MEADOWBROOK INSURANCE GROUP INC
Form 10-K
March 15, 2010

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

FORM 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2009

or

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

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

Michigan	**38-2626206**
(State of Incorporation)	*(IRS Employer Identification No.)*
26255 American Drive, Southfield, MI	**48034-6112**
(Address of principal executive offices)	*(Zip Code)*

Registrant s telephone number, including area code: (248) 358-1100
Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Exchange on Which Registered**
Common Stock, $.01 par value per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 þ No o

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 o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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 o Accelerated filer þ Non-accelerated filer o Smaller reporting company o
(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 o No þ

The aggregate market value of the voting and non-voting common stock held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of June 30, 2009 was $347,543,421. As of March 10, 2010, there were 55,201,542 shares of the Company s common stock ($.01 par value) outstanding.

Documents Incorporated by Reference

Certain portions of the Registrant s Proxy Statement for the 2010 Annual Shareholders Meeting scheduled for May 18, 2010 are incorporated by reference into Part III of this report.

MEADOWBROOK INSURANCE GROUP, INC.

PART I

ITEM 1. *BUSINESS*

The Company

Meadowbrook Insurance Group, Inc. (We, Our, Us, or Meadowbrook) (NYSE: MIG) is a holding company organiz as a Michigan corporation in 1985. Meadowbrook was founded in 1955 as Meadowbrook Insurance Agency and was subsequently incorporated in Michigan in 1965. Our principal executive offices are located at 26255 American Drive, Southfield, Michigan 48034-6112 (telephone number: (248) 358-1100.

We serve as a holding company for our 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), as well as, American Indemnity Insurance Company, Ltd. (American Indemnity). We also serve as a holding company for Meadowbrook, Inc. (Meadowbrook), Crest Financial Corporation, and their respective subsidiaries. In addition, as described below, we also serve as a holding company for 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 Co. (Propic) is a wholly owned subsidiary of ProCentury.

Star, Savers, Williamsburg, Ameritrust, Century, and PIC are collectively referred to as the Insurance Company Subsidiaries.

Pursuant to accounting guidance, Accounting Standards Codification (ASC) 810 *Consolidations* (ASC 810), we do not consolidate our subsidiaries, Meadowbrook Capital Trust I and II (the Trusts), as they are not variable interest entities and we are not the primary beneficiary of the Trusts. Our consolidated financial statements, however, include the equity earnings of the Trusts. In addition and in accordance with ASC 810, we do not consolidate our subsidiary American Indemnity. While we and our subsidiary Star are the common shareholders, neither are the primary beneficiaries of American Indemnity. Our consolidated financial statements, however, include the equity earnings of American Indemnity. The equity earnings in our Trusts and American Indemnity are reflected in our Consolidated Statement of Income as equity earnings of unconsolidated subsidiaries.

ProCentury Merger

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 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. Refer to Note 2 *ProCentury Merger* in the Notes to the Consolidated Financial Statements for additional discussion of the Merger and a pro forma presentation of financial results for the combined company.

ProCentury is a specialty insurance company, which primarily underwrites general liability, commercial property, environmental, garage, 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.

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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.

Five months of earnings of ProCentury are included in our financial statements as of and for the year ended December 31, 2008. Twelve months of earnings are included for the year ended December 31, 2009.

Since the completion of the Merger, we have been executing on numerous revenue enhancement opportunities and leveraging the infrastructure as summarized below:

Revenue enhancement opportunities:

launching a new wholesale relationship in the Midwest;

offering a surplus lines market for an existing workers compensation partner in New England; and

utilization of existing program capabilities for Century general agents.

Leveraging shared infrastructure and increased size:

developing Centers of Expertise for claims management;

increased size and diversity benefit costs of reinsurance;

enhanced marketing capabilities through joint business development functions; and

geographic expansion of Century offerings through existing admitted markets.

Executing on opportunities to leverage other niche capabilities;

combined capabilities allow us to receive and evaluate more opportunities; and

independently, neither company would have been able to meet the comprehensive risk management solutions that some opportunities require.

Other Significant Acquisitions

In April 2007, we acquired the business of U.S. Specialty Underwriters, Inc. (USSU). USSU is a specialty program manager that produces fee based income by underwriting targeted classes within excess workers compensation coverage for a select group of insurance companies.

In November 2005, we acquired the business of Insurance & Benefit Consultants (IBC) of Sarasota, Florida. IBC is a retail and wholesale agency specializing in group and individual health insurance products and personal financial planning services.

In August 1999, we acquired the assets of TPA Associates, Inc., all the outstanding stock of TPA Insurance Agency, Inc., and Preferred Insurance Agency, Inc. (collectively, TPA). TPA is a program-oriented risk management company that provides risk management services to self-insured clients, manages alternative risk management programs, performs underwriting, and loss control services for unaffiliated insurance companies.

In July 1998, we acquired Florida Preferred Administrators, Inc. (Florida Preferred), a third party administrator and Ameritrust. In December 2002, Ameritrust became a wholly owned subsidiary of Star. Florida Preferred provides a broad range of risk management services for Ameritrust and other third parties.

In July 1997, we acquired Crest Financial Corporation (Crest), a California-based holding company, which formerly owned Williamsburg. Crest provides risk management services primarily to Williamsburg. On December 31, 1999, Williamsburg became a wholly owned subsidiary of Star.

In July 1990, we acquired Savers.

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Recent Equity Investment

In July 2009, our subsidiary, Star, purchased a 28.5% ownership interest in an insurance holding limited liability company for $14.8 million in cash. We are not required to consolidate this investment as we are not the primary beneficiary of the business. Our ownership interest is significant, but is less than a majority ownership and, therefore, we are accounting for this investment under the equity method of accounting. Therefore, Star will recognize 28.5% of the profits and losses as a result of this equity interest ownership.

Employees

At March 5, 2010, we employed approximately 918 associates to service our clients and provide management services to our Insurance Company Subsidiaries as described below. We believe we have good relationships with our associates.

Overview and Operational Structure

For over thirty years, we have specialized in providing full service risk management and insurance solutions for our clients. By forming risk-sharing partnerships, we align our financial objectives with our clients. By utilizing our products and services, small to medium-sized client groups gain access to more sophisticated risk management techniques previously available only to larger corporations. This enables our clients to control insurance costs and achieve more predictable underwriting results.

We were founded in 1955 as a retail insurance agency. We earn commission revenue through the operation of our retail property and casualty insurance agencies, located in Michigan, California, and Florida.

We define our business segments as specialty insurance operations and agency operations. These two distinct business operations derive revenue from the following sources:

Specialty Insurance Operations:

Net earned premiums derived from admitted and non-admitted products and programs, as well as risk sharing vehicles.

Fee-for-service revenue derived from managed program revenue, as well as municipality and association clients.

Investment income.

Agency Operations:

Commission revenue agency commission from non-affiliated carriers.

Our specialty insurance operations and agency operations are entirely supported by our full-service processing capabilities, which provide the essential functions necessary in a risk management organization.

Specialty Insurance Operations

Our specialty insurance operations provide underwriting and insurance administration services. We market and underwrite specialty property and casualty insurance programs and products on both an admitted and non-admitted basis through a broad and diverse network of independent retail, wholesale program administrators and general agents, who value service, specialized knowledge, and focused expertise. Our primary focus is on niche or specialty products and program business and risk management solutions for our customers. The services and coverages we provide are tailored to meet specific requirements of defined client groups and their members, which may include specialty program underwriting; admitted and excess and surplus lines insurance products; alternative risk transfer solutions, 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 provide various

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types of property and casualty insurance coverage, primarily to associations or similar groups of members and to the specified classes of business of our agents. With our specialty programs and products, we seek to combine profitable underwriting, investment returns and efficient capital management to deliver consistent long-term growth in shareholder value.

As an admitted carrier we provide a market for more traditional lines of business and coverages that are offered by standard markets. Traditional admitted markets typically serve businesses that:

- are low to medium hazard;
- have more predictable underwriting results;
- are adequately rated and priced by rates and policy forms that are filed and approved by state regulatory agencies;
- require the protection of state guaranty funds; and
- are required to purchase admitted insurance products.

As an excess and surplus lines provider we market to customers with hard-to-place risks, for which standard or admitted insurers typically choose not to insure. In the excess and surplus lines market, we serve businesses that are unable to obtain coverage from standard or admitted carriers for a variety of reasons, including the following:

- the unique nature of the insured business is outside the risk profile of standard lines carriers;
- the risk associated with an insured is higher than the risk anticipated by a standard lines carrier when it filed its rates and forms for regulatory approval, which prevents it from charging a premium that is thought to be appropriate for the heightened risk;
- many geographic regions are considered to be adverse or more risky markets in which to operate due to legal, regulatory or claims issues or because they are too remote to warrant a marketing effort and, as a result, agents in theses areas have a limited choice of admitted insurers; and
- small agent organizations who do not generate enough premium volume to qualify for direct relationships with standard lines carriers.

Our insurance 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 California and New England. 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 of the United States. 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.

We recognize revenue related to the services and coverages from our specialty insurance operations within seven categories: net earned premiums, management fees, claims fees, loss control fees, reinsurance placement, investment income, and net realized gains (losses).

Specialty Insurance Operations Programs and Products

The admitted programs that we write as part of our specialty insurance operations are characterized by risks that are homogeneous within programs but have a diverse geographic profile. Generally, the average account premium is small and due to the specialized nature of the program and distribution style, our admitted programs have high premium retention levels. This helps create stability in our business amid the cyclicality of the insurance industry. Two examples of admitted programs we write are coverages for picture framers and music equipment stores. We seek to write rollover programs that have a history of proven profitable performance. The admitted programs that we write and retain are the result of long-term, stable relationships with distribution partners that have a targeted and specialized distribution style.

The excess and surplus lines business we write is characterized by broad classes of Main Street commercial risks that are ineligible for coverage by the standard market. Similar to our admitted programs, the average account premium size for the excess and surplus lines risks we write is small. Two examples of markets we serve with our excess and surplus lines offering are restaurants and habitational classes, such as apartments and hotels. The excess and surplus lines regulatory environment allows rate and form freedom, which gives us the flexibility to design tailored coverage forms that are often more restrictive than those available in the admitted market. The high degree of flexibility contributes to heightened competition during soft markets and creates the potential for rapid expansion during hard markets.

The non-admitted programs we write have characteristics that are similar to our admitted programs, however, the commercial risks we provide coverage for are ineligible for coverage by the standard or admitted market. With this focus on non-admitted program underwriting, we are able to provide coverage for start-up organizations and relatively low volume programs that other markets are unable or unwilling to serve. Two examples of non-admitted programs we offer are coverages for pet-sitters and oil and gas contractors.

We also offer coverage for specialty markets, where specific and unique underwriting expertise is required. We develop solutions for specific market segments that may leverage either our admitted market or non-admitted market product capabilities, or both, depending on the market need. The specific and unique underwriting expertise that is required to write business profitably in the segments we serve creates barriers to entry for new competitors. Two examples of specialty markets we serve are the transportation and environmental markets.

Description of Specialty Insurance Operations

Based upon the particular risk management goals of our clients, market conditions and our assessment of the opportunity for operating profit, our specialty insurance operations offer solutions on a fully-insured basis, a risk-sharing basis, or a managed basis, in response to a specific market opportunity. In a managed program, we earn service fee revenue by providing certain operational functions and other services to a client s risk-bearing entity, but generally do not share in the operating results. In a risk-sharing program, we share the operating results with the client through a reinsurance agreement with an insurance company, captive, or rent-a-captive. In a profit-sharing structure, we pay an agent a commission that is adjusted based on the operating results of the program. These structures, other than the profit-sharing commission structure, are licensed insurance or reinsurance companies and are accounted for in accordance with accounting guidance as it relates to reinsurance and insurance products. In risk-sharing programs, we derive revenue from net earned premiums, fee-for-service revenue and commissions, and investment income. In addition, we may benefit from the fees our risk management subsidiary earns for services we perform on behalf of our Insurance Company Subsidiaries. These fees are eliminated upon consolidation. However, the fees associated with the captive s portion of the program are reimbursed through a ceding commission. For a fully-insured program, we provide insurance products without a risk-bearing mechanism and derive revenue from net earned premiums and investment income.

Fully-Insured Programs and Products:

With a fully-insured program, we provide our insurance products and derive revenue from net earned premiums and investment income. Fully-insured programs are generally developed in response to specific market opportunities and may evolve into a risk-sharing relationship.

Risk-Sharing Programs:

Quota Sharing: With a client risk-sharing program, our Insurance Company Subsidiaries underwrite individual primary insurance policies for members of a group or association, or a specific industry and then

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share the operating results with the client or client group through a reinsurance agreement with an insurance company, captive, or rent-a-captive. In some instances, a captive owned by a client or client group reinsures a portion of the risk on a quota-share basis. A captive is an insurance company or reinsurance company, which is formed for the purpose of insuring or reinsuring risks related to the businesses of its shareholders or members. A rent-a-captive allows organizations to obtain the benefits of a captive insurance company, without the initial costs and capital investment required to form their own captive. This is often an interim step utilized by groups and associations prior to forming their own captive. As part of its participation in a rent-a-captive, the client group purchases redeemable preferred stock of our unconsolidated subsidiary. These shares entitle the client group to participate in profits and losses of the program through a dividend or additional capital contribution. Dividends or additional capital contributions are determined and accrued on the basis of underwriting profits or losses plus investment income on trust accounts less costs. These structures are licensed insurance or reinsurance companies, which have a self-sustaining integrated set of activities and assets, and are in the reinsurance business for the purpose of providing a return to their investors, who are the shareholders (primary beneficiaries) of the captive company. The primary beneficiaries have their own equity at risk, decision making authority, and the ability to absorb losses. The transactions associated with these structures are accounted for in accordance with accounting guidance as it relates to reinsurance and insurance products.

In addition to premium revenue and investment income from the net retained portion of our operating results, we may also be compensated through the receipt of fees for policy issuance services and acquisition costs, captive administration, reinsurance placement, loss prevention services, and claims administrative and handling services. However, the fees associated with the captive s portion of the program are reimbursed through a ceding commission. For financial reporting purposes, ceding commissions are treated as a reduction in underwriting expenses. In addition, we may benefit from the fees our risk management subsidiary earns for services we perform on behalf of our Insurance Company Subsidiaries. These fees are eliminated upon consolidation.

Our experience has been that the number of claims and the cost of losses tend to be lower in risk-sharing programs than with traditional forms of insurance. We believe that client risk-sharing motivates participants to focus on underwriting selection, loss prevention, risk control measures and adherence to stricter underwriting guidelines.

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The following schematic illustrates the basic elements in many of our client risk-sharing programs.

QUOTA SHARE REINSURANCE RISK-SHARING STRUCTURE

(1) We account for transactions with these risk-sharing clients as reinsurance, in accordance with accounting guidance as it relates to reinsurance and insurance products.

The captive s shareholders, which may or may not include the insured, and its board of directors make the decision to form the captive or terminate the captive, based upon either their own analysis or the analysis performed by an independent third party consultant they hire. The shareholders of the captive make the decision whether to invest and how much to invest in the captive. This decision may be based upon advice from third party consultants.

The agent of the business will make the decision to submit the risk to the insurance company for underwriting and the policyholders make the decision to purchase the quoted policy.

The captive administrator provides administrative services to the captive in exchange for a fee. This fee is usually a fixed amount, but can be a variable amount based upon premium volume, and is negotiated on an annual basis with the captive s board of directors. Such services may include bookkeeping, providing regulatory information, and other administrative services. We also may provide loss prevention, claims handling, underwriting, and other insurance services directly to certain of our captives. However, our risk management services subsidiary provides these services to our Insurance Company Subsidiaries for a fee, which is eliminated upon consolidation. The costs associated with these services are included within the premium quoted to the policyholder.

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In accordance with ASC 810, our variable interest in the captive is limited to administrative fees based upon a fixed amount or a percentage of premiums and the credit risk associated with any reinsurance recoverables recognized.

The captives are generally capitalized with common stock and may use preferred stock in isolated instances. The captive s variability is: (1) created based upon the experience of their portion of business directly written through our Insurance Company Subsidiaries and ceded to the captive on a quota share basis; and (2) absorbed by the captive s shareholders.

In general, the captive s common and/or preferred shareholders are either the agents or producers of the business, a sponsoring group or association, a group of policyholders, a policyholder, or a general agent. The captive s shareholders are not related parties of ours pursuant to related accounting guidance.

By design, the capital base of the captive is structured to absorb the projected losses of the program, and the captive s shareholders bear the risk of loss. Through a trust agreement, we protect ourselves from potential credit risk related to reinsurance recoverables from the captive by a collateral requirement of up to 110% of the estimated reserves for losses and unearned premiums. In addition, we monitor the capital adequacy and financial leverage ratios of the captive to mitigate future credit risk.

In another variation of client risk-sharing, we establish retrospectively rated programs for individual accounts. With this type of program, we work with the client to develop the appropriate self-insured retention and loss fund amount and then help arrange for excess-of-loss reinsurance. The client reimburses us for all claim payments within the client s retention. We generally earn a management fee (which includes claims and loss control fees). In most of these programs, we also share in the operating results with the client and receive a ceding commission in the excess-of-loss reinsurance contract to reimburse us for expenses, including a fee for services.

Profit-Sharing: In a profit-sharing commission program, we provide our agent the opportunity to accept an upfront provisional commission rate that is then adjusted either upward or downward, based on the actual underwriting results as compared to predetermined metrics.

Managed Programs:

With a fee-for-service or managed program, we earn revenue by providing certain operational and administrative functions and other services to a client s risk-bearing entity, but generally do not share in the operating results of the program. We believe our fee-for-service or managed programs provide a consistent source of revenue, as well as opportunities for revenue growth without a proportionate increase in capital requirements. Revenue growth may occur through the sale of existing products to additional members of the group, the expansion of coverages and services provided to existing programs and the creation of programs for new client groups.

Services for which we receive revenue from fee-for-service or managed programs include:

program design and development;

underwriting;

reinsurance placement;

policy administration;

loss prevention and control;

claims administration and handling;

litigation management;

information technology and processing;

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accounting functions; and

general operational functions and oversight of the program.

The fees we receive from these managed programs are generally either a fixed amount or based on a percentage of premium serviced or by claim count.

We also provide insurance management services to public entity associations and currently provide services to public entity pools and other insurance entities, which provide insurance coverage for participants, including city, county, township, villages and other quasi governmental entities in three states, as well as other diverse industry groups.

