****for Three Months and Nine Months Ended September 30, 2009 and 2008**

| Derivatives Contracts for Fair Value Hedges          | Gain or (Loss) Recognized in Income on Derivatives |                 |                                      |                  |
|--|--|-----------------|--------------------------------------|------------------|
|  | Three Months Ended September 30, 2009              | 2008            | Nine Months Ended September 30, 2009 | 2008             |
|  | (Amounts in thousands)                             |                 |                                      |                  |
| Interest rate contracts - Interest expense           | \$ 1,854   | \$ 846          | \$ 5,203                             | \$ 3,736         |
|  |  |                 |                                      |                  |
| Derivatives Contracts for Cash Flow Hedges           | Gain or (Loss) Recognized in OCI on Derivatives    |                 |                                      |                  |
|  | Three Months Ended September 30, 2009              | 2008            | Nine Months Ended September 30, 2009 | 2008             |
|  | (Amounts in thousands)                             |                 |                                      |                  |
| Interest rate contracts - Other comprehensive income | \$ (187)   | \$ (186)        | \$ 315                               | \$ 83            |
|  |  |                 |                                      |                  |
| Derivatives Not Designated as Hedging Instruments    | Gain or (Loss) Recognized in Income on Derivatives |                 |                                      |                  |
|  | Three Months Ended September 30, 2009              | 2008            | Nine Months Ended September 30, 2009 | 2008             |
|  | (Amounts in thousands)                             |                 |                                      |                  |
| Interest rate contract - Other revenue               | \$ (866)   | \$              | \$ (1,528)                           | \$               |
| Equity contracts - Net realized investment gains     | 20   | 2,998           | 6,429                                | 11,174           |
| <b>Total</b>   | <b>\$ (846)</b>                                    | <b>\$ 2,998</b> | <b>\$ 4,901</b>                      | <b>\$ 11,174</b> |

There were no gains or losses on derivative instruments designated as cash flow hedges reclassified from accumulated other comprehensive income into earnings during the three or nine month periods ended September 30, 2009.

The interest rate contract not designated as a hedging instrument is an interest rate swap entered into on February 6, 2009. The purpose of the swap is to offset the variability of cash flows resulting from the variable interest rate of a \$120 million credit facility which was used for the acquisition of AIS.

Most equity contracts consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy. This is permitted for the Company's insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset allocation throughout various industries.

For additional disclosures regarding equity contracts, see Note 5 of Condensed Notes to Consolidated Financial Statements.

**7. Acquisition**

Effective January 1, 2009, the Company acquired all of the membership interests of AIS Management LLC, a California limited liability company, which is the parent company of AIS and PoliSeek. AIS is a major producer of automobile insurance in the state of California and was the Company's largest independent broker. This preexisting relationship did not require measurement at the date of acquisition as there was no settlement of executory contracts between the Company and AIS as part of the acquisition.

Goodwill of \$37.6 million arising from the acquisition consists largely of the efficiencies and economies of scale expected from combining the operations of the Company and AIS, and is expected to be fully deductible for income tax purposes in 2009 and future years.

The Company recognized the assets acquired and the liabilities assumed at the acquisition date, measured at their fair values as of that date. The following table summarizes the consideration paid for AIS and the allocation of the purchase price.

|   | <b>January 1, 2009</b><br><b>(Amounts in thousands)</b> |                |
|---|---|----------------|
| <b>Consideration</b>  |   |                |
| Cash  | \$  | 120,000        |
| <b>Fair value of total consideration transferred</b>                              | <b>\$</b>   | <b>120,000</b> |
| Acquisition-related costs   | \$  | 2,000          |
| <b>Recognized amounts of identifiable assets acquired and liabilities assumed</b> |   |                |
| Financial assets  | \$  | 12,875         |
| Property, plant, and equipment  |   | 2,915          |
| Favorable leases  |   | 1,725          |
| Trade names   |   | 15,400         |
| Customer relationships  |   | 51,200         |
| Software & technology   |   | 4,850          |
| Liabilities assumed   |   | (6,608)        |
| <b>Total identifiable net assets</b>  |   | <b>82,357</b>  |
| Goodwill  |   | 37,643         |
| <b>Total</b>  | <b>\$</b>   | <b>120,000</b> |

The weighted-average amortization periods for intangible assets with definite lives, by asset class, are: 24 years for trade names, 11 years for customer relationships, 10 years for technology, 2 years for software, and 3 years for lease agreements.

A contingent consideration arrangement requires the Company to pay the former owner of AIS up to an undiscounted maximum amount of \$34.7 million. The potential undiscounted amount of all future payments that the Company could be required to make under the contingent consideration arrangement is between \$0 and \$34.7 million. Based on the actual to date and the projected performance of the AIS business through December 31, 2010, the Company does not expect to pay the contingent consideration. That estimate of future performance is based on significant inputs that are not observable in the market, including management's projections of future cash flows, which are considered Level 3 inputs. Key assumptions in determining the estimated contingent consideration include (a) a discount rate of 10.7% and (b) a decline in revenues ranging from 5.0% to 8.0%. As of November 3, 2009, the estimates for the contingent consideration arrangement, the range of outcomes, and the assumptions used to develop the estimates have not changed.

The fair value of the financial assets acquired includes cash, prepaid expenses and receivables from customers. The acquired receivables of \$6.6 million at fair value were fully collected during the three-month period ended March 31, 2009. The fair value of the liabilities assumed includes accounts payable and other accrued liabilities.

The following table reflects the amount of revenue and net income of AIS, which are included in the Company's consolidated statements of operations for the three-month and nine-month periods ended September 30, 2009, and the revenue of the combined entity for the three-month and nine-month periods ended September 30, 2008, had the acquisition date been January 1, 2008.

|                 | Three Months ended September 30,<br>2008 (pro<br>forma) | Nine Months ended September 30,<br>2008 (pro forma) |
|-----------------|---|---|
|                 | (Amounts in thousands)                                  |   |
| Combined entity |   |   |
| Revenues (1)    | \$ 462,005  | \$ 1,925,014  |
| Net income (2)  | N/A   | N/A   |

  

|                | Three<br>Months<br>ended<br>September 30,<br>2009 | Nine Months ended<br>September 30,<br>2009 |
|----------------|---|--|
|                | (Amounts in thousands)                            |  |
| AIS            |   |  |
| Revenues (3)   | \$ 3,110  | \$ 9,066                                   |
| Net income (3) | \$ 516  | \$ 1,189                                   |

(1) Includes net premiums earned, net investment income, net realized investment gains/losses and commission revenues.

(2) 2008 pro forma net income for the combined entity is not available as AIS was previously consolidated into its parent company and separate financial statements were not available.

(3) Excludes intercompany transactions with the Company's insurance subsidiaries.

## 8. Intangible Assets

The following table reflects the components of intangible assets as of September 30, 2009. There were no intangible assets as of December 31, 2008.

|                         | Gross Carrying<br>Amount | September 30, 2009<br>Accumulated<br>Amortization | Net Carrying<br>Amount |
|-------------------------|--------------------------|---|------------------------|
|                         | (Amounts in thousands)   |   |                        |
| Customer relationships  | \$ 51,640                | \$ (3,649)  | \$ 47,991              |
| Trade names             | 15,400                   | (481)   | 14,919                 |
| Software and technology | 4,850                    | (529)   | 4,321                  |
| Favorable leases        | 1,725                    | (430)   | 1,295                  |
|                         | \$ 73,615                | \$ (5,089)  | \$ 68,526              |



Intangible assets are amortized on a straight-line basis over their weighted average lives. Intangible assets amortization expense was \$1.7 million for the three-month period ended September 30, 2009 and \$5.1 million for the nine-month period ended September 30, 2009. The following table outlines the estimated future amortization expense related to intangible assets as of September 30, 2009:

| Year Ending December 31, | (Amounts in thousands) |
|--------------------------|------------------------|
| Remainder of 2009        | \$ 1,703               |
| 2010                     | 6,812                  |
| 2011                     | 6,358                  |
| 2012                     | 6,144                  |
| 2013                     | 5,969                  |
| Thereafter               | 41,540                 |
| <b>Total</b>             | <b>\$ 68,526</b>       |

## 9. Goodwill

There were no changes in the carrying amount of goodwill for the three-month period ended September 30, 2009. The changes in the carrying amount of goodwill for the nine-month period ended September 30, 2009 are as follows:

|   | Nine Months Ended<br>September 30, 2009<br>(Amounts in thousands) |
|---|---|
| Balance as of January 1, 2009           | \$ 41,557   |
| Purchase price adjustments              | 1,293   |
| <b>Balance as of September 30, 2009</b> | <b>\$ 42,850</b>  |

The purchase price adjustments are the result of additional information obtained in conjunction with the finalization of the purchase price allocation as of March 31, 2009. Goodwill is reviewed for impairment on an annual basis and between annual tests if potential impairment indicators exist. No impairment indications were identified during any of the periods presented.

