

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

May 08, 2009

Table of Contents

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

FORM 10-Q

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

For the quarter ended March 31, 2009

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES
EXCHANGE ACT OF 1934**

**Commission File Number 1-14094
Meadowbrook Insurance Group, Inc.**
(Exact name of Registrant as specified in its charter)

Michigan **38-2626206**
(State of Incorporation) (IRS Employer Identification No.)

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

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

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company
(Do not check if a smaller reporting company)

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The aggregate number of shares of the Registrant's Common Stock, \$.01 par value, outstanding on May 1, 2009, was 57,447,707.

TABLE OF CONTENTS

	PAGE
<u>PART I FINANCIAL INFORMATION</u>	
<u>ITEM 1 FINANCIAL STATEMENTS</u>	
<u>Consolidated Statements of Income (unaudited)</u>	3
<u>Consolidated Statements of Comprehensive Income (unaudited)</u>	4
<u>Consolidated Balance Sheets (unaudited)</u>	5
<u>Consolidated Statement of Cash Flows (unaudited)</u>	6
<u>Notes to Consolidated Financial Statements (unaudited)</u>	7-29
<u>ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	30-51
<u>ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	51-53
<u>ITEM 4 CONTROLS AND PROCEDURES</u>	53-54
<u>PART II OTHER INFORMATION</u>	
<u>ITEM 1 LEGAL PROCEEDINGS</u>	55
<u>ITEM 1A RISK FACTORS</u>	55
<u>ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	55
<u>ITEM 6 EXHIBITS</u>	55-56
<u>SIGNATURES</u>	57
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	

Table of Contents

PART 1 FINANCIAL INFORMATION
ITEM 1
FINANCIAL STATEMENTS
MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF INCOME
For the Three Months Ended March 31,
(Unaudited)
(in thousands, except share data)

	2009	2008
Revenues		
Premiums earned		
Gross	\$ 155,014	\$ 83,971
Ceded	(25,976)	(17,949)
Net earned premiums	129,038	66,022
Net commissions and fees	10,237	12,031
Net investment income	12,342	7,148
Net realized losses	(1,992)	(31)
Total revenues	149,625	85,170
Expenses		
Losses and loss adjustment expenses	88,698	48,739
Reinsurance recoveries	(18,911)	(11,078)
Net losses and loss adjustment expenses	69,787	37,661
Salaries and employee benefits	19,827	12,755
Policy acquisition and other underwriting expenses	23,969	13,147
Other administrative expenses	10,393	8,832
Amortization expense	1,508	1,551
Interest expense	2,782	1,311
Total expenses	128,266	75,257
Income before taxes and equity earnings	21,359	9,913
Federal and state income tax expense	7,874	2,911
Equity earnings of affiliates	55	56
Net income	\$ 13,540	\$ 7,058
Earnings Per Share		
Basic	\$ 0.24	\$ 0.19
Diluted	\$ 0.24	\$ 0.19
Weighted average number of common shares		

Edgar Filing: MEADOWBROOK INSURANCE GROUP INC - Form 10-Q

Basic	57,392,499	37,012,104
Diluted	57,410,327	37,103,270
Dividends paid per common share	\$ 0.02	\$ 0.02

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

3

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Three Months Ended March 31,
(Unaudited)
(in thousands)

	2009	2008
Net income	\$13,540	\$7,058
Other comprehensive income, net of tax:		
Unrealized gains on securities	6,035	1,789
Net deferred derivative gain (losses) hedging activity	329	(449)
Less: reclassification adjustment for investment losses included in net income	2,014	65
Other comprehensive gains, net of tax	8,378	1,405
Comprehensive income	\$21,918	\$8,463

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

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	March 31, 2009 (Unaudited)	December 31, 2008
ASSETS		
Investments		
Debt securities available for sale, at fair value (amortized cost of \$1,003,650 and \$977,613)	\$ 1,022,329	\$ 986,483
Equity securities available for sale, at fair value (amortized cost of \$27,293 and \$27,660)	20,486	22,577
Cash and cash equivalents	73,208	76,588
Accrued investment income	11,017	10,441
Premiums and agent balances receivable, net	127,011	117,675
Reinsurance recoverable on:		
Paid losses	9,686	8,337
Unpaid losses	261,157	260,366
Prepaid reinsurance premiums	32,385	31,885
Deferred policy acquisition costs	57,265	56,454
Deferred federal income taxes	16,630	22,718
Goodwill	119,205	119,028
Other intangible assets	45,544	46,951
Other assets	53,570	54,413
Total assets	\$ 1,849,493	\$ 1,813,916
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities		
Losses and loss adjustment expenses	\$ 897,690	\$ 885,697
Unearned premiums	287,064	282,086
Debt	57,875	60,250
Debtures	80,930	80,930
Accounts payable and accrued expenses	26,329	27,839
Funds held and reinsurance balances payable	25,134	27,793
Payable to insurance companies	274	3,221
Other liabilities	16,016	7,930
Total liabilities	1,391,312	1,375,746
Shareholders Equity		
Common stock, \$0.01 stated value; authorized 75,000,000 shares; 57,447,707 and 57,341,989 shares issued and outstanding	574	573
Additional paid-in capital	313,876	314,641
Retained earnings	139,548	127,157

Edgar Filing: MEADOWBROOK INSURANCE GROUP INC - Form 10-Q

Note receivable from officer	(846)	(852)
Accumulated other comprehensive income (loss)	5,029	(3,349)
Total shareholders' equity	458,181	438,170
Total liabilities and shareholders' equity	\$1,849,493	\$1,813,916

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

5

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Three Months Ended March 31,
(Unaudited)
(in thousands)

	2009	2008
Cash Flows From Operating Activities		
Net income	\$ 13,540	\$ 7,058
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of other intangible assets	1,508	1,551
Amortization of deferred debenture issuance costs	121	118
Depreciation of furniture, equipment, and building	1,221	745
Net accretion of discount and premiums on bonds	815	696
Loss on sale of investments, net	2,014	100
Gain on sale of fixed assets	(22)	(22)
Incremental tax benefits from stock options exercised		(80)
Long-term incentive plan expense	203	209
Deferred income tax expense (benefit)	1,710	(1,089)
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Premiums and agent balances receivable	(9,336)	(7,270)
Reinsurance recoverable on paid and unpaid losses	(2,140)	1,722
Prepaid reinsurance premiums	(500)	(1,120)
Deferred policy acquisition costs	(811)	(1,494)
Other assets	(216)	(921)
Increase (decrease) in:		
Losses and loss adjustment expenses	11,993	5,519
Unearned premiums	4,978	6,497
Payable to insurance companies	(2,947)	(332)
Funds held and reinsurance balances payable	(2,659)	(554)
Other liabilities	756	(2,490)
Total adjustments	6,688	1,785
Net cash provided by operating activities	20,228	8,843
Cash Flows From Investing Activities		
Purchase of debt securities available for sale	(159,136)	(22,037)
Proceeds from sales and maturities of debt securities available for sale	135,081	44,797
Purchase of equity securities available for sale	(27,522)	
Proceeds from sales of equity securities available for sale	27,324	
Capital expenditures	(360)	(664)
Acquisition of U.S. Specialty Underwriters, Inc. (1)		(20,971)
Other investing activities	4,178	(453)
Net cash (used in) provided by investing activities	(20,435)	673

Cash Flows From Financing Activities

Payment of lines of credit	(2,375)	
Book overdrafts	712	326
Dividends paid on common stock	(1,149)	(740)
Cash payment for payroll taxes associated with long-term incentive plan net stock issuance	(330)	
Incremental tax benefits from stock options exercised		80
Other financing activities	(31)	(15)
Net cash used in financing activities	(3,173)	(349)
Net (decrease) increase in cash and cash equivalents	(3,380)	9,167
Cash and cash equivalents, beginning of period	76,588	40,845
Cash and cash equivalents, end of period	\$ 73,208	\$ 50,012

Supplemental Disclosure of Non-Cash Investing and Financing Activities:

- (1) Effective January 31, 2008, the Company exercised its option to purchase the remainder of the economics related to the acquisition of the USSU business.

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

Table of Contents

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

NOTE 1 Summary of Significant Accounting Policies

Basis of Presentation and Management Representation

The consolidated financial statements include accounts, after elimination of intercompany accounts and transactions, of Meadowbrook Insurance Group, Inc. (the Company), its wholly owned subsidiary Star Insurance Company (Star), and Star's wholly owned subsidiaries, Savers Property and Casualty Insurance Company (Savers), Williamsburg National Insurance Company (Williamsburg), and Ameritrust Insurance Corporation (Ameritrust). The consolidated financial statements also include Meadowbrook, Inc., Crest Financial Corporation, and their respective subsidiaries. In addition, the consolidated financial statements also include ProCentury Corporation (ProCentury) and its wholly owned subsidiaries. ProCentury's wholly owned subsidiaries consist of Century Surety Company (Century) and its wholly owned subsidiary ProCentury Insurance Company (PIC). In addition, ProCentury Risk Partners Insurance Company, Ltd., is a wholly owned subsidiary of ProCentury. Star, Savers, Williamsburg, Ameritrust, Century, and PIC are collectively referred to as the Insurance Company Subsidiaries.

Meadowbrook and ProCentury entered into a merger agreement (the Merger Agreement) pursuant to which ProCentury and its wholly owned subsidiaries, became a wholly owned subsidiary of Meadowbrook as of August 1, 2008 (the Merger). Meadowbrook accounted for the Merger as a purchase business combination and applied fair value estimates to the acquired assets and liabilities of ProCentury as of August 1, 2008. The Consolidated Statements of Income for the three month period ended March 31, 2008, reflect only the consolidated results of Meadowbrook. Refer to *Note 2 ~ ProCentury Merger*, for additional discussion of the Merger and a pro forma presentation of financial results of the combined company as of March 31, 2008.

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

In the opinion of management, the consolidated financial statements reflect all normal recurring adjustments necessary to present a fair statement of the results for the interim period. Preparation of financial statements under generally accepted accounting principles (GAAP) requires management to make estimates. Actual results could differ

Table of Contents

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

from those estimates. The results of operations for the three months ended March 31, 2009 are not necessarily indicative of the results expected for the full year.

These financial statements and the notes thereto should be read in conjunction with the Company's audited financial statements and accompanying notes included in its Annual Report on Form 10-K, as filed with the United States Securities and Exchange Commission, for the year ended December 31, 2008.

Revenue Recognition

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

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

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

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

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

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

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

Earnings Per Share

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

Outstanding options of 1,500 and 68,250 for the three months ended March 31, 2009 and 2008, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive. There were no shares issuable pursuant to stock options included in diluted earnings per share for the three months ended March 31, 2009. Shares issuable pursuant to stock options included in diluted earnings per share were 239 for the three months ended March 31, 2008. Shares related to the Company's Long Term Incentive Plan (LTIP) included in diluted earnings per share were 17,828 and 90,927 for the three months ended March 31, 2009 and 2008, respectively.

Income Taxes

As of March 31, 2009 and December 31, 2008, the Company did not have any unrecognized tax benefits.

Interest costs and penalties related to income taxes are classified as interest expense and other administrative expenses, respectively. As of March 31, 2009 and December 31, 2008, the Company had no accrued interest or penalties related to uncertain tax positions.

The Company and its subsidiaries are subject to U.S. federal income tax as well as to income tax of multiple state jurisdictions. Tax returns for all years after 2004 are subject to future examination by tax authorities.