Description of Major Specialty Insurance Services

Our risk management subsidiary provides the following services to our fee-for-service clients and to our Insurance Company Subsidiaries for a fee. The fees associated with services provided to our Insurance Company Subsidiaries are eliminated upon consolidation. The costs associated with these services are charged to our insureds in the form of premiums.

Program and Product Design. Before implementing a new program, we generally review: (1) financial projections for the contemplated program, (2) historical loss experience, (3) actuarial studies of the underlying risks, (4) the credit worthiness of the potential agent or client, and (5) the availability of reinsurance. Our senior management team and associates representing each of the risk-management disciplines work together to design, market, and implement new programs. Our due diligence process is structured to provide a risk assessment of the program and how the program fits within our entity wide business plan and risk profile.

Underwriting Risk Selection and Policy Issuance. Through our risk management subsidiary, we perform underwriting services for our Insurance Company Subsidiaries that meet our corporate underwriting guidelines. We retain ultimate underwriting authority and monitor adherence to our corporate underwriting guidelines through periodic audits. Our underwriting personnel help develop the proper criteria for selecting risks, while actuarial and reinsurance personnel evaluate and recommend the appropriate levels of rate and risk retention. The program is then tailored according to the requirements and qualifications of each client. With managed programs, we may also perform underwriting services based upon the profile of the specific program for a fee.

Claims Administration and Handling. Through our risk management subsidiary, we provide substantially all claims management and handling services for workers compensation and most other lines, such as property, professional liability, and general liability. Our claims handling standards are set by our corporate claims department and are monitored through self-audits, corporate claim audits, internal controls, and other executive oversight reports. We handle substantially all claims functions for the majority of the programs we manage. Our involvement in claims administration and handling provides feedback to program managers in assessing the client s risk environment and the overall structure of the program.

Loss Prevention and Control. Through our risk management subsidiary, we provide loss control services, which are designed to help clients prevent or limit the impact of certain loss events. Through an evaluation of the client s workplace environment, our loss control specialists assist the client in planning and implementing a loss prevention program and, in certain cases, provide educational and training programs. With our managed programs, we provide these same services for a fee based upon the profile of the specific program.

Administration of Risk-Bearing Entities. We generate fee revenue by assisting in the formation and administration of risk-bearing entities for clients and agents. Through our subsidiaries in Bermuda and Washington D.C., we provide administrative services for certain captives and/or rent-a-captives.

Reinsurance Placement. Through our reinsurance intermediary subsidiary, we earn commissions from placing excess-of-loss reinsurance and insurance coverage with high deductibles for insurance companies, captives, and managed self-insured programs. Reinsurance is also placed for clients who do not have other business relationships with us.

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Sales, Marketing, and Public Relations. We market our programs and services to associations, professional and trade groups, local, regional and national insurance agents, and insurance consultants. Sales and marketing efforts include personal contact through independent agents, direct mail, telemarketing, association publications/newsletters, advertising, Internet-based marketing including our corporate website (www.meadowbrook.com), and subsidiary branch/division websites. We access or manage a range of distribution systems and regional agency networks on a program-specific basis.

Business Processing Technology Platform. We provide a select set of internet-based business processing systems to our agents to automate the capability to rate, quote, bind and service insurance policies in a timely and efficient manner. Advantage is a processing system for quoting and binding workers compensation insurance policies. CenturyOnLine (COL) is a processing system for quoting and binding general liability, property and garage insurance policies underwritten by our excess and surplus lines facility, Century. Further, we provide additional systems on a network-accessible basis for processing select package and commercial auto programs. In addition to reducing our internal administrative processing costs, these systems enhance underwriting practices by automating risk selection criteria.

We also participate in seminars, trade and industry conventions such as Target Markets Program Administrators Association, American Association of Managing General Agents, American Society of Association Executives, Self Insurance Institute of America, National Association of Professional Surplus Lines Offices, Public Risk Management Association, and various individual state independent agent associations.

Agency Operations

Our agency operations segment earns commission revenue through the operation of its retail property and casualty insurance agencies, located in Michigan, California, and Florida. These agencies produce commercial, personal lines, life and accident and health insurance, with more than fifty unaffiliated insurance carriers. These agencies produce an immaterial amount of business for our affiliated Insurance Company Subsidiaries.

Customer Concentration

In our opinion, no material part of our business is dependent upon a single customer or group of customers. The loss of any one customer would not have a material adverse effect on our results of operations or financial condition. No one customer or group of affiliated customers accounts for 10% or more of the Company s consolidated revenues.

Objective and Strategy

Our corporate objective is to generate predictable earnings across the market cycle, with a long term targeted return on average equity range of 10%-17%. Our strategy is to maximize the unique characteristics of our balanced business model to:

Generate profitable underwriting results from our insurance operations;

Generate consistent investment income with a low-risk, high-quality, primarily fixed income portfolio;

Leverage invested assets to equity;

Generate stable, consistent fee and commission income through our agency and specialty insurance operations; and

Generate free cash flow from dividends from our Insurance Company Subsidiaries and non-regulated insurance administration services.

Our overall objectives and strategies may be influenced by interest rates, insurance market cycle conditions, and general economic conditions.

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Approach on Underwriting Discipline

As an underwriter, we underwrite for predictability and profitability by adhering to the following business practices as they relate to our corporate underwriting discipline:

- Re-underwrite excess and surplus lines business for accuracy and completeness;
- Limit exposure to catastrophe-prone areas and purchase reinsurance;
- Our associates have a broad and deep underwriting experience and expertise;
- Our actuarial team supports underwriting with pricing and loss analysis;
- New opportunities undergo a thorough new business due diligence process;
- Robust program controls help monitor all programs for performance; and
- We maintain long-term agent relationships, which are matched with high quality reinsurance partners.

Insurance Company Subsidiaries

Our Insurance Company Subsidiaries issue insurance policies. Through our Insurance Company Subsidiaries, we provide specialty insurance programs and products where 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. Our Insurance Company Subsidiaries primarily focus is on specialty products and program business for our customers, which consist of select independent, general agents, and wholesale agents with either a defined geographic specialty and / or product specialty. These programs are generally designed specifically for trade groups and associations, whose members are homogeneous in nature. Members are typically small-to-medium sized businesses. We compensate our distribution network primarily on a flat commission rate based upon premiums written, or other risk-sharing mechanism, as previously described.

Through our excess and surplus lines insurance carriers, we provide coverage for risks that either do not fit the underwriting criteria of standard carriers with which the retail agent has a direct relationship, or they are of a class or risk that the standard market generally avoids since the regulated nature of that market does not allow for customized terms or rates. Non-standard risks can be underwritten profitably, however, by the excess and surplus market, by using highly specific coverage forms with terms based on individual risk assessment, rather than the risk profile of the most desirable members of the class. When a certain risk has been excluded from the standard market, the retail agents need quick placement with the excess and surplus lines market in order to maintain coverage for the insured. As a result, the primary basis for competition within the excess and surplus lines industry can be focused more on service and availability rather than rate.

Our programs focus on select classes of property and casualty business which, through our due diligence process, we believe have demonstrated a fundamentally sound prospect for generating underwriting profits. We occasionally do offer our programs on a multi-state basis; but more generally, our programs operate on a regional or state-specific basis. We provide underwriting authority to our regional offices based upon underwriting guidelines established by our corporate underwriting department, which we monitor through underwriting audits and a series of executive underwriting and rate monitor reports. We seek to avoid geographic concentration of risks that might lead to aggregation of exposure to losses from natural or intentionally caused catastrophic events. We also handle the majority of our claims through our regional offices based upon standards set forth by our corporate claims office and monitored through a series of self-audits and corporate claims audit, internal control audits, and executive claims monitoring reports. American Indemnity, a Bermuda-based insurance company which offers our clients a captive or rent-a-captive option, complements our Insurance Company Subsidiaries.

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In addition, we may at times place risks directly with third party insurance carriers and participate in the risk as a reinsurer. Such arrangements typically generate management fee revenue and provide a means to manage premium leverage ratios.

Our Insurance Company Subsidiaries primarily offer workers compensation, commercial multiple peril, general liability, marine and other liability coverages on both an admitted and non-admitted basis. Our Insurance Company Subsidiaries maintain a variety of licenses in order for us to write on an admitted and / or a non-admitted basis in all fifty states, including the District of Columbia.

Our insurance operations are subject to various leverage tests (e.g., premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. Our targets for gross and net written premium to statutory surplus are 2.75 to 1.0 and 2.25 to 1.0, respectively. As of December 31, 2009, on a statutory consolidated basis, gross and net premium leverage ratios were 2.0 to 1.0 and 1.6 to 1.0, respectively.

The following table summarizes gross written premiums, net earned premiums, and net written premiums for the years ended December 31, 2009, 2008, 2007, 2006, and 2005 (in thousands):

n Premium	2009	%	2008	%	2007	%	2006	%	2005
npensation	$ 233,269	33.87%	$ 137,503	30.04%	$ 116,717	33.69%	$ 118,794	35.90%	$ 133,732
ulti-Peril	43,428	6.31%	29,114	6.36%	69,970	20.20%	67,764	20.48%	59,928
ulti-Peril	54,901	7.97%	37,519	8.20%	30,394	8.77%	26,591	8.04%	26,050
	169,968	24.68%	116,988	25.56%	28,550	8.24%	20,001	6.04%	16,167
uto Liability	92,632	13.45%	73,952	16.16%	61,119	17.64%	59,308	17.92%	59,144
s	94,489	13.72%	62,607	13.68%	39,701	11.46%	38,414	11.61%	37,188
	$ 688,687	100.00%	$ 457,683	100.00%	$ 346,451	100.00%	$ 330,872	100.00%	$ 332,209

Premium	2009	%	2008	%	2007	%	2006	%	2005
mpensation	$ 163,834	30.36%	$ 109,312	29.57%	$ 102,256	38.13%	$ 108,085	42.40%	$ 119,423
Multi-Peril	37,133	6.88%	46,326	12.53%	50,031	18.65%	45,192	17.73%	38,541
Multi-Peril	45,660	8.46%	31,847	8.61%	21,018	7.84%	17,946	7.04%	16,288
y	140,486	26.04%	74,470	20.14%	15,571	5.81%	10,433	4.09%	8,072
Auto	79,802	14.79%	62,306	16.85%	53,469	19.94%	49,341	19.36%	45,374
es	72,687	13.47%	45,460	12.30%	25,852	9.64%	23,923	9.38%	22,261
	$ 539,602	100.00%	$ 369,721	100.00%	$ 268,197	100.00%	$ 254,920	100.00%	$ 249,959

Premium	2009	%	2008	%	2007	%	2006	%	2005
mpensation	$ 206,246	35.56%	$ 120,507	32.12%	$ 105,003	37.47%	$ 104,846	39.92%	$ 117,287
Multi-Peril	38,825	6.69%	24,690	6.58%	52,815	18.85%	48,737	18.55%	42,157
Multi-Peril	45,462	7.84%	30,270	8.07%	23,465	8.37%	18,767	7.14%	17,713
y	131,921	22.75%	87,760	23.39%	18,915	6.75%	12,384	4.71%	8,004
Auto	82,499	14.22%	64,678	17.24%	52,798	18.84%	52,950	20.16%	49,122
es	75,065	12.94%	47,289	12.60%	27,215	9.71%	24,984	9.51%	23,851
	$ 580,018	100.00%	$ 375,194	100.00%	$ 280,211	100.00%	$ 262,668	100.00%	$ 258,134

As previously indicated, the Merger with ProCentury was completed following the close of business on July, 31, 2008. Therefore, the above table includes only five months of premium for ProCentury for the year ended December 31, 2008 and twelve months for the year ended December 31, 2009.

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In 2009, we had an increase in our premium writings specific to our workers compensation line of business, which was primarily related to our new relationship with a general agent who specializes in non-contractors workers compensation in the Midwest, California, and other western states, as well as new programs which included a general agent that focuses on the food service industry and a general agent who focuses on heterogeneous workers compensation in the Southeast region of the United States. For 2009, our workers compensation rates were down approximately 2.5%, which was primarily due to declines in mandated rate levels in select states.

Prior to 2008, we had a shift in our mix of business, which was intended to diversify our product line and produce more predictable and stable results. We had a decline in workers compensation premium from 2005 primarily because we exited a limited number of small programs that were no longer meeting our underwriting standards. Also, we experienced an overall reduction in audit-related premiums, and a decline in the amount of residual market assignments we receive relative to workers compensation premiums. The residual market assignments are in essence a form of a tax whereby any workers compensation risk that cannot be written in the voluntary market is assigned to carriers underwriting workers compensation business in that state. In addition, workers compensation declined over the past few years due to a reduction in premium writings because of competition and past mandatory rate deceases, specifically in Florida, Massachusetts and Nevada.

The Merger with ProCentury contributed to the overall diversification of our business mix. Specifically within our other liability line of business which accounted for 25% and 26% in 2009 and 2008, respectively, compared to less than 10% in the prior years, as noted above. The majority of our other liability line of business is primarily related to shorter tail classes of business, such as habitational risks of hotels, motels and apartments, and mercantile operations. The majority of our primary liability insurance policies have limits between $500,000 and $1.0 million.

Additionally, prior to the Merger we had relatively low property related premium and exposure to property perils. Historically, approximately 35% of ProCentury s production was property related. Property classes include fire and allied lines, non-liability portions of commercial multi-peril, and inland and ocean marine. Our property business has an inherently short tail, but has exposure to catastrophe perils. The majority of the property business has limits of less than $2.0 million. Through the use of treaty, automatic facultative and certificate facultative reinsurance, we retain the first $1.0 million of each risk up to $4.0 million for any one loss occurrence. We attempt to minimize catastrophic risk through reinsurance and geographic diversification. We write a limited amount of property coverage for the peril of wind on fixed properties in Florida, counties along the Gulf of Mexico and in states along the eastern seaboard.

Overall, we had growth in new business from programs implemented in 2008 and 2009. The increase in premium volume in lines other than workers compensation has been driven by new programs we have implemented with both existing and new program agents, all of which have a history of profitability and for which we believe we are receiving adequate pricing to produce our targeted return on equity. Rates in other lines of business declined by only less than 1% and our excess and surplus lines rates were down by approximately 4%. While the market for excess and surplus lines remained competitive in 2009, our Century operations traditional business production was only down slightly.

A.M. Best Company (A.M. Best), which rates insurance companies based on factors of concern to policyholders, maintains a letter scale rating system ranging from A++ (Superior) to F (In Liquidation). In evaluating a company s financial and operating performance, A.M. Best reviews the company s profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its loss and loss expense reserves, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. A.M. Best ratings are directed toward the concerns of policyholders and insurance agencies and are not intended for the protection of investors or as a recommendation to buy, hold or sell securities. Currently our financial strength rating by A.M. Best for our Insurance Company Subsidiaries is an A− (Excellent) rating.

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Reserves

The following table shows the development of reserves for unpaid losses and loss adjustment expenses (LAE) from 2000 through 2009 for our Insurance Company Subsidiaries, and the deconsolidation impact of American Indemnity. Development on the ProCentury acquired reserves is not included for the years prior to 2008, which was the year of the Merger. The lower portion of the table reflects the impact of reinsurance for the years 2000 through 2009, reconciling the net reserves shown in the upper portion of the table to gross reserves.

Additional information relating to our reserves is included within the *Losses and Loss Adjustment Expenses and Reinsurance Recoverables* section of Note 1 *Summary of Significant Accounting Policies* and Note 5 *Liability for Losses and Loss Adjustment Expenses* of the Notes to the Consolidated Financial Statements, as well as to the *Critical Accounting Policies* section and the *Reserves* section of Item 7, *Management s Discussion and Analysis*.

Analysis of Loss and Loss Adjustment Expense Development (1)

				Years Ended December 31,				
2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**200**
				(In thousands)				
$ 172,862	$ 198,653	$ 193,116	$ 192,019	$ 226,996	$ 271,423	$ 302,655	$ 341,541	$ 625,
(3,744)	(5,572)	(2,973)	(2,989)					
$ 169,118	$ 193,081	$ 190,143	$ 189,030	$ 226,996	$ 271,423	$ 302,655	$ 341,541	$ 625,
70,952	77,038	78,023	71,427	79,056	83,271	81,779	95,393	173,
115,669	130,816	122,180	118,729	124,685	133,809	140,308	155,745	
146,548	157,663	151,720	145,279	153,780	170,226	207,227		
160,673	176,172	167,288	159,220	171,946	210,110			
171,992	186,847	174,778	169,980	195,328				
179,010	191,936	180,489	184,663					
182,954	196,486	190,133						
186,198	204,386							
192,782								
182,976	199,171	193,532	193,559	231,880	268,704	295,563	330,416	596,
186,191	205,017	196,448	203,394	227,462	263,069	286,647	327,862	
189,632	207,379	202,126	205,650	226,437	261,319	283,583		
190,305	211,394	203,738	202,748	226,492	260,373			

196,158	213,802	202,028	202,716	229,746				
199,520	212,274	201,786	203,727					
198,500	212,292	201,355						
198,670	211,550							
198,481								
$ (29,363)	**$ (18,469)**	**$ (11,212)**	**$ (14,697)**	**$ (2,750)**	**$ 11,050**	**$ 19,072**	**$ 13,679**	**$ 28,**
17.4%	9.6%	5.9%	7.8%	1.2%	**4.1%**	**6.3%**	**4.0%**	
169,118	**193,081**	**190,143**	**189,030**	**226,996**	**271,423**	**302,655**	**341,541**	**625,**
168,962	195,943	181,817	147,446	151,161	187,254	198,422	198,461	260,
338,080	389,024	371,960	336,476	378,157	458,677	501,077	540,002	885,
198,481	**211,550**	**201,355**	**203,727**	**229,746**	**260,373**	**283,583**	**327,862**	**596,**
262,111	287,474	257,730	246,445	206,281	210,880	207,605	208,825	256,
460,592	499,024	459,085	450,172	436,027	471,253	491,188	536,687	853,
$ (122,512)	$ (110,000)	$ (87,125)	$ (113,696)	$ (57,870)	$ (12,576)	$ 9,889	$ 3,315	$ 32,

(1) We performed an evaluation of our business relationships and determined our wholly owned subsidiary, American Indemnity, did not meet the tests for consolidation, as neither us, nor our subsidiary Star, are the primary beneficiaries of American Indemnity. Therefore,

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effective January 1, 2004, we deconsolidated American Indemnity on a prospective basis in accordance with related accounting guidance. Accordingly, we adjusted the reserves and development within the above table.