## 10. Share-Based Compensation

The Company accounts for share-based compensation using the modified prospective transition method. Under this transition method, share-based compensation expense includes compensation expense for all share-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, based on the estimated grant-date fair value. Share-based compensation expense for all share-based payment awards granted or modified on or after January 1, 2006 is based on the estimated grant-date fair value. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is the option vesting term of four or five years, for only those shares expected to vest. The fair value of stock option awards is estimated using the Black-Scholes option pricing model.

## 11. Income Taxes

The Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return once a more-likely-than-not threshold has been met. For a tax position that meets the recognition threshold, the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement is recognized in the financial statements.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states. Tax years that remain subject to examination by major taxing jurisdictions are 2006 through 2008 for federal taxes and 2001 through 2008 for California state taxes.

There were no material changes to the total amount of unrecognized tax benefits related to tax uncertainties during the nine months ended September 30, 2009. The Company does not expect any changes in such unrecognized tax benefits to have a significant impact on its consolidated financial statements within the next 12 months. The Company recognizes interest and assessed penalties related to unrecognized tax benefits as part of income taxes.



The Company is currently under examination by the California Franchise Tax Board for tax years 2001 through 2005. The taxing authority has proposed significant adjustments to the Company's California tax liabilities. Management does not believe that the ultimate outcome of this examination will have a material impact on the Company's financial position. However, an unfavorable outcome may have a material impact on the Company's results of operations in the period of such resolution.

Deferred tax assets and liabilities are recorded with respect to temporary differences in the accounting treatment of items for financial reporting purposes and for income tax purposes. Where, in management's judgment and based on the weight of all available evidence, it is more likely than not that some amount of recorded deferred tax assets will not be realized, a valuation allowance is established for the portion that is not realizable.

At September 30, 2009, the Company's deferred income taxes were in a net asset position partly as a result of the fair value declines in the investment portfolio originating in 2008, which resulted from extreme volatility in the capital markets and a widening of credit spreads beyond historic norms. Realization of deferred tax assets is dependent on generating sufficient taxable income of an appropriate nature to offset tax losses. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to avoid losing the full benefits of its deferred tax assets. Although realization is not assured, management believes it is more likely than not that the Company's deferred tax assets will be realized.

## **12. Contingencies**

The Company is, from time to time, named as a defendant in various lawsuits incidental to its insurance business. In most of these actions, plaintiffs assert claims for punitive damages, which are not insurable under judicial decisions. The Company has established reserves for lawsuits in which the Company is able to estimate its potential exposure and the likelihood that the court will rule against the Company is probable. The Company vigorously defends these actions, unless a reasonable settlement appears appropriate. An unfavorable ruling against the Company in the actions currently pending may have a material impact on the Company's quarterly results of operations in the period of such ruling; however, none is expected to be material to the Company's financial position. For a discussion of the Company's pending material litigation, see the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

## **13. Recently Issued Accounting Standards**

In April 2009, the FASB issued a new accounting standard related to the recognition and presentation of other-than-temporary impairments. The new standard amends the other-than-temporary impairment guidance in GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. Under the new accounting standard, the portion of other-than-temporary impairment on a debt security related to credit loss is recognized in current period earnings, and the remaining portion is recognized in other comprehensive income if the holder does not intend to sell the security and it is more likely than not that the holder will not be required to sell the security prior to recovery. If requirements related to intent and ability to hold the securities are not met, interest related impairment is recorded in current period earnings. As the Company elected to apply the fair value accounting option to all available for sale investments as of January 1, 2008, the new standard is not applicable to the Company.

In August 2009, the FASB issued a new accounting standard related to fair value measurements and disclosures for liabilities which amends the earlier FASB standard related to fair value measurements and disclosures. The new standard provides clarification in circumstances that a quoted price in an active market for an identical liability is not available, and a reporting entity is required to measure fair value using one or more valuation techniques. In addition, the new standard also addresses practice difficulties caused by the tension between fair value measurements based on the price that would be paid to transfer a liability to a new obligor and contractual or legal requirements that prevent such transfers from taking place. The new standard will be effective for the interim reporting period ending December 31, 2009. The adoption of the new standard is not expected to have a material impact on the Company's consolidated financial statements.

In September 2009, the FASB issued a new accounting standard related to fair value measurements and disclosures. The standard expands the circumstances in which a practical expedient may be used to estimate fair value to include investments in foreign and other entities that have attributes of investment companies, report net asset value or its equivalent to their investors, and calculate net asset value or its equivalent consistent with the measurement principles of the AICPA Investment Companies Guide. The practical expedient cannot be used for investments that have a readily determinable fair value. The new standard sets forth disclosure requirements for investments within its scope. It also addresses whether the practical expedient, net asset value, can be used when it is probable the investor will sell the investment in a secondary market transaction, differences between the reporting date of the investor and investee, and determining the level of classification in the fair value hierarchy. The amendments are effective for interim and annual periods ending after December 15, 2009. The adoption of the new standard is not expected to have a material impact on the Company's consolidated financial statements.

#### **14. Subsequent Events**

The Company evaluated subsequent events through November 3, 2009, the date the financial statements were issued, and noted no significant matters to be disclosed.

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

#### **I. Overview**

##### *A. General*

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, natural disasters, general economic conditions, the general regulatory environment in those states in which an insurer operates, state regulation of premium rates, and other factors such as changes in tax laws. The property and casualty industry has been highly cyclical, with periods of high premium rates and shortages of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a large impact on the ability of the Company to grow and retain business. Additionally, with the election of the fair value option, changes in the fair value of the investment portfolio are reflected in the consolidated statements of operations, which may result in volatility of earnings, particularly in times of high volatility in the capital markets.

The Company utilizes standard industry measures to report operating results that may not be presented in accordance with GAAP. Included within Management's Discussion and Analysis of Financial Condition and Results of Operations is a non-GAAP financial measure, net premiums written, which represents the premiums charged on policies issued during a fiscal period less any reinsurance. The measure is not intended to replace, and should be read in conjunction with, the Company's GAAP financial results and is reconciled to the most directly comparable GAAP measure, net premiums earned, below in Results of Operations.

**B. Operations**

The Company generates its revenues through the issuance of insurance policies, primarily covering personal automobiles and dwellings through 13 insurance subsidiaries ( Insurance Companies ). The Company also offers mechanical breakdown insurance, commercial and dwelling fire insurance, umbrella insurance, commercial automobile insurance and commercial property insurance. These policies are mostly sold through independent agents and brokers who receive a commission averaging 17% of net premiums written for selling policies. The Company believes that it has a thorough underwriting process that gives the Company an advantage over its competitors. The Company views its agent relationships and underwriting process as one of its primary competitive advantages because it allows the Company to charge lower prices yet realize better margins than many competitors. The Company operates primarily in California, the only state in which it operated prior to 1990. The Company has since expanded its operations into the following states: Georgia and Illinois (1990), Oklahoma and Texas (1996), Florida (1998), Virginia and New York (2001), New Jersey (2003), and Arizona, Pennsylvania, Michigan and Nevada (2004). Direct premiums written during the nine-month period ended September 30, 2009 by state and line of business were:

|              | Private Passenger<br>Auto | Commercial<br>Auto | Homeowners | Other<br>Lines | Total        |       |
|--------------|---------------------------|--------------------|------------|----------------|--------------|-------|
|              | (Amounts in thousands)    |                    |            |                |              |       |
| California   | \$ 1,291,867              | \$ 51,821          | \$ 155,544 | \$ 39,545      | \$ 1,538,777 | 78.0% |
| Florida      | 107,487                   | 10,736             | 12,317     | 4,847          | 135,387      | 6.8%  |
| Texas        | 54,412                    | 5,591              | 1,333      | 12,976         | 74,312       | 3.8%  |
| New Jersey   | 61,068                    |                    |            | 179            | 61,247       | 3.1%  |
| Other states | 125,201                   | 5,777              | 13,662     | 19,211         | 163,851      | 8.3%  |
| Total        | \$ 1,640,035              | \$ 73,925          | \$ 182,856 | \$ 76,758      | \$ 1,973,574 | 100%  |
|              | 83.1%                     | 3.7%               | 9.3%       | 3.9%           | 100%         |       |

The Company also generates income from its investment portfolio. Approximately \$109.3 million in pre-tax investment income was generated during the nine-month period ended September 30, 2009 on average investments of approximately \$3.2 billion, at cost, compared to \$116.4 million pre-tax investment income during the corresponding period in 2008 on average investments of approximately \$3.5 billion, at cost. The portfolio is managed by Company personnel with a view towards maximizing after-tax yields and limiting interest rate and credit risk.