Recent Accounting Pronouncements

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary-Impairments* (FSP FAS 115-2 and 124-2). FSP FAS 115-2 and 124-2 requires entities to separate an other-than-temporary impairment of a debt security into two components when there are credit related losses associated with the impaired debt security for which management believes the Company does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its amortized cost basis. If management concludes a

Table of Contents

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

security is other-than-temporarily impaired, FSP FAS 115-2 and 124-2 requires that the difference between the fair value and the amortized cost of the security be presented as an other-than-temporary-impairment charge within earnings, with an offset for any noncredit-related loss component of the other-than-temporary-impairment charge to be recognized in other comprehensive income. FSP FAS 115-2 and 124-2 is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009 subject also to early adoption of FSP FAS 157-4 (see below).

In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* (FSP FAS 157-4). FSP FAS 157-4 supercedes FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active*. FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with Statement of Financial Accounting Standards (SFAS) No. 157 *Fair Value Measurements* when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity. In addition, if there is evidence that the transaction for the asset or liability is not orderly, the entity shall place little, if any weight on that transaction price as an indicator of fair value. FSP FAS 157-4 is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009 subject also to early adoption of FSP FAS 115-2 and 124-2 (see above).

The Company elected to defer the adoption of FSP FAS 115-2 and 124-2 and FAS 157-4 until the second quarter of 2009. The Company believes the adoption will not result in a significant difference to its current other-than-temporary-impairment review or fair value measurements. The Company is currently evaluating the impact of the adoption of these FSP s on its results of operations and financial position.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1 amends SFAS No. 107 *Disclosures about Fair Value of Financial Instruments* to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. FSP FAS 107-1 and APB 28-1 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The Company elected to defer the adoption of FSP FAS 107-1 and APB 28-1 until the second quarter of 2009.

In April 2009, the FASB issued FSP FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies* (FSP FAS 141(R)-1). FSP FAS 141(R)-1 amends the guidance in SFAS No. 141(R), *Business Combinations*, by requiring that assets and liabilities assumed in a business combination that arise from contingencies be recognized at fair value only if fair value can be reasonably estimated. FSP FAS 141(R)-1 is effective for

Table of Contents

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

business combinations for which the acquisition date is on or after December 15, 2008. The Company does not expect FSP FAS 141(R)-1 to have a material impact on its consolidated financial condition or results of operations.

NOTE 2 ProCentury Merger

Following the close of business on July 31, 2008, the Merger of Meadowbrook and ProCentury was completed. Under the terms of the Merger Agreement, ProCentury shareholders were entitled to receive, for each ProCentury common share, either \$20.00 in cash or Meadowbrook common stock based on a 2.50 exchange ratio, subject to adjustment as described within the Merger Agreement. In accordance with the Merger Agreement, the stock price used in determining the final cash and share consideration portion of the purchase price was based on the volume-weighted average sales price of a share of Meadowbrook common stock for the 30-day trading period ending on the sixth trading day before the completion of the Merger, or \$5.7326. Based upon the final proration, the total purchase price was \$227.2 million, of which \$99.1 million consisted of cash, \$122.7 million in newly issued common stock, and approximately \$5.4 million in transaction related costs. The total number of new common shares issued for purposes of the stock portion of the purchase price was 21.1 million shares.

The Merger was accounted for under the purchase method of accounting, which ultimately resulted in goodwill of \$59.5 million equaling the excess of the purchase price over the fair value of identifiable assets as of December 31, 2008. Goodwill is not amortized, but is subject to at least annual impairment testing. Identifiable intangibles of \$21.0 million and \$5.0 million were recorded related to agent relationships and trade names, respectively.

As of March 31, 2009, the Company recorded an increase to goodwill of approximately \$177,000. This increase to goodwill was primarily related to adjustments recorded during the first quarter of 2009 to reflect updated information on certain accruals and related expenses.

ProCentury is a specialty insurance company, which primarily underwrites general liability, commercial property, environmental, garage keepers, commercial multi-peril, commercial auto, surety, and marine insurance primarily in the excess and surplus lines, or non-admitted market through a select group of general agents. The excess and surplus lines market provides insurance coverage for customers with hard-to-place risks that standard or admitted insurers typically choose not to insure.

The combined company maintained the Meadowbrook Insurance Group, Inc. name and the New York Stock Exchange symbol of MIG.

As described above, the purchase price consisted of both cash and stock consideration. The value of the equity issued, in accordance with SFAS No. 141 *Business Combinations*, (SFAS 141) was based on an average of the closing prices

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

of Meadowbrook common shares for the two trading days before through the two trading days after Meadowbrook announced the final exchange ratio on July 24, 2008. The purchase price also includes the transaction costs incurred by Meadowbrook. The purchase price, as calculated at December 31, 2008 and as adjusted at March 31, 2009, after the Company's first quarter review, was calculated as follows (in thousands):

	As Calculated at December 31, 2008	Subsequent Purchase Accounting Adjustments	As Adjusted at March 31, 2009
Cash consideration portion of purchase price	\$ 99,073	\$	\$ 99,073
Value of equity issued for stock consideration portion of purchase price	122,725		122,725
Transaction related costs of Meadowbrook	5,949	(71)	5,878
 Purchase price	 \$227,747	 \$ (71)	 \$227,676

The Company obtained third-party valuations of certain fixed assets and other intangible assets, which have been reflected within the purchase price allocation. In accordance with SFAS 141, the Company will continue to review and account for any adjustments, up to a twelve month period following the close of the Merger, in order to reflect updated information on certain accruals, related expenses, or other potential valuation adjustments, if further refined information becomes available.

The following table summarizes the fair values of ProCentury's assets and liabilities assumed upon the closing of the Merger and as adjusted for subsequent purchase accounting adjustments.

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

	As Calculated at December 31, 2008	Subsequent Purchase Accounting Adjustments (in thousands)	As Adjusted at March 31, 2009
ASSETS			
Cash	\$ 23,248	\$	\$ 23,248
Investments	412,542		412,542
Agent balances	36,497		36,497
Deferred policy acquisition costs	27,435		27,435
Federal income taxes recoverable	7,386		7,386
Deferred taxes	7,451		7,451
Reinsurance recoverables	45,522		45,522
Prepaid insurance premiums	17,695		17,695
Goodwill	59,490	177	59,667
Other intangible assets	26,000		26,000
Other assets	27,164	(248)	26,916
Total Assets	\$690,430	\$ (71)	\$ 690,359
LIABILITIES			
Losses and loss adjustment expenses	\$289,533	\$	\$ 289,533
Unearned premiums	126,259		126,259
Reinsurance funds held and balances payable	13,911		13,911
Debentures	25,000		25,000
Other liabilities	7,980		7,980
Total Liabilities	462,683		462,683
Purchase price	\$227,747	\$ (71)	\$ 227,676

The following table reflects the unaudited pro forma results for the three months ended March 31, 2008, giving effect to the Merger as if it had occurred as though the companies had been combined as of the beginning of that period.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

	For the Three Months Ended March 31, 2008
Revenues	\$ 138,471
Expenses	121,007
Income before taxes and equity earnings	17,464
Income tax expense	5,238
Equity earnings of affiliates	56
Net income	\$ 12,282
Net income per diluted share	\$ 0.21
Weighted average number of common shares:	
Diluted	58,224,227

NOTE 3 Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan*Stock Options*

The Company has issued stock options pursuant to its 1995 and 2002 Amended and Restated Stock Option Plans (the Plans). Currently, the Plans have either five or ten-year option terms and are exercisable and vest in equal increments over the option term. Since 2003, the Company has not issued any new stock options to employees. As of March 31, 2009, the Company had 1,500 options outstanding, all of which are exercisable.

Long Term Incentive Plan

The Company maintains a Long Term Incentive Plan (the LTIP). The LTIP provides participants with the opportunity to earn cash and stock awards based upon the achievement of specified financial goals over a three-year performance period. At the end of a three-year performance period, and if the performance targets for that period are achieved, the Compensation Committee of the Board of Directors shall determine the amount of LTIP awards that are payable to participants in the LTIP for the current performance period. One-half of any LTIP award will be payable in cash and one-half of the award will be payable in the form of a stock award. If the Company achieves the performance targets for the three-year performance period, payment of the cash portion of the award would be made in three annual installments, with the first payment being paid

Table of Contents

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

as of the end of the that performance period and the remaining two payments to be paid in the subsequent two years. Any unpaid portion of a cash award is subject to forfeiture if the participant voluntarily leaves the Company or is discharged for cause. The portion of the award to be paid in the form of stock will be issued as of the end of that performance period. The number of shares of Company's common stock subject to the stock award shall equal the dollar amount of one-half of the LTIP award divided by the market value of Company's common stock on the first date of the beginning of the performance period. The stock awards shall be made subject to the terms and conditions of the LTIP and Plans. The Company accrues awards based upon the criteria set-forth and approved by the Compensation Committee, as included in the LTIP.

With the ProCentury merger, the Company's Compensation Committee and its Board of Directors determined that the Company's opportunity for successfully integrating the ProCentury merger would be heightened and shareholder value increased, if all participants were in the same equity-based plan beginning in 2009. As a result, its Compensation Committee approved the termination of Company's current 2007-2009 LTIP effective December 31, 2008 and established a new plan for 2009-2011 based on new performance targets. Based on this amendment, the current LTIP participants would receive their award based on a two-year performance period, rather than a three-year period. Therefore, the total award would be approximately two-thirds of the original three-year award. There were no accounting adjustments as a result of the amendment as there were no changes to the underlying plan, only an adjustment to the performance period.

In 2008, the Company achieved its specified financial goals for the 2007-2008 plan years. On February 13, 2009, the Company's Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of the LTIP award for the 2007-2008 plan years, which included both a cash and stock award. The total cash distribution was \$1.6 million, of which approximately \$530,000 was paid out in 2009 with the remainder to be paid out in 2010 and 2011. The stock portion of the LTIP award was \$1.6 million, which resulted in the issuance of 161,686 shares of the Company's common stock. Of the 161,686 shares issued, 55,968 shares were retired for payment of the participant's associated withholding taxes related to the compensation recognized by the participant. The stock portion of the award was fully expensed as of December 31, 2008. The cash portion of the award is being expensed over a five-year period. In addition, the Company's Board of Directors and the Compensation Committee of the Board of Directors approved the new performance targets for the 2009-2011 plan years. The Company began accruing for the LTIP payout for the 2009-2011 plan years as of March 31, 2009.

At March 31, 2009, the Company had approximately \$491,000 and approximately \$203,000 accrued for the cash and stock award, respectively, for all plan years under the LTIP. As previously indicated, the stock portion for the 2007-2008 plan years was fully expensed as of December 31, 2008. At December 31, 2008, the Company had \$1.6 million and \$1.6 million accrued for the cash and stock award, respectively, for all plan

Table of Contents

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

years under the LTIP. Shares related to the Company's LTIP included in diluted earnings per share were 17,828 and 90,927 for the three months ended March 31, 2009 and 2008, respectively.

Deferred Compensation Plan

The Company maintains an Executive Nonqualified Excess Plan (the "Excess Plan"). The Excess Plan is intended to be a nonqualified deferred compensation plan that will comply with the provisions of Section 409A of the Internal Revenue Code. The Company maintains the Excess Plan to provide a means by which certain key management employees may elect to defer receipt of current compensation from the Company in order to provide retirement and other benefits, as provided for in the Excess Plan. The Excess Plan is funded solely by the participating employees and maintained primarily for the purpose of providing deferred compensation benefits for eligible employees. At March 31, 2009 and December 31, 2008, the Company had \$805,000 and \$690,000 accrued for the Excess Plan, respectively.