The following table sets forth the difference between generally accepted accounting principles (GAAP) reserves for loss and loss adjustment expenses and statutory reserves for loss and loss adjustment expenses at December 31 (in thousands):

	2009	2008
GAAP reserves for losses and LAE	$ 949,177	$ 885,697
Reinsurance recoverables for unpaid losses	(266,801)	(260,366)
Allowances against reinsurance recoverables*		(481)
Statutory reserves for losses and LAE	$ 682,376	$ 624,850

* The GAAP allowance for reinsurance recoverables is reported as a Schedule F penalty or a non-admitted asset for the purpose of statutory accounting.

For the year ended December 31, 2009, we reported a decrease of $32.2 million in gross ultimate loss estimates for accident years 2008 and prior, or 3.6% of $885.7 million of gross loss and LAE reserves at January 1, 2009. We reported a $28.7 million decrease in net ultimate loss and LAE estimates for accident years 2008 and prior, or 4.6% of $625.3 million of net loss and LAE reserves at January 1, 2009.

For the year ended December 31, 2008, we reported a decrease of $103,000 in gross ultimate loss estimates for accident years 2007 and prior, or 0.02% of $540.0 million of gross losses and LAE reserves at January 1, 2008. The gross development excludes development on ProCentury reserves acquired on August 1, 2008. We reported an $11.1 million decrease in net ultimate loss and LAE estimates for accident years 2007 and prior, or 3.3% of $341.5 million of Meadowbrook only net loss and LAE reserves at January 1, 2008, because the table reflects reserves as of January 1, 2008, which was pre-Merger. The ProCentury acquired reserves of $247.7 million had prior year favorable development of $5.7 million. Thus, total net development on prior accident year reserves is $16.8 million.

Reinsurance

Information relating to our reinsurance structure and treaty information is included within Note 6 *Reinsurance* of the Notes to the Consolidated Financial Statements.

Investments

Information relating to our investment portfolio is included within Note 3 *Investments* of the Notes to the Consolidated Financial Statements and the *Investments* section of Item 7, *Management s Discussion and Analysis*, as well as Item 7A *Quantitative and Qualitative Disclosures about Market Risk.*

Competition and Pricing

We compete with other providers of specialty insurance programs, products, and risk management services, as well as, with traditional providers of commercial insurance. Both the specialty program segment and the traditional property and casualty insurance markets are highly competitive. Our specialty programs, products and services compete with products and services offered by insurance companies, other providers of insurance services (including domestic and foreign insurers and reinsurers and insurance agents), as well as with self-insurance plans, captives managed by others, and a variety of other risk-financing vehicles and mechanisms. These competitive products are offered by other companies that may have greater financial resources than we do. Our agency operations compete with other local, regional, and national insurance agencies for individual client insurance needs.

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The market for specialty insurance programs, products and services is significantly influenced by market conditions affecting the traditional property and casualty insurance industry. Insurance market conditions historically have been subject to significant variability due to premium rate competition, natural disasters and other catastrophic events, judicial trends, changes in the investment and interest rate environment, regulation, general economic conditions, and unemployment rates. Pricing is a primary means of competition in the commercial insurance market. Competition is also based on the availability and quality of products, quality and speed of service (including claims service), financial strength, ratings, distribution systems and technical expertise. The primary basis for competition among risk management providers varies with the financial and insurance needs and resources of each potential insured. Principal factors that are considered by insureds include an analysis of the net present-value (after-tax) of the cost of financing the insured s expected level of losses; the amount of excess coverage provided in the event losses exceed expected levels; cash flow and tax planning considerations; and the expected quality and consistency of the services to be provided. We believe that we are able to compete based on our experience, the quality of our products and services, our processing technology platforms, and our program-oriented approach. However, our ability to successfully compete is dependent upon a number of factors, including market and competitive conditions, many of which are outside of our control.

Regulation

Insurance Company Regulation

Our Insurance Company Subsidiaries are subject to regulation in the states where they conduct business. State insurance regulations generally are designed to protect the interests of policyholders, state insurance consumers or claimants rather than shareholders or other investors. The nature and extent of such state regulation varies by jurisdiction, but generally involves:

- prior approval of the acquisition of control of an insurance company or of any company controlling an insurance company;
- regulation of certain transactions entered into by an insurance company with any of its affiliates;
- approval of premium rates, forms and policies used for many lines of insurance;
- standards of solvency and minimum amounts of capital and surplus that must be maintained;
- establishment of reserves required to be maintained for unearned premium, loss and loss adjustment expense, or for other purposes;
- limitations on types and amounts of investments;
- underwriting and claims settlement practices;
- restrictions on the size of risks that may be insured by a single company;
- licensing of insurers and agents;
- deposits of securities for the benefit of policyholders; and

the filing of periodic reports with respect to financial condition and other matters.

In addition, state regulatory examiners perform periodic examinations of insurance companies. The results of these examinations can give rise to regulatory orders requiring remedial, injunctive or other corrective action.

Insurance Holding Company Regulation

We operate as an insurance holding company system and are subject to regulation in the jurisdictions in which we conduct business. These regulations require that each insurance company in the system register with the insurance department of its state of domicile and furnish information concerning the operations of companies within the holding company system that may materially affect the operations, management or financial condition of the insurers within the system domiciled in that state. The insurance laws similarly provide that all transactions among members of a holding company system must be fair and reasonable. Transactions between insurance subsidiaries and their parents and affiliates generally must be disclosed to the state regulators, and prior approval of the applicable state insurance regulator generally is required for any material or extraordinary transaction. In addition, a change of control of a domestic insurer or of any controlling person requires the prior approval of the state insurance regulator. Generally, any person who acquires ten percent or more of the outstanding voting securities of the insurer or its parent company is presumed to have acquired control of the domestic insurer.

Various State and Federal Regulation

Insurance companies are also affected by a variety of state and federal legislative and regulatory measures and judicial decisions that define and extend the risks and benefits for which insurance is sought and provided. These include redefinition of risk exposure in areas such as product liability, environmental damage, and workers compensation. In addition, individual state insurance departments may prevent premium rates for some classes of insureds from reflecting the level of risk assumed by the insurer for those classes. Such developments may adversely affect the profitability of various lines of insurance. In some cases, these adverse effects on profitability can be minimized through repricing, if permitted by applicable regulations, of coverages or limitations or cessation of the affected business.

Reinsurance Intermediary

Our reinsurance intermediary is also subject to regulation. Under applicable regulations, the intermediary is responsible, as a fiduciary, for funds received on account of the parties to the reinsurance transaction and is required to hold such funds in appropriate bank accounts subject to restrictions on withdrawals and prohibitions on commingling.

Licensing and Agency Contracts

We, or certain of our designated employees, must be licensed to act as agents by state regulatory authorities in the states in which we conduct business. Regulations and licensing laws vary in individual states and are often complex.

Insurance licenses are issued by state insurance regulators upon application and may be of perpetual duration or may require periodic renewal. We must apply for and obtain appropriate new licenses before we can expand into a new state on an admitted basis or offer new lines of insurance that require separate or additional licensing.

Insurers operating on an admitted basis must file premium rate schedules and policy or coverage forms for review and approval by the insurance regulators. In many states, rates and policy forms must be approved prior to use, and insurance regulators have broad discretion in judging whether an insurer s rates are adequate, not excessive and not unfairly discriminatory.

The applicable licensing laws and regulations in all states are subject to amendment or reinterpretation by state regulatory authorities, and such authorities are vested in most cases with relatively broad discretion as to the granting, revocation, suspension and renewal of licenses. The possibility exists that we, or our employees, could be excluded, or temporarily suspended, from continuing with some or all of our activities in, or otherwise subjected to penalties by, a particular state.

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Insurance Regulation Concerning Change or Acquisition of Control

Star, Williamsburg, and Ameritrust are domestic property and casualty insurance companies organized under the insurance laws (the Insurance Codes) of Michigan, while Savers, Century, PIC, and Propic are organized under the Insurance Codes of Missouri, Ohio, Texas, and Washington D.C., respectively. The Insurance Codes provide that acquisition or change of control of a domestic insurer or of any person that controls a domestic insurer cannot be consummated without the prior approval of the relevant insurance regulatory authority. A person seeking to acquire control, directly or indirectly, of a domestic insurance company or of any person controlling a domestic insurance company must generally file with the relevant insurance regulatory authority an application for change of control (commonly known as a Form A) containing information required by statute and published regulations and provide a copy of such Form A to the domestic insurer. In Michigan and Missouri, control is generally presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote or holds proxies representing ten percent or more of the voting securities of the company.

In addition, many state insurance regulatory laws contain provisions that require pre-notification to state agencies of a change in control of a non-domestic admitted insurance company in that state. While such pre-notification statutes do not authorize the state agency to disapprove the change of control, such statutes do authorize issuance of a cease and desist order with respect to the non-domestic admitted insurer if certain conditions exist, such as undue market concentration.

Any future transactions that would constitute a change in control would also generally require prior approval by the Insurance Departments of Michigan, Missouri, Ohio, Texas, and Washington D.C. and would require pre-acquisition notification in those states that have adopted pre-acquisition notification provisions and in which the insurers are admitted. Such requirements may deter, delay or prevent certain transactions that could be advantageous to our shareholders.

Membership in Insolvency Funds and Associations and Mandatory Pools

Most states require admitted property and casualty insurers to become members of insolvency funds or associations, which generally protect policyholders against the insolvency of such insurers. Members of the fund or association must contribute to the payment of certain claims made against insolvent insurers. Maximum contributions required by law in any one year vary between 1% and 2% of annual premium written by a member in that state. For 2009, 2008, and 2007, assessments from insolvency funds were $491,000, $196,000, and $156,000, respectively. Most of these payments are recoverable through future policy surcharges and premium tax reductions. Except for New Jersey, business written on a surplus lines basis is not subject to state guaranty fund assessments.

Our Insurance Company Subsidiaries are also required to participate in various mandatory insurance facilities or in funding mandatory pools, which are generally designed to provide insurance coverage for consumers who are unable to obtain insurance in the voluntary insurance market. Among the pools participated in are those established in certain states to provide windstorm and other similar types of property coverage. These pools typically require all companies writing applicable lines of insurance in the state for which the pool has been established to fund deficiencies experienced by the pool based upon each company s relative premium writings in that state, with any excess funding typically distributed to the participating companies on the same basis. To the extent that reinsurance treaties do not cover these assessments, they may adversely affect us. For 2009, 2008, and 2007, total assessments paid to all such facilities were $2.7 million, $2.4 million, and $2.6 million, respectively.

Restrictions on Dividends and Risk-Based Capital

For information on Restrictions on Dividends and Risk-based Capital which affect us please refer to Note 10 *Regulatory Matters and Rating Issues* of the Notes to the Consolidated Financial Statements and the *Regulatory and Rating Issues* section within Item 7, *Management s Discussion and Analysis*.

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NAIC-IRIS Ratios

The National Association of Insurance Commissioners (NAIC) Insurance Regulatory Information System (IRIS) was developed by a committee of state insurance regulators and is primarily intended to assist state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies operating in their respective states. IRIS identifies thirteen industry ratios and specifies usual values for each ratio. Departure from the usual values on four or more ratios generally leads to inquiries or possible further review from individual state insurance commissioners. Refer to the *Regulatory and Rating Issues* section of Item 7, *Management s Discussion and Analysis*.

Effect of Federal Legislation

The Terrorism Risk Insurance Act of 2002 (TRIA) established a program under which the United States federal government will provide governmental support for businesses that suffer damages from certain acts of international terrorism. In 2007, TRIA was extended through December 31, 2014. The terms of the legislation enacted now also include domestic terrorist acts. TRIA serves as an additional high layer of reinsurance against losses that may arise from a terrorist incident. The impact to us resulting from TRIA is minimal as we generally do not underwrite risks that are considered targets for terrorism, avoid concentration of exposures in both property and workers compensation, and have terrorism coverage included in our reinsurance treaties to cover the most likely exposure.

Update on SEC Investigation

On April 2, 2008, the United States Securities and Exchange Commission (SEC) requested that ProCentury voluntarily provide information relating to its construction defect reserves for the fiscal years 2003 through 2006. ProCentury produced information and related documents in response to this request and follow-up requests, as well as executed tolling agreements. On August 10, 2009, the SEC notified in writing the Company, Century and certain of Century s current and former officers that it had completed its investigation and that it did not intend to recommend the filing of any enforcement action.

Available Information

Our Internet address is www.meadowbrook.com. There we make available, free of charge, our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Statements of Beneficial Ownership (Forms 3, 4, and 5), and any amendments to those reports, as soon as reasonably practicable after we electronically file such material with, or furnish to, the SEC. You may read and copy materials we file with the SEC at the SEC s Public Reference Room at 100 F Street, N.E., Washington D.C., 20549. You may obtain information about the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site that contains reports, proxy statements, and other information that we file at www.sec.gov. Our SEC reports can also be accessed through the investor relations section of our website. The information found on our website is not part of this or any other report we file with, or furnished to the SEC. The Charters of the Nominating and Governance Committee, the Compensation Committee, the Audit Committee, the Finance Committee, and the Investment Committee of our Board of Directors are also available on our website, or available in print to any shareholder who requests this information. In addition, our Corporate Governance documents, Code of Conduct, and our Business Conduct Policy are available on our website, or in print to any shareholder who requests this information.

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ITEM 1A. ***RISK FACTORS***

If our estimates of reserves for losses and loss adjustment expenses are not adequate, we will have to increase our reserves, which would result in reductions in net income, retained earnings, statutory surplus, liquidity, and may limit our ability to pay future dividends and service debt.

We establish reserves for losses and expenses related to the adjustment of losses for the insurance policies we write. In many cases, several years may elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of the loss. We determine the amount of these reserves based on our best estimate and judgment of the losses and costs we will incur on existing insurance policies. While we believe our reserves are adequate, we base these reserves on assumptions about past and future events. The following factors could have a substantial impact on our future loss experience:

- the amounts of claims settlements and awards;
- claims development patterns;
- legislative and judicial activity;
- changes in inflation and economic conditions; and
- the accuracy and timely reporting of claim information.

Actual losses and the costs we incur related to the adjustment of losses under insurance policies could exceed, perhaps substantially, the amount of reserves we establish. When we increase reserves, our pre-tax income for the period will decrease by a corresponding amount. An increase in reserves may also require us to write off a portion of our deferred acquisition costs asset, which would cause a further reduction of pre-tax income in that period.

If our financial strength ratings are reduced, we may be adversely impacted.

Insurance companies are subject to financial strength ratings produced by external rating agencies. Higher ratings generally indicate greater financial stability and a stronger ability to pay claims. Ratings are assigned by rating agencies to insurers based upon factors they believe are important to policyholders. Ratings are not recommendations to buy, hold, or sell our securities.

Our ability to write business is most influenced by our rating from A.M. Best. A.M. Best ratings are designed to assess an insurer s financial strength and ability to meet continuing obligations to policyholders. Currently, our financial strength rating from A.M. Best is A− (Excellent) for our Insurance Company Subsidiaries. There can be no assurance that A.M. Best will not change this rating in the future. A rating downgrade from A.M. Best could materially adversely affect the business we write and our results of operations.

If market conditions cause our reinsurance to be more costly or unavailable, we may be required to bear increased risks or reduce the level of our underwriting commitments.

As part of our overall risk and capacity management strategy, we purchase reinsurance for significant amounts of risk underwritten by our Insurance Company Subsidiaries, especially for the excess-of-loss and severity risks. Market conditions beyond our control determine the availability and cost of the reinsurance we purchase, which may affect the level of our business and profitability. Our reinsurance facilities are generally subject to annual renewal. We may be unable to maintain our current reinsurance facilities or to obtain other reinsurance in adequate amounts and at favorable rates. Increases in the cost of reinsurance would adversely affect our profitability. In addition, if we are unable to renew our expiring facilities or to obtain new reinsurance on favorable terms, either our net exposure to risk would increase or, if we are unwilling to bear an increase in net risk exposures, we would have to reduce the amount of risk we underwrite.

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The current economic downturn and continuing volatility in the financial market could materially and adversely affect our business.

In 2008 and 2009, the capital and credit markets experienced unprecedented volatility. While economic conditions have recently improved, this trend may not continue and therefore, there can be no assurance that we will not experience an adverse effect, which may have a material impact on our overall financial condition and results of operations.

We are subject to credit risk with respect to the obligations of our reinsurers and risk-sharing partners. The inability of our reinsurers or risk-sharing partners to meet their obligations could adversely affect our profitability.

We purchase reinsurance by transferring part of the risk we have assumed (known as ceding) to a reinsurance company in exchange for part of the premium we receive in connection with the risk under pro rata and excess-of-loss contracts. These reinsurance arrangements diversify our business and reduce our exposure to large losses or from hazards of an unusual nature. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred, the ceding of insurance does not discharge us of our primary liability to our policyholder. If all or any of the reinsuring companies fail to pay or pay on a timely basis, we would be liable for such defaulted amounts. Therefore, we are subject to credit risk with respect to the obligations of our reinsurers. If our reinsurers fail to pay us or fail to pay on a timely basis, our financial results and financial condition could be adversely affected. In order to minimize our exposure to significant losses from reinsurer insolvencies, we evaluate the financial condition of our reinsurers and monitor the economic characteristics of the reinsurers on an ongoing basis and, if appropriate, we may require trust agreements to collateralize the reinsurers financial obligation to us.

In addition, with our risk-sharing programs, we are subject to credit risk with respect to the payment of claims by our clients captive, rent-a-captive, large deductible programs and indemnification agreements, as well as on the portion of risk either ceded to captives or retained by our clients. The capitalization and creditworthiness of prospective risk-sharing partners is one of the factors we consider upon entering into and renewing risk-sharing programs. Generally, we collateralize balances due from our risk-sharing partners through funds withheld trusts or stand-by letters of credit issued by highly rated banks. No assurance can be given regarding the future ability of any of our risk-sharing partners to meet their obligations. The inability of our risk-sharing partners to meet their obligations could adversely affect our profitability.

Severe weather conditions and other catastrophes may result in an increase in the number and amount of claims incurred.

The majority of our property business is exposed to the risk of severe weather conditions and other catastrophes. Catastrophes can be caused by various events, including natural events, such as hurricanes, winter weather, tornadoes, windstorms, earthquakes, hailstorms, severe thunderstorms and fires, and other events, such as explosions, terrorist attacks and riots. The incidence and severity of catastrophes and severe weather conditions are inherently unpredictable. Severe weather conditions and catastrophes can cause losses in the lines of business acquired with the Merger. Generally these losses result in an increase in the number of claims incurred as well as the amount of compensation sought by claimants. In 2008, we recorded $5.4 million of net after tax losses related to catastrophe losses. In 2009, we did not have any catastrophic related losses. Currently, we purchase catastrophe reinsurance to cover for a potential catastrophe. However, it is possible that a catastrophic event or multiple catastrophic events could cause our loss and loss adjustment expense reserves to increase and our liquidity and financial condition to decline. Refer to Note 6 *Reinsurance* for a detailed description of our reinsurance treaties and structure.