The Company's operating results have allowed it to consistently generate positive cash flow from operations, which was approximately \$156.5 million and \$72.6 million for the nine-month periods ended September 30, 2009 and 2008, respectively. Cash flow from operations has historically been used to pay shareholder dividends and to help support growth.

**II. Results of Operations****Three Months Ended September 30, 2009 compared to Three Months Ended September 30, 2008****A. Revenue**

Net premiums earned and net premiums written for the three-month period ended September 30, 2009 decreased approximately 6.2% and 4.7%, respectively, from the corresponding period in 2008. The decrease in net premiums written is primarily due to a decrease in the number of policies written and slightly lower average premiums per policy reflecting continuing soft market conditions.

Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels. Net premiums earned, the most directly comparable GAAP measure, represents the portion of net premiums written that is recognized as income in the financial statements for the period presented and earned on a pro-rata basis over the term of the policies. The following is a reconciliation of total Company net premiums written to net premiums earned:

|                      | Three Months Ended September 30, |            |
|----------------------|----------------------------------|------------|
|                      | 2009                             | 2008       |
|                      | (in thousands)                   |            |
| Net premiums written | \$ 662,756                       | \$ 695,142 |

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|  |            |            |
|--|------------|------------|
| (Increase) decrease in net unearned premiums | (8,998)    | 1,463      |
| Net premiums earned                          | \$ 653,758 | \$ 696,605 |

**B. Profitability**

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table reflects the Insurance Companies' loss ratio, expense ratio and combined ratio determined in accordance with GAAP:

|                | <b>Three Months ended September 30,</b> |             |
|----------------|---|-------------|
|                | <b>2009</b>                             | <b>2008</b> |
| Loss ratio     | 68.3%                                   | 73.5%       |
| Expense ratio  | 28.1%                                   | 28.5%       |
| Combined ratio | 96.4%                                   | 102.0%      |

The loss ratio is calculated by dividing losses and loss adjustment expenses by net premiums earned. The loss ratio for the three-month period ended September 30, 2009 is lower than the three-month period ended September 30, 2008 primarily as a result of positive reserve development in 2009 compared to adverse reserve development in 2008 coupled with lower loss frequency in 2009. Partially offsetting this are higher loss severities recorded in 2009 as well as lower average premiums earned per policy.

The expense ratio is determined by matching expenses to the period over which net premiums were earned, rather than to the period that net premiums were written. The expense ratio slightly decreased primarily due to cost savings achieved as a result of the AIS acquisition.

The combined ratio of losses and expenses is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results; and a combined ratio over 100% generally reflects unprofitable underwriting results.

**C. Investments**

The following table summarizes the investment results of the Company:

|  | <b>Three Months ended September 30,</b> |              |
|--|---|--------------|
|  | <b>2009</b>                             | <b>2008</b>  |
|  | <b>(Amounts in thousands)</b>           |              |
| Average invested assets at cost (1)    | \$ 3,169,577                            | \$ 3,442,190 |
| Net investment income:                 |   |              |
| Before income taxes                    | \$ 35,208                               | \$ 38,086    |
| After income taxes                     | \$ 32,006                               | \$ 33,390    |
| Average annual yield on investments:   |   |              |
| Before income taxes                    | 4.4%                                    | 4.4%         |
| After income taxes                     | 4.0%                                    | 3.9%         |
| Net realized investment gains (losses) | \$ 171,373                              | \$ (276,973) |

(1) Fixed maturities at amortized cost, and equities and short-term investments at cost.

Included in net income are net realized investment gains of \$171.4 million for the three-month period ended September 30, 2009 compared with net realized investment loss of \$277.0 million for the three-month period ended September 30, 2008. Net realized investment gains include gains of \$191.3 million for the three-month period ended September 30, 2009 due to changes in the fair value of total investments pursuant to election of the fair value accounting option compared with losses \$254.1 million for the three-month period ended September 30, 2008. The gains during the three-month period ended September 30, 2009 arise from the market value improvements on the Company's fixed maturity and equity securities. During the three-month period ended September 30, 2009, the Company recorded approximately \$136.1 million and \$55.3 million in gains due to changes in the fair value of its fixed maturity portfolio and equity portfolio, respectively. The primary cause of the significant gains in fair value of equity securities was the overall improvement in the equity markets, which saw a growth of approximately 15.0% in the S&P 500 Index during the three-month period ended September 30, 2009.

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The income tax expenses (benefit) for the three-month periods ended September 30, 2009 and 2008 were \$71.5 million and \$(112.8) million, respectively. The increase in expense resulted primarily from changes in the fair value of the investment portfolio.



**Nine Months Ended September 30, 2009 compared to Nine Months Ended September, 2008****A. Revenue**

Net premiums earned and net premiums written in the nine-month period ended September 30, 2009 decreased approximately 7.0% and 6.5%, respectively, from the corresponding period in 2008. The decrease in net premiums written is primarily due to a decrease in the number of policies written and slightly lower average premiums per policy reflecting the continuing soft market conditions.

Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels. Net premiums earned, the most directly comparable GAAP measure, represents the portion of net premiums written that is recognized as income in the financial statements for the period presented and earned on a pro-rata basis over the term of the policies. The following is a reconciliation of total Company net premiums written to net premiums earned:

|                                   | <b>Nine Months Ended September 30,</b> |                     |
|-----------------------------------|--|---------------------|
|                                   | <b>2009</b>                            | <b>2008</b>         |
|                                   | <b>(in thousands)</b>                  |                     |
| Net premiums written              | \$ 1,971,053                           | \$ 2,108,585        |
| Decrease in net unearned premiums | 7,979                                  | 20,140              |
| <b>Net premiums earned</b>        | <b>\$ 1,979,032</b>                    | <b>\$ 2,128,725</b> |

**B. Profitability**

Loss and expense ratios are used to interpret the underwriting experience of property and casualty insurance companies. The following table reflects the Insurance Companies' loss ratio, expense ratio and combined ratio determined in accordance with GAAP:

|                       | <b>Nine Months ended September 30,</b> |              |
|-----------------------|--|--------------|
|                       | <b>2009</b>                            | <b>2008</b>  |
| Loss ratio            | 67.5%                                  | 69.7%        |
| Expense ratio         | 29.0%                                  | 28.4%        |
| <b>Combined ratio</b> | <b>96.5%</b>                           | <b>98.1%</b> |

The loss ratio is calculated by dividing losses and loss adjustment expenses by net premiums earned. The loss ratio was affected by positive development of approximately \$40 million and adverse development of approximately \$46 million on prior periods' loss reserves for the nine-month periods ended September 30, 2009 and 2008, respectively. Excluding the effect of prior accident years' loss development, the loss ratio was 69.5% and 67.5% for the nine-month periods ended September 30, 2009 and 2008, respectively. The increase in the loss ratio excluding the effect of prior accident years' loss development is primarily due to increased loss severity and lower average premiums earned per policy, partially offset by lower loss frequency.

The expense ratio is determined by matching expenses to the period over which net premiums were earned, rather than to the period that net premiums were written. The expense ratio increased primarily due to an accrual for a reduction in workforce during the three-month period ended March 31, 2009 and the impact of the amortization of AIS deferred commissions, both of which are described below.

The combined ratio of losses and expenses is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results; and a combined ratio over 100% generally reflects unprofitable underwriting results.

To improve profitability, during the three-month period ended March 31, 2009, the Company implemented several cost reduction programs, including a salary freeze, a suspension of the employee 401(k) matching program, and a workforce reduction of approximately 360 employees (7% of workforce) primarily located in California. As a result of the workforce reduction, an \$8 million expense was recorded (\$5 million to losses and loss adjustment expenses, \$3 million to other operating expenses) during the three-month period ended March 31, 2009. The

annualized cost savings from these cost reduction programs are expected to be over \$20 million.

Prior to the acquisition of AIS, the Company deferred the recognition of commissions paid to AIS to match the earnings of the related premiums. As AIS is now a wholly-owned subsidiary, commissions paid are no longer deferrable. During the nine-month period ended September 30, 2009, the amortization of deferred commissions offset by corresponding deferred direct sales cost reduced pre-tax income on the statement of operations by \$15 million.