NOTE 4 Reinsurance

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

The Company receives ceding commissions in conjunction with its reinsurance activities. These ceding commissions are offset against the related underwriting expenses and were \$4.8 million and \$2.5 million for the three months ended March 31, 2009 and 2008, respectively.

At March 31, 2009 and December 31, 2008, the Company had reinsurance recoverables for paid and unpaid losses of \$270.8 million and \$268.7 million, respectively.

Table of Contents

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

In regard to the Company's excess-of-loss reinsurance, the Company manages its credit risk on reinsurance recoverables by reviewing the financial stability, A.M. Best Company rating, capitalization, and credit worthiness of prospective and existing risk-sharing partners. The Company generally does not seek collateral where the reinsurer is rated A- or better by A.M. Best Company, has \$500 million or more in surplus, and is admitted in the state of Michigan. As of March 31, 2009, the largest unsecured reinsurance recoverable is due from an admitted reinsurer with an A A.M. Best Company rating and accounts for 25.5% of the total recoverable for paid and unpaid losses.

In regard to the Company's risk-sharing partners (client captive or rent-a-captive quota-share non-admitted reinsurers), the Company manages credit risk on reinsurance recoverables by reviewing the financial stability, capitalization, and credit worthiness of prospective or existing reinsurers or partners. The Company customarily collateralizes reinsurance balances due from non-admitted reinsurers through funds withheld trusts or stand-by letters of credit issued by highly rated banks.

To date, the Company has not, in the aggregate, experienced material difficulties in collecting reinsurance recoverables.

The Company has historically maintained an allowance for the potential exposure to the uncollectibility of certain reinsurance balances. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. While management believes the allowances to be adequate, no assurance can be given, regarding the future ability of any of the Company's risk-sharing partners to meet their financial obligations.

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

As of March 31, 2009, there have been no material changes in the Company's reinsurance treaties from those included in its Annual Report on Form 10-K for the year ended December 31, 2008.

Table of Contents**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)****NOTE 5 Debt****Credit Facilities**

On July 31, 2008, the Company executed \$100 million in senior credit facilities (the Credit Facilities). The Credit Facilities included a \$65.0 million term loan facility, which was fully funded upon the closing of its Merger with ProCentury and a \$35.0 million revolving credit facility, which was partially funded upon closing of the Merger. As of March 31, 2009, the outstanding balance on its term loan facility was \$57.9 million. The Company did not have an outstanding balance on its revolving credit facility as of March 31, 2009. The undrawn portion of the revolving credit facility is available to finance working capital and for general corporate purposes, including but not limited to, surplus contributions to its Insurance Company Subsidiaries to support premium growth or strategic acquisitions. At December 31, 2008, the Company had an outstanding balance of \$60.25 million on its term loan and did not have an outstanding balance on its revolving credit facility.

The principal amount outstanding under the Credit Facilities provides for interest at LIBOR, plus the applicable margin, or at the Company's option, the base rate. The base rate is defined as the higher of the lending bank's prime rate or the Federal Funds rate, plus 0.50%, plus the applicable margin. The applicable margin is determined by the consolidated indebtedness to consolidated total capital ratio. In addition, the Credit Facilities provide for an unused facility fee ranging between twenty basis points and forty basis points, based on our consolidated leverage ratio as defined by the Credit Facilities. At March 31, 2009, the interest rate on the Company's term loan was 5.95%, which consisted of a fixed rate of 3.95%, as described in Note 7 ~ *Derivative Instruments*, plus an applicable margin of 2.00%.

The debt covenants applicable to the Credit Facilities consist of: (1) minimum consolidated net worth starting at eighty percent of pro forma consolidated net worth after giving effect to the acquisition of ProCentury, with quarterly increases thereafter, (2) minimum Risk Based Capital Ratio for Star of 1.75 to 1.00, (3) maximum permitted consolidated leverage ratio of 0.35 to 1.00, (4) minimum consolidated debt service coverage ratio of 1.25 to 1.00, and (5) minimum A.M. Best Company rating of B++. As of March 31, 2009, the Company was in compliance with these debt covenants.

Debentures

The following table summarizes the principal amounts and variables associated with the Company's debentures (in thousands):

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

Year of Issuance	Description	Year Callable	Year Due	Interest Rate Terms	Interest Rate at March 31, 2009 (1)	Principal Amount
2003	Junior subordinated debentures	2008	2033	Three-month LIBOR, plus 4.05%	5.27%	\$ 10,310
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.00%	5.23%	13,000
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.20%	5.45%	12,000
2005	Junior subordinated debentures	2010	2035	Three-month LIBOR, plus 3.58%	4.90%	20,620
	Junior subordinated debentures (2)	2007	2032	Three-month LIBOR, plus 4.00%	5.27%	15,000
	Junior subordinated debentures (2)	2008	2033	Three-month LIBOR, plus 4.10%	5.33%	10,000
					Total	\$ 80,930

(1) The underlying three-month LIBOR rate varies as a result of the interest rate reset dates used in determining the three-month LIBOR rate, which varies for each long-term debt item each quarter.

(2) Represents the junior subordinated debentures acquired in conjunction with the Merger.

Excluding the junior subordinated debentures acquired in conjunction with the Merger, the Company received a total of \$53.3 million in net proceeds from the issuance of the above long-term debt, of which \$26.2 million was contributed to the surplus of its Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes. Associated with the issuance of the above long-term debt, the Company incurred approximately \$1.7 million in issuance costs for commissions paid to the placement agents in the transactions.

The issuance costs associated with these debentures have been capitalized and are included in other assets on the balance sheet. As of June 30, 2007, these issuance costs were being amortized over a seven year period as a component of interest expense. The seven year amortization period represented management's best estimate of the estimated useful life of the bonds related to both the senior debentures and junior subordinated debentures. Beginning July 1, 2007, the Company reevaluated its best estimate and determined a five year amortization period to be a more accurate representation of the estimated useful life. Therefore, this change in amortization period from seven years to five years has been applied prospectively beginning July 1, 2007.

The junior subordinated debentures issued in 2003 and 2005 were issued in conjunction with the issuance of \$10.0 million and \$20.0 million in mandatory redeemable trust preferred securities to a trust formed by an institutional investor from the Company's unconsolidated subsidiary trusts, respectively.

Table of Contents

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

In relation to the junior subordinated debentures acquired in conjunction with the Merger, the Company also acquired the remaining unamortized portion of the capitalized issuance costs associated with these debentures. The remaining unamortized portion of the issuance costs acquired was \$625,000. These are included in other assets on the balance sheet. The remaining balance is being amortized over a five year period beginning August 1, 2008, as a component of interest expense.

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

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

NOTE 6 Fair Value Measurements

The Company's available for sale investment portfolio consists primarily of debt securities, which are recorded in accordance with SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The change in fair value of these investments is recorded as a component of other comprehensive income. In addition, the Company has eight interest rate swaps that are designated as cash flow hedges, in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Company records these interest rate swap transactions at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income.

The implementation of SFAS No. 157 resulted in expanded disclosures about securities measured at fair value, as discussed below.

SFAS No. 157 establishes a three-level hierarchy for fair value measurements that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs) and the reporting entity's own assumptions about market participants' assumptions (unobservable inputs). The hierarchy level assigned to each security in the Company's available for sale portfolio is based upon its assessment of the transparency and reliability of the inputs used in the valuation as of the measurement date. The three hierarchy levels are defined as follows:

Level 1 Observable unadjusted quoted prices in active markets for identical securities.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

The fair value measurements of exchange-traded preferred and common equities, and mutual funds were based on Level 1 inputs, or quoted market prices in active markets.

The fair value measurements of a slight portion of the Company's fixed income securities, comprising 2.1% of the fair value of the total fixed income portfolio, were based on Level 1 inputs.

Level 2 Observable inputs other than quoted prices in active markets for identical securities, including: quoted prices in active markets for similar securities; quoted prices for identical or similar securities in markets that are not active; inputs other than quoted prices that are observable for the security (e.g., interest rates, yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, credit risks, default rates); and inputs derived from or corroborated by observable market data by correlation or other means.

The fair value measurements of substantially all of the Company's fixed income securities, comprising 96.8% of the fair value of the total fixed income portfolio, were based on Level 2 inputs.

The fair values of the Company's interest rate swaps were based on Level 2 inputs.

Level 3 Unobservable inputs, including the reporting entity's own data (e.g., cash flow estimates), as long as there are no contrary data indicating market participants would use different assumptions.

The fair value measurements for twenty-one securities, comprising 1.1% of the fair value of the total fixed income portfolio, were based on Level 3 inputs, due to the limited availability of corroborating market data. Inputs for valuation of these securities included benchmark yields, broker quotes, and models based on cash flows and other inputs.

The fair values of securities were based on market values obtained from an independent pricing service that were evaluated using pricing models that vary by asset class and incorporate available trade, bid, and other market information and price quotes from well established independent broker-dealers. The independent pricing service monitors market indicators, industry and economic events, and for broker-quoted only securities, obtains quotes from market makers or broker-dealers that it recognizes to be market participants.

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis, classified by the SFAS No. 157 valuation hierarchy as of March 31, 2009 (in thousands):

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

	Total	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for Sale Securities	\$1,042,815	\$22,059	\$1,009,842	\$ 10,914
Derivatives interest rate swaps	\$ (8,433)	\$	\$ (8,433)	\$

The following table presents changes in Level 3 available-for-sale investments measured at fair value on a recurring basis as of March 31, 2009 (in thousands):

	Fair Value Measurement Using Significant Unobservable Inputs Level 3
Balance as of January 1, 2009	\$ 11,991
Total gains or losses (realized/unrealized):	
Included in earnings	53
Included in other comprehensive income	274
Purchases, issuances and settlements	(674)
Transfers in and out of Level 3	(730)
Balance as of March 31, 2009	\$ 10,914
Total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	\$

Items Measured at Fair Value on a Nonrecurring Basis

At March 31, 2009, as classified by the SFAS No. 157 valuation hierarchy, the Company held three Level 1 and eighteen Level 2 available for sale securities measured at

Table of Contents

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

fair value on a nonrecurring basis. The Company did not have any Level 3 securities measured at fair value on a nonrecurring basis. In accordance with the Company's conclusion that the securities were other than temporarily impaired, the carrying value of the assets held in the amount of \$3.4 million were written down to their fair value of \$1.3 million, resulting in an impairment charge of \$2.1 million.

Recent Accounting Pronouncements

On April 9, 2009, the FASB issued three related Staff Positions to clarify the requirements in SFAS No. 157 for fair value measurements in inactive markets, modify the recognition and measurement of other than temporary impairments of debt securities, and require companies to disclose the fair values of financial instruments in interim periods. The final Staff Positions are effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. Refer to Note 1 *Summary of Significant Accounting Policies* for further descriptions.

The Company elected to defer the adoption of these Staff Positions until the second quarter of 2009. The Company believes the adoption will not result in a significant difference to its current other than temporary impairment review or fair value measurements and is currently evaluating the impact of the adoption of these Staff Positions on its results of operations and financial position.

NOTE 7 Derivative Instruments

The Company has entered into interest rate swap transactions to mitigate its interest rate risk on its existing debt obligations. The Company accrues for these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities*, as subsequently amended. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and recognized as an adjustment to interest expense.