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We face competitive pressures in our business that could cause our revenues to decline and adversely affect our profitability.

We compete with a large number of other companies in our selected lines of business. We compete, and will continue to compete, with major United States, foreign and other regional insurers, as well as mutual companies, specialty insurance companies, underwriting agencies and diversified financial services companies. Many of our competitors have greater financial and marketing resources than we do. Our profitability could be adversely affected if we lose business or any of our agents to competitors offering similar or better products at or below our prices.

A number of new, proposed or potential legislative or industry developments could further increase competition in our industry. These developments include:

the formation of new insurers and an influx of new capital in the marketplace as existing companies attempt to expand their business as a result of better pricing and/or terms;

programs in which state-sponsored entities provide property insurance in catastrophe-prone areas, other alternative market types of coverage; or other non-property insurance and

changing practices created by the Internet, which has increased competition within the insurance business.

These developments could make the property and casualty insurance marketplace more competitive by increasing the supply of insurance capacity. In that event, the current market softens further, and it may negatively influence our ability to maintain or increase rates. Accordingly, these developments could have an adverse effect on our business, financial condition and results of operations.

Our results may fluctuate as a result of many factors, including cyclical changes in the insurance industry.

The results of companies in the property and casualty insurance industry historically have been subject to significant fluctuations and uncertainties. Our industry s profitability can be affected by:

rising levels of actual costs that are not known by companies at the time they price their products;

volatile and unpredictable developments, including man-made, weather-related and other natural catastrophes or terrorist attacks;

changes in loss reserves resulting from the general claims and legal environments as different types of claims arise and judicial interpretations relating to the scope of insurer s liability develop;

fluctuations in interest rates, inflationary pressures and other changes in the investment environment, which affect returns on invested assets and may impact the ultimate payout of losses; and

an increase in medical costs beyond historic or expected annual inflationary levels.

The demand for property and casualty insurance can also vary significantly, rising as the overall level of economic activity increases and falling as that activity decreases. The property and casualty insurance industry historically is cyclical in nature, with periods of reduced underwriting capacity and favorable premium rates alternating with periods of excess underwriting capacity and flat or falling premium rates. These fluctuations in demand and supply could produce underwriting results that would have a negative impact on our financial condition and results of operations.

Our geographic concentration ties our performance to the business, economic, natural perils, man made perils, and regulatory conditions within our concentrated regions.

One of our predominate lines of business is workers compensation (30.4% of net earned premiums in 2009), which is concentrated in California (35.7% of 2009 workers compensation net earned premiums) and

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New England (13.9% of 2009 workers compensation net earned premiums). Accordingly, unfavorable business, economic or regulatory conditions in these states could negatively impact our business. In addition, California and some of the New England states are exposed to climate and environmental changes, natural perils such as earthquakes, water supplies, and the possibility of pandemics or terrorist acts. Accordingly, we could suffer losses as a result of catastrophic events in these states. In addition, general economic conditions affecting these regions could have an adverse effect on the business we write within these states. Because our business is concentrated in this manner, we may be exposed to economic and regulatory risks or risk from natural perils that are greater than the risks associated with greater geographic diversification. Refer to Note 6 *Reinsurance* for further information regarding our reinsurance structure related to workers compensation business.

Our success depends on our ability to appropriately price the risks we underwrite.

Our financial results depend on our ability to underwrite and collect adequate premium rates for a wide variety of risks. Rate adequacy is necessary to generate sufficient premiums to pay losses, loss expenses and underwriting expenses and to earn a profit. In order to price our products accurately, we must collect and properly analyze a substantial amount of data, develop, test and apply appropriate rating formulas, closely monitor and timely recognize changes in trends and project both severity and frequency of losses with reasonable accuracy. Our ability to undertake these efforts successfully and price our products accurately is subject to a number of risks and uncertainties, some of which are outside our control. These uncertainties include:

- the availability of sufficient reliable data and our ability to properly analyze available data;
- the uncertainties that inherently characterize estimates and assumptions;
- the selection and application of appropriate rating and pricing techniques;
- any changes in legal standards, claim settlement practices, medical care expenses and restoration costs;
- changes in mandated rates or benefits set by the state regulators; and
- legislative actions.

Consequently, we could underprice risks, which would negatively affect our profit margins, or we could overprice risks, which could reduce our sales volume and competitiveness. In either event, our profitability could be materially and adversely affected.

The failure of any of the loss limitation methods we employ could have a material adverse effect on our results of operations and financial condition.

We seek to limit our loss exposure by writing a number of our insurance and reinsurance contracts on an excess-of-loss basis. Excess-of-loss insurance and reinsurance indemnifies the insured against losses in excess of a specified amount. In addition, we limit program size for each client and purchase third-party reinsurance for our own account. In the case of our assumed proportional reinsurance treaties, we seek per occurrence limitations or loss and loss adjustment expense ratio caps to limit the impact of losses ceded by the client. In proportional reinsurance, the reinsurer shares a proportional part of the premiums and losses of the reinsured. We also seek to limit our loss exposure by geographic diversification. Various provisions of our policies, such as limitations or exclusions from coverage or choice of forum negotiated to limit our risks, may not be enforceable in the manner we intend. As a result, one or more catastrophic or other events could result in claims that substantially exceed our expectations, which could have an adverse effect on our results of operations or financial condition. Likewise, for catastrophe events and for per risk events we buy a limited amount of reinsurance coverage that we believe is adequate to reimburse for our large losses with a very high degree of probability, should the unlikely event occur that exceeds our reinsurance coverage then the amounts in excess of our reinsurance coverage could adversely impact our financial condition or results of operations.

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Our investment results and, therefore, our financial condition may be impacted by changes in the business, financial condition or operating results of the entities in which we invest, as well as changes in government monetary policies, general economic conditions and overall capital market conditions, all of which impact interest rates.

Our results of operations depend, in part, on the performance of our investments. Interest rates are highly sensitive to many factors, including governmental monetary policies and domestic and international economic and political conditions. Fluctuations in interest rates affect our returns on and the fair value of our fixed-maturity and equity securities. In addition, market volatility can make it difficult to value certain of our securities if trading becomes less frequent. Interest rates in the United States are currently at historical lows. Increases in interest rates may reduce the fair value of our investments in available for sale fixed-maturity and equity securities. In addition, defaults by third parties who fail to pay or perform obligations could reduce our investment income and could result in further investment losses in our portfolio.

Our fixed-maturity and equity investments are subject to:

- credit risk, which is the risk that our investments will decrease in value due to unfavorable changes in the financial prospects or a downgrade in the credit rating of an entity in which we have invested;

- equity price risk, which is the risk that we will incur economic loss due to a decline in common or preferred stock or bond mutual fund share prices; and

- interest rate risk, which is the risk that our investments may decrease in value due to increases in interest rates.

Our fixed-maturity investment portfolio includes mortgage-backed and other asset-backed securities. As with other fixed-maturity investments, the fair value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose us to prepayment risks on these investments. When interest rates fall, mortgage-backed securities are prepaid more quickly than expected and the holder must reinvest the proceeds at lower interest rates. Our mortgage-backed securities currently consist of securities with features that reduce the risk of prepayment, but there is no guarantee that we will not invest in other mortgage-backed securities that lack this protection. In periods of increasing interest rates, mortgage-backed securities are prepaid more slowly, which may require us to receive interest payments that are below the prevailing interest rates for longer than expected.

Our investment portfolio also includes equity securities. These investments are in preferred and common stocks of individual companies, which are subject to economic loss from the decline in preferred and common share prices. As a result, the fair value of these investments will be determined by the specific financial prospects of these individual companies, as well as the equity markets in general.

As of the result of the risks described above, the value of our investment portfolio could decrease, we could experience reduced net investment income, and we could incur realized investment losses, which could adversely affect our results of operations, financial condition, cash flows, and liquidity.

We could be forced to sell investments to meet our liquidity requirements.

We believe we maintain adequate amounts of cash and short-term investments to pay claims, and do not expect to have to sell securities prematurely for such purposes. We may, however, decide to sell securities as a result of changes in interest rates, credit quality, the rate or repayment or other similar factors. A significant increase in market interest rates could result in a situation in which we are required to sell securities at depressed prices to fund claims payments. Since the securities within our investment portfolio are carried at fair value, we expect these securities would be sold with no material impact on our net equity, although it could result in net realized losses. If these securities are sold, future net investment income may be reduced if we are unable to reinvest in securities with similar yields.

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If our businesses do not perform well, we may be required to recognize an impairment of our goodwill, which could have a material adverse effect on our results of operations and financial condition.

Goodwill represents the excess of the amounts we paid to acquire subsidiaries and other businesses over the fair value of their net assets at the date of acquisition. We evaluate existing goodwill for impairment on an annual basis as of October 1st, or more frequently if events or changes in circumstances indicate that the asset might be impaired. Goodwill impairment is performed at the reporting unit level. To test goodwill for impairment, we are required to estimate the fair value of each reporting unit. Since quoted market prices in an active market are not available for our reporting units, other valuation techniques are used. We have developed a model to estimate the fair value of our reporting units utilizing a discounted cash flow valuation technique (DCF model). A DCF model is selected to be comparable to what would be used by market participants to estimate fair value. The impairment test incorporates estimates of future cash flows; allocations of certain assets, liabilities and cash flows among reporting units; future growth rates; terminal value amounts; and the applicable weighted-average cost of capital used to discount those estimated cash flows. These estimates are based on our judgment. If it is determined that the goodwill has been impaired, we would be required to write down the goodwill by the amount of the impairment, with a corresponding charge to net income. Such impairments could have a material adverse effect on our results of operations or financial position.

Acquisitions and integration of acquired businesses may result in operating difficulties, which may prevent us from achieving the expected benefits.

At times, we may investigate and pursue acquisition opportunities if we believe such opportunities are consistent with our long-term objectives and that the expected benefits exceed the risks. Achieving such benefits is subject to a number of uncertainties, including whether the combined businesses are integrated in an efficient and effective manner, as well as general competitive factors in the marketplace. We conduct due diligence, however, the process of integrating an acquired company or business can potentially be complex and costly. Sometimes we can be confronted with unexpected issues that may present significant risks, which could materially impact our business, financial condition, results of operations, and cash flows. In addition, we could potentially pay more for an acquisition than its actual worth, which could materially impact our financial condition, results of operations, and cash flows.

Because we are heavily regulated by the states in which we operate, we may be limited in the way we operate.

We are subject to extensive supervision and regulation in the states in which we operate. The supervision and regulation relate to numerous aspects of our business and financial condition. The primary purpose of the supervision and regulation is to maintain compliance with insurance regulations and to protect policyholders and not our shareholders. The extent of regulation varies, but generally is governed by state statutes. These statutes delegate regulatory, supervisory and administrative authority to state insurance departments. This system of regulation covers, among other things:

- standards of solvency, including risk-based capital measurements;
- restrictions on the nature, quality and concentration of investments;
- restrictions on the types of terms that we can include in the insurance policies we offer;
- required methods of accounting;

required reserves for unearned premiums, losses and other purposes;

permissible underwriting and claims settlement practices; and

assessments for the provision of funds necessary for the settlement of covered claims under certain insurance policies provided by impaired, insolvent or failed insurance companies.

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The regulations of the state insurance departments may affect the cost or demand for our products and may impede us from obtaining rate increases or taking other actions we might wish to take to increase our profitability. Furthermore, we may be unable to maintain all required licenses and approvals and our business may not fully comply with the wide variety of applicable laws and regulations or the relevant authority s interpretation of the laws and regulations. Also, regulatory authorities have relatively broad discretion to grant, renew or revoke licenses and approvals. If we do not have the requisite licenses and approvals or do not comply with applicable regulatory requirements, the insurance regulatory authorities could stop or temporarily suspend us from conducting some or all of our activities or monetarily penalize us.

Although the United States federal government does not directly regulate the insurance business, changes in federal legislation, regulation, and / or administrative policies in several areas, including changes in financial services regulation (e.g.; the repeal of the McCarran-Ferguson Act) and federal taxation, can significantly harm the insurance industry.

Litigation may have an adverse effect on our business

We 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, we vigorously defend 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 the policy at issue, errors and omissions insurance or other appropriate insurance. In terms of deductibles associated with such insurance, we have established provisions against these items, which are believed to be adequate in light of current information and legal advice. With the assistance of outside counsel, we adjust such provisions according to new developments or changes in the strategy in dealing with such matters. On the basis of current information, we do not expect the outcome of the claims, lawsuits and proceedings to which we are subject to, either individually, or in the aggregate, will have a material adverse effect on our 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.

Our reliance on producers subjects us to their credit risk.

With respect to our agency billed premiums generated by our Insurance Company Subsidiaries, producers collect premiums from the policyholders and forward them to us. In certain jurisdictions, when the insured pays premium for these policies to producers for payment, the premium might be considered to have been paid under applicable insurance laws and the insured will no longer be liable to us for those amounts, whether or not we have actually received the premium from the producer. Consequently, we assume a degree of credit risk associated with producers. Although producers failures to remit premiums to us have not caused a material adverse impact on us to date, there may be instances where producers collect premium but do not remit it to us and we may be required under applicable law to provide the coverage set forth in the policy despite the actual lack of collection of the premium by us. Current economic conditions arising since 2008 have increased the risk of agent insolvency. Because the possibility of these events is dependent in large part upon the financial condition and internal operations of our producers, we may not be able to quantify any potential exposure presented by the risk. If we are unable to collect premium from our producers in the future, our financial condition and results of operations could be materially and adversely affected.

Provisions of the Michigan Business Corporation Act, our articles of incorporation and other corporate governing documents and the insurance laws of Michigan and Missouri may discourage takeover attempts.

The Michigan Business Corporation Act contains anti-takeover provisions. Chapter 7A (the Fair Price Act) of the Business Corporation Act applies to us and may have an anti-takeover effect and may delay, defer

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or prevent a tender offer or takeover attempt that a shareholder might consider in their best interest, including those attempts that might result in shareholders receiving a premium over market price for their shares.

The Fair Price Act provides that a supermajority vote of ninety percent of the shareholders and no less than two-thirds of the votes of non interested shareholders must approve a business combination. The Fair Price Act defines a business combination to encompass any merger, consolidation, share exchange, sale of assets, stock issue, liquidation, or reclassification of securities involving an interested shareholder or certain affiliates. An interested shareholder is generally any person who owns ten percent or more of the outstanding voting shares of the company. An affiliate is a person who directly or indirectly controls, is controlled by, or is under common control with, a specified person. The supermajority vote required by the Fair Price Act does not apply to business combinations that satisfy certain conditions. These conditions include, among others: (i) the purchase price to be paid for the shares of the company in the business combination must be at least equal to the highest of either (a) the market value of the shares or (b) the highest per share price paid by the interested shareholder within the preceding two-year period or in the transaction in which the shareholder became an interested shareholder, whichever is higher; and (ii) once becoming an interested shareholder, the person may not become the beneficial owner of any additional shares of the company except as part of the transaction that resulted in the interested shareholder becoming an interested shareholder or by virtue of proportionate stock splits or stock dividends.

Our articles of incorporation allow our Board of Directors to issue one or more classes or series of preferred stock with voting rights, preferences and other privileges as the Board of Directors may determine. The possible issuance of preferred shares could adversely affect the holders of our common stock and could prevent, delay, or defer a change of control.

We are also subject to the laws of Michigan, Ohio, Texas, Washington D.C., and Missouri, which govern insurance holding companies. Under these laws, a person generally must obtain the applicable Insurance Department s approval to acquire, directly or indirectly, five to ten percent or more of the outstanding voting securities of our Insurance Company Subsidiaries. An Insurance Department s determination of whether to approve an acquisition would be based on a variety of factors, including an evaluation of the acquirer s financial stability, the competence of its management, and whether competition in that state would be reduced. These laws may prevent, delay or defer a change of control of us or our Insurance Company Subsidiaries.

Most states assess our Insurance Company Subsidiaries to provide funds for failing insurance companies and those assessments could be material.

Our Insurance Company Subsidiaries are subject to assessments in most states where we are licensed for the provision of funds necessary for the settlement of covered claims under certain policies provided by impaired, insolvent or failed insurance companies. Maximum contributions required by law in any one year vary by state, and have historically been less than one percent of annual premiums written. We cannot predict with certainty the amount of future assessments. Significant assessments could have a material adverse effect on our financial condition and results of operations.

We may require additional capital in the future, which may not be available or may only be available on unfavorable terms.

Our future capital requirements depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. To the extent that our present capital is insufficient to meet future operating requirements and/or cover losses, we may need to raise additional funds through financings. If we had to raise additional capital, equity or debt financing may not be available or may be on terms that are not favorable to us. In the case of equity financings, dilution to our shareholders could result, and in any case such securities may have rights, preferences and privileges that are senior to those of the shares currently outstanding. If we cannot obtain adequate capital on favorable terms or at all, our business, operating results and financial condition could be adversely affected.

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Our status as an insurance holding company with no direct operations could adversely affect our ability to meet our debt obligations and pay shareholder dividends.

We are a holding company that transacts the majority of our business through our Insurance Company Subsidiaries. Our ability to meet our obligations on our outstanding debt, and to pay our expenses and shareholder dividends, may depend upon the surplus and earnings of our Insurance Company Subsidiaries and their ability to pay dividends to us. Payments of dividends to us by our Insurance Company Subsidiaries are restricted by state insurance laws, including laws establishing minimum solvency and liquidity thresholds, and could be subject to revised restrictions in the future. As a result, at times, we may not be able to receive dividends from our Insurance Company Subsidiaries and we may not receive dividends in amounts necessary to meet our debt obligations or to pay shareholder dividends on our capital stock. In addition, the payment of shareholder dividends by us is within the discretion of our Board of Directors and depends on numerous factors, including our results of operations, financial condition, competition, market conditions, capital requirements and other factors that our Board of Directors considers relevant.

Our performance is dependent on the continued services and performance of our senior management and other key personnel.

The success of our business is dependent on our ability to retain and motivate our senior management and key management personnel and their efforts. The loss of the services of any of our executive officers or other key employees could have a material adverse effect on our business, financial condition, results of operations, and cash flows. We have existing employment or severance agreements with Robert S. Cubbin, Christopher J. Timm, Karen M. Spaun, Michael G. Costello, and other senior executives. We maintain a key person life insurance policy on Robert S. Cubbin, our President and CEO. The loss of any of these officers or other key personnel could cause our ability to implement our business strategies to be delayed or hindered.