**C. Investments**

The following table summarizes the investment results of the Company:

|  | <b>Nine Months ended September 30,</b> |              |
|--|--|--------------|
|  | <b>2009</b>                            | <b>2008</b>  |
|  | <b>(Amounts in thousands)</b>          |              |
| Average invested assets at cost (1)    | \$ 3,211,524                           | \$ 3,468,969 |
| Net investment income:                 |  |              |
| Before income taxes                    | \$ 109,334                             | \$ 116,380   |
| After income taxes                     | \$ 97,976                              | \$ 102,195   |
| Average annual yield on investments:   |  |              |
| Before income taxes                    | 4.5%                                   | 4.5%         |
| After income taxes                     | 4.1%                                   | 3.9%         |
| Net realized investment gains (losses) | \$ 352,549                             | \$ (332,614) |

(1) Fixed maturities at amortized cost, and equities and short-term investments at cost.

Included in net income are net realized investment gains of \$352.5 million for the nine-month period ended September 30, 2009 compared with net realized investment losses of \$332.6 million for the nine-month period ended September 30, 2008. Net realized investment gains include gains of \$405.6 million for the nine month period ended September 30, 2009 due to changes in the fair value of total investments pursuant to election of the fair value accounting option compared with losses of \$324.8 million for the nine-month period ended September 30, 2008. The gains during the nine-month period ended September 30, 2009 arise from the market value improvements on the Company's fixed maturity and equity securities. During the nine-month period ended September 30, 2009, the Company recorded approximately \$283.5 million and \$122.2 million in gains due to changes in the fair value of its fixed maturity portfolio and equity portfolio, respectively. The primary cause of the significant gains in the Company's equity portfolio was due to the large allocation to energy related stocks. Energy related stocks experienced a significant growth in value, more than that of the overall stock market, which saw a growth of approximately 17% in the S&P 500 Index.

The income tax expenses (benefit) for the nine-month periods ended September 30, 2009 and 2008 were \$161.4 million and \$(102.4) million, respectively. The increase in expense resulted primarily from changes in the fair value of the investment portfolio.

**III. Liquidity and Capital Resources**

**A. Cash Flows**

The principal sources of funds for the Insurance Companies are premiums, sales and maturities of invested assets and dividend and interest income from invested assets. The principal uses of funds for the Insurance Companies are the payment of claims and related expenses, operating expenses, dividends to Mercury General and the purchase of investments.

The Company has generated positive cash flow from operations for over twenty consecutive years. Because of the Company's long track record of positive operating cash flows, it does not attempt to match the duration and timing of asset maturities with those of liabilities. Rather, the Company manages its portfolio with a view towards maximizing total return with an emphasis on after-tax income. With combined cash and short-term investments of \$330.4 million at September 30, 2009, the Company believes its cash flow from operations is adequate to satisfy its liquidity requirements without the forced sale of investments. However, the Company operates in a rapidly evolving and often unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that the Company's sources of funds will be sufficient to meet its liquidity needs or that the Company will not be required to raise additional funds to meet those needs, including future business expansion, through the sale of equity or debt securities or from credit facilities with lending institutions.

Net cash provided from operating activities in the nine-month period ended September 30, 2009 was \$156.5 million, an increase of \$83.8 million over the corresponding period in 2008. This increase was primarily due to additional operating cash flows from AIS, decrease in losses and loss adjustment expenses and tax expenses paid during the nine-month period ended September 30, 2009 compared with the corresponding period in 2008. The Company has utilized the cash provided from operating activities primarily for the development of information technology such as the NextGen and Mercury First computer systems and the payment of dividends to its shareholders. Funds derived from the sale, redemption or maturity of fixed maturity investments of \$391.3 million were primarily reinvested by the Company in high grade fixed maturity securities.

The following table shows the estimated fair value of fixed maturity securities at September 30, 2009 by contractual maturity in the next five years:

|  | <b>Fixed maturities</b>       |         |
|--|-------------------------------|---------|
|  | <b>(Amounts in thousands)</b> |         |
| Due in one year or less                  | \$                            | 23,664  |
| Due after one year through two years     |                               | 28,066  |
| Due after two years through three years  |                               | 37,638  |
| Due after three years through four years |                               | 92,406  |
| Due after four years through five years  |                               | 119,910 |
|  | \$                            | 301,684 |

Effective January 1, 2009, the Company acquired AIS for \$120 million. The acquisition was financed by a \$120 million credit facility that is secured by municipal bonds held as collateral. The credit facility calls for the collateral requirement to be greater than the loan amount. The collateral requirement is calculated as the fair market value of the municipal bonds held as collateral multiplied by the advance rates, which vary based on the credit quality and duration of the assets held and range between 75% and 100% of the fair value of each bond. The loan matures on January 1, 2012 with interest payable at a floating rate of LIBOR rate plus 125 basis points. In addition, the Company may be required to pay up to \$34.7 million over the next two years as additional consideration for the AIS acquisition. The Company plans to fund that portion of the purchase price, if necessary, from cash on hand and cash flow from operations. On February 6, 2009, the Company entered into an interest rate swap of its floating LIBOR rate on the loan for a fixed rate of 1.93%, resulting in a total fixed rate of 3.18%. The purpose of the swap is to offset the variability of cash flows resulting from the variable interest rate. The swap is not designated as a hedge and changes in the fair value are adjusted through the consolidated statement of operations in the period of change.

## ***B. Invested Assets***

### **Portfolio Composition**

An important component of the Company's financial results is the return on its investment portfolio. The Company's investment strategy emphasizes safety of principal and consistent income generation, within a total return framework. The investment strategy has historically focused on maximizing after-tax yield with a primary emphasis on maintaining a well diversified, investment grade, fixed income portfolio to support the underlying liabilities and achieve return on capital and profitable growth. The Company believes that investment yield is maximized by selecting assets that perform favorably on a long-term basis and by disposing of certain assets to enhance after-tax yield and minimize the potential effect of downgrades and defaults. The Company believes that this strategy maintains the optimal investment performance necessary to sustain investment income over time. The Company's portfolio management approach utilizes a recognized market risk and asset allocation strategy as the primary basis for the allocation of interest sensitive, liquid and credit assets as well as for determining overall below investment grade exposure and diversification requirements. Within the ranges set by the asset allocation strategy, tactical investment decisions are made in consideration of prevailing market conditions.

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The following table sets forth the composition of the total investment portfolio of the Company at September 30, 2009 and December 31, 2008:

|   | September 30, 2009  |                     | December 31, 2008 |                  |
|---|---------------------|---------------------|-------------------|------------------|
|   | Cost (1)            | Fair Value          | Cost (1)          | Fair Value       |
| (Amounts in thousands)                            |                     |                     |                   |                  |
| <b>Fixed maturity securities:</b>                 |                     |                     |                   |                  |
| U.S. government bonds and agencies                | \$ 8,960            | \$ 9,128            | \$ 9,633          | \$ 9,898         |
| States, municipalities and political subdivisions | 2,408,791           | 2,462,347           | 2,370,879         | 2,187,668        |
| Mortgage-backed securities                        | 137,134             | 125,773             | 216,483           | 202,326          |
| Corporate securities                              | 92,944              | 88,932              | 77,097            | 65,727           |
| Collateralized debt obligations                   | 43,838              | 42,185              | 48,929            | 13,120           |
| Redeemable preferred stock                        | 450                 | 450                 | 5,450             | 2,934            |
|   | 2,692,117           | 2,728,815           | 2,728,471         | 2,481,673        |
| <b>Equity securities:</b>                         |                     |                     |                   |                  |
| <b>Common stock:</b>                              |                     |                     |                   |                  |
| Public utilities                                  | 28,833              | 33,715              | 32,293            | 39,148           |
| Banks, trusts and insurance companies             | 14,265              | 14,396              | 20,451            | 11,328           |
| Industrial and other                              | 264,074             | 227,114             | 330,030           | 186,294          |
| Non-redeemable preferred stock                    | 14,739              | 12,495              | 20,999            | 10,621           |
|   | 321,911             | 287,720             | 403,773           | 247,391          |
| Short-term investments                            | 126,328             | 126,172             | 208,278           | 204,756          |
| <b>Total investments</b>                          | <b>\$ 3,140,356</b> | <b>\$ 3,142,707</b> | <b>3,340,522</b>  | <b>2,933,820</b> |

(1) Fixed maturities at amortized cost, and equities and short-term investments at cost.

At September 30, 2009, approximately 78.1% of the Company's total investment portfolio at fair value and 90% of its total fixed maturity investments at fair value were invested in tax-exempt state and municipal bonds. Equity holdings consist of perpetual preferred stocks and dividend-bearing common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend exclusion. At September 30, 2009, 92.8% of short-term investments consisted of highly rated short-duration securities redeemable on a daily or weekly basis. The Company does not have any material direct equity investment in subprime lenders.