The following table summarizes the rates and amounts associated with the Company's interest rate swaps (in thousands):

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

Effective Date	Expiration Date	Debt Instrument	Counterparty Interest Rate Terms	Fixed Rate	Fixed Amount at March 31, 2009
10/06/2005	05/24/2009	Senior debentures	Three-month LIBOR, plus 4.20%	8.925%	\$ 5,000
10/06/2005	09/16/2010	Junior subordinated debentures	Three-month LIBOR, plus 3.58%	8.340%	20,000
04/23/2008	05/24/2011	Senior debentures	Three-month LIBOR, plus 4.20%	7.720%	7,000
04/23/2008	06/30/2013	Junior subordinated debentures	Three-month LIBOR, plus 4.05%	8.020%	10,000
04/29/2008	04/29/2013	Senior debentures	Three-month LIBOR, plus 4.00%	7.940%	13,000
07/31/2008	07/31/2013	Term loan (1)	Three-month LIBOR	3.950%	57,875
08/15/2008	08/15/2013	Junior subordinated debentures (2)	Three-month LIBOR	3.780%	10,000
09/04/2008	09/04/2013	Junior subordinated debentures (2)	Three-month LIBOR	3.790%	15,000

(1) Relates to the Company's term loan, which has an effective date of July 31, 2008 and an expiration date of July 31, 2013. The Company is required to make fixed rate interest payments on the current balance of the term loan, amortizing in accordance with the term loan amortization schedule. The Company fixed only the variable interest portion of the loan. The actual

interest payments associated with the term loan also include an additional rate of 2.00% in accordance with the credit agreement, as of March 31, 2009.

- (2) Relates to the debentures acquired from the ProCentury merger. The Company fixed only the variable interest portion of the debt. The actual interest payments associated with the debentures also include an additional rate of 4.10% and 4.00% on the \$10.0 million and \$15.0 million debentures, respectively.

In relation to the above interest rate swaps, the net interest expense incurred for the three months ended March 31, 2009, was approximately \$798,000. The net interest income received for the three months ended March 31, 2008, was approximately \$16,000.

As of March 31, 2009 and December 31, 2008, the total fair value of the interest rate swaps was approximately (\$8.4 million) and (\$8.9 million), respectively. Accumulated other comprehensive income at March 31, 2009 and December 31, 2008, included accumulated loss on the cash flow hedge, net of taxes, of approximately \$5.5 million and \$5.8 million, respectively.

In December 2005, the Company entered into a \$6.0 million convertible note receivable with an unaffiliated insurance agency. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This agency has been a producer for the Company for over ten years. As security for the loan, the borrower granted the Company a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible at the option of the Company based upon a pre-determined formula. The

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At March 31, 2009, the estimated fair value of the derivative was not material to the financial statements.

NOTE 8 Shareholders Equity

At March 31, 2009, shareholders' equity was \$458.2 million, or a book value of \$7.98 per common share, compared to \$438.2 million, or a book value of \$7.64 per common share, at December 31, 2008.

In July 2008, the Company's Board of Directors authorized management to purchase up to 3,000,000 shares of the Company's common stock in market transactions for a period not to exceed twenty-four months. For the three months ended March 31, 2009 the Company did not repurchase any common stock. For the year ended December 31, 2008, the Company purchased and retired 800,000 shares of common stock for a total cost of approximately \$4.9 million. As of March 31, 2009, the Company has available up to 2.2 million shares remaining to be purchased.

On February 13, 2009, the Company's Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of the Company's LTIP award for the 2007-2008 plan years, which included both a cash and stock award. The stock portion of the LTIP award was \$1.6 million, which resulted in the issuance of 161,686 shares of the Company's common stock. Of the 161,686 shares issued, 55,968 shares were retired for payment of the participant's associated withholding taxes related to the compensation recognized by the participant. Refer to Note 3 ~ *Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan* for further detail. The retirement of the shares for the associated withholding taxes reduced the Company's paid in capital by approximately \$329,000.

The Company paid dividends to its common shareholders of \$1.1 million as of March 31, 2009. As of December 31, 2008, the Company paid dividends to its common shareholders of \$3.8 million. On May 1, 2009, the Company's Board of Directors declared a quarterly dividend of \$0.02 per common share. The dividend is payable on June 1, 2009, to shareholders of record as of May 15, 2009.

When evaluating the declaration of a dividend, the Company's Board of Directors considers a variety of factors, including but not limited to, cash flow, liquidity needs, results of operations, industry conditions, and its overall financial condition. As a holding company, the Company's ability to pay cash dividends to its shareholders is partially dependent on dividends and other permitted payments from its Insurance Company Subsidiaries.

Table of Contents

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

NOTE 9 Segment Information

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

Specialty Insurance Operations

The specialty insurance operations segment, which includes insurance company specialty programs and fee-for-service specialty or managed programs, focuses on specialty or niche insurance business. Specialty insurance operations provide services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention, and reinsurance placement, along with various types of property and casualty insurance coverage, including workers compensation, commercial multiple peril, general liability, commercial auto liability, excess and surplus lines, environmental, garage keepers, surety, legal, professional liability, errors & omissions, inland marine, and other lines of business. Insurance coverage is provided primarily to associations or similar groups of members and to specified classes of business of the Company's agents. The Company recognizes revenue related to the services and coverages the specialty insurance operations provides within seven categories: net earned premiums, management fees, claims fees, loss control fees, reinsurance placement, investment income, and net realized gains (losses).

The Company included the results of operations related to ProCentury within the specialty insurance operations.

Agency Operations

The Company earns commissions through the operation of its retail property and casualty insurance agencies, which are located in Michigan, California, and Florida. The agency operations produce commercial, personal lines, life, and accident and health insurance, for more than fifty unaffiliated insurance carriers. The agency produces an immaterial amount of business for its affiliated Insurance Company Subsidiaries.

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

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

	For the Three Months Ended March 31,	
	2009	2008
Revenues		
Net earned premiums	\$ 129,038	\$ 66,022
Management fees	5,278	6,032
Claims fees	1,966	2,180
Loss control fees	489	510
Reinsurance placement	65	296
Investment income	12,212	6,970
Net realized losses	(1,992)	(31)
Specialty insurance operations	147,056	81,979
Agency operations	2,794	3,328
Holding Company interest income earned	130	178
Intersegment revenue	(355)	(315)
Consolidated revenue	\$ 149,625	\$ 85,170
Pre-tax income:		
Specialty insurance operations	\$ 27,411	\$ 12,912
Agency operations (1)	338	763
Non-allocated expenses	(6,390)	(3,762)
Consolidated pre-tax income	\$ 21,359	\$ 9,913

(1) The Company's agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate

overhead allocation excludes those expenses specific to the holding company. For the three months ended March 31, 2009 and 2008, the allocation of corporate overhead to the agency operations segment was \$798,000 and \$753,000, respectively.

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

	For the Three Months Ended March 31,	
	2009	2008
Holding company expenses	\$ (2,100)	\$ (900)
Amortization	(1,508)	(1,551)
Interest expense	(2,782)	(1,311)
	\$ (6,390)	\$ (3,762)

NOTE 10 Commitments and Contingencies

The Company, and its subsidiaries, are subject at times to various claims, lawsuits and proceedings relating principally to alleged errors or omissions in the placement of insurance, claims administration, consulting services and other business transactions arising in the ordinary course of business. Where appropriate, the Company vigorously

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(Unaudited)

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

NOTE 11 Earnings Per Share

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

The following table is a reconciliation of the income and share data used in the basic and diluted earnings per share computations for the three months ended March 31 (in thousands, except per share amounts):

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

	2009	2008
Net income, as reported	\$ 13,540	\$ 7,058
Common shares:		
Basic		
Weighted average shares outstanding	57,392,499	37,012,104
Diluted		
Weighted average shares outstanding	57,392,499	37,012,104
Dilutive effect of:		
Stock options		239
Share awards under long term incentive plan	17,828	90,927
Total	57,410,327	37,103,270
Net income per common share		
Basic	\$ 0.24	\$ 0.19
Diluted	\$ 0.24	\$ 0.19

Table of Contents

ITEM 2
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
For the Periods ended March 31, 2009 and 2008

Forward-Looking Statements

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

Business Overview

We are a publicly traded specialty insurance underwriter and insurance administration services company, which serves the needs of underserved market segments that value service and specialized knowledge. We market and underwrite specialty property and casualty insurance products on both an admitted and non-admitted basis through a broad and diverse network of independent retail, wholesale program administrators and general agents. We primarily focus on niche or specialty program business and risk management solutions for agents, professional and trade associations, pools, trusts, and small to medium-sized insureds. These solutions include specialty program underwriting; excess and surplus lines insurance products; alternative risk transfer solutions; agency operations; and insurance administration services. Program business refers to an aggregation of individually underwritten risks that have some unique characteristic and are distributed through a select group of general agencies, retail agencies and program administrators. We define our business segments as specialty insurance operations and agency operations.

Table of Contents

Our programs are diversified geographically, by class and line of business, type of insured and distribution. Within the workers compensation line of business, we have a regional focus in New England, Florida, and Nevada. Within the commercial auto and commercial multiple peril line of business, we have a regional focus in the Southeast and California. Within the general liability line of business we have a focus in Texas. Our fee-for-service business is managed on a regional basis with an emphasis in the Midwest, New England, and southeastern regions, as well as the self-insured market in Nevada. Our corporate strategy emphasizes a regional focus and diverse sources of revenue between underwritten premiums, service fee revenue, and commissions. This allows us to leverage fixed costs over a larger revenue base and take advantage of new opportunities.

On July 31, 2008, the merger of Meadowbrook Insurance Group, Inc. and ProCentury Corporation (ProCentury) was completed (Merger). Under the terms of the merger agreement, ProCentury shareholders were entitled to receive, for each ProCentury common share, either \$20.00 in cash or Meadowbrook common stock based on a 2.5000 exchange ratio, subject to adjustment as described within the merger agreement. In accordance with the merger agreement, the stock price used in determining the final cash and share consideration portion of the purchase price was based on the volume-weighted average sales price of a share of Meadowbrook common stock for the 30-day trading period ending on the sixth trading day before the completion of the Merger, or \$5.7326. Based upon the final proration, the total purchase price was \$227.2 million, of which \$99.1 million consisted of cash, \$122.7 million in newly issued common stock, and approximately \$5.4 million in transaction related costs. The total number of common shares issued for purposes of the stock portion of the purchase price was 21.1 million shares.

ProCentury is a specialty insurance company, which primarily underwrites general liability, commercial property, environmental, garage keepers, commercial multi-peril, commercial auto, surety, and marine insurance primarily in the excess and surplus lines, or non-admitted, market through a select group of general agents. The excess and surplus lines market provides insurance coverage for customers with hard-to-place risks that standard or admitted insurers typically choose not to insure.

Critical Accounting Policies

In certain circumstances, we are required to make estimates and assumptions that affect amounts reported in our consolidated financial statements and related footnotes. We evaluate these estimates and assumptions on an on-going basis based on a variety of factors. There can be no assurance, however, that actual results will not be materially different than our estimates and assumptions, and that reported results of operation will not be affected by accounting adjustments needed to reflect changes in these estimates and assumptions. The accounting estimates and related risks described in our Annual Report on Form 10-K as filed with the United States Securities and Exchange Commission on March 16, 2009, are those that we consider to be our critical accounting estimates. For the three months ended March 31, 2009, there have been no material changes in regard to any of our critical accounting estimates.