Our future success also will depend on our ability to attract, train, motivate and retain other highly skilled technical, managerial, marketing, and customer service personnel. Competition for these employees is strong and we may not be able to successfully attract, integrate or retain sufficiently qualified personnel. In addition, our future success depends on our ability to attract, retain and motivate our agents and other producers. Our failure to attract and retain the necessary personnel and producers could have a material adverse effect on our business, financial condition, results of operations, and cash flows.

Although we have paid cash dividends in the past, we may not pay cash dividends in the future.

The declaration and payment of dividends is subject to the discretion of our Board of Directors and will depend on our financial condition, results of operations, cash flows, cash requirements, future prospects, regulatory and contractual restrictions on the payment of dividends by our Insurance Company Subsidiaries and other factors deemed relevant by our Board of Directors. There is no requirement that we must, and we cannot assure you that we will, declare and pay any dividends in the future. Our Board of Directors may determine to retain such capital for general corporate or other purposes.

We rely on our information technology and telecommunications systems to conduct our business.

Our business is dependent upon the uninterrupted functioning of our information technology and telecommunication systems. We rely upon our systems, as well as the systems of our vendors, to underwrite and process our business, make claim payments, provide customer service, provide policy administration services, such as endorsements, cancellations and premium collections, comply with insurance regulatory requirements and perform actuarial and other analytical functions necessary for pricing and product development. Our operations are dependent upon our ability to timely and efficiently process our business and protect our information and telecommunications systems from physical loss, telecommunications failure or other similar catastrophic events, as well as from security breaches. While we have implemented business contingency plans and other reasonable and appropriate internal controls to protect our systems from interruption, loss or security breaches, a sustained business interruption or system failure could adversely impact our ability to process our business, provide customer service, pay claims in a timely manner or perform other necessary business functions. Likewise, a security breach of our computer systems could also interrupt or damage our operations or harm our reputation in the event confidential customer information is disclosed to third parties. In addition, the cost to remedy a severe security breach could also be substantial. These circumstances could have a material adverse effect upon our financial condition, results of operations, cash flows, or reputation.

Managing technology initiatives and obtaining the efficiencies anticipated with technology implementation may present significant challenges.

While technological enhancements and initiatives can streamline several business processes and ultimately reduce the costs of operations, these initiatives can present short-term costs and implementation risks. Projections of associated costs, implementation timelines, and the benefits of those results may be inaccurate and such inaccuracies could increase over time. In addition, there are risks associated with not achieving the anticipated efficiencies from technology implementation that could impact our financial condition, results of operations, and cash flows.

ITEM 1B. *UNRESOLVED STAFF COMMENTS*

None.

ITEM 2. *PROPERTIES*

In 1998, we purchased land in Southfield, Michigan for a cost of $3.2 million. In 2004, the construction of our corporate headquarters was completed on half of this land and in December 2004 we relocated to the new office building. Our corporate headquarters are approximately 72,000 square feet. The total construction cost of the building approximated $12.0 million, which was paid in full at the closing on January 19, 2005.

In 2003, we entered into a Purchase and Sale Agreement, whereby we agreed to sell the remaining portion of the land to an unaffiliated third party for the purpose of constructing an office building adjacent to our corporate headquarters. Under the Purchase and Sale Agreement, the third party agreed to pay $2.1 million for the land, $1.2 million for their share of the costs related to the common areas of the building, and other related costs of approximately $226,000. In May 2005, we closed on the transaction.

The unaffiliated third party had until July 2007 to pay the principal balance, however we negotiated an extension through May 1, 2009. Subsequent to the expiration of the extension, it has been determined the unaffiliated third party does not intend to pay the remaining principal balance. Therefore, we intend to foreclose on the property in 2010.

With the ProCentury merger, we assumed the lease of their corporate headquarters, an approximately 44,000 square foot office building located in Westerville, Ohio. The lease agreement for this building has an initial term of ten years, which expires in 2013.

We are also a party to various leases, including other leases acquired from ProCentury, for other locations in which we have offices. We do not consider any of these leases to be material.

ITEM 3. *LEGAL PROCEEDINGS*

We 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, we vigorously defend 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 the policy at issue, errors and omissions insurance or other appropriate insurance. In terms of deductibles associated with such insurance, we have established provisions against these items, which are believed to be adequate in light of current information and legal advice. In accordance with accounting guidance, 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 in our consolidated financial statements. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. With the assistance of outside counsel, we adjust such provisions according to new developments or changes in the strategy in dealing with such matters. On the basis of current information, we do not expect the outcome of the claims, lawsuits and proceedings to which we are subject to, either individually, or in the aggregate, will have a material adverse effect on our 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.

ITEM 4. ***RESERVED***

MEADOWBROOK INSURANCE GROUP, INC.

PART II

ITEM 5. ***Market Price of and Dividends on the Registrant s Common Equity and Related Stockholder Matters***

Shareholder Information
Corporate Headquarters
26255 American Drive
Southfield, MI 48034-6112
Phone: (248) 358-1100

Transfer Agent & Registrar
BNY Mellon Shareowner Services
P.O. Box 358015
Pittsburgh, PA 15252-8015

Annual Meeting
The Annual Meeting of Shareholders will be held at:
2:00 p.m.
May 18, 2010

Independent Registered Public Accounting Firm
Ernst & Young LLP
Detroit, MI

Stock Listing
New York Stock Exchange
Symbol: MIG

Corporate Headquarters
26255 American Drive
Southfield, MI

Corporate Counsel
Howard & Howard Attorneys PLLC.
Royal Oak, MI

Shareholder Relations and Form 10-K

A copy of our 2009 Annual Report and Form 10-K, as filed with the Securities and Exchange Commission, may be obtained upon written request to our Financial Reporting Department at our corporate headquarters, or contact:

Karen M. Spaun, Senior Vice President and Chief Financial Officer
(248) 204-8178 karen.spaun@meadowbrook.com

Direct Investment Plan

Our Shareholder Investment Plan (Plan) offers a simple and systematic way to purchase our common stock without paying brokerage fees or commissions. With the Plan s many flexible features, an account may be customized to reflect individual financial and investment objectives. If you would like additional information including a prospectus and an application, please contact:

BNY Mellon Shareowner Services
1-800- 442-8134

Or visit their website at **www.bnymellon.com/shareowner/isd**

Share Price and Dividend Information

Our common stock is traded on the New York Stock Exchange under the symbol MIG. The following table sets forth the high and low closing sale prices of our common shares as reported by the NYSE and our quarterly dividends declared for each period shown:

December 31, 2009	High	Low	Dividends
First Quarter	$ 7.01	$ 5.08	$ 0.02
Second Quarter	7.64	5.70	0.02
Third Quarter	8.21	6.27	0.03
Fourth Quarter	7.75	6.53	0.03

MEADOWBROOK INSURANCE GROUP, INC.

December 31, 2008	High	Low	Dividends
First Quarter	$ 9.95	$ 7.16	$ 0.02
Second Quarter	8.60	5.20	0.02
Third Quarter	8.25	5.20	0.02
Fourth Quarter	7.59	3.97	0.02

For additional information regarding dividend restrictions, refer to the *Liquidity and Capital Resources* section of *Management s Discussion and Analysis.*

When evaluating the declaration of a dividend, our Board of Directors considers a variety of factors, including but not limited to, our cash flow, liquidity needs, results of operations strategic plans, industry conditions, our overall financial condition and other relevant factors. As a holding company, the ability to pay cash dividends is partially dependent on dividends and other permitted payments from our subsidiaries. In 2009 and 2008, the Insurance Company Subsidiaries paid dividends to our holding company of $39.5 million and $46.2 million, respectively.

Shareholders of Record

As of March 10, 2010, there were approximately 264 shareholders of record of our common stock. For purposes of this determination, Cede & Co., the nominee for the Depositary Trust Company is treated as one holder.

Purchase of Equity Securities by the Issuer

In July 2008, our Board of Directors authorized management to purchase up to 3.0 million shares of our common stock in market transactions for a period not to exceed twenty-four months. Recently, on February 12, 2010, our Board of Directors authorized us to purchase up to 5.0 million shares of our common stock in market transactions for a period not to exceed twenty-four months. This share repurchase plan replaced the existing share repurchase plan authorized in July 2008.

The following table presents information with respect to repurchases of our common stock made during the quarterly period ended December 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
October 1 October 31, 2009		$		1,900,000
November 1 November 30, 2009	533,008	$ 6.92		1,366,992

December 1	December 31, 2009	1,094,894	$	7.16	272,098
Total		1,627,902	$	7.08	

MEADOWBROOK INSURANCE GROUP, INC.

Performance Graph

The following graph sets forth, for the five year period ended December 31, 2009, the cumulative total stockholder return for the Company s common stock, the Russell 2000 Index, and a Peer Group index. The graph assumes the investment of $100 on December 31, 2004 in Common Stock of the Company, the Russell 2000 Index, and a Peer Group index. The stock price performance represented on the following graph is not necessarily indicative of future stock price performance.

The performance graph shall not be deemed soliciting material or to be filed with the Securities and Exchange Commission, nor shall such information be deemed to be incorporated by reference into any future filing of the Company under the Securities Exchange Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent the Company specifically incorporates it by reference into such filing.

Comparison of Five Year Cumulative Total Return

	Period Ending					
Index	***12/31/04***	***12/31/05***	***12/31/06***	***12/31/07***	***12/31/08***	***12/31/09***
Meadowbrook Insurance Group, Inc.	100.00	117.03	198.20	188.58	130.74	152.33
Russell 2000	100.00	104.55	123.76	121.82	80.66	102.58
SNL Insurance $1B-$2.5B	100.00	115.46	144.94	140.54	115.72	126.38

MEADOWBROOK INSURANCE GROUP, INC.

ITEM 6. *SELECTED CONSOLIDATED FINANCIAL DATA*

	For the Years Ended December 31,				
	2009	2008	2007	2006	2005
	(In thousands, except per share and ratio data)				
Income Statement Data:					
Gross written premiums	$ 688,687	$ 457,683	$ 346,451	$ 330,872	$ 332,209
Net written premiums	580,018	375,194	280,211	262,668	258,134
Net earned premiums	539,602	369,721	268,197	254,920	249,959
Net commissions and fees	37,881	42,904	45,988	41,172	35,916
Net investment income	50,366	36,624	26,400	22,075	17,975
Net realized (losses) gains	(225)	(11,422)	150	69	167
Total revenue	627,624	437,827	340,735	318,236	304,017
Net losses and LAE	307,087	212,885	150,969	146,293	151,542
Policy acquisition and other underwriting expenses	110,715	69,294	53,717	50,479	44,439
Other administrative expenses	39,413	35,000	32,269	28,824	26,810
Salaries and employee benefits	80,923	62,862	56,433	54,569	51,331
Amortization expense	5,781	6,310	1,930	590	373
Interest expense	10,596	7,681	6,030	5,976	3,856
Income before income taxes and equity earnings	73,109	43,795	39,387	31,505	25,666
Equity earnings of affiliates, net of tax	874				
Equity earnings of unconsolidated subsidiaries, net of tax	(12)	269	331	128	1
Net income	52,650	27,397	27,992	22,034	17,910
Earnings per share Diluted	$ 0.92	$ 0.61	$ 0.85	$ 0.75	$ 0.60
Balance Sheet Data:					
Total investments and cash and cash equivalents	$ 1,203,215	$ 1,085,648	$ 651,601	$ 527,600	$ 460,233
Total assets	1,989,816	1,813,916	1,113,966	969,000	901,344
Loss and LAE reserves	949,177	885,697	540,002	501,077	458,677
Debt	49,875	60,250		7,000	7,000
Debentures	80,930	80,930	55,930	55,930	55,930
Shareholders equity	502,881	438,170	301,894	201,693	177,365
Book value per share	$ 9.06	$ 7.64	$ 8.16	$ 6.93	$ 6.19
Other Data:					
GAAP ratios (insurance companies only):					
Net loss and LAE ratio(1)	60.7%	62.0%	61.2%	62.3%	65.2%
Expense ratio(1)	31.9%	31.3%	34.2%	34.5%	33.5%
Combined ratio	92.6%	93.3%	95.4%	96.8%	98.7%

Accident year combined ratio(2)		97.9%		97.8%		98.0%		97.9%		96.8%
Total (favorable) adverse development on prior years	$	(28,670)	$	(16,772)	$	(7,091)	$	(2,719)	$	4,884

MEADOWBROOK INSURANCE GROUP, INC.

(1) Both the GAAP loss and loss adjustment expense ratio and the GAAP expense ratio are calculated based upon unconsolidated insurance company operations. The following table details these ratios and includes the intercompany fees, which are eliminated upon consolidation.

(2) The accident year combined ratio is the sum of the expense ratio and accident year loss ratio. The accident year loss ratio measures loss and LAE occuring in a particular year, regardless of when they are reported and does not take into consideration changes in estimates in loss reserves from prior accident years.

Unconsolidated GAAP data Ratio Calculation Table:

	For the Years Ended December 31,				
	2009	2008	2007	2006	2005
Net earned premiums	$ 539,602	$ 369,721	$ 268,197	$ 254,920	$ 249,959
Consolidated net losses and LAE	$ 307,087	$ 212,885	$ 150,969	$ 146,293	$ 151,542
Intercompany claim fees	20,339	16,296	13,058	12,553	11,523
Unconsolidated net losses and LAE	$ 327,426	$ 229,181	$ 164,027	$ 158,846	$ 163,065
GAAP net loss and LAE ratio	60.7%	62.0%	61.2%	62.3%	65.2%
Consolidated policy acquisition and other underwriting expenses	$ 110,715	$ 69,349	$ 53,717	$ 50,479	$ 44,439
Intercompany administrative and other underwriting fees	61,422	46,371	37,890	37,442	39,231
Unconsolidated policy acquisition and other underwriting expenses	$ 172,137	$ 115,720	$ 91,607	$ 87,921	$ 83,670

As previously indicated, the Merger with ProCentury was completed following the close of business on July, 31, 2008. Therefore, the above table includes only five months of financial results for ProCentury for the year ended December 31, 2008 and twelve months of financial results for the year ended December 31, 2009.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS

ITEM 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Forward-Looking Statements

This Form 10-K may provide information including certain statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These include statements regarding the intent, belief, or current expectations of management, including, but not limited to, those statements that use the words believes, expects, anticipates, estimates, or similar expressions. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties, and results could differ materially from those indicated by such forward-looking statements. Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements are: the frequency and severity of claims; uncertainties inherent in reserve estimates; catastrophic events; a change in the demand for, pricing of, availability or collectibility of reinsurance; increased rate pressure on premiums; 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. We market and underwrite specialty property and casualty insurance programs and products on both an admitted and non-admitted basis through a broad and diverse network of independent retail, wholesale program administrators and general agents, who value service, specialized knowledge, and focused expertise. We primarily focus on niche or specialty products and 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.

Our insurance 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 California and New England. 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 of the United States. 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

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

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 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, 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.

Five months of earnings of ProCentury are included in our financial statements as of and for the year ended December 31, 2008. Twelve months of earnings are included as of and for the year ended December 31, 2009.

Since the completion of the Merger, we have been executing on numerous revenue enhancement opportunities and leveraging the infrastructure as summarized below:

Revenue enhancement opportunities:

- launching a new wholesale relationship in the Midwest;
- offering a surplus lines market need for an existing workers compensation partner in New England; and
- utilization of existing program capabilities for Century general agents.

Leveraging shared infrastructure and increased size;

- developing Centers of Expertise for claims management:
- increased size and diversity benefit costs of reinsurance;
- enhanced marketing capabilities through joint business development functions; and
- geographic expansion of Century offerings through existing admitted markets.

Executing on opportunities to leverage other niche capabilities:

- combined capabilities allow us to receive and evaluate more opportunities; and
- independently, neither company would have been able to meet the comprehensive risk management solutions that some opportunities require.

Specialty Insurance Operations

Our 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. Our 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, surety, legal, professional liability, errors and omissions, inland marine, and other lines of business, where we see a market need and a profit potential. Insurance coverage is provided primarily to associations or similar groups of members and to specified classes of business of our agents. We recognize revenue related to the services and coverages the

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

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).

We included the results of operations related to ProCentury within the specialty insurance operations. Therefore, specialty insurance operations include five months of results for ProCentury for the year ended December 31, 2008 and twelve months of results for the year ended December 31, 2009.

In addition, our subsidiary, Star, purchased a 28.5% ownership interest in an insurance holding limited liability company. This ownership interest is significant, but is less than a majority ownership and, therefore, is accounted for under the equity method of accounting. Star, therefore, will recognize 28.5% of the profits and losses as a result of this equity interest ownership. For segment reporting purposes, the equity earnings related to this investment is shown gross of tax. Equity earnings of affiliates, relates to our proportionate share of this investment, which we consider to be consistent with our specialty insurance operations and, therefore, we have included the respective equity earnings within the specialty insurance operations segment.

With a fee-for-service or managed program, we earn revenue by providing certain operational and administrative functions and other services to a client s risk-bearing entity, but generally do not share in the operating results of the program. The fees we receive from these programs are generally either a fixed amount or based on a percentage of premium serviced or claim count.

Based upon the particular risk management goals of our clients, market conditions and our assessment of the opportunity for operating profit, our specialty insurance operations offer solutions on a fully-insured basis, a risk-sharing basis, or a managed basis, in response to a specific market opportunity. In a managed program, we earn service fee revenue by providing certain operational functions and other services to a client s risk-bearing entity, but generally do not share in the operating results. In a risk-sharing program, we share the operating results with the client through a reinsurance agreement with an insurance company, captive, or rent-a-captive. In a profit-sharing structure, we pay an agent a commission that is adjusted based on the operating results of the program. These structures, other than the profit-sharing commission structure, are licensed insurance or reinsurance companies and are accounted for in accordance with accounting guidance as it relates to reinsurance and insurance products. In risk-sharing programs, we derive revenue from net earned premiums, fee-for-service revenue and commissions, and investment income. In addition, we may benefit from the fees our risk management subsidiary earns for services we perform on behalf of our Insurance Company Subsidiaries. These fees are eliminated upon consolidation. However, the fees associated with the captive s portion of the program are reimbursed through a ceding commission. For a fully-insured program, we provide insurance products without a risk-bearing mechanism and derive revenue from net earned premiums and investment income. For further descriptions of our insurance programs and products refer to the Business section.