During the nine-month period ended September 30, 2009, the Company recognized approximately \$352.5 million in net realized investment gains, which include approximately \$278.4 million and \$67.9 million related to fixed maturity securities and equity securities, respectively. Included in the gains were \$283.5 million and \$122.2 million in gains due to changes in the fair value of the Company's fixed maturity portfolio and equity security portfolio, respectively, as a result of electing the fair value option. Partially offsetting these gains were approximately \$5.1 million and \$54.6 million in loss from the sale of fixed maturity securities and equity securities, respectively.

### **Fixed maturity securities**

Fixed maturity securities include debt securities and redeemable preferred stocks, which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company's asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs, tax planning considerations or other economic factors. A primary exposure for the fixed maturity securities is interest rate risk. The longer the duration, the more sensitive the asset is to market interest rate fluctuations. As assets with longer maturity dates tend to produce higher current yields, the Company's historical investment philosophy resulted in a portfolio with a moderate duration. The nominal average maturity of the overall bond portfolio, including short-term investments, was 12.5 years at September 30, 2009, which reflects a portfolio heavily weighted in investment grade tax-exempt municipal bonds. Fixed maturity investments purchased by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The call-adjusted average maturity of the overall bond portfolio, including short-term investments, was approximately 6.6 years, related to holdings which are heavily weighted with high coupon issues that are expected to be called prior to maturity. The modified duration of the overall bond portfolio reflecting anticipated early calls was 5.0 years at September 30, 2009, including collateralized mortgage obligations with modified durations of approximately 1.8 years and short-term investments that carry no duration. Modified duration measures the length of time it takes, on average, to receive the present value of all the cash flows produced by a bond, including reinvestment of interest. As it measures four factors (maturity, coupon rate, yield and call terms), which determine sensitivity to changes in interest rates; modified duration is considered a better indicator of price volatility than simple maturity alone.

Another exposure related to the fixed maturity securities is credit risk, which is managed by maintaining a weighted-average portfolio credit quality rating of AA-. To calculate the weighted-average credit quality ratings as disclosed throughout this Form 10-Q, individual securities were weighted based on fair value and a credit quality numeric score that was assigned to each rating grade. Bond holdings are broadly diversified geographically, within the tax-exempt sector. Holdings in the taxable sector consist principally of investment grade issues. At September 30, 2009, bond holdings rated below investment grade and non rated bonds totaled \$92.0 million and \$85.3 million, respectively, at fair value, and represented approximately 3.4% and 3.1%, respectively, of total fixed maturity securities. At December 31, 2008, bond holdings of lower than investment grade and non rated bonds totaled \$55.4 million and \$49.5 million, respectively, and represented approximately 2.2% and 2.0%, respectively, of total fixed maturity securities.

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The following table presents the credit quality rating of the Company's fixed maturity portfolio by security type at September 30, 2009 at fair value. Credit quality ratings are based on the average of ratings assigned by nationally recognized securities rating organizations. Credit ratings for the Company's fixed maturity portfolio were stable during the nine-month period ended September 30, 2009, with 91.2% of fixed maturity securities at fair value experiencing no change in their overall rating. Approximately 5.6% experienced downgrades during the period, offset by approximately 3.2% in credit upgrades. The majority of the downgrades were due to continued downgrading of the monoline insurance carried on much of the municipal holdings. The majority of the downgrades was slight and still within the investment grade portfolio and only approximately \$10.1 million at fair value was downgraded to below investment grade during the quarter, allowing the Company to maintain a high overall credit rating on its fixed maturity securities.

|  | September 30, 2009     |            |            |            |                 | Total        |
|--|------------------------|------------|------------|------------|-----------------|--------------|
|  | AAA                    | AA (2)     | A (2)      | BBB (2)    | Non Rated/Other |              |
|  | (Amounts in thousands) |            |            |            |                 |              |
| <b>U.S. government bonds and agencies:</b> |                        |            |            |            |                 |              |
| Treasuries                                 | \$ 5,867               | \$         | \$         | \$         | \$              | \$ 5,867     |
| Government agency                          | 3,261                  |            |            |            |                 | 3,261        |
| Total                                      | 9,128                  |            |            |            |                 | 9,128        |
|  | 100.0%                 |            |            |            |                 | 100.0%       |
| <b>Municipal securities:</b>               |                        |            |            |            |                 |              |
| Insured (1)                                | 4,609                  | 553,318    | 703,762    | 83,094     | 36,723          | 1,381,506    |
| Uninsured                                  | 262,973                | 344,421    | 246,359    | 175,256    | 51,832          | 1,080,841    |
| Total                                      | 267,582                | 897,739    | 950,121    | 258,350    | 88,555          | 2,462,347    |
|  | 10.9%                  | 36.4%      | 38.6%      | 10.5%      | 3.6%            | 100.0%       |
| <b>Mortgage-backed securities:</b>         |                        |            |            |            |                 |              |
| Agencies                                   | 95,155                 |            |            |            |                 | 95,155       |
| <b>Non-agencies:</b>                       |                        |            |            |            |                 |              |
| Prime                                      | 8,394                  |            | 447        | 602        | 7,030           | 16,473       |
| Alt-A                                      | 1,921                  | 3,131      | 5,252      |            | 3,841           | 14,145       |
| Total                                      | 105,470                | 3,131      | 5,699      | 602        | 10,871          | 125,773      |
|  | 83.9%                  | 2.5%       | 4.5%       | 0.5%       | 8.6%            | 100.0%       |
| <b>Corporate securities:</b>               |                        |            |            |            |                 |              |
| Financial                                  | 4,496                  | 11,003     | 17,335     | 5,701      | 18,943          | 57,478       |
| Energy                                     |                        |            |            | 6,046      | 9,408           | 15,454       |
| Communications                             |                        |            |            | 6,637      |                 | 6,637        |
| Utilities                                  |                        |            |            | 3,579      | 1,768           | 5,347        |
| Basic materials                            |                        |            |            | 3,936      |                 | 3,936        |
| Consumer - cyclical                        |                        |            |            |            | 80              | 80           |
| Total                                      | 4,496                  | 11,003     | 17,335     | 25,899     | 30,199          | 88,932       |
|  | 5.0%                   | 12.4%      | 19.5%      | 29.1%      | 34.0%           | 100.0%       |
| <b>Redeemable preferred stock:</b>         |                        |            |            |            |                 |              |
| Corporate - Hybrid (CDO)                   |                        |            |            |            | 42,185          | 42,185       |
| Redeemable preferred stock                 |                        |            |            |            | 450             | 450          |
| Total                                      |                        |            |            |            | 42,635          | 42,635       |
|  |                        |            |            |            | 100.0%          | 100.0%       |
| Total                                      | \$ 386,676             | \$ 911,873 | \$ 973,155 | \$ 284,851 | \$ 172,260      | \$ 2,728,815 |
|  | 14.2%                  | 33.4%      | 35.7%      | 10.4%      | 6.3%            | 100.0%       |

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(1) Insured municipal bonds based on underlying ratings: AAA: \$12,133, AA: \$373,794, A: \$713,280, BBB: \$114,357, Non rated/Other: \$167,942

(2) Intermediate ratings are offered at each level (e.g., AA includes AA+, AA and AA-).

### **1. Municipal securities**

The Company had approximately \$2.5 billion at fair value (\$2.4 billion at amortized cost) in municipal bonds at September 30, 2009, with an unrealized gain of \$53.6 million. Approximately half of the municipal bond positions are insured by bond insurers. For insured municipal bonds that have underlying ratings, the weighted-average rating was A+ at September 30, 2009.



The following table shows the Company's insured municipal bond portfolio by bond insurer at September 30, 2009 and at December 31, 2008.

| Municipal bond insurer | September 30, 2009 |                        | December 31, 2008 |              |
|------------------------|--------------------|------------------------|-------------------|--------------|
|                        | Rating (1)         | Fair value             | Rating (1)        | Fair value   |
|                        |                    | (Amounts in thousands) |                   |              |
| MBIA                   | BBB                | \$ 729,614             | BBB               | \$ 606,301   |
| AMBAC                  | CC                 | 221,059                | BBB               | 193,701      |
| FSA                    | AA                 | 199,952                | AA                | 205,249      |
| XLCA                   | CC                 | 48,777                 | CCC               | 38,393       |
| ASSURED GTY            | AA                 | 43,562                 | AA                | 16,664       |
| CIFG                   | CC                 | 17,558                 | B                 | 16,278       |
| RADIAN                 | BB                 | 15,461                 | BBB               | 15,155       |
| ACA                    | NR                 | 14,736                 | NR                | 13,899       |
| FGIC                   | NR                 | 3,952                  | CCC               | 9,048        |
| Other                  | N/A                | 86,835                 | N/A               | 81,283       |
|                        |                    | \$ 1,381,506           |                   | \$ 1,195,971 |

(1) Management's estimate of average of ratings issued by Standard & Poor's, Moody's and Fitch.