Table of Contents

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008

Executive Overview

Our results for the first quarter of 2009 include the positive impact from continued selective growth, coupled with our adherence to strict corporate underwriting guidelines, as well as a focus on current accident year price adequacy, and the benefits derived from leveraging of fixed costs. Our first quarter results included a \$2.1 million impairment charge on our investment portfolio. These impairments primarily consisted of asset-backed securities with rising default rates, declining prepayment speeds, and increasing loss severity of collateral value. In addition, this impairment charge also consisted of a few corporate securities where the issuer experienced deteriorating business conditions and results, which put pressure on its valuation and, to a lesser extent, further deterioration in preferred stock securities. Our generally accepted accounting principles (GAAP) combined ratio improved 6.2 percentage points to 87.7% for the first quarter of 2009, from 93.9% in 2008. Net operating income, excluding amortization, increased 106.8% to \$17.8 million, compared to \$8.6 million in 2008.

Gross written premium increased \$69.5 million, or 76.8%, to \$160.0 million, compared to \$90.5 million in 2008. Included in this increase was \$52.1 million in gross written premiums related to our Century Surety Company (Century) operations. Excluding the gross written premiums related to the Century operations, the remaining 19.3% increase was primarily the result of growth in new business from programs implemented in late 2008 and early 2009. We anticipate further growth throughout the year as the annualized premiums of these programs continue to be realized. The anticipated growth for the balance of the year is emanating from workers compensation initiatives underway in the Southeast, Midwest and Western states, as well as a full year benefit of our new and expanded transportation program, as well as rate increases in select states and programs. In addition, we continue to experience selective growth within existing programs consistent with our corporate underwriting guidelines and our controls over price adequacy.

As we begin our first full year of operations after the merger with ProCentury, we are beginning to see opportunities emerge as we use Meadowbrook s admitted market capabilities to expand our footprint with Century s wholesale agents in areas including marine, garage, and workers compensation, and as we roll out surplus lines products through an existing Meadowbrook workers compensation agents in markets not previously serviced by ProCentury, and as we leverage costs by creating economies of scale for purchasing reinsurance and managing the back office operations. By utilizing the capabilities of our combined company, we have also begun underwriting environmental related risks. Century s environmental expertise has now been combined with the Company s workers compensation and automobile liability platform to provide an integrated program for environmental risks. The standard surety operation for Century is now being marketed as Star Surety to take advantage of the higher treasury listing and broader licensing and filing capabilities of Star. Combined, the expanded agent

Table of Contents

relationships are rounding out agency relationship needs and are anticipated to grow both our programs and products.

Results of Operations

Net income for the three months ended March 31, 2009, was \$13.5 million, or \$0.24 per dilutive share, compared to net income of \$7.1 million, or \$0.19 per dilutive share, for the comparable period of 2008. Net operating income, a non-GAAP measure, increased \$9.2 million, or 130.8%, to \$16.3 million, or \$0.28 per dilutive share, compared to net operating income of \$7.1 million, or \$0.19 per dilutive share for the comparable period in 2008, with lower weighted average shares outstanding. Total weighted average shares outstanding for the three months ended March 31, 2009 were 57,410,327, compared to 37,103,270 for the comparable period in 2008. This increase in the weighted average shares is primarily the result of the equity issued in connection with the ProCentury merger.

Net income for the three months ended March 31, 2009, was negatively impacted by after-tax realized losses of \$2.8 million, or \$0.04 per diluted share, as a result of the other than temporary impairments primarily related to certain asset-backed securities, corporate bonds, and preferred stocks. Our expense ratio improved 1.3 percentage points as a result of a lower level of insurance related assessments. Our expense ratio also improved as a result of our leveraging of fixed costs. In addition, net investment income increased 72.7% to \$12.3 million, primarily related to the investments acquired with the ProCentury merger. Overall, we continue to see favorable prior accident year reserve development, as well as selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy.

Revenues for the three months ended March 31, 2009, increased \$64.5 million, or 75.7%, to \$149.6 million, from \$85.2 million for the comparable period in 2008. This increase reflects a \$63.0 million increase in net earned premiums, of which \$49.7 million related to our Century operations. Excluding the net earned premiums related to our Century operations, the increase of \$13.3 million, was primarily the result of overall growth within our existing programs and new business we implemented in 2008 and 2009. Our overall net commission and fees were down 14.9%, or \$1.8 million, as further explained below.

In addition, the revenues reflect a \$5.2 million increase in investment income, which primarily reflects the increase in invested assets acquired with the ProCentury merger, as well as continued cash flow from operations.

As previously indicated, our results for the three months ended March 31, 2009, included the recognition of other than temporary impairments of \$2.1 million. These impairments primarily consisted of asset-backed securities, a few corporate securities and, to a lesser extent, preferred stock securities.

Table of Contents*Specialty Insurance Operations*

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

	For the Three Months Ended March 31,	
	2009	2008
Revenue:		
Net earned premiums	\$ 129,038	\$ 66,022
Management fees	5,278	6,032
Claims fees	1,966	2,180
Loss control fees	489	510
Reinsurance placement	65	296
Investment income	12,212	6,970
Net realized losses	(1,992)	(31)
 Total revenue	 \$ 147,056	 \$ 81,979
 Pre-tax income		
Specialty insurance operations	\$ 27,411	\$ 12,912

Revenues from specialty insurance operations increased \$65.1 million, or 79.4%, to \$147.1 million for the three months ended March 31, 2009 from \$82.0 million for the comparable period in 2008.

Net earned premiums increased \$63.0 million, or 95.4%, to \$129.0 million for the three months ended March 31, 2009, from \$66.0 million in the comparable period in 2008. This increase was the result of \$49.7 million in net earned premiums related to our Century operations. The remaining increase of \$13.3 million was primarily the result of growth within our existing programs and the new business we began writing in 2008.

Management fees decreased \$754,000, or 12.5%, to \$5.3 million for the three months ended March 31, 2009, from \$6.0 million for the comparable period in 2008. In 2008, we converted a portion of the policies produced by USSU to our Insurance Company Subsidiaries. The decrease in management fees primarily relates to the intercompany management fees associated with the USSU policies that we brought in house. These fees are now eliminated upon consolidation, but do not impact overall consolidated results. In addition, a program we previously managed is now performing its own policy administration services. This decrease was also the result of a decrease in fees related to our New England-based programs, caused by a decrease in premium volume and continued competition.

Claim fees decreased \$214,000, or 9.8%, to \$2.0 million for the three months ended March 31, 2009, from \$2.2 million for the comparable period in 2008. This decrease is primarily the result of lower premium volumes related to self-insured programs, which is the basis for the fee revenue.

Table of Contents

Net investment income increased \$5.2 million, or 75.2%, to \$12.2 million in 2009, from \$7.0 million in 2008. This increase is primarily the result of \$5.3 million in net investment income related to ProCentury. Overall, invested assets increased due to the inclusion of ProCentury's invested assets from the Merger of approximately \$425.1 million at July 31, 2008, coupled with the investing from positive cash flows from operations. The positive cash flows from operations were primarily due to favorable underwriting results. The average investment yield for March 31, 2009 was 4.5%, compared to 4.4% in 2008. The current pre-tax book yield was 4.4%. The current after-tax book yield was 3.3%, compared to 3.3% in 2008. The duration of the investment portfolio is 4.3 years at March 31, 2009, compared to 4.1 years at March 31, 2008.

Specialty insurance operations generated pre-tax income of \$27.4 million for the three months ended March 31, 2009, compared to pre-tax income of \$12.9 million for the comparable period in 2008. This increase in pre-tax income demonstrates a continued improvement in underwriting results including favorable reserve development on prior accident years, selective growth in premium, adherence to our strict underwriting guidelines, and our overall leveraging of fixed costs. In addition, this improvement was also attributable to an increase in net investment income. Partially offsetting these improvements were the previously mentioned other than temporary impairments we recognized in the first quarter of 2009. The GAAP combined ratio was 87.7% for the three months ended March 31, 2009, compared to 93.9% for the same period in 2008.

Net loss and loss adjustment expenses (LAE) increased \$32.1 million, to \$69.8 million for the three months ended March 31, 2009, from \$37.7 million for the same period in 2008. Our loss and LAE ratio decreased 3.7 percentage points to 58.0% for the three months ended March 31, 2009, from 61.7% for the same period in 2008. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. The loss and LAE ratio of 58.0% includes pre-tax favorable development of \$8.3 million, or 6.5 percentage points, compared to pre-tax favorable development of \$2.9 million, or 4.3 percentage points in 2008. The increase in our favorable development in comparison to 2008 was primarily the result of an increase in favorable development within our workers' compensation, professional liability, and general liability lines of business due to lower frequency and severity and better than expected claims results. Additional discussion of our reserve activity is described below within the *Other Items ~ Reserves* section.

Our expense ratio decreased 2.5 percentage points to 29.7% for the three months ended March 31, 2009, from 32.2% for the same period in 2008. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. This decrease in the expense ratio in comparison to 2008 is the result of lower insurance related assessments, primarily related to premium tax credits received from 2008 premium tax returns, which lowered the expense ratio by 1.3 percentage points for the quarter, and the impact of lower insurance assessments from the Century operations, offset by slightly higher commission and internal costs associated with Century's book of business.

Table of Contents*Agency Operations*

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

	For the Three Months Ended March 31,	
	2009	2008
Net commission	\$2,794	\$3,328
Pre-tax income (1)	\$ 338	\$ 763

(1) Our agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate overhead allocation excludes those expenses specific to the holding company. For the three months ended March 31, 2009 and 2008, the allocation of corporate overhead to the agency operations segment was \$798,000 and \$753,000, respectively.

Revenue from agency operations, which consists primarily of agency commission revenue, decreased \$535,000, to \$2.8 million for the three months ended March 31, 2009, from \$3.3 million for the comparable period in 2008. This decrease primarily reflects regional competition and a softer insurance market within our mid to larger Michigan accounts and isolated competitive pricing pressure in the California automobile market. In addition, this decrease is

partially attributable to a \$300,000 adjustment to reduce an agency commission accrual.

Agency operations generated pre-tax income, after the allocation of corporate overhead, of \$338,000 for the three months ended March 31, 2009, compared to \$763,000 for the comparable period in 2008. The decrease in the pre-tax income is primarily attributable to the decrease in agency commission revenue mentioned above.

Other Items

Reserves

At March 31, 2009, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was \$636.5 million. We established a reasonable range of reserves of approximately \$578.9 million to \$675.3 million. This range was established primarily by considering the various indications derived from standard actuarial techniques and other appropriate reserve considerations. The following table sets forth this range by line of business (in thousands):

Table of Contents

Line of Business	Minimum Reserve Range	Maximum Reserve Range	Selected Reserves
Workers Compensation (1)	\$ 167,921	\$ 185,927	\$ 179,098
Commercial Multiple Peril / General Liability	283,807	346,070	320,830
Commercial Automobile	90,454	101,572	97,018
Other	36,743	41,727	39,587
Total Net Reserves	\$578,925	\$675,296	\$636,533

- (1) Includes
Residual
Markets

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

The key assumptions used in our selection of ultimate reserves included the underlying actuarial methodologies, a review of current pricing and underwriting initiatives, an evaluation of reinsurance costs and retention levels, and a detailed claims analysis with an emphasis on how aggressive claims handling may be impacting the paid and incurred loss data trends embedded in the traditional actuarial methods. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the three months ended March 31, 2009 and the year ended December 31, 2008.