In addition to premium revenue and investment income from our net retained portion of the operating results, we may also be compensated through the receipt of fees for policy issuance services and acquisition costs, captive administration, reinsurance placement, loss prevention services, and claims administrative and handling services. In addition, we may benefit from the fees our risk management subsidiary earns for services we perform on behalf of our Insurance Company Subsidiaries. These fees are eliminated upon consolidation. However, the fees associated with the captive s portion of the program are reimbursed through a ceding commission. For financial reporting purposes, ceding commissions are treated as a reduction in underwriting expenses.

With fully insured programs, we provide our insurance products without a risk-bearing mechanism and derive revenue from net earned premiums and investment income. Fully insured programs are generally developed in response to specific market opportunities and may evolve into a risk-sharing arrangement.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

Agency Operations

We earn commission revenue through the operation of our retail property and casualty insurance agencies, 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 our affiliated Insurance Company Subsidiaries.

In recent years, we have derived our revenue from the following sources (in thousands):

	For the Years Ended December 31,		
	2009	**2008**	**2007**
Revenues			
Net earned premiums	$ 539,602	$ 369,721	$ 268,197
Management fees	18,901	21,168	23,963
Claims fees	7,428	8,879	9,025
Loss control fees	1,975	2,069	2,151
Reinsurance placement	931	728	929
Investment income	49,910	35,888	25,487
Net realized (losses) gains	(225)	(11,422)	150
Specialty insurance operations	618,522	427,031	329,902
Agency operations	9,561	11,064	11,316
Holding Company interest income earned	456	736	913
Intersegment revenue	(915)	(1,004)	(1,396)
Consolidated revenue	$ 627,624	$ 437,827	$ 340,735

Critical Accounting Policies

General

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, the 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. We believe the following policies are the most sensitive to estimates and judgments.

Losses and Loss Adjustment Expenses

Significant periods of time can elapse between the occurrence of a loss, the reporting of the loss to the insurer, and the insurer s payment of that loss. To recognize liabilities for unpaid losses and loss adjustment expenses (LAE), insurers establish reserves as balance sheet liabilities representing estimates of amounts needed to pay reported and unreported net losses and LAE.

We establish a liability for losses and LAE, which represents case based estimates of reported unpaid losses and LAE and actuarial estimates of incurred but not reported losses (IBNR) and LAE. Such liabilities, by necessity, are based upon estimates and, while we believe the amount of our reserves is adequate, the ultimate liability may be greater or less than the estimate. As of December 31, 2009 and 2008, we have accrued $949.2 million and $885.7 million of gross loss and LAE reserves, respectively.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

Components of Losses and Loss Adjustment Expense

The following table sets forth our gross and net reserves for losses and LAE based upon an underlying source of data, at December 31, 2009 (in thousands):

	Case	IBNR	Total
Direct	$ 263,064	$ 570,095	$ 833,159
Assumed-Directly Managed(1)	39,474	46,909	86,383
Assumed-Residual Markets(2)	9,401	12,505	21,906
Assumed-Retroceded	958	387	1,345
Assumed-Other	4,528	1,856	6,384
Gross	317,425	631,752	949,177
Less Ceded	84,534	182,267	266,801
Net	$ 232,891	$ 449,485	$ 682,376

(1) Directly managed represents business managed and processed by our underwriting, claims, and loss control departments, utilizing our internal systems and related controls.

(2) Residual markets represent mandatory pooled workers compensation business allocated to individual insurance company writers based on the insurer s market share in a given state.

The reserves referenced in the above table related to our direct and assumed business, which we directly manage and are established through transactions processed through our internal systems and related controls. Accordingly, the case reserves are established on a current basis, therefore there is no delay or lag in reporting of losses from a ceding company, and IBNR is determined utilizing various actuarial methods based upon historical data. Ultimate reserve estimates related to assumed business from residual markets are provided by individual states on a two quarter lag between the date of the evaluation and the receipt of the estimate from the National Council on Compensation Insurance (NCCI), and include an estimated reserve based upon actuarial methods for this lag. Assumed business, that is subsequently 100% retroceded to participating reinsurers, relates to business previously discontinued and now is in run-off. Relative to assumed business from other sources, we receive case and paid loss data within a forty-five day reporting period and develop our estimates for IBNR based on both current and historical data.

The completeness and accuracy of data received from cedants on assumed business that we do not manage directly is verified through monthly reconciliations to detailed statements, inception to date rollforwards of claim data, actuarial estimates of historical trends, field audits, and a series of management oversight reports on a program basis.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

The following table sets forth our net case and IBNR reserves for losses and LAE by line of business at December 31, 2009 (in thousands):

	Net Case	Net IBNR	Total
Workers Compensation	$ 80,001	$ 105,728	$ 185,729
Residual Markets	9,401	12,506	21,907
Commercial Multiple Peril/General Liability	84,710	248,978	333,688
Commercial Automobile	42,618	62,850	105,468
Other	16,161	19,423	35,584
Total	$ 232,891	$ 449,485	$ 682,376

Claim Reserving Process and Methodology

When a claim is reported to one of our Insurance Company Subsidiaries, for the majority of claims, our claims personnel within our risk management subsidiary will establish a case reserve for the estimated amount of the ultimate payment. The amount of the reserve is primarily based upon a case-by-case evaluation of the type of claim involved, the circumstances surrounding each claim, and the policy provisions relating to the type of losses. The estimate reflects the informed judgment of such personnel based on general insurance reserving practices, which focus on the ultimate probable cost of each reported claim, as well as the experience and knowledge of the claims person. Until the claim is resolved, these estimates are revised as deemed necessary by the responsible claims personnel based on subsequent developments, new information or periodic reviews of the claims.

In addition to case reserves and in accordance with industry practice, we maintain estimates of reserves for losses and LAE incurred but not yet reported. We project an estimate of ultimate losses and LAE at each reporting date. The difference between the projected ultimate loss and LAE reserves and the case loss reserves and LAE reserves, is carried as IBNR reserves. By using both estimates of reported claims and IBNR determined using generally accepted actuarial reserving techniques, we estimate the ultimate liability for losses and LAE, net of reinsurance recoverables.

In developing claim and claim adjustment expense reserve estimates, we perform a complete and detailed reserve analyses each quarter. To perform this analysis, the data is organized at a reserve category level. A reserve category can be a line of business such as commercial automobile liability, or it may be a particular geographical area within a line of business such as Nevada workers compensation. The reserves within a reserve category level are characterized as either short tail or long tail. About 96% of our reserves can be characterized as coming from long tail lines of business. For long tail business, several years may lapse between the time the business is written and the time when all claims are settled. Our long-tail exposures include workers compensation, commercial automobile liability, general liability, professional liability, products liability, excess, and umbrella. Short-tail exposures include property, commercial automobile physical damage, a portion of ocean marine, and inland marine. The analyses generally review losses both gross and net of reinsurance.

The standard actuarial methods that we use to project ultimate losses for both long-tail and short-tail exposures include, but are not limited to, the following:

- Paid Development Method
- Incurred Development Method
- Paid Bornhuetter-Ferguson Method
- Reported Bornhuetter-Ferguson Method
- Initial Expected Loss Method
- Paid Roll-forward Method

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

Incurred Roll-forward Method
Construction Defect Method

All of these methods are consistently applied to every reserve category where they are applicable and they create indications for each accident year. We use judgment selecting the best estimate from within these estimates or adjusted estimates. As such, no one method or group of methods is strictly used for any line of business or reserve category within a line of business. The individual selections by year are our best judgments based on the strengths and weaknesses of the method, indications, the inherent variability in the data and the specific modifications to selections for data characteristics.

A brief description of the methods and some discussion of their inherent strengths, weaknesses and uses are as follows:

Paid Development Method. This method uses historical, cumulative paid losses by accident year and develops those actual losses to estimated ultimate losses based upon the assumption that each accident year will develop to estimated ultimate cost in a manner that is analogous to prior years, adjusted as deemed appropriate for the expected effects of known changes in the claim payment environment, and to the extent necessary supplemented by analyses of the development of broader industry data.

Selection of the paid loss pattern requires analysis of several factors including the impact of inflation on claims costs, the rate at which claims professionals make claim payments and close claims, the impact of judicial decisions, the impact of underwriting changes, the impact of large claim payments and other factors. Claim cost inflation itself requires evaluation of changes in the cost of repairing or replacing property, changes in the cost of medical care, changes in the cost of wage replacement, judicial decisions, legislative changes and other factors. Because this method assumes that losses are paid at a consistent rate, changes in any of these factors can impact the results. Since the method does not rely on case reserves, it is not directly influenced by changes in the adequacy of case reserves.

Incurred Development Method. This method uses historical, cumulative reported loss dollars by accident year and develops those actual losses to estimated ultimate losses based upon the assumption that each accident year will develop to estimated ultimate cost in a manner that is analogous to prior years, adjusted as deemed appropriate for the expected effects of known changes in the claim payment and case reserving environment, and to the extent necessary supplemented by analyses of the development of broader industry data.

Since the method uses more data (case reserves in addition to paid losses) than the paid development method, the incurred development patterns may be less variable than paid patterns. However, selection of the incurred loss pattern requires analysis of all of the factors listed in the description of the paid development method. In addition, the inclusion of case reserves can lead to distortions if changes in case reserving practices have taken place and the use of case incurred losses may not eliminate the issues associated with estimating the incurred loss pattern subsequent to the most mature point available.

Paid Bornhuetter-Ferguson Method. This is a method that assigns partial weight to initial expected losses for each accident year and partial weight to observed paid losses. The weights assigned to the initial expected losses decrease as the accident year matures.

The method assumes that only future losses will develop at the expected loss ratio level. The percent of paid loss to ultimate loss implied from the paid development method is used to determine what percentage of ultimate loss is yet to be paid. The use of the pattern from the paid development method requires consideration of all factors listed in the description of the paid development method. The estimate of losses yet to be paid is added to current paid losses to estimate the ultimate loss for each year. This method will react very slowly if actual ultimate loss ratios are different from expectations due to changes not accounted for by the expected loss ratio calculation.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

Reported Bornhuetter-Ferguson Method. This is a method that assigns partial weight to the initial expected losses and partial weight to observed reported loss dollars (paid losses plus case reserves). The weights assigned to the initial expected losses decrease as the accident year matures.

The use of case incurred losses instead of paid losses can result in development patterns that are less variable than paid patterns. However, the inclusion of case reserves can lead to distortions if changes in case reserving have taken place, and the method requires analysis of all the factors that need to be reviewed for the expected loss ratio and incurred development methods.

Initial Expected Loss Method. This method is used directly, and as an input to the Bornhuetter-Ferguson methods. Initial expected losses for an accident year are based on adjusting prior accident year projections to the current accident year levels using underlying loss trends, rate changes, benefit changes, reinsurance structure and cost changes and other pertinent adjustments specific to the line of business.

This method may be useful if loss development patterns are inconsistent, losses emerge very slowly, or there is relatively little loss history from which to estimate future losses. The selection of the expected loss ratio requires analysis of loss ratios from earlier accident years or pricing studies and analysis of inflationary trends, frequency trends, rate changes, underwriting changes, and other applicable factors.

Paid Roll-forward Method. This method adjusts prior estimates of ultimate losses based on the actual paid loss emergence in the quarter compared to the expected emergence. It is useful in determining reserves that avoid overreacting to ordinary fluctuations in the development patterns.

Incurred Roll-forward Method. This method adjusts prior estimates of ultimate losses based on the actual case incurred loss emergence in the quarter compared to the expected emergence. It may also be useful in determining reserves that avoid overreacting to ordinary fluctuations in the development patterns and generally reacts faster than the paid roll-forward method.

Claims for short-tail lines of business settle more quickly than long-tail lines of business, and in general, loss development factors for short-tail lines are smaller than long-tail lines. For long-tail lines, we tend to rely on initial expected loss methods throughout the current accident year then move to development factor based methods for older accident years. Development methods on short-tail lines are generally reliable in the third and fourth quarter of the initial accident year and recorded loss ratios reflect a blend of the development and forecast methods. Short-tail lines represent 4% of our total reserves at December 31, 2009.

Construction Defect Method. The provision for IBNR loss and ALAE for construction defect claims is analyzed by projecting the number of IBNR claim counts and applying a selected severity (i.e., a frequency severity type approach). The provision for development on reported claims is projected using a methodology similar to the incurred loss development approach described above. However, the claims are organized in a report year rather than accident year format. The advantage of this is that it substantially reduces the length or tail of the development.

The reserve categories where the above methods are not applicable are few. The largest of these is our workers compensation residual market reserve category, where we utilize detailed reserve analyses performed by the industry statistical agency NCCI in making our estimates. We adjust these estimates for timing differences in the reporting of the data. The other reserve categories that deviate from the above methods are smaller; as a group constituting approximately one percent of the total reserves.

Each of the methods listed above requires the selection and application of parameters and assumptions. For all but the initial expected loss method, the key assumptions are the patterns with which our aggregate claims data will be paid or will emerge over time (development patterns). These patterns incorporate inherent assumptions of claims cost inflation rates and trends in the frequency of claims, both overall and by severity of claim. These are affected by underlying loss trends, rate changes, benefit changes, reinsurance

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structure and cost changes and other pertinent adjustments which are explicit key assumptions underlying the initial expected loss method. Each of these key assumptions is discussed in the following paragraphs.

To analyze the development patterns, we compile, to the extent available, long-term and short-term historical data for our insurance subsidiaries, organized in a manner which provides an indication of the historical development patterns. To the extent that the historical data may provide insufficient information about future patterns whether due to environmental changes such as legislation or due to the small volume or short history of data for some segments of our business benchmarks based on industry data, and forecasts made by industry rating bureaus regarding the effect of legislative benefit changes on such patterns, may be used to supplement, adjust, or replace patterns based on our insurance companies historical data.

Actuarial judgment is required in selecting the patterns to apply to each segment of data being analyzed, and our views regarding current and future claim patterns are among the factors that enter into our establishment of the reserve for losses and LAE at each balance sheet date. When short-term averages or external rate bureau analyses indicate the claims patterns are changing from historical company or industry patterns, the new or forecasted information typically is factored into the methodologies. When new claims emergence or payment patterns have appeared in the actual data repeatedly over multiple evaluations, those new patterns are given greater weight in the selection process.

Because some claims are paid over many years, the selection of claim emergence and payment patterns involves judgmentally estimating the manner in which recently occurring claims will develop for many years and at times, decades in the future. When it is likely the actual development will occur in the distant future, the potential for actual development to differ substantially from historical patterns or current projections is increased.

This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. In particular, the development factor based methods all have as a key assumption that the development of losses in the future will follow a pattern similar to those measured by past experience and as adjusted either explicitly or by actuarial judgment. 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 and varied factors. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the years ended December 31, 2009 and 2008.

Variability of Claim Reserve Estimates

By its nature, the estimate of ultimate losses and LAE is subject to variability due to differences between our assumptions and actual events in the future. Although many factors influence the actual cost of claims and our corresponding reserve estimates, we do not measure and estimate values for all of these variables individually. This is due to the fact that many of the factors known to impact the cost of claims cannot be measured directly, such as the impact on claim costs due to economic inflation, coverage interpretations and jury determinations. In most instances, we rely on our historical experience or industry information to estimate the values for the variables that are explicitly used in our reserve analyses. We assume that the historical effect of these unmeasured factors, which is embedded in our experience or industry experience, is representative of the future effects of these factors. Where we have reason to expect a change in the effect of one of these factors, we perform analyses to perform the necessary adjustments.

One implicit assumption underlying development patterns is that the claims inflation trends will continue into the future similar to their past patterns. To estimate the sensitivity of the estimated ultimate loss and settlement expense payments to an unexpected change in inflationary trends, our actuarial department derives expected payment patterns separately for each major line of business. These patterns were applied to the December 31, 2009 loss and settlement expense reserves to generate estimated annual incremental loss and

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settlement expense payments for each subsequent calendar year. Then, for the purpose of sensitivity testing, an explicit annual inflationary variance of one percent was added to the inflationary trend that is implicitly embedded in the estimated payment pattern, and revised incremental loss and settlement expense payments were calculated. General inflation trends have been fairly stable over the past several years but there have been fluctuations of one to two percent over the past ten years and therefore we used a one percent annual inflation variance factor. The effect differed by line of business but overall was a three percent change in reserve adequacy or approximately $13.4 million effect on after tax net income. A variance of this type would typically be recognized in loss and settlement expense reserves and, accordingly, would not have a material effect on liquidity because the claims have not been paid.

An explicit assumption used in the analysis is the set of initial expected loss ratios (IELRs) used in the current accident year reserve projections and in some of the prior accident year ultimate loss indications. To estimate the sensitivity of the estimated ultimate loss to a change in IELRs, the actuarial department recasted the loss reserve indications using a set of IELRs all one percent higher than the final IELRs. The overall impact of a one percent change in IELRs would be a corresponding one percent change in reserve adequacy or a $4.6 million effect on after tax net income. Often the loss ratios by line of business will vary from the IELR in different directions causing them to partially offset each other. A variance of this type would typically be recognized in loss and settlement expense reserves and, accordingly, would not have a material effect on liquidity because the claims have not been paid.

The other factors having influence upon the loss and LAE reserve levels are too numerous and interdependent to efficiently model and test for sensitivity. Likewise, the development factors by reserve category and age are too numerous to model and test for sensitivity. Instead, ranges are estimated by reserve category considering past history, fluctuations in the development patterns, emerging issues, trends and other factors. The ranges are compiled and the total range is estimated considering the sensitivity to all of the underlying factors together. The resulting range is our best estimate of the expected ongoing variability in the loss reserves.

Historic development as shown within the *Analysis of Loss and Loss Adjustment Expense Development* table has been six percent or less in the last five years but was ten to seventeen percent in the years prior to the underwriting and reserving shift in 2002. At that time, we concentrated our efforts on eliminating underwriting relationships where we had substantial liabilities above an aggregate exposure retained by risk sharing associations and captives. For a large share of our business, we also accelerated the pace at which we brought the claim administration to our employees and away from outside third party administrators. This change enabled us to more rapidly recognize trends and underlying loss patterns, and establish more accurate reserves in a timely manner.

Our range of loss and LAE reserves table shows that presently we estimate them as going from favorable development of 9.1% to unfavorable of 6.1%. The range was evaluated based on the ultimate loss estimates from the actuarial methods described above.