The Company considers the strength of the underlying credit as a buffer against potential market value declines which may result from future rating downgrades of the bond insurers. In addition, the Company has a long-term time horizon for its municipal bond holdings which generally allows it to recover the full principal amounts upon maturity, avoiding forced sales prior to maturity, of bonds that have declined in market value due to the bond insurers' rating downgrades. Based on the uncertainty surrounding the financial condition of these insurers, it is possible that there will be additional downgrades to below investment grade ratings by the rating agencies in the future, and such downgrades could impact the estimated fair value of municipal bonds.

At September 30, 2009, municipal securities included auction rate securities. The Company owned \$3.0 million at fair value of auction rate securities at September 30, 2009 and December 31, 2008. Auction rate securities were valued based on a discounted cash flow model with certain inputs that were not observable in the market and are considered Level 3 inputs.

## **2. Mortgage-backed securities**

The mortgage-backed securities portfolio is categorized as loans to prime borrowers except for approximately \$14.1 million and \$16.3 million (\$17.9 million and \$20.0 million amortized cost) of Alt-A mortgages at September 30, 2009 and December 31, 2008, respectively. Alt-A mortgage backed securities are at fixed or variable rates and include certain securities that are collateralized by residential mortgage loans issued to borrowers with stronger credit profiles than sub-prime borrowers, but do not qualify for prime financing terms due to high loan-to-value ratios or limited supporting documentation. At September 30, 2009, the Company had no holdings in commercial mortgage-backed securities.

The weighted-average rating of the Company's Alt-A mortgages is BBB+ and the weighted-average rating of the entire mortgage backed securities portfolio is AA+.

## **3. Corporate securities**

Included in the fixed maturity securities are \$88.9 million of fixed rated corporate securities which have a duration of 4.95 years and a weighted-average rating of A-.

**4. Collateralized Debt Obligations**

Included in fixed maturities securities are \$42.2 million of collateralized debt obligations, which represent approximately 1.3% of the total investment portfolio at September 30, 2009, and have a duration of 3.14 years.

**Equity securities**

Equity holdings consist of non-redeemable preferred stocks and common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend exclusion. The net gain due to changes in fair value of the Company's equity portfolio during the nine-month period ended September 30, 2009 was \$122.2 million. The primary cause of the significant gains in the Company's equity portfolio was due to the large allocation to energy related stocks. During the nine-month period ended September 30, 2009, energy related stocks experienced a significant growth in value, more than that of the overall stock market, which saw a growth of approximately 17% in the S&P 500 Index.

The Company's common stock allocation is intended to enhance the return of and provide diversification for the total portfolio. At September 30, 2009, 8.8% of the total investment portfolio at fair value was held in equity securities, compared to 8.4% at December 31, 2008.

**Short-term investments**

At September 30, 2009, short-term investments include money market accounts, options, and short-term bonds which are highly rated short duration securities and redeemable within one year.

**C. Regulatory Capital Requirement**

Industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3.0 to 1. Based on the combined surplus of all the Insurance Companies of \$1.5 billion at September 30, 2009, and net premiums written for the twelve months ended on that date of \$2.6 billion, the ratio of premium writings to surplus was 1.8 to 1.

**IV. Regulatory and Litigation Matters**

The Department of Insurance ( DOI ) in each state in which the Company operates conducts periodic financial and market conduct examinations of the Company's insurance subsidiaries domiciled within the respective state. The following table provides a summary of current financial and market conduct examinations:

| State | Exam Type             | Period Under Review   | Status  |
|-------|-----------------------|-----------------------|---|
| CA    | Rating & Underwriting | 2004 to 2007          | Field work has been completed. Awaiting final report. |
| NJ    | Market Conduct        | Sept 2007 to Aug 2008 | Field work has been completed. Awaiting final report. |
| TX    | Financial             | 2005 to 2008          | Data submitted and field work is pending.             |

No material findings have been noted in the examinations above.

The Company is supporting The Continuous Coverage Auto Insurance Discount Act ( CCAIDA ), a California ballot initiative which is targeted for the June 2010 ballot. If passed, the CCAIDA will provide for a portable persistency discount, allowing insurance companies to offer new customers discounts based on having continuous insurance coverage from any insurance company. Currently, the California DOI allows insurance companies to provide persistency discounts based on continuous coverage only with existing customers. While the company expects this to be beneficial for the insurance consumer, there are consumer activist groups both supporting and opposing the initiative.

In March 2006, the California DOI issued an Amended Notice of Non-Compliance ( NNC ) to the NNC originally issued in February 2004 alleging that the Company charged rates in violation of the California Insurance Code, willfully permitted its agents to charge broker fees in violation of California law, and willfully misrepresented the actual price insurance consumers could expect to pay for insurance by the amount of a fee charged by the consumer's insurance broker. Through this action, the California DOI seeks to impose a fine for each policy in which the Company allegedly permitted an agent to charge a broker fee, which the California DOI contends is the use of an unapproved rate, rating plan or rating system. Further, the California DOI seeks to impose a penalty for each and every date on which the Company allegedly used a misleading advertisement alleged in the NNC. Finally, based upon the conduct alleged, the California DOI also contends that the Company acted fraudulently in violation of Section 704(a) of the California Insurance Code, which permits the California Commissioner of Insurance to suspend certificates of authority for a period of one year.



The Company filed a Notice of Defense in response to the NNC. The Company does not believe that it has done anything to warrant a monetary penalty from the California DOJ. The San Francisco Superior Court, in *Robert Krumme, On Behalf Of The General Public v. Mercury Insurance Company, Mercury Casualty Company, and California Automobile Insurance Company*, denied plaintiff's requests for restitution or any other form of retrospective monetary relief based on the same facts and legal theory. While a hearing before the administrative law judge was set to start on September 14, 2009, the hearing was vacated and continued to a future date to be determined.

The Company is, from time to time, named as a defendant in various lawsuits incidental to its insurance business. In most of these actions, plaintiffs assert claims for punitive damages which are not insurable under judicial decisions. The Company has established reserves for lawsuits in which the Company is able to estimate its potential exposure and the likelihood that the court will rule against the Company is probable. The Company vigorously defends these actions, unless a reasonable settlement appears appropriate. An unfavorable ruling against the Company in the actions currently pending may, but is not likely to, have a material impact on the Company's quarterly results of operations; however, it is not expected to be material to the Company's financial position. For a further discussion of the Company's pending material regulatory matters and litigation, see the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

## **V. Critical Accounting Policies and Estimates**

### ***A. Reserves***

The preparation of the Company's condensed consolidated financial statements requires judgment and estimates. The most significant is the estimate of loss reserves. Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim and, therefore, the reserve that is required. Changes in the regulatory and legal environment, results of litigation, medical costs, the cost of repair materials and labor rates, among other factors, can all impact ultimate claim costs. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of a claim, the more variable the ultimate settlement amount can be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims.

The Company also engages independent actuarial consultants to review the Company's reserves and to provide the annual actuarial opinions required under state statutory accounting requirements. The Company does not rely on actuarial consultants for GAAP reporting or periodic report disclosure purposes. The Company analyzes loss reserves quarterly primarily using the incurred loss development, average severity and claim count development methods described below. The Company also uses the paid loss development method to analyze loss adjustment expense reserves and industry claims data as part of its reserve analysis. When deciding which method to use in estimating its reserves, the Company evaluates the credibility of each method based on the maturity of the data available and the claims settlement practices for each particular line of business or coverage within a line of business. When establishing the reserve, the Company will generally analyze the results from all of the methods used rather than relying on one method. While these methods are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

The incurred loss development method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current case incurred losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss development method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of business which have a long operating history. The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts. The average severity method coupled with the claim count development method provide meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing reserves. The paid loss development method analyzes historical payment patterns to estimate the amount of losses yet to be paid. The Company primarily uses this method for loss adjustment expenses because specific case reserves are generally not established for loss adjustment expenses.

In states with little operating history where there are insufficient claims data to prepare a reserve analysis relying solely on Company historical data, the Company generally projects ultimate losses using industry average loss data or expected loss ratios. As the Company develops an operating history in these states, the Company will rely increasingly on the incurred loss development and average severity and claim count development methods. The Company analyzes catastrophe losses separately from non-catastrophe losses. For catastrophe losses, the Company determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on reserves established by adjusters and average losses on previous similar catastrophes.

At September 30, 2009, the Company recorded its point estimate of approximately \$1,055.9 million in losses and loss adjustment expenses liability which includes approximately \$360.6 million of incurred but not reported ( IBNR ) loss reserves. IBNR includes estimates, based upon past experience, of ultimate developed costs which may differ from case estimates, unreported claims which occurred on or prior to September 30, 2009 and estimated future payments for reopened claims. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date; however, since the provisions are necessarily based upon estimates, the ultimate liability may be more or less than such provision.