For the three months ended March 31, 2009, we reported a decrease in net ultimate loss estimates for accident years 2008 and prior of \$8.3 million, or 1.3% of \$625.3 million of net loss and LAE reserves at December 31, 2008. The decrease in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2009 that differed from the projected activity. There were no significant changes in the key assumptions utilized in the analysis and calculations of our reserves during 2008 and for the three months ended March 31, 2009. The major components of this change in ultimate loss estimates are as follows (in thousands):

Table of Contents

Line of Business	Reserves at		Incurred Losses			Paid Losses		Reserves at March 31, 2009
	December 31, 2008	Current Year	Prior Years	Total Incurred	Current Year	Prior Years	Total Paid	
Workers Compensation	\$ 147,813	\$ 22,218	\$ (1,945)	\$ 20,273	\$ (658)	\$ 12,633	\$ 11,975	\$ 156,111
Residual Markets	23,984	1,722	(1,704)	18	146	869	1,015	22,987
Commercial Multiple Peril / General Liability	317,188	26,313	(3,740)	22,573	(1,334)	20,265	18,931	320,830
Commercial Automobile	92,788	15,536	232	15,768	1,305	10,233	11,538	97,018
Other	43,558	12,346	(1,191)	11,155	941	14,185	15,126	39,587
Net Reserves	625,331	\$ 78,135	\$ (8,348)	\$ 69,787	\$ 400	\$ 58,185	\$ 58,585	636,533
Reinsurance Recoverable	260,366							261,157
Consolidated	\$ 885,697							\$ 897,690

Line of Business	Reserves at December 31, 2008	Re-estimated Reserves at March 31, 2009 on Prior Years	Development as a Percentage of Prior
			Year Reserves
Workers Compensation	\$ 147,813	\$ 145,868	-1.3%
Commercial Multiple Peril / General Liability	317,188	313,448	-1.2%
Commercial Automobile	92,788	93,020	0.3%
Other	43,558	42,367	-2.7%
Sub-total	601,347	594,703	-1.1%
Residual Markets	23,984	22,280	-7.1%
Total Net Reserves	\$ 625,331	\$ 616,983	-1.3%

Workers Compensation Excluding Residual Markets

The projected net ultimate loss estimate for the workers compensation line of business, excluding residual markets, decreased \$1.9 million, or 1.3% of net workers compensation reserves. This net overall decrease reflects decreases of \$455,000, \$293,000, and \$845,000 in accident years 2008, 2007, and 2005, respectively. These decreases reflect better than expected experience for several of our workers compensation programs, including a Nevada, Florida, New Jersey, and a countrywide workers compensation association program. Actual losses reported during the quarter were

less than expected given the prior actuarial assumptions. These decreases were offset by an increase of \$530,000 in accident year 2003, due to unfavorable development in a Florida-based program. The change in ultimate loss estimates for all other accident years was insignificant.

Commercial Multiple Peril and General Liability

Table of Contents

The commercial multiple peril line and general liability line of business had a decrease in net ultimate loss estimates of \$3.7 million, or 1.2% of net commercial multiple peril and general liability reserves. The net decrease reflects decreases of \$3.8 million, \$1.0 million, \$1.1 million, \$1.8 million and \$1.4 million in the ultimate loss estimates for accident years 2008, 2007, 2006, 1997 and 1994, respectively. These decreases were due to better than expected claim emergence in general liability business. These decreases were offset by increases of \$1.8 million, \$427,000, \$1.9 million, and \$448,000 for accident years 2004, 2000, 1998 and 1996, respectively. These increases were due to greater than expected claim emergence in general liability business and an excess liability program. The change in ultimate loss estimates for all other accident years was insignificant.

Commercial Automobile

The projected net ultimate loss estimate for the commercial automobile line of business increased \$232,000, or 0.3% of net commercial automobile reserves. This net overall increase reflects an increase of \$677,000 in accident year 2005, due to greater than expected claim emergence in an excess liability program and a garage program. This increase was offset by a decrease of \$694,000 in accident year 2007, due to better than expected case reserve development on a California-based program and an excess liability program. The change in ultimate loss estimates for all other accident years was insignificant.

Other

The projected net ultimate loss estimate for the other lines of business decreased \$1.2 million, or 2.7% of net reserves. This net decrease reflects a reduction of \$1.1 million in the net ultimate loss estimate for accident year 2007. This decrease is primarily due to better than expected case reserve development during the calendar year in a professional liability program and property business. The change in ultimate loss estimates for all other accident years was insignificant.

Residual Markets

The workers compensation residual market line of business had a decrease in net ultimate loss estimates of \$1.7 million, or 7.1% of net reserves. This decrease reflects a reduction of \$2.0 million in accident year 2008. We record loss reserves as reported by the National Council on Compensation Insurance (NCCI), plus a provision for the reserves incurred but not yet analyzed and reported to us due to a two quarter lag in reporting. These changes reflect a difference between our estimate of the lag incurred but not reported and the amounts reported by the NCCI in the year. The change in ultimate loss estimates for all other accident years was insignificant.

Salaries and Employee Benefits and Other Administrative Expenses

Salaries and employee benefits for the three months ended March 31, 2009, increased \$7.1 million, or 55.4%, to \$19.8 million, from \$12.8 million for the comparable period in 2008. This increase is primarily the result of the salary expense related to our Century

Table of Contents

operations. This increase is also the result of an increase in variable compensation, in comparison to 2008.

Other administrative expenses increased \$1.6 million, or 17.7%, to \$10.4 million, from \$8.8 million for the comparable period in 2008. This increase is primarily the result of an overall increase in administrative expenses related to our Century operations. In addition, this increase is also attributable to an increase in holding company expenses, primarily related to legal fees and an increase in director fees. Partially offsetting this increase is a reduction in the management fee previously associated with our acquisition of USSU. In January 2008, we exercised our option to purchase the remainder of the economics related to the acquisition of the USSU business, by terminating the management agreement with the former owners, thereby eliminating the management fee associated with the Management Agreement.

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

Amortization Expense

Amortization expense for the three months ended March 31, 2009, remained flat at \$1.5 million in comparison to 2008. Amortization expense primarily relates to the other intangibles related to our acquisition of the USSU business, a public entity excess book of business, and the agent relationships and trade names associated with the ProCentury merger.

Interest Expense

Interest expense for the three months ended March 31, 2009, increased \$1.5 million, or 112.2%, to \$2.8 million, from \$1.3 million for the comparable period in 2008. Interest expense is primarily attributable to our debentures, which are described within the *Liquidity and Capital Resources* section of Management's Discussion and Analysis, as well as our term loan. The overall increase primarily relates to interest expense related to the term loan we used to finance a portion of the purchase price for the ProCentury merger. In addition, the increase in interest expense is partially related to the interest related to the trust preferred debt instruments acquired with the Merger. The average interest rate for the first quarter of 2009 was 7.14%, compared to 8.41% in the first quarter of 2008. This decrease reflects the impact of a lower cost of debt associated with the term loan, which had an average interest rate of 5.95% in the first quarter of 2009. The 2008 interest primarily related to the debentures.

Income Taxes

Income tax expense, which includes both federal and state taxes, for the three months ended March 31, 2009, was \$7.9 million, or 36.9% of income before taxes. For the same period last year, we reflected an income tax expense of \$2.9 million, or 29.4% of income

Table of Contents

before taxes. The increase in the effective tax rate from 2008 to 2009 reflects the impact of a valuation allowance established in 2009 for other than temporary impaired investments where there were not any realized capital gains to offset the realized capital losses. Excluding the impact of this deferred tax valuation, the effective income tax rate would have been 29.8%, for the three months ended March 31, 2009. The increase from 29.3% in 2008 to 29.8% in 2009 reflects a lower contribution of investment income to pre-tax income. Investment income represented 57.8% of pre-tax income in the first quarter of 2009, compared to 72.1% in the first quarter of 2008. This decrease reflects the improved underwriting results in 2009, compared to 2008. Tax exempt securities as a percentage of total invested assets were 42.6% and 42.1% at March 31, 2009 and 2008, respectively.

Other Than Temporary Impairments

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

During the quarter ended March 31, 2009, after review of our investment portfolio in relation to this policy, we recorded a pre-tax realized loss of \$2.1 million. These impairments primarily consisted of asset-backed securities with rising default rates, declining prepayment speeds, and increasing loss severity of collateral value. In addition, this impairment charge also consisted of a few corporate securities where the company experienced disappointing earnings, which put pressure on valuation and, to a lesser extent, further deterioration in preferred stock securities.

At March 31, 2009, we had 269 securities that were in an unrealized loss position. At March 31, 2009, twenty-eight of those investments, with an aggregate fair value of \$40.9 million and \$4.6 million unrealized loss, have been in an unrealized loss position for more than twelve months. Positive evidence considered, where applicable, in reaching our conclusion that the investments in an unrealized loss position are not other than temporarily impaired consisted of: 1) there were no specific credit events that caused concerns; 2) there were no past due interest payments; 3) our ability and intent to retain the investment for a sufficient amount of time to allow an anticipated recovery in value; and 4) changes in fair value were considered normal in relation to overall fluctuations in interest rates.

Table of Contents

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

	March 31, 2009					
	Less than 12 months		Greater than 12 months		Total	
	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses
Debt Securities:						
Debt securities issued by U.S. Government and agencies	\$	\$	\$	\$	\$	\$
Obligations of states and political subdivisions	49,978	(765)	18,580	(797)	68,558	(1,562)
Corporate securities	61,657	(4,074)	6,675	(1,173)	68,332	(5,247)
Mortgage and asset-backed securities	18,833	(3,988)	15,639	(2,656)	34,472	(6,644)
Equity Securities:	20,283	(7,069)			20,283	(7,069)
Totals	\$150,751	\$(15,896)	\$40,894	\$(4,626)	\$191,645	\$(20,522)

	December 31, 2008					
	Less than 12 months		Greater than 12 months		Total	
	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses
Debt Securities:						
Debt securities issued by U.S. Government and agencies	\$	\$	\$	\$	\$	\$
Obligations of states and political subdivisions	130,948	(3,516)	4,778	(360)	135,726	(3,876)
Corporate securities	72,962	(4,021)	8,141	(928)	81,103	(4,949)
Mortgage and asset-backed securities	43,891	(5,701)	11,600	(2,392)	55,491	(8,093)
Equity Securities:	21,166	(5,141)			21,166	(5,141)
Totals	\$268,967	\$(18,379)	\$24,519	\$(3,680)	\$293,486	\$(22,059)

As of March 31, 2009, gross unrealized gains and (losses) on securities were \$36.7 million and (\$20.5 million), respectively. As of December 31, 2008, gross unrealized gains and (losses) on securities were \$25.8 million and (\$22.1 million), respectively.

LIQUIDITY AND CAPITAL RESOURCES

Our principal sources of funds are insurance premiums, investment income, proceeds from the maturity and sale of invested assets from our Insurance Company Subsidiaries, and risk management fees and agency commissions from our non-regulated subsidiaries. Funds are primarily used for the payment of claims, commissions, salaries and employee

Table of Contents

benefits, other operating expenses, shareholder dividends, share repurchases, and debt service.

A significant portion of our consolidated assets represents assets of our Insurance Company Subsidiaries that may not be transferable to the holding company in the form of dividends, loans or advances. The restriction on the transferability to the holding company from our Insurance Company Subsidiaries is limited by regulatory guidelines. These guidelines generally specify that dividends can be paid only from unassigned surplus and only to the extent that all dividends in the current twelve months do not exceed the greater of 10% of total statutory surplus as of the end of the prior fiscal year or 100% of the statutory net income for the prior year. Using these criteria, the available ordinary dividend available to be paid from the Insurance Company Subsidiaries during 2009 is \$39.5 million without prior regulatory approval. The Insurance Company Subsidiaries paid ordinary dividends of \$8.3 million during the three months ended March 31, 2009. In addition to ordinary dividends, the Insurance Company Subsidiaries have the capacity to pay \$31.1 million of extraordinary dividends in 2009 with prior regulatory approval. The Insurance Company Subsidiaries' ability to pay future dividends without advance regulatory approval is dependent upon maintaining a positive level of unassigned surplus, which in turn, is dependent upon the Insurance Company Subsidiaries generating net income. Total statutory dividends paid from our Insurance Company Subsidiaries during 2008 was \$46.2 million.