Pre-tax Impact on Earnings from a Variance in Future Loss Payments and Case Reserves as of December 31, 2009
(in thousands)

Line of Business	Minimum Reserve Range	Maximum Reserve Range

Workers Compensation (including Residual Markets)	$	(12,888)	(6.2)%	$	7,965	3.8%
Commercial Multiple Peril/General Liability		(39,955)	(12.0)%		26,691	8.0%
Commercial Automobile		(6,758)	(6.4)%		5,226	5.0%
Other		(2,543)	(7.1)%		1,912	5.4%
Total	$	(62,143)	(9.1)%	$	41,795	6.1%

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The sensitivity around our workers compensation reserves primarily reflects the size and the maturity of the underlying book of business. Our workers compensation reserves represent 30% of our total reserves at December 31, 2009.

The sensitivity around our commercial multiple peril / general liability reserves primarily reflects the longer duration of reserves relating to our liability excess program, which started in 2003, and construction defect exposure, which together represent approximately 29% of the $333.7 million reserves in this line of business as of December 31, 2009. These lines of business are subject to greater uncertainty than the remainder of our book of business.

The sensitivity around our commercial automobile reserves primarily reflects the speed of reporting of the underlying losses, as well as the maturity of the case law surrounding automobile liability.

The sensitivity around the other lines of business primarily reflects the size of the underlying book of business. Our other reserves represent 5% of total reserves at December 31, 2009. A large portion of these reserves represent professional liability programs which tend to be claims-made and reinsured at lower limits, therefore reducing the volatility that is inherent in a smaller book of business. Another large portion represents property claims, which have a shorter reporting and payout pattern than liability and workers compensation claims.

All of our reserves are sensitive to changes in the underlying claim payment and case reserving practices, as well as the other sources of variations mentioned above.

Reinsurance Recoverables

Reinsurance recoverables represent (1) amounts currently due from reinsurers on paid losses and LAE, (2) amounts recoverable from reinsurers on case basis estimates of reported losses and LAE, and (3) amounts recoverable from reinsurers on actuarial estimates of IBNR losses and LAE. Such recoverables, by necessity, are based upon estimates. Reinsurance does not legally discharge us from our legal liability to our insureds, but it does make the assuming reinsurer liable to us to the extent of the reinsurance ceded. Instead of being netted against the appropriate liabilities, ceded unearned premiums and reinsurance recoverables on paid and unpaid losses and LAE are reported separately as assets in our consolidated balance sheets. Reinsurance recoverable balances are also subject to credit risk associated with the particular reinsurer. In our selection of reinsurers, we continually evaluate their financial stability. While we believe our reinsurance recoverables are collectible, the ultimate recoverable may be greater or less than the amount accrued. At December 31, 2009 and 2008, reinsurance recoverables on paid and unpaid losses were $274.5 million and $268.7 million, respectively.

In our risk-sharing programs, we are subject to credit risk with respect to the payment of claims by our clients captive, rent-a-captive, large deductible programs, indemnification agreements, or on the portion of risk either ceded to the captives, or retained by the clients. The capitalization and credit worthiness of prospective risk-sharing partners is one of the factors we consider upon entering into and renewing risk-sharing programs. We collateralize balances due from our risk-sharing partners through funds withheld trusts or stand-by letters of credit issued by highly rated banks. We have historically maintained an allowance for the potential uncollectibility of certain reinsurance balances due from some risk-sharing partners, some of which may be in dispute. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. At December 31, 2009, we believe this allowance is adequate. To date, we have not, in the aggregate, experienced material difficulties in collecting balances from our risk-sharing partners. No assurance can be given, however, regarding the future ability of our risk-sharing partners to meet their obligations.

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Investments

Our investment securities are classified as available for sale. Investments classified as available for sale are available to be sold in the future in response to our liquidity needs, changes in market interest rates, tax strategies and asset-liability management strategies, among other reasons. Available for sale securities that are not determined to be other-than-temporary impaired (OTTI) are reported at fair value, with unrealized gains and losses reported in the accumulated other comprehensive income component of shareholders equity, net of deferred taxes and, accordingly have no effect on net income.

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.

Available for sale securities are reviewed for declines in fair value that are determined to be other-than-temporary. For a debt security, if we intend to sell a security and it is more likely than not we will be required to sell a debt security before recovery of our amortized cost basis and the fair value of the debt security is below amortized cost, we conclude that an OTTI impairment has occurred and the amortized cost is written down to current fair value, with a corresponding charge to realized loss in the Consolidated Statements of Income. If we do not intend to sell a debt security and it is not more likely than not we will be required to sell a debt security before recovery of our amortized cost basis but the present value of the cash flows expected to be collected is less than the amortized cost of the debt security (referred to as the credit loss), we conclude that an OTTI has occurred and the amortized cost is written down to the estimated recovery value with a corresponding charge to realized loss in the Consolidated Statements of Income, as this is also deemed the credit portion of the OTTI. The remainder of the decline to fair value is recorded in Other Comprehensive Income as an unrealized non-credit OTTI in the Consolidated Statements of Comprehensive Income.

When assessing our intent to sell a debt security and if it is more likely than not we will be required to sell a debt security before recovery of our cost basis, facts and circumstances such as, but not limited to, decisions to reposition our security portfolio, sale of securities to meet cash flow needs and sales of securities to capitalize on favorable pricing, are evaluated. In order to determine the amount of the credit loss for a debt security, we calculate the recovery value by performing a discounted cash flow analysis based on the current cash flows and future cash flows expected to be recovered. The discount rate is the effective interest rate implicit in the underlying debt security upon issuance. The effective interest rate is the original yield or the coupon if the debt security was previously impaired. If an OTTI exists and there is not sufficient cash flows or other information to determine a recovery value of the security, we conclude that the entire OTTI is credit-related and the amortized cost for the security is written down to current fair value with a corresponding charge to realized loss in the Consolidated Statements of Income.

To determine the recovery period of a debt security, we consider the facts and circumstances surrounding the underlying issuer including, but not limited to the following:

Historical and implied volatility of the security;

Length of time and extent to which the fair value has been less than amortized cost;

Conditions specifically related to the security such as default rates, loss severities, loan to value ratios, current levels of subordination, third party guarantees, and vintage;

Specific conditions in an industry or geographic area;

Any changes to the rating of the security by a rating agency;

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Failure, if any, of the issuer of the security to make scheduled payments; and

Recoveries or additional declines in fair value subsequent to the balance sheet date.

In periods subsequent to the recognition of an OTTI, the security is accounted for as if it had been purchased on the measurement date of the OTTI. Therefore, for a fixed maturity security, the discount or reduced premium is reflected in net investment income over the contractual term of the investment in a manner that produces a constant effective yield.

For an equity security, if we do not have the ability and intent to hold the security for a sufficient period of time to allow for a recovery in value, we conclude that an OTTI has occurred, and the cost of the equity security is written down to the current fair value, with a corresponding charge to realized loss within the Consolidated Statements of Income. When assessing our ability and intent to hold the equity security to recovery, we consider, among other things, the severity and duration of the decline in fair value of the equity security, as well as the cause of decline, a fundamental analysis of the liquidity, business prospects and overall financial condition of the issuer.

Revenue Recognition

We account for our reinsurance and insurance products in accordance with Accounting Standards Codification (ASC) 944 *Financial Services Insurance*.

Premiums written, which include direct, assumed, and ceded premiums 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 NCCI, or residual market business. The pools cede 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, we estimate premium and loss activity based on historical and market based results. Historically, we have not experienced any material difficulties or disputes in collecting balances from NCCI; and therefore, no provision for doubtful accounts is recorded related to the assumed premium estimate.

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

We review, on an ongoing basis, the collectibility of our receivables and establish an allowance for estimated uncollectible accounts. As of December 31, 2009 and 2008, the allowance for uncollectibles on receivables was $3.4 million and $2.9 million, respectively.

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Equity Earnings of Affiliates

Equity earnings represent investments in affiliates in which we do not exercise control and have a 20% or more voting interest. Such investments in affiliates are accounted for using the equity method of accounting. We have an equity interest in one affiliate, and the equity earnings of this interest were recorded in net income. Equity earnings, net of tax, for 2009 were $874,000. We had no equity earnings related to this affiliate for 2008 and 2007. We did not receive any dividends from this affiliate in 2009.

Additionally, we are recording the equity earnings in this affiliate based on a month lag due to timing differences in respect to the availability of information, as permissible under FASB ASC 323-10-35-6, *Investments Equity Method and Joint Ventures Subsequent Measurement.*

Legal Contingencies

We 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, we vigorously defend 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 the policy at issue, errors and omissions insurance or other appropriate insurance. In terms of deductibles associated with such insurance, we have established provisions against these items, which are believed to be adequate in light of current information and legal advice. In accordance with accounting guidance, 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 is provided for the costs to resolve these claims in our consolidated accompanying financial statements. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. We, with the assistance of outside counsel, adjust such provisions according to new developments or changes in the strategy in dealing with such matters. On the basis of current information, we do not expect the outcome of the claims, lawsuits and proceedings to which we are subject to, either individually, or in the aggregate, will have a material adverse effect on our 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.

Goodwill

We evaluate existing goodwill for impairment on an annual basis as of October 1st, or more frequently if events or changes in circumstances indicate that the asset might be impaired. Goodwill impairment is performed at the reporting unit level. To test goodwill for impairment, we are required to estimate the fair value of each reporting unit. Since quoted market prices in an active market are not available for our reporting units, other valuation techniques are used. We have developed a model to estimate the fair value of our reporting units utilizing a discounted cash flow valuation technique (DCF model). A DCF model is selected to be comparable to what would be used by market participants to estimate fair value. The impairment test incorporates estimates of future cash flows; allocations of certain assets, liabilities and cash flows among reporting units; future growth rates; terminal value amounts; and the applicable weighted-average cost of capital used to discount those estimated cash flows. These estimates are based on management s judgment. The estimates and projections used in the estimate of fair value are consistent with our forecast and long-range plans.

In accordance with accounting guidance, we concluded our reporting units to be agency operations and specialty insurance operations. The nature of the business and economic characteristics of all agency operations and all specialty insurance operations are similar based upon, but not limited to, the following; (1) management alignment within each reporting unit, (2) our Insurance Company Subsidiaries operate under a

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reinsurance pooling arrangement, and (3) our ability to leverage our expertise and fixed costs within each reporting unit.

Deferred Policy Acquisition Costs

Commissions and other costs of acquiring insurance business that vary with and are primarily related to the production of new and renewal business are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Investment earnings are anticipated in determining the recoverability of such deferred amounts. We reduce these costs for premium deficiencies. There were no premium deficiencies for the years ended December 31, 2009, 2008 and 2007.

Federal Income Taxes

We provide for federal income taxes based on amounts we believe we ultimately will owe. Inherent in the provision for federal income taxes are estimates regarding the deductibility of certain items and the realization of certain tax credits. In the event the ultimate deductibility of certain items or the realization of certain tax credits differs from estimates, we may be required to significantly change the provision for federal income taxes recorded in the consolidated financial statements. Any such change could significantly affect the amounts reported in the consolidated statements of income.

We utilize the asset and liability method of accounting for income tax. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when necessary to reduce the deferred tax assets to the amounts more likely than not to be realized.

Results of Operations

Executive Overview

Our results for the full year 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 our fixed costs. Our generally accepted accounting principles (GAAP) combined ratio improved 0.7 percentage points to 92.6% for the year ended December 31, 2009, from 93.3% in 2008. Net operating income, excluding amortization, increased 31.4% to $59.3 million, compared to $45.1 million in 2008.

Our 2009 year to date results included a pre-tax loss of $3.5 million related to impairment charges on our investment portfolio. This is down from a pre-tax loss of $11.7 million in 2008, which were also related to impairment charges. In September 2008, at the height of the economy s financial crisis, we experienced losses primarily in preferred stock investments in Fannie Mae, Freddie Mac, Lehman Brothers, and GMAC. Our exposure to unrealized losses and other than temporarily impaired securities decreased during 2009, as the financial markets began to stabilize and improve.

The 2009 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 included 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.

Offsetting the impairment charges in 2009, were pre-tax realized gains of $3.6 million that we recognized in the fourth quarter of 2009 from the sale of certain securities which were sold for tax planning purposes.

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Our investment portfolio as of December 31, 2009, includes pre-tax net unrealized gains of $44.5 million, or a $0.80 book value per share, compared to pre-tax net unrealized gains of $3.8 million in 2008, or a $0.07 book value per share. After-tax net unrealized gains were $28.9 million, or a $0.52 book value per share, compared to after-tax net unrealized gains of $2.5 million, or a $0.04 book value per share in 2008. Our conservative investment philosophy, which focuses on a high quality, short duration investments with both diversifications in specific securities, as well as investment sectors, has minimized our asset risk in relation to our GAAP equity.

Gross written premium increased $231.0 million, or 50.5%, to $688.7 million, compared to $457.7 million in 2008. Included in this increase was $139.7 million in gross written premiums related to our Century Surety Company (Century) operations. In addition, this increase includes $92.2 million in gross written premiums related to our new relationship with a program agent who specializes in non-contractors workers compensation in the Midwest, California, and other western states, as well as new programs which include a general agent that focuses on the food services industry and a general agent who focuses on heterogeneous workers compensation in the Southeast region of the United States. The increase is also a result of growth in new business from programs implemented in 2008 and 2009. We anticipate further growth during 2010 as the annualized premiums of these programs continue to be realized. In addition, we continue to experience selective growth within existing programs consistent with our corporate underwriting guidelines and our controls over price adequacy. While the level of rate decreases has slowed, we have seen a continued competitive market. Along with the recession, there has been downward pressure on revenue growth, but a decrease in frequency of losses has helped to support underwriting profitability.

With 2009 as our first full year of operations after the merger with ProCentury, we continue to see opportunities emerge as we use our 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 agent in markets not previously serviced by ProCentury, and as we continue to 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 existing 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. The combined platform has expanded agent relationships and rounded out agency relationship needs, which should grow both our programs and products.

In July 2009, our subsidiary, Star, purchased a 28.5% ownership interest in an insurance holding limited liability company for $14.8 million in cash. This ownership interest is significant, but is less than a majority ownership and, therefore, is accounted for under the equity method of accounting. Star, therefore, will recognize 28.5% of the profits and losses as a result of this equity interest ownership.

On June 24, 2009, we announced the affirmation of A.M. Best Company s financial strength rating of A− (Excellent) for our Insurance Company Subsidiaries.

2009 compared to 2008:

Net income for the year ended December 31, 2009, increased 92.2%, or $25.3 million to $52.7 million, or $0.92 per dilutive share, compared to net income of $27.4 million, or $0.61 per dilutive share, for the comparable period of

2008. Net operating income, a non-GAAP measure, increased $14.7 million, or 37.9%, to $53.5 million, or $0.93 per dilutive share, compared to net operating income of $38.8 million, or $0.86 per dilutive share for the comparable period in 2008, with lower weighted average shares outstanding. Total diluted weighted average shares outstanding for the year ended December 31, 2009 were 57,413,391,

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compared to 44,995,712 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 year ended December 31, 2009, included net after-tax realized losses of $865,000, or $0.01 per diluted share, which consisted of other than temporary impairments primarily related to certain asset-backed securities, corporate bonds, and preferred stocks, which were primarily offset by the previously mentioned realized gains recognized in the fourth quarter of 2009 for tax planning purposes. The net after-tax realized losses of $865,000, or $0.01 per diluted share, compares to after-tax realized losses of $11.4 million, or $0.25 per diluted share in 2008. Net investment income increased 37.5% to $50.4 million, primarily related to the increase in invested assets as a result of 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. Net income for the year ended December 31, 2008, included after tax catastrophe losses of $5.4 million related to Hurricanes Gustav and Ike. The favorable improvement within net income was slightly offset by lower net commission and fee revenue.

Revenues for the year ended December 31, 2009, increased $189.8 million, or 43.3%, to $627.6 million, from $437.8 million for the comparable period in 2008. This increase reflects a $169.9 million increase in net earned premiums, of which $114.2 million related to our Century operations. Excluding the net earned premiums related to our Century operations, the increase of $55.7 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 11.7%, or $5.0 million, as further explained below. In addition, the revenues reflect a $13.7 million increase in investment income, which primarily reflects the increase in invested assets as a result of the ProCentury merger, as well as continued positive cash flow from operations.

For the year ended December 31, 2009, we recorded pre-tax and after-tax equity earnings of $1.3 million, or $0.02 per share and $874,000, or $0.015 per share respectively. The equity earnings relate to our share of earnings relating to our 28.5% ownership interest in an insurance holding limited liability company, as described above.

2008 compared to 2007:

Net income for the year ended December 31, 2008, was $27.4 million, or $0.61 per dilutive share, compared to net income of $28.0 million, or $0.85 per dilutive share, for the comparable period of 2007. Net operating income, a non-GAAP measure, increased $10.9 million, or 39.2%, to $38.8 million, or $0.86 per dilutive share, compared to net operating income of $27.9 million, or $0.84 per dilutive share for the comparable period in 2007, with lower weighted average shares outstanding. Total weighted average shares outstanding for the year ended December 31, 2008 were 44,995,712, compared to 33,101,965 for the comparable period in 2007. This increase in the weighted average shares was primarily the result of the equity issued in connection with the ProCentury merger, as well as a full year impact of the shares issued in July 2007 related to our capital raise.

Net income for the year ended December 31, 2008, was negatively impacted by after-tax realized losses of $11.4 million, or $0.25 per diluted share, primarily as a result of the other than temporary impairments in certain preferred stock investments, which primarily related to Freddie Mac, Fannie Mae, and Lehman Brothers investments, but also included several corporate bonds and asset-backed and mortgage-backed securities. In addition, net income for the year included the after-tax impact of catastrophe losses related to Hurricanes Gustav and Ike of $5.4 million, or

$0.12 per diluted share. In addition, net income included amortization expense of $6.3 million, compared to $1.9 million in 2007. We experienced improvements in our expense ratio as we continued to benefit from the elimination of the fronting fees associated with our prior use of an unaffiliated insurance carrier s A rated policy forms. Our expense ratio also benefited by our ability to further leverage fixed costs in the management company. In addition, net investment income increased 38.7% to $36.6 million. Somewhat offsetting the positive variables was a substantial increase in amortization expense

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related to the acquisition of the USSU business in 2007. In addition, amortization expense increased due to the other intangibles acquired in the ProCentury merger.