The Company evaluates its reserves quarterly. When management determines that the estimated ultimate claim cost requires reduction for previously reported accident years, positive development occurs and a reduction in losses and loss adjustment expenses is reported in the current period. If the estimated ultimate claim cost requires an increase for previously reported accident years, negative development occurs and an increase in losses and loss adjustment expenses is reported in the current period. For the nine-month period ended September 30, 2009, the Company reported positive development of approximately \$40 million on the 2008 and prior accident years' loss and loss adjustment expense reserves which at December 31, 2008 totaled approximately \$1.1 billion. The positive development in 2009 is largely the result of re-estimates of accident year 2008 California bodily injury losses which have experienced both lower average severities and fewer late reported claims (claim count development) than was originally estimated at December 31, 2008.

For a further discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

#### ***B. Premiums***

The Company's insurance premiums are recognized as income ratably over the term of the policies, that is, in proportion to the amount of insurance protection provided. Unearned premiums are carried as a liability on the balance sheet and are computed on a monthly pro-rata basis. The Company evaluates its unearned premiums periodically for premium deficiencies by comparing the sum of expected claim costs, unamortized acquisition costs and maintenance costs to related unearned premiums, net of investment income. To the extent that any of the Company's lines of business become substantially unprofitable, a premium deficiency reserve may be required. The Company does not expect this to occur on any of its significant lines of business.

#### ***C. Investments***

Beginning January 1, 2008, all of the Company's fixed maturity and equity investments are classified as trading and carried at fair value as required when electing the fair value option, with changes in fair value reflected in net realized investment gains or losses in the consolidated statements of operations. Prior to January 1, 2008, the Company's fixed maturity and equity investment portfolios were classified either as available for sale or trading and carried at fair value, with changes in fair value of available for sale securities reflected in unrealized gains or losses in the consolidated statements of comprehensive income and changes in fair value of trading securities reflected in net realized investment gains or losses in the consolidated statements of operations. Equity holdings, including non-sinking fund preferred stocks, are, with minor exceptions, actively traded on national exchanges or trading markets, and were valued at the last transaction price on the balance sheet date.

#### ***D. Fair Value of Financial Instruments***

Certain financial assets and financial liabilities are recorded at fair value. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair values of the Company's financial instruments are generally based on, or derived from, executable bid prices. In the case of financial instruments transacted on recognized exchanges, the observable prices represent quotations for completed transactions from the exchange on which the financial instrument is principally traded.

The Company's financial instruments include securities issued by the U.S. government and its agencies, securities issued by states and municipalities, certain corporate and other debt securities, corporate equity securities, and exchange traded funds. Over 99% of the fair value of the financial instruments held at September 30, 2009 is based on observable market prices, observable market parameters, or is derived from such prices or parameters. The availability of observable market prices and pricing parameters can vary across different financial instruments. Observable market prices and pricing parameters in a financial instrument, or a related financial instrument, are used to derive a price without requiring significant judgment.

Certain financial instruments that the Company holds or may acquire may lack observable market prices or market parameters currently or in future periods because they are less actively traded. The fair value of such instruments is determined using techniques appropriate for each particular financial instrument. These techniques may involve some degree of judgment. The price transparency of the particular financial instrument will determine the degree of judgment involved in determining the fair value of the Company's financial instruments. Price transparency is affected by a wide variety of factors, including, for example, the type of financial instrument, whether it is a new financial instrument and not yet established in the marketplace, and the characteristics particular to the transaction. Financial instruments for which actively quoted prices or pricing parameters are available or for which fair value is derived from actively quoted prices or pricing parameters will generally have a higher degree of price transparency. By contrast, financial instruments that are thinly traded or not quoted will generally have diminished price transparency. Even in normally active markets, the price transparency for actively quoted instruments may be reduced for periods of time during periods of market dislocation. Alternatively, in thinly quoted markets, the participation of market makers willing to purchase and sell a financial instrument provides a source of transparency for products that otherwise is not actively quoted.

#### ***E. Income Taxes***

At September 30, 2009, the Company's deferred income taxes were in a net asset position partly as a result of the fair value declines in the investment portfolio originating in 2008, which resulted from extreme volatility in the capital markets and a widening of credit spreads beyond historic norms. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established.

Management's recoverability assessment is based on estimates of anticipated capital gains, capital gains realized in prior years, when available, that could be utilized through carryback, and tax-planning strategies available to generate future taxable capital gains, all of which would contribute to the realization of deferred tax benefits. The Company expects to hold certain quantities of debt securities, which are currently in loss positions, to recovery or maturity. Management believes unrealized losses related to these debt securities, which represent a significant portion of the unrealized loss positions at quarter-end, are not due to default risk. Thus, the principal amounts are believed to be fully realizable at maturity. The Company has a long-term horizon for holding these securities, which management believes will allow avoidance of forced sales prior to maturity. The Company has prior years' realized capital gains available to offset the majority of realized capital losses, via the filing of carryback refund claims. The Company also has unrealized gains in its investment portfolio which could be realized through asset dispositions, at management's discretion. Further, the Company has the capability to generate additional realized capital gains by entering into a sale-leaseback transaction using one or more properties of its appreciated real estate holdings. Finally, the Company has an established history of generating capital gain premiums earned through its common stock call option program. Based on the continued existence of the options market, the substantial amount of capital committed to supporting the call option program, and the Company's favorable track record in generating net capital gains from this program in both upward and downward markets, management believes it will be able to generate sufficient amounts of option premium capital gains (more than sufficient to offset any losses on the underlying stocks employed in the program) on a consistent, long term basis.

The Company has the capability to implement tax planning strategies as it has a steady history of generating positive cash flow from operations, as well as the reasonable expectation that its cash flow needs can be met in future periods without the forced sale of its investments. This capability will enable management to use its discretion in controlling the timing and amount of realized losses it generates during future periods. By prudent utilization of some or all of these actions, management believes that it has the ability and intent to generate capital gains, and minimize tax losses, in a manner sufficient to avoid losing the full benefits of its deferred tax assets. Management will continue to assess the need for a valuation allowance on a quarterly basis. Although realization is not assured, management believes it is more likely than not that the Company's deferred tax assets will be realized.

#### ***F. Goodwill***

Goodwill represents the excess of amounts paid for acquiring businesses over the fair value of the net assets acquired. The Company annually evaluates goodwill for impairment using widely accepted valuation techniques to estimate the fair value of its reporting units. The Company also reviews its goodwill for impairment whenever events or changes in circumstances indicate that it is more likely than not that the carrying amount of goodwill may exceed its implied fair value.



### ***G. Contingent Liabilities***

The Company has known, and may have unknown, potential liabilities which include claims, assessments or lawsuits relating to the Company's business. The Company continually evaluates these potential liabilities and accrues for them or discloses them in the notes to the condensed consolidated financial statements where required. While it is not possible to know with certainty the ultimate outcome of contingent liabilities, an unfavorable result may have a material impact on the Company's quarterly results of operations; however, it is not expected to be material to the Company's financial position.

### **VI. Forward-Looking Statements**

Certain statements in this report on Form 10-Q that are not historical facts 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 forward-looking statements may address, among other things, the Company's strategy for growth, business development, regulatory approvals, market position, expenditures, financial results and reserves. Forward-looking statements are not guarantees of performance and are subject to important factors and events that could cause the Company's actual business, prospects and results of operations to differ materially from the historical information contained in this Form 10-Q and from those that may be expressed or implied by the forward-looking statements.

Factors that could cause or contribute to such differences include, among others: the competition currently existing in the automobile insurance markets in states where the Company does business; the cyclical and general competitive nature of the property and casualty insurance industry and general uncertainties regarding loss reserve or other estimates; the accuracy and adequacy of the Company's pricing methodologies; a successful integration of the operations of AIS and the achievement of the synergies and revenue growth from the acquisition of AIS; the Company's success in managing its business in states outside of California; the impact of potential third party bad-faith legislation, changes in laws or regulations, tax position challenges by the California Franchise Tax Board, and decisions of courts, regulators and governmental bodies, particularly in California; the Company's ability to obtain and the timing of premium rate changes for the Company's private passenger automobile policies; the performance of and general market risk associated with the Company's investment portfolio, including the impact of current economic conditions on the Company's market and investment portfolio; uncertainties related to assumptions and projections generally, inflation and changes in economic conditions; changes in driving patterns and loss trends; court decisions and trends in litigation and health care and auto repair costs; adverse weather conditions or natural disasters in the markets served by the Company; the stability of the Company's information technology systems and the ability of the Company to execute on its information technology initiatives; the Company's ability to realize current deferred tax assets or to hold certain securities with current loss positions to recovery or maturity; acts of war and terrorist activities; and other uncertainties, all of which are difficult to predict and many of which are beyond the Company's control. GAAP prescribes when a Company may reserve for particular risks including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain periods.