We also generate operating cash flow from non-regulated subsidiaries in the form of commission revenue, outside management fees, and intercompany management fees. These sources of income are used to meet debt service, shareholders' dividends, and other operating expenses of the holding company and non-regulated subsidiaries. Earnings before interest, taxes, depreciation, and amortization from non-regulated subsidiaries were approximately \$1.2 million for the three months ended March 31, 2009.

We have a line of credit totaling \$35.0 million, of which there was no outstanding balance at March 31, 2009. The undrawn portion of the revolving credit facility is available to finance working capital and for general corporate purposes, including but not limited to, surplus contributions to our Insurance Company Subsidiaries to support premium growth or strategic acquisitions.

Cash flow provided by operations for the three months ended March 31, 2009 and 2008 was \$20.2 million and \$8.8 million, respectively. The increase in cash flow from operations reflects growth in underwriting profits and growth in net investment income.

Other Items

Debentures

The following table summarizes the principal amounts and variables associated with our debentures (in thousands):

Table of Contents

Year of Issuance	Description	Year Callable	Year Due	Interest Rate Terms	Interest Rate at March 31, 2009 (1)	Principal Amount
2003	Junior subordinated debentures	2008	2033	Three-month LIBOR, plus 4.05%	5.27%	\$ 10,310
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.00%	5.23%	13,000
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.20%	5.45%	12,000
2005	Junior subordinated debentures	2010	2035	Three-month LIBOR, plus 3.58%	4.90%	20,620
	Junior subordinated debentures (2)	2007	2032	Three-month LIBOR, plus 4.00%	5.27%	15,000
	Junior subordinated debentures (2)	2008	2033	Three-month LIBOR, plus 4.10%	5.33%	10,000
Total						\$ 80,930

(1) The underlying three-month LIBOR rate varies as a result of the interest rate reset dates used in determining the three-month LIBOR rate, which varies for each long-term debt item each quarter.

(2) Represents the junior subordinated debentures acquired in conjunction with the Merger.

Excluding the junior subordinated debentures acquired in conjunction with the Merger, we received a total of \$53.3 million in net proceeds from the issuance of the above long-term debt, of which \$26.2 million was contributed to the surplus of our Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes. Associated with the issuance of the above long-term debt we incurred approximately \$1.7 million in

issuance costs for commissions paid to the placement agents in the transactions.

The issuance costs associated with these debentures have been capitalized and are included in other assets on the balance sheet. As of June 30, 2007, these issuance costs were being amortized over a seven year period as a component of interest expense. The seven year amortization period represented management's best estimate of the estimated useful life of the bonds related to both the senior debentures and junior subordinated debentures. Beginning July 1, 2007, we reevaluated our best estimate and determined a five year amortization period to be a more accurate representation of the estimated useful life. Therefore, this change in amortization period from seven years to five years has been applied prospectively beginning July 1, 2007.

The junior subordinated debentures issued in 2003 and 2005, were issued in conjunction with the issuance of \$10.0 million and \$20.0 million in mandatory redeemable trust preferred securities to a trust formed by an institutional investor from our unconsolidated subsidiary trusts, respectively.

Table of Contents

In relation to the junior subordinated debentures acquired in conjunction with the Merger, we also acquired the remaining unamortized portion of the capitalized issuance costs associated with these debentures. The remaining unamortized portion of the issuance costs we acquired was \$625,000. These are included in other assets on the balance sheet. The remaining balance is being amortized over a five year period beginning August 1, 2008, as a component of interest expense.

Interest Rate Swaps

We have entered into interest rate swap transactions to mitigate our interest rate risk on our existing debt obligations. We accrue for these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities*, as subsequently amended. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and recognized as an adjustment to interest expense.

The following table summarizes the rates and amounts associated with our interest rate swaps (in thousands):

					Fixed Amount at March 31, 2009
Effective Date	Expiration Date	Debt Instrument	Counterparty Interest Rate Terms	Fixed Rate	
10/06/2005	05/24/2009	Senior debentures	Three-month LIBOR, plus 4.20%	8.925%	\$ 5,000
10/06/2005	09/16/2010	Junior subordinated debentures	Three-month LIBOR, plus 3.58%	8.340%	20,000
04/23/2008	05/24/2011	Senior debentures	Three-month LIBOR, plus 4.20%	7.720%	7,000
04/23/2008	06/30/2013	Junior subordinated debentures	Three-month LIBOR, plus 4.05%	8.020%	10,000
04/29/2008	04/29/2013	Senior debentures	Three-month LIBOR, plus 4.00%	7.940%	13,000
07/31/2008	07/31/2013	Term loan (1)	Three-month LIBOR	3.950%	57,875
08/15/2008	08/15/2013	Junior subordinated debentures (2)	Three-month LIBOR	3.780%	10,000
09/04/2008	09/04/2013	Junior subordinated debentures (2)	Three-month LIBOR	3.790%	15,000

(1) Relates to our term loan, which has an effective date of July 31, 2008 and an expiration date of July 31, 2013. We are required to make fixed rate interest payments on the current balance

of the term loan, amortizing in accordance with the term loan amortization schedule. We fixed only the variable interest portion of the loan. The actual interest payments associated with the term loan also include an additional rate of 2.00% in accordance with the credit agreement, as of March 31, 2009.

- (2) Relates to the debentures acquired from the ProCentury merger. We fixed only the variable interest portion of the debt. The actual interest payments associated with the debentures also include an additional rate of 4.10% and 4.00% on the \$10.0 million and \$15.0 million debentures, respectively.

Table of Contents

In relation to the above interest rate swaps, the net interest expense incurred for the three months ended March 31, 2009, was approximately \$798,000. The net interest income received for the three months ended March 31, 2008, was approximately \$16,000.

As of March 31, 2009 and December 31, 2008, the total fair value of the interest rate swaps was approximately (\$8.4 million) and (\$8.9 million), respectively. Accumulated other comprehensive income at March 31, 2009 and December 31, 2008, included accumulated loss on the cash flow hedge, net of taxes, of approximately \$5.5 million and \$5.8 million, respectively.

Credit Facilities

On July 31, 2008, we executed \$100 million in senior credit facilities (the Credit Facilities). The Credit Facilities included a \$65.0 million term loan facility, which was fully funded upon the closing of our Merger with ProCentury and a \$35.0 million revolving credit facility, which was partially funded upon closing of the Merger. As of March 31, 2009, the outstanding balance on our term loan facility was \$57.9 million. We did not have an outstanding balance on our revolving credit facility as of March 31, 2009. The undrawn portion of the revolving credit facility is available to finance working capital and for general corporate purposes, including but not limited to, surplus contributions to our Insurance Company Subsidiaries to support premium growth or strategic acquisitions. At December 31, 2008, we had an outstanding balance of \$60.25 million on our term loan and did not have an outstanding balance on our revolving credit facility.

The principal amount outstanding under the Credit Facilities provides for interest at LIBOR, plus the applicable margin, or at our option, the base rate. The base rate is defined as the higher of the lending bank's prime rate or the Federal Funds rate, plus 0.50%, plus the applicable margin. The applicable margin is determined by the consolidated indebtedness to consolidated total capital ratio. In addition, the Credit Facilities provide for an unused facility fee ranging between twenty basis points and forty basis points, based on our consolidated leverage ratio as defined by the Credit Facilities. At March 31, 2009, the interest rate on our term loan was 5.95%, which consisted of a fixed rate of 3.95%, plus an applicable margin of 2.00%.

The debt covenants applicable to the Credit Facilities consist of: (1) minimum consolidated net worth starting at eighty percent of pro forma consolidated net worth after giving effect to the acquisition of ProCentury, with quarterly increases thereafter, (2) minimum Risk Based Capital Ratio for Star of 1.75 to 1.00, (3) maximum permitted consolidated leverage ratio of 0.35 to 1.00, (4) minimum consolidated debt service coverage ratio of 1.25 to 1.00, and (5) minimum A.M. Best Company rating of B++. As of March 31, 2009, we were in compliance with these debt covenants.

Investment Portfolio

Table of Contents

As of March 31, 2009 and December 31, 2008, the recorded values of our investment portfolio, including cash and cash equivalents, were \$1.1 billion and \$1.1 billion, respectively.

In general, we believe our overall investment portfolio is conservatively invested. The duration of the investment portfolio at March 31, 2009 is 4.3 years, compared to 4.1 years at March 31, 2008. Our pre-tax book yield is 4.4%. The current after-tax yield is 3.3%, compared to 3.3% in 2008. Approximately 98.4% of our fixed income investment portfolio is investment grade.

Shareholders Equity

At March 31, 2009, shareholders equity was \$458.2 million, or a book value of \$7.98 per common share, compared to \$438.2 million, or a book value of \$7.64 per common share, at December 31, 2008.

In July 2008, our Board of Directors authorized management to purchase up to 3,000,000 shares of our common stock in market transactions for a period not to exceed twenty-four months. For the three months ended March 31, 2009, we did not repurchase any common stock. For the year ended December 31, 2008, we purchased and retired 800,000 shares of common stock for a total cost of approximately \$4.9 million. As of March 31, 2009, we have available up to 2.2 million shares remaining to be purchased.

On February 13, 2009, our Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of our LTIP award for the 2007-2008 plan years, which included both a cash and stock award. The stock portion of the LTIP award was \$1.6 million, which resulted in the issuance of 161,686 shares of our common stock. Of the 161,686 shares issued, 55,968 shares were retired for payment of the participant's associated withholding taxes related to the compensation recognized by the participant. Refer to Note 3 ~ *Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan* for further detail. The retirement of the shares for the associated withholding taxes reduced paid in capital by approximately \$329,000.

We paid dividends to our common shareholders of \$1.1 million during the three months ended March 31, 2009. During 2008, we paid dividends to our common shareholders of \$3.8 million. On May 1, 2009, our Board of Directors declared a quarterly dividend of \$0.02 per common share. The dividend is payable on June 1, 2009, to shareholders of record as of May 15, 2009.

When evaluating the declaration of a dividend, our Board of Directors considers a variety of factors, including but not limited to, cash flow, liquidity needs, results of operations, industry conditions, and its overall financial condition. As a holding company, our ability to pay cash dividends to our shareholders is partially dependent on dividends and other permitted payments from our Insurance Company Subsidiaries.

Procentury Merger

Table of Contents

Following the close of business on July 31, 2008, our Merger with ProCentury was completed. In accordance with the Merger Agreement, the stock price used in determining the final cash and share consideration portion of the purchase price was based on the volume-weighted average sales price of a share of Meadowbrook common stock for the 30-day trading period ending on the sixth trading day before the completion of the Merger, or \$5.7326. Based upon the final proration, the total purchase price was \$227.2 million, of which \$99.1 million consisted of cash, \$122.7 million in newly issued common stock, and approximately \$5.4 million in transaction related costs. The total number of new common shares issued for purposes of the stock portion of the purchase price was 21.1 million shares.