Revenues increased $97.1 million, or 28.5%, to $437.8 million for the year ended December 31, 2008, from $340.7 million for the comparable period in 2007. This increase reflected a $101.5 million increase in net earned premiums, of which $80.6 million related to ProCentury. Excluding the net earned premiums related to ProCentury, the increase was primarily the result of overall growth within our existing programs and new business we began underwriting in 2007 and 2008. Our overall net commissions and fees were down 6.7%, or $3.1 million. This decrease was primarily the result of a decrease in fees related to our New England-based programs, caused by a decrease in premium volume due to reduced rates in the self-insured markets on which the fees are based, due to mandatory rate reductions and an increase in competition. In addition, this decrease reflected slightly lower agency commission revenue, which resulted from more competitive pricing in certain jurisdictions. In 2008, we converted a portion of the policies produced by USSU to our Insurance Company Subsidiaries. The intercompany management fees associated with that portion of the underwritten policies of the USSU business that we brought in house were $2.2 million for the year ended December 31, 2008. These fees are now eliminated upon consolidation, thereby lowering net commissions and fees, but not impacting overall consolidated results.

In addition, the revenues reflected a $10.2 million increase in investment income, which primarily reflected the increase in invested assets acquired in the ProCentury merger. The remaining increase in investment income was partially the result of overall positive cash flow and the net proceeds received from our equity offering in July 2007. Slightly offsetting the increases was the $11.4 million in realized losses, primarily related to the other than temporary impairments recorded in the last half of 2008, as previously indicated.

Specialty Insurance Operations

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

	For the Years Ended December 31,		
	2009	2008	2007
Revenue:			
Net earned premiums	$ 539,602	$ 369,721	$ 268,197
Management fees	18,901	21,168	23,963
Claims fees	7,428	8,879	9,025
Loss control fees	1,975	2,069	2,151
Reinsurance placement	931	728	929
Investment income	49,910	35,888	25,487
Net realized (losses) gains	(225)	(11,422)	150
Total revenue	$ 618,522	$ 427,031	$ 329,902
Pre-tax income:			

Specialty insurance operations	$ 97,346	$ 60,125	$ 47,898

2009 compared to 2008:

Revenues from specialty insurance operations increased $191.5 million, or 44.8%, to $618.5 million for the year ended December 31, 2009 from $427.0 million for the comparable period in 2008.

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Net earned premiums increased $169.9 million, or 45.9%, to $539.6 million for the year ended December 31, 2009, from $369.7 million in the comparable period in 2008. This increase was the result of $114.2 million in net earned premiums related to our Century operations. The remaining increase of $55.7 million was primarily the result of growth within our existing programs and the new business we implemented in 2008 and 2009.

Management fees decreased $2.3 million, or 10.7%, to $18.9 million for the year ended December 31, 2009, from $21.2 million for the comparable period in 2008. This decrease primarily relates to two programs we previously managed where the client is now performing their own policy administration services. This decrease is also due to an overall decrease in fees within our specialty program manager subsidiary, primarily as a result of competitive pricing pressures. In addition, this decrease was the result of a decrease in fees in our New England-based self-insured programs, caused by a decrease in premium volume from continued competition and poor economic conditions.

Claim fees decreased $1.5 million, or 16.3%, to $7.4 million for the year ended December 31, 2009, from $8.9 million for the comparable period in 2008. This decrease primarily relates to a program we previously managed where the client is now performing their own claim administrative services. In addition, this decrease is related to the loss of a specific workers compensation program and is also related to lower premium volumes related to self-insured programs, which is the basis for the fee revenue.

Net investment income increased $14.0 million, or 39.1%, to $49.9 million for the year ended December 31, 2009, from $35.9 million for the comparable period in 2008. This increase is primarily the result of $12.7 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 of positive cash flows from operations. Total cash flows from operations as of December 31, 2009 were $127.7 million, compared to $93.9 million in 2008. The positive cash flows from operations were primarily due to favorable underwriting results. The average investment yield for December 31, 2009 was 4.40%, compared to 4.22% in 2008. The current pre-tax book yield was 4.44%. The current after-tax book yield was 3.36%, compared to 3.32% in 2008. The duration of the investment portfolio is 4.4 years at December 31, 2009, compared to 4.5 years at December 31, 2008.

Specialty insurance operations generated pre-tax income of $97.3 million for the year ended December 31, 2009, compared to pre-tax income of $60.1 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. This improvement was also attributable to an increase in net investment income. In addition, this improvement was attributable to an increase of $11.2 million related to realized gains and losses. Pre-tax realized losses for the year ended December 31, 2009 were $225,000, compared to a pre-tax loss of $11.4 million for the comparable period in 2008. The realized losses recognized in the year related to impairment charges related to specific securities as previously mentioned, offset by realized gains from sales of certain securities for tax planning purposes. The realized loss in 2008 related to the other than temporary impairments recognized in the fourth quarter of 2008, which related to securities within the investment portfolio acquired with the ProCentury merger. The GAAP combined ratio was 92.6% for the year ended December 31, 2009, compared to 93.3% for the same period in 2008.

Net loss and loss adjustment expenses (LAE) increased $94.2 million, or 44.3%, to $307.1 million for the year ended December 31, 2009, from $212.9 million for the same period in 2008. Our loss and LAE ratio decreased

1.3 percentage points to 60.7% for the year ended December 31, 2009, from 62.0% for the same period in 2008. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. Our accident year loss ratio, which is a non-GAAP measure, was 66.0% in 2009, compared to 66.5% in 2008. An accident year loss ratio measures losses and LAE occurring in a particular year, regardless of when they are reported and does not take into consideration changes in estimates in loss reserves from prior accident years.

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Our 2009 accident year loss ratio is a good means of comparison to historical trends and current industry estimates. We continue to see favorable development primarily resulting from within our general liability line of business due to lower frequency and severity and better than expected incurred and paid claims results. To a lesser extent, we continue to experience favorable development in workers compensation, auto liability, and professional liability, slightly offset by unfavorable development in our excess liability line of business. In addition, we revised our estimated claims handling costs through a comprehensive actual costs study, which increased favorable development within our unallocated loss adjustment expense reserve. Our results in 2008 included after-tax catastrophe losses of $5.4 million related to Hurricanes Gustav and Ike. Additional discussion of our reserve activity is described below within the *Other Items Reserves* section.

Our expense ratio was 31.9% for the year ended December 31, 2009, compared to 31.3% for the same period in 2008. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. Our overall leveraging of fixed costs has been somewhat offset by the higher level of internal costs and reductions in ceding commission, primarily related to a reduction in risk-sharing partner participation and a reduction in the ceding commission rate within one particular line of business on a specific program. In addition, the overall proportion of risk sharing programs in relation to our overall book of business has decreased as a result of the ProCentury merger. In addition, higher average direct commission rates associated with Century s business also contributed to the increase in the expense ratio, which includes twelve months of these costs for 2009 and only five months in 2008. The higher commissions were slightly offset by lower insurance related assessments. As a surplus lines carrier, Century is not subject to premium taxes on its non-admitted business.

2008 compared to 2007:

Revenues from specialty insurance operations increased $97.1 million, or 29.4%, to $427.0 million for the year ended December 31, 2008, from $329.9 million for the comparable period in 2007.

Net earned premiums increased $101.5 million, or 37.8%, to $369.7 million for the year ended December 31, 2008, from $268.2 million in the comparable period in 2007. This increase was primarily the result of $79.3 million in net earned premiums related to ProCentury. Excluding the net earned premiums related to ProCentury, net earned premiums increased $22.2 million, or 8.3%. This increase was primarily the result of overall growth within our existing programs and the new business we began writing in 2007 and 2008, as well as additional selective growth consistent with our corporate underwriting guidelines.

Management fees decreased $2.8 million, or 11.7%, to $21.2 million for the year ended December 31, 2008, from $24.0 million in the comparable period in 2007. This decrease was primarily the result of a decrease in fees related to our New England-based programs, primarily caused by a decrease in premium volume due to reduced rates in the self-insured markets on which the fees are based, due to mandatory rate reductions and an increase in competition.

Claim fees remained relatively flat for 2008 compared to 2007.

Net investment income increased $10.4 million, or 40.8%, to $35.9 million in 2008, from $25.5 million in 2007. This increase was primarily the result of $8.7 million in net investment income related to ProCentury. Overall, invested assets increased due to the inclusion of ProCentury s invested assets, which were $434.3 million at December 31, 2008, coupled with the investing from positive cash flows from operations. The positive cash flows from operations were due to favorable underwriting results, increased fee revenue, and the lengthening of the duration of our reserves. The increase in the duration of our reserves reflected the impact of growth in our excess liability business, which was implemented at the end of 2003. This type of business has a longer duration than the average reserves on our other programs and was a larger proportion of reserves. In addition, the increase in average invested assets reflects cash flows from our equity offering in July 2007. The average investment yield for December 31, 2008 was 4.22%, compared to 4.6% in 2007. The current pre-tax book yield was 4.4%. The current after-tax book yield for the year ended December 31, 2008

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was 3.3%, compared to 3.4% in 2007. The duration of the investment portfolio was 4.5 years at December 31, 2008, compared to 4.3 years at December 31, 2007.

Specialty insurance operations generated pre-tax income of $60.1 million for the year ended December 31, 2008, compared to pre-tax income of $47.9 million for the comparable period in 2007. This increase in pre-tax income primarily demonstrated 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 attributable to an increase in net investment income. Partially offsetting these improvements were the previously mentioned other than temporary impairments recognized in the investment portfolio in the last half of the year, which primarily related to securities within the investment portfolio acquired with the Merger. In addition, these improvements were also partially offset by the impact of the losses incurred with the two hurricanes, as mentioned above. The GAAP combined ratio was 93.3% for the year ended December 31, 2008, compared to 95.4% for the same period in 2007.

Net loss and loss adjustment expenses (LAE) increased $61.9 million, or 41.0%, to $212.9 million for the year ended December 31, 2008, from $151.0 million for the same period in 2007. Our loss and LAE ratio increased 0.8 percentage points to 62.0% in 2008, from 61.2% for the same period in 2007. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. Net loss and LAE includes $49.2 million of net loss and LAE expense related to ProCentury. In addition, the loss and LAE ratio of 62.0% includes 2.3 percentage points related to the previously mentioned catastrophe losses. The loss and LAE ratio includes favorable development of $16.8 million, or 4.5 percentage points, compared to favorable development of $7.1 million, or 2.6 percentage points in 2007. The increase in our favorable development in comparison to 2007 was primarily the result of an increase in favorable development within our auto liability and general liability lines of business due to lower frequency and severity and better than expected claims results. This was somewhat offset by an increase in adverse development for an excess program.

Our expense ratio decreased 2.9 percentage points to 31.3% for the year ended December 31, 2008, from 34.2% for the same period in 2007. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. The decrease in our expense ratio reflects the anticipated decrease in commission due to the elimination of the fronting fees paid in 2007 to an unaffiliated insurance carrier to use their A rated policy forms, which was approximately 0.6 percentage points incurred in 2007, compared to no costs in 2008. Despite a higher level of internal fixed costs at ProCentury, we achieved a 0.5 percentage point improvement on the expense ratio from leveraging the fixed costs of the combined company. In addition, lower insurance related assessments and a lower level of other underwriting expenses, such as loss control and commissions relating to mix of business also contributed to this improvement.

Agency Operations

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

	For the Years Ended December 31,		
	2009	**2008**	**2007**

Net commission	$ 9,561	$ 11,064	$ 11,316
Pre-tax (loss) income(1)	$ (1,010)	$ 1,142	$ 2,087

(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 years ended December 31, 2009, 2008, and 2007, the allocation of corporate overhead to the agency operations segment was $3.4 million, $2.8 million, and $2.8 million, respectively.

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2009 compared to 2008:

Revenue from agency operations, which consists primarily of agency commission revenue, was $9.6 million for the year ended December 31, 2009, compared to $11.1 million for the comparable period in 2008. This decrease primarily reflects regional competition, poor economic conditions, 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 a pre-tax loss, after the allocation of corporate overhead, of ($1.0) million for the year ended December 31, 2009, compared to pre-tax income of $1.1 million 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.

2008 compared to 2007:

Revenue from agency operations, which consists primarily of agency commission revenue, decreased $252,000, or 2.2%, to $11.1 million for the year ended December 31, 2008, from $11.3 million for the comparable period in 2007. This decrease primarily reflected regional competition and a softer insurance market within our mid to larger Michigan accounts and isolated competitive pricing pressure in the California automobile market.

Agency operations generated pre-tax income, after the allocation of corporate overhead, of $1.1 million for the year ended December 31, 2008, compared to $2.1 million for the comparable period in 2007. The decrease in the pre-tax income was primarily attributable to the decrease in agency commission revenue mentioned above.

Other Items

Reserves

At December 31, 2009, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was $682.4 million. We established a reasonable range of reserves of approximately $620.2 million to $724.2 million. This range was established primarily by considering the various indications derived from standard actuarial techniques and other appropriate reserve considerations. The following table sets forth this range by line of business (in thousands):

Line of Business	Minimum Reserve Range	Maximum Reserve Range	Selected Reserves
Workers Compensation(1)	$ 194,753	$ 215,606	$ 207,636
Commercial Multiple Peril/General Liability	293,767	360,413	333,687
Commercial Automobile	98,676	110,660	105,469

Other		33,037		37,492		35,584
Total Net Reserves	$	620,233	$	724,171	$	682,376

(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

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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 years ended December 31, 2009 and 2008.

For the year ended December 31, 2009, we reported a decrease in net ultimate loss estimates for accident years 2008 and prior of $28.7 million, or 4.6% 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 2009 and 2008. The major components of this change in ultimate loss estimates are as follows (in thousands):

	Reserves at	Incurred Losses			Paid Losses			Reserves at
Line of Business	**December 31, 2008**	**Current Year**	**Prior Years**	**Total Incurred**	**Current Year**	**Prior Years**	**Total Paid**	**December 31, 2009**
Workers Compensation	$ 147,813	$ 104,259	$ (7,787)	$ 96,472	$ 17,495	$ 41,061	$ 58,556	$ 185,729
Residual Markets	23,984	6,588	(3,585)	3,003	2,474	2,606	5,080	21,907
Commercial Multiple Peril/General Liability	317,188	101,992	(9,395)	92,597	3,626	72,471	76,097	333,688
Commercial Automobile	92,788	66,080	(4,073)	62,007	16,722	32,605	49,327	105,468
Other	43,558	56,838	(3,830)	53,008	36,200	24,782	60,982	35,584
Net Reserves	625,331	$ 335,757	$ (28,670)	$ 307,087	$ 76,517	$ 173,525	$ 250,042	682,376
Reinsurance Recoverable	260,366							266,801
Consolidated	$ 885,697							$ 949,177

	Reserves at	Re-estimated Reserves at December 31,	Development as a Percentage of

Line of Business	December 31, 2008	2009 on Prior Years	Prior Year Reserves
Workers Compensation	$ 147,813	$ 140,026	(5.3)%
Commercial Multiple Peril/General Liability	317,188	307,793	(3.0)%
Commercial Automobile	92,788	88,715	(4.4)%
Other	43,558	39,728	(8.8)%
Sub-total	601,347	576,262	(4.2)%
Residual Markets	23,984	20,399	(14.9)%
Total Net Reserves	$ 625,331	$ 596,661	(4.6)%

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Workers Compensation Excluding Residual Markets

The projected net ultimate loss estimate for the workers compensation line of business excluding residual markets decreased $7.8 million, or 5.3% of net workers compensation reserves. This net overall decrease reflects decreases of $2.6 million, $1.2 million, and $3.3 million in accident years 2007, 2006, and 2005, respectively. The decreases reflect better than expected experience for many of our workers compensation programs, including a Nevada, Florida, New England, and countrywide workers compensation association program. Actual losses reported were less than expected given the prior actuarial assumptions. These decreases were offset by an increase of $507,000 in the net ultimate loss estimate for accident year 2003. This increase in the net ultimate loss estimate for this accident year was due to greater than expected claim emergence in a Florida workers compensation program. The change in ultimate loss estimates for all other accident years was insignificant.

Commercial Multiple Peril and General Liability

The commercial multiple peril line and general liability line of business had a decrease in net ultimate loss estimates of $9.4 million, or 3.0% of net commercial multiple peril and general liability reserves. The net decrease reflects decreases of $5.0 million, $6.8 million, $701,000 and $1.5 million in the ultimate loss estimates for accident years 2008, 2007, 2006 and 1994, respectively. The decreases were due to better than expected claim emergence in general liability business. These decreases were offset by increases in the net ultimate loss estimates of $716,000, $1.8 million and $1.4 million for accident years 2005, 2004 and 2003, respectively. These increases were due to greater than expected claim emergence in 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 decreased $4.1 million, or 4.4% of net commercial automobile reserves. This net overall decrease reflects decreases of $611,000, $2.9 million and $662,000 for accident years 2008, 2007 and 2005, respectively. The decreases for these accident years were due to better than expected claim emergence in two California-based programs and an excess liability program. These decreases were offset by increases of $635,000 and $629,000 in accident years 2006 and 2004, respectively. These increases were due to greater than expected claim emergence in an excess liability program and a garage 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 $3.8 million, or 8.8% of net reserves. This net decrease reflects decreases of $860,000, $1.3 million and $675,000 in the net ultimate loss estimate for accident years 2008, 2007 and 2005, respectively. These decreases were primarily due to better than expected case reserve development during the calendar year in a professional liability program. The change in ultimate loss estimates for all other accident years was insignificant.

Residual Markets

The workers compensation residual market line of business had a decrease in net ultimate loss estimate of $3.6 million, or 14.9% of net reserves. This decrease reflects decreases of $2.4 million and $598,000 in accident years 2008 and 2007, respectively. 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.

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Salaries and Employee Benefits

Salaries and employee benefits increased $18.0 million, or 28.7%, to $80.9 million in 2009, from $62.9 million in 2008. This increase was primarily the result of the salary expense related to our Century operations. This increase was also the result of an increase in variable compensation, in comparison to 2008, due to performance criteria established by our Compensation Committee of the Board of Directors. The increase in variable compensation was primarily attributable to the inclusion of additional participants into the variable compensation plans due to the ProCentury merger, as well as overall improved financial results.

Salaries and employee benefits increased $6.4 million, or 11.4%, to $62.9 million in 2008, from $56.4 million in 2007. Included in the $62.9 million were salaries and employee benefits related to ProCentury of $9.1 million. Excluding the salaries and employee benefits related to ProCentury, overall salaries and employee benefits would have decreased $2.6 million. This decrease primarily reflected a decrease in variable compensation. The decrease in variable compensation, in comparison to 2007, reflected the increase in our targeted measure for earning variable compensation. In addition, this decrease was the result of a decrease in profit sharing commissions. The decrease in profit sharing commissions was the result of our purchase of an excess liability book of business. As a result of us owning the book of business, we no longer pay the profit sharing commissions.

Additional discussion of our variable compensation plan is described below under *Variable Compensation*.

Other Administrative Expenses

Other administrative expenses increased $4.4 million, or 12.6%, to $39.4 million in 2009, from $35.0 million in