The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise. Investors are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Form 10-Q or, in the case of any document the Company incorporates by reference, the date of that document. Investors also should understand that it is not possible to predict or identify all factors and should not consider the risks set forth above to be a complete statement of all potential risks and uncertainties. If the expectations or assumptions underlying the Company's forward-looking statements prove inaccurate or if risks or uncertainties arise, actual results could differ materially from those predicted in any forward-looking statements. The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements. Any forward-looking statements should also be considered in light of the information provided in Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2008 and in Item 1A. Risk Factors in Part II - Other Information of this Quarterly Report on Form 10-Q.



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

The Company is subject to various market risk exposures. Primary market risk exposures are changes in interest rates, equity prices and credit risk. Adverse changes to these rates and prices may occur due to changes in the liquidity of a market, or to changes in market perceptions of credit worthiness and risk tolerance. The following disclosure reflects estimates of future performance and economic conditions. Actual results may differ.

***Overview***

The Company's investment policies define the overall framework for managing market and investment risks, including accountability and controls over risk management activities, and specify the investment limits and strategies that are appropriate given the liquidity, surplus, product profile and regulatory requirements of the subsidiaries. Executive oversight of investment activities is conducted primarily through the Company's investment committee. The investment committee focuses on strategies to enhance yields, mitigate market risks and optimize capital to improve profitability and returns.

The Company manages exposures to market risk through the use of asset allocation, duration and credit ratings. Asset allocation limits place restrictions on the total funds that may be invested within an asset class. Duration limits on the fixed maturities portfolio place restrictions on the amount of interest rate risk that may be taken. Comprehensive day-to-day management of market risk within defined tolerance ranges occurs as portfolio managers buy and sell within their respective markets based upon the acceptable boundaries established by investment policies.

***Credit risk***

Credit risk is risk due to uncertainty in a counterparty's ability to meet its obligations. Credit risk is managed by maintaining a weighted-average fixed maturities portfolio credit quality rating of AA-. Historically, the ten-year default rate per Moody's for AA rated municipal bonds has been less than 1%. The Company's municipal bond holdings, which represent 90.2% of its fixed maturity portfolio at September 30, 2009 at fair value, are broadly diversified geographically. Approximately 99.7% of municipal bond holdings are in the tax-exempt sector. The largest holdings are in populous states such as Texas (15.3%) and California (12.4%); however, such holdings are further diversified primarily between cities, counties, schools, public works, hospitals and state general obligations. In California, the Company owns approximately \$8.4 million at fair value of general obligations of the state at September 30, 2009. Credit risk is addressed by limiting exposure to any particular issuer to ensure diversification. Taxable fixed maturity securities represent 10% of the Company's fixed maturity portfolio. Approximately 38.2% of the Company's taxable fixed maturity securities were comprised of U.S. government bonds and agencies, which were rated AAA at September 30, 2009. Approximately 13% of the Company's taxable fixed maturity securities were rated below investment grade. Below investment grade issues are considered "watch list" items by the Company, and their status is evaluated within the context of the Company's overall portfolio and its investment policy on an aggregate risk management basis, as well as their ability to recover their investment on an individual issue basis.

Credit ratings for the Company's fixed maturity portfolio were stable during the nine-month period ended September 30, 2009, with 91.2% of the fixed maturity portfolio at fair value experiencing no change in their overall rating. Approximately 5.6% experienced downgrades during the period, offset by approximately 3.2% in credit upgrades. The majority of the downgrades were due to continued downgrading of the monoline insurance carried on much of the municipal holdings. The majority of the downgrades was slight and still within the investment grade portfolio and only approximately \$10.1 million at fair value was downgraded to below investment grade during the quarter, allowing the Company to maintain a high overall credit rating on its fixed maturity securities.

***Equity price risk***

Equity price risk is the risk that the Company will incur losses due to adverse changes in the general levels of the equity markets.

At September 30, 2009, the Company's primary objective for common equity investments is current income. The fair value of the equity investment consists of \$275.2 million in common stocks and \$12.5 million in non-redeemable preferred stocks. The common stock equity assets are typically valued for future economic prospects as perceived by the market. The current market expectation is cautiously optimistic following government programs designed to sustain the economy. The Company has also allocated more to the energy sector relative to the S&P 500 Index to hedge against potential inflationary pressures on the equity markets possible in a sudden economic recovery.

The common equity portfolio represents approximately 8.8% of total investments at fair value. Beta is a measure of a security's systematic (non-diversifiable) risk, which is the percentage change in an individual security's return for a 1% change in the return of the market. The weighted-average Beta for the Company's common stock holdings was 1.16 at September 30, 2009. Based on a hypothetical 25% or 50% reduction in the overall value of the stock market, the fair value of the common stock portfolio would decrease by approximately \$79.8 million or \$159.6 million, respectively.

#### ***Interest rate risk***

Interest rate risk is the risk that the Company will incur a loss due to adverse changes in interest rates relative to the interest rate characteristics of interest bearing assets and liabilities. This risk arises from many of its primary activities, as the Company invests substantial funds in interest sensitive assets and issues interest sensitive liabilities. Interest rate risk includes risks related to changes in U.S. Treasury yields and other key benchmarks, as well as changes in interest rates resulting from the widening credit spreads and credit exposure to collateralized securities.

The value of the fixed maturity portfolio, which represents 86.8% of total investments at fair value, is subject to interest rate risk. As market interest rates decrease, the value of the portfolio increases and vice versa. A common measure of the interest sensitivity of fixed maturity assets is modified duration, a calculation that utilizes maturity, coupon rate, yield and call terms to calculate an average age of the expected cash flows. The longer the duration, the more sensitive the asset is to market interest rate fluctuations.

The Company has historically invested in fixed maturity investments with a goal towards maximizing after-tax yields and holding assets to the maturity or call date. Since assets with longer maturity dates tend to produce higher current yields, the Company's historical investment philosophy resulted in a portfolio with a moderate duration. Bond investments made by the Company typically have call options attached, which further reduce the duration of the asset as interest rates decline. The increase in municipal bond credit spreads in 2008 caused overall interest rates to increase, which resulted in the increase in the duration of the Company's portfolio. Consequently, the modified duration of the bond portfolio, including short-term investments, is 5.0 years at September 30, 2009. Given a hypothetical parallel increase of 100 basis or 200 basis points in interest rates, the fair value of the bond portfolio at September 30, 2009 would decrease by approximately \$142.5 million or \$284.9 million, respectively.

Effective January 2, 2002, the Company entered into an interest rate swap of its fixed rate obligation on its \$125.0 million fixed 7.25% rate senior notes for a floating rate. The interest rate swap has the effect of hedging the fair value of the senior notes.

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

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

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

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

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect the Company's internal control over financial reporting. The Company's process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies which may be identified during this process.



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**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is, from time to time, named as a defendant in various lawsuits incidental to its insurance business. In most of these actions, plaintiffs assert claims for punitive damages which are not insurable under judicial decisions. The Company has established reserves for lawsuits in which the Company is able to estimate its potential exposure and the likelihood that the court will rule against the Company is probable. The Company vigorously defends these actions, unless a reasonable settlement appears appropriate. An unfavorable ruling against the Company in the actions currently pending may have a material impact on the Company's quarterly results of operations; however, none is expected to be material to the Company's financial position. For a detailed description of the pending material lawsuits, see the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

**Item 1A. Risk Factors**

The Company's business, operations, and financial position are subject to various risks. These risks are described elsewhere in this report and in its other filings with the United States Securities and Exchange Commission, including the Company's Annual Report on Form 10-K for the year ended December 31, 2008. The risk factors identified in the Company's Annual Report on Form 10-K for the year ended December 31, 2008 have not changed in any material respect.

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

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

- 15.1 Report of Independent Registered Public Accounting Firm
- 15.2 Awareness Letter of Independent Registered Public Accounting Firm
- 31.1 Certification of Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Registrant's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Registrant's Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be

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incorporated by reference into any filing of the Company.

- 32.2 Certification of Registrant's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.

**SIGNATURES**

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

**MERCURY GENERAL CORPORATION**

Date: November 3, 2009

By: /s/ Gabriel Tirador  
Gabriel Tirador  
President and Chief Executive Officer

Date: November 3, 2009

By: /s/ Theodore Stalick  
Theodore Stalick  
Vice President and Chief Financial Officer