The Merger was accounted for under the purchase method of accounting, which resulted in goodwill of \$59.5 million equaling the excess of the purchase price over the fair value of identifiable assets, as of December 31, 2008. Goodwill is not amortized, but is subject to at least annual impairment testing. Identifiable intangibles of \$21.0 million and \$5.0 million were recorded related to agent relationships and trade names, respectively.

As of March 31, 2009, we recorded an increase to goodwill of approximately \$177,000. This increase to goodwill was primarily related to adjustments recorded during the first quarter of 2009 to reflect updated information on certain accruals and related expenses.

Adjusted Expense Ratio

Included in our GAAP expense ratio is the impact of the margin associated with our fee-based operations. If the profit margin from our fee-for-service business is recognized as an offset to our underwriting expense, a more realistic picture of our operating efficiency emerges. The following table illustrates our adjusted expense ratio, which reflects the GAAP expense ratio of our insurance company subsidiaries, net of the pre-tax profit, excluding investment income, of our fee-for-service and agency subsidiaries (in thousands):

Table of Contents

	For the Three Months Ended March 31,	
	2009	2008
Net earned premiums	\$ 129,038	\$ 66,022
Less: Consolidated net loss and LAE	69,787	37,661
Intercompany claim fees	5,108	3,106
Unconsolidated net loss and LAE	74,895	40,767
Consolidated policy acquisition and other underwriting expenses	23,969	13,147
Intercompany administrative and other underwriting fees	14,366	8,088
Unconsolidated policy acquisition and other underwriting expenses	38,335	21,235
Underwriting income	\$ 15,808	\$ 4,020
GAAP combined ratio as reported	87.7%	93.9%
Specialty insurance operations pre-tax income	\$ 27,411	\$ 12,912
Less: Underwriting income	15,808	4,020
Net investment income and realized losses	10,350	7,117
Fee-based operations pre-tax income	1,253	1,775
Agency operations pre-tax income	338	763
Total fee-for-service pre-tax income	\$ 1,591	\$ 2,538
GAAP expense ratio as reported	29.7%	32.2%
Adjustment to include pre-tax income from total fee-for-service income (1)	1.2%	3.8%
GAAP expense ratio as adjusted	28.5%	28.4%
GAAP loss and LAE ratio as reported	58.0%	61.7%
GAAP combined ratio as adjusted	86.5%	90.1%
Reconciliation of consolidated pre-tax income:		
Specialty insurance operations pre-tax income:		
Fee-based operations pre-tax income	\$ 1,253	\$ 1,775
Underwriting income	15,808	4,020
Net investment income and realized losses	10,350	7,117

Total specialty insurance operations pre-tax income	27,411	12,912
Agency operations pre-tax income	338	763
Less: Holding company expenses	2,100	900
Interest expense	2,782	1,311
Amortization expense	1,508	1,551
Consolidated pre-tax income	\$ 21,359	\$ 9,913

- (1) Adjustment to include pre-tax income from total fee-for-service income is calculated by dividing total fee-for-service income by net earned premiums.

Table of Contents

Contractual Obligations and Commitments

For the three months ended March 31, 2009, there were no material changes in relation to our contractual obligations and commitments, outside of the ordinary course of our business.

Convertible Note

In December 2005, we entered into a \$6.0 million convertible note receivable with an unaffiliated insurance agency. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This agency has been a producer for us for over ten years. As security for the loan, the borrower granted us a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible upon our option based upon a pre-determined formula, beginning in 2008. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At March 31, 2009, the estimated fair value of the derivative is not material to the financial statements.

Recent Accounting Pronouncements

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary-Impairments* (FSP FAS 115-2 and 124-2). FSP FAS 115-2 and 124-2 requires entities to separate an other-than-temporary impairment of a debt security into two components when there are credit related losses associated with the impaired debt security for which management believes the Company does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its amortized cost basis. If management concludes a security is other-than-temporarily impaired, FSP FAS 115-2 and 124-2 requires that the difference between the fair value and the amortized cost of the security be presented as an other-than-temporary-impairment charge within earnings, with an offset for any noncredit-related loss component of the other-than-temporary-impairment charge to be recognized in other comprehensive income. FSP FAS 115-2 and 124-2 is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009 subject also to early adoption of FSP FAS 157-4 (see below).

In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* (FSP FAS 157-4). FSP FAS 157-4 supercedes FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active*. FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with Statement of Financial Accounting Standards

Table of Contents

(SFAS) No. 157 *Fair Value Measurements* when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity. In addition, if there is evidence that the transaction for the asset or liability is not orderly, the entity shall place little, if any weight on that transaction price as an indicator of fair value. FSP FAS 157-4 is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009 subject also to early adoption of FSP FAS 115-2 and 124-2 (see above).

We elected to defer the adoption of FSP FAS 115-2 and 124-2 and FAS 157-4 until the second quarter of 2009. We believe the adoption will not result in a significant difference to our current other-than-temporary-impairment review or fair value measurements. We are currently evaluating the impact of the adoption of these FSPs on our results of operations and financial position.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1 amends SFAS No. 107 *Disclosures about Fair Value of Financial Instruments* to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. FSP FAS 107-1 and APB 28-1 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. We elected to defer the adoption of FSP FAS 107-1 and APB 28-1 until the second quarter of 2009.

In April 2009, the FASB issued FSP FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination that Arise from Contingencies* (FSP FAS 141(R)-1). FSP FAS 141(R)-1 amends the guidance in SFAS No. 141(R), *Business Combinations*, by requiring that assets and liabilities assumed in a business combination that arise from contingencies be recognized at fair value only if fair value can be reasonably estimated. FSP FAS 141(R)-1 is effective for business combinations for which the acquisition date is on or after December 15, 2008. We do not expect FSP FAS 141(R)-1 to have a material impact on our consolidated financial condition or results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates as well as other relevant market rate or price changes. The volatility and liquidity in the markets in which the underlying assets are traded directly influence market risk. The following is a discussion of our primary risk exposures and how those exposures are currently managed as of March 31, 2009. Our market risk sensitive instruments are primarily related to fixed income securities, which are available for sale and not held for trading purposes.

Table of Contents

Interest rate risk is managed within the context of an asset and liability management strategy where the target duration for the fixed income portfolio is based on the estimate of the liability duration and takes into consideration our surplus. The investment policy guidelines provide for a fixed income portfolio duration of between three and a half and five and a half years. At March 31, 2009, our fixed income portfolio had a modified duration of 4.25, compared to 4.47 at December 31, 2008.

At March 31, 2009, the fair value of our investment portfolio, excluding cash and cash equivalents, was \$1.0 billion. Our market risk to the investment portfolio is primarily interest rate risk associated with debt securities. Our exposure to equity price risk is related to our investments in relatively small positions of preferred stocks and mutual funds with an emphasis on dividend income. These investments comprise 2.16% of our investment portfolio.

Our investment philosophy is one of maximizing after-tax earnings and has historically included significant investments in tax-exempt bonds. We continue to increase our holdings of tax-exempt securities based on our desire to maximize after-tax investment income. For our investment portfolio, there were no significant changes in our primary market risk exposures or in how those exposures are managed compared to the year ended December 31, 2008. We do not anticipate significant changes in our primary market risk exposures or in how those exposures are managed in future reporting periods based upon what is known or expected to be in effect.

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

	Rates Down 100bps	Rates Unchanged	Rates Up 100bps
Fair Value	\$1,058,544	\$1,020,266	\$963,095
Yield to Maturity or Call	4.28%	5.32%	6.61%
Effective Duration	4.41	4.57	4.98

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

Table of Contents

Our debentures are subject to variable interest rates. Thus, our interest expense on these debentures is directly correlated to market interest rates. At March 31, 2009 and December 31, 2008, we had debentures of \$80.9 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$809,000.

Our term loan is subject to variable interest rates. Thus, our interest expense on our term loan is directly correlated to market interest rates. At March 31, 2009, we had an outstanding balance on our term loan of \$57.9 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$579,000. At December 31, 2008, we had an outstanding balance on our term loan of \$60.25 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$602,500.

We have entered into interest rate swap transactions to mitigate our interest rate risk on our existing debt obligations. We accrue for these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities*, as subsequently amended. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and recognized as an adjustment to interest expense. Refer to Note 7 ~ *Derivative Instruments* for further detail relating to our interest rate swap transactions.

In addition, our revolving line of credit under which we can borrow up to \$35.0 million is subject to variable interest rates. Thus, our interest expense on the revolving line of credit is directly correlated to market interest rates. At March 31, 2009 and December 31, 2008, we did not have an outstanding balance on our revolving line of credit.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures.

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

Table of Contents

can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

As of March 31, 2009, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of disclosure controls. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls were effective in recording, processing, summarizing, and reporting, on a timely basis, material information required to be disclosed in the reports we file under the Exchange Act and is accumulated and communicated, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no significant changes in our internal control over financial reporting during the three month period ended March 31, 2009, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

The information required by this item is included under Note 10 *Commitments and Contingencies* of the Notes to the Consolidated Financial Statements of the Company's Form 10-Q for the three months ended March 31, 2009, which is hereby incorporated by reference.

ITEM 1A. RISK FACTORS

There have been no material changes to the Risk Factors previously disclosed in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2008 and our other filings with the Securities and Exchange Commission.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In July 2008, the Company's Board of Directors authorized management to purchase up to 3,000,000 shares of the Company's common stock in market transactions for a period not to exceed twenty-four months.

The following table represents information with respect to repurchases of the Company's common stock for the quarterly period ended March 31, 2009:

Period	Total Number of Shares	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that may yet be Repurchased Under the Plans or Programs
January 1 - January 31, 2009		\$		2,200,000
February 1 - February 28, 2009		\$		2,200,000
March 1 - March 31, 2009		\$		2,200,000
Total		\$		

ITEM 6. EXHIBITS

The following documents are filed as part of this Report:

Exhibit No.	Description
10.1	Employment Agreement between the Company and Robert S. Cubbin, dated January 1, 2009 (incorporated by reference to Exhibit 10.1 from Current Report on Form 8-K filed on January 7, 2009).

Table of Contents

Exhibit No.	Description
10.2	Employment Agreement between the Company and Michael G. Costello, dated January 1, 2009 (incorporated by reference to Exhibit 10.2 from Current Report on Form 8-K filed on January 7, 2009).
10.3	Form of senior executive Employment Agreement between the Company and senior executive, effective January 1, 2009 (incorporated by reference to Exhibit 10.3 from Current Report on Form 8-K filed on January 7, 2009).
31.1	Certification of Robert S. Cubbin, Chief Executive Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
31.2	Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Robert S. Cubbin, Chief Executive Officer of the Corporation.
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation.

Table of Contents

SIGNATURES

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

Meadowbrook Insurance Group, Inc.

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

Dated: May 8, 2009

57

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description
10.1	Employment Agreement between the Company and Robert S. Cubbin, dated January 1, 2009 (incorporated by reference to Exhibit 10.1 from Current Report on Form 8-K filed on January 7, 2009).
10.2	Employment Agreement between the Company and Michael G. Costello, dated January 1, 2009 (incorporated by reference to Exhibit 10.2 from Current Report on Form 8-K filed on January 7, 2009).
10.3	Form of senior executive Employment Agreement between the Company and senior executive, effective January 1, 2009 (incorporated by reference to Exhibit 10.3 from Current Report on Form 8-K filed on January 7, 2009).
31.1	Certification of Robert S. Cubbin, Chief Executive Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
31.2	Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Robert S. Cubbin, Chief Executive Officer of the Corporation.
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation.