MEADOWBROOK INSURANCE GROUP INC
Form 10-K
March 14, 2006

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, 2005

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 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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, 2005 was $134,581,194. As of March 3, 2006, there were 28,767,321 shares of the Company s common stock ($.01 par value) outstanding.

Documents Incorporated by Reference

Certain portions of the Registrant s Proxy Statement for the 2006 Annual Meeting scheduled for May 10, 2006 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 , or Us) (NYSE: MIG) is a holding company organized as a Michigan corporation in 1985. We were formerly known as Star Holding Company and in November 1995, upon acquisition of Meadowbrook, Inc. (Meadowbrook), we changed our name. Meadowbrook was founded in 1955 as Meadowbrook Insurance Agency and was subsequently incorporated in Michigan in 1965.

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, Williamsburg National Insurance Company, and Ameritrust Insurance Corporation (which collectively are referred to as the Insurance Company Subsidiaries), as well as, American Indemnity Insurance Company, Ltd. (American Indemnity) and Preferred Insurance Company, Ltd. We also serve as a holding company for Meadowbrook, Crest Financial Corporation, and their subsidiaries.

Significant Acquisitions

November 1, 2005, we acquired the business of Insurance & Benefit Consultants (IBC) of Sarasota, Florida. IBC is a retail agency specializing in group and individual health insurance products and personal financial planning services.

September 16, 2005, Meadowbrook Capital Trust II (Trust II), a Delaware trust, was formed and in turn issued $20.0 million of mandatorily redeemable trust preferred securities to a trust formed by an institutional investor. Pursuant to Financial Accounting Standards Board Interpretation Number (FIN) 46(R), we do not consolidate the Trust II as it is not a variable interest entity and we are not the primary beneficiary. The consolidated financial statements, however, include the equity earnings of the Trust II.

Effective January 1, 2004, our rent-a-captive subsidiary, American Indemnity, which was acquired in 1994, was deconsolidated due to the adoption of FIN 46(R). In accordance with FIN 46(R), we performed an evaluation of our business relationships and determined American Indemnity did not satisfy the tests for consolidation. Although we and our subsidiary Star are the common shareholders, we are not the primary beneficiaries of American Indemnity. The preferred shareholders of American Indemnity bear the risk of loss, and therefore are the primary beneficiaries. The consolidated financial statements, however, include the equity earnings of American Indemnity. The deconsolidation did not have a material impact on our financials.

In September 2003, Meadowbrook Capital Trust I (Trust I), a Delaware trust, was formed and in turn issued $10.0 million of mandatorily redeemable trust preferred securities to a trust formed by an institutional investor. Pursuant to FIN 46(R), we do not consolidate the Trust I as it is not a variable interest entity and we are not the primary beneficiary. The consolidated financial statements, however, include the equity earnings of the Trust I.

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., and approximately ninety-four percent of the outstanding stock of Preferred Insurance Company, Ltd. (PICL) (collectively, TPA). TPA is a program-oriented risk management company that provides risk management services to self-insured clients, manages alternative risk management programs, and performs underwriting, policy issuance and loss control services for an unaffiliated insurance company. In January 2002, we purchased the remaining six percent minority interest of PICL for $288,000.

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In July 1998, we acquired Florida Preferred Administrators, Inc. (Florida Preferred), a third party administrator, and Southeastern Holding Corporation, a holding company for Ameritrust Insurance Corporation (Ameritrust), both of which are domiciled in Sarasota, Florida. In December 2002, Southeastern Holding Corporation was dissolved and Ameritrust became a wholly owned subsidiary of Star. Florida Preferred provides a broad range of risk management services for Ameritrust.

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

In November 1996, we acquired Association Self Insurance Services, Inc. (ASI) of Montgomery, Alabama, which is a full service risk management operation focused on insurance pools and trust funds whose services include claims administration and handling, loss control and prevention, managed care, and policy issuance. ASI s operations were consolidated with Meadowbrook s existing operations in Montgomery, Alabama.

In July 1990, we acquired Savers Property and Casualty Insurance Company (Savers).

Employees

At March 3, 2006, we employed approximately 648 associates to service our clients and provide management services to the *Insurance Operations* as defined below. We believe we have good relationships with our employees.

Overview

We are a full-service risk management organization which focuses on niche or specialty program business and risk management solutions for agents, brokers, professional and trade associations, pools, trusts, and small to medium-sized insureds. Our programs are primarily on a regional basis with a single line of business within a program. We have a regional focus in New England, Florida, and Nevada within the workers compensation line of business. We also have a regional focus in California within commercial auto and commercial multiple peril. Our fee-for-service business is also on a regional basis with an emphasis in the Midwest and southeastern regions. We are among the top twenty insurance agents in the United States. We currently manage over $700 million in gross written premiums.

We were founded in 1955 as a retail insurance agency. Today, our Michigan-based retail insurance agency operations are consistently ranked as a leading business insurance agency in Michigan. We earn commission revenue through the operation of our retail property and casualty insurance agencies.

Since 1976, we have also specialized in providing risk management 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 potentially turn risk management into a profit center. By having their capital at risk, our clients are motivated to reduce exposure and share in the underwriting profits and investment income derived from their risk management plan.

Based upon the particular risk management goals of our clients and our assessment of the opportunity for operating profit, we offer solutions on a managed basis, a risk-sharing basis, or a fully-insured basis, in response to a specific market opportunity. In a managed program, we earn service fee revenue by providing management 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 a captive or rent-a-captive. The captive and rent-a-captive structures are licensed reinsurance companies and are accounted for under the provisions of Statement of Financial Accounting Standards

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(SFAS) No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* . 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 the ceding commission. In a fully-insured program, we provide insurance products without a risk-bearing mechanism and derive revenue from net earned premiums and investment income.

We have developed a broad range of capabilities and services in the design, management, and servicing of our clients risk management needs. These capabilities and services include:

- program and product design;
- underwriting, risk selection, and policy issuance;
- sales, marketing, and public relations to members of groups;
- administration of risk-bearing entities, such as mutual insurance companies, captives, rent-a-captives, public entity pools, and risk retention and risk purchasing groups;
- claims handling and administration;
- loss prevention and control;
- reinsurance placement;
- risk analysis and identification;
- actuarial and loss reserve analysis;
- information technology and processing;
- feasibility studies;
- litigation management;
- accounting and financial statement preparation;
- regulatory compliance; and
- audit support.

We are committed to a strong underwriting discipline and controlled growth. We continually focus on the leveraging of fixed costs, strong internal controls and overall process improvements. We remain dedicated to growing our margins and return on equity, as well as growing all aspects of our balanced revenue sources. With the strength of our balance sheet and our concerted efforts aimed toward improving productivity, we are optimistic of our future results.

Company Segments

Agency Operations

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

In total, our agency operations generated commissions of $11.3 million, $9.8 million, and $9.4 million, for the years ended December 31, 2005, 2004, and 2003, respectively.

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Specialty Risk Management Operations

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

Net earned premiums include the following lines of business:

- Workers Compensation
- Commercial Multiple Peril
- General Liability
  - Errors and Omissions
  - Automobile
  - Owners, Landlord and Tenant
- Employment Practices Liability
- Professional Liability
  - Medical
  - Real Estate Appraisers
  - Pharmacists
- Inland Marine
- Product Liability
- Excess Reinsurance
- Commercial Property

Description of Specialty Risk Management Programs

Managed Programs: With a managed program, we earn fee-for-service revenue by providing management 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 managed programs provide a consistent source of revenue, as well as opportunities for revenue growth without a proportionate increase in capital. 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 fee revenue from managed programs include:

- program design and development;
- underwriting;
- reinsurance placement;

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policy administration;

loss prevention and control;

claims administration and handling;

litigation management;

information technology and processing;

accounting functions; and

general management and oversight of the program.

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

We provide insurance management services to public entity associations and currently manage public entity pools and other insurance entities, which provide insurance coverage for approximately 1,700 participants, including city, county, township, and village governments in three states, as well as other diverse industry groups.

Risk-Sharing Programs:

Client Risk-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 share the operating results with the client or client group through a reinsurance agreement with a 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. The captive and rent-a-captive structures are licensed 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. Therefore, the transactions associated with the captive and rent-a-captive structures are accounted for under the provisions of SFAS No. 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*

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 the ceding commission. For financial reporting purposes, ceding commissions are treated as a reduction in underwriting expenses.

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 loss prevention, risk control measures and to adhere to stricter underwriting guidelines.

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

CAPTIVE RISK-SHARING STRUCTURE

(1) We account for transactions with these risk-sharing clients as reinsurance under the provisions of SFAS No. 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Clients.*

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 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/producer 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 do not provide loss prevention, claims handling, underwriting, and other insurance services directly to the captive. 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.

In applying FIN 46(R) s provisions to the captive risk-sharing structure, 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 (1) is 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) is 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 either FASB Statement No. 57, *Related Party Disclosures,* or paragraph 16 of FIN 46(R).

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. We protect ourselves from potential credit risk related to reinsurance recoverables from the captive by a collateral requirement in a trust agreement equal to a multiple 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 participate in the operating results of the reinsurance coverage and receive a ceding commission in the client risk-sharing reinsurance contract to reimburse us for expenses and our fee for services.

In another version of client risk-sharing, the agent accepts an up-front commission that is adjusted up or down based on operating results of the program produced.

In 2004, certain brokerage and insurance companies unrelated to the Company were investigated by regulatory and legal authorities. The investigation primarily related to two issues: (1) improper payment of contingent commissions by insurance companies to brokers who represented the policyholder; and (2) alleged price fixing and/or bid rigging. We have not received a subpoena from regulatory or legal authorities. Our Code of Conduct, Business Conduct Policy and other corporate policies prohibits these type of activities. We monitor our business relationships in an effort to assure adherence to legal and other regulatory mandates.

Following this highly publicized investigation, many state insurance departments sent letters of inquiry to insurance companies requesting information on contingent commission payments. We have responded to each letter of inquiry requesting such information. In the event state insurance departments adopt any new regulatory laws relating to contingent commissions, we will implement any necessary changes in order to comply with any new regulatory pronouncements.

Fully-Insured Programs: With a fully-insured program, we provide our insurance products without a risk-sharing mechanism and derive revenue from net earned premiums and investment income. Fully-insured programs are generally developed only in response to specific market opportunities and when we believe there is potential to evolve into a risk-sharing mechanism.

Description of Major Specialty Risk Management 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 primary 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 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.

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Underwriting Risk Selection and Policy Issuance. With our fully-insured and risk-sharing programs, through our risk management subsidiary, we perform underwriting services for our Insurance Company Subsidiaries that meet our corporate underwriting guidelines. We maintain substantially all ultimate underwriting authority and monitor compliance with our corporate underwriting guidelines through a periodic underwriting audit process and with a system of internal control procedures. 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 perform underwriting services based upon the profile of the specific program for a fee.

Claims Administration and Handling. With our fully insured and risk-sharing programs, through personnel in our risk management services subsidiary, we provide substantially all claims management and handling services for workers compensation and most other casualty 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, 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. With our fully insured and risk-sharing programs, 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. We currently provide administrative services for over fifteen captives and/or rent-a-captives and hold an insignificant minority interest in three of these captives. We also hold an insignificant minority interest in one former captive which we no longer manage and is currently in run-off. These services are provided by one of our subsidiaries in Bermuda or Barbados.

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

Sales, Marketing, and Public Relations. We market our programs and services to associations, groups, local, regional and national insurance agents, and insurance consultants. Sales and marketing efforts include personal contact through independent agents, direct mail, telemarketing, advertising, internet-based marketing including affiliations with an insurance based web portal (captive.com) and our corporate website (www.meadowbrook.com), and attendance at seminars and trade and industry conventions.

In June 2000, we launched our Advantage System (Advantage) and Agents Edge™. Advantage is an internet-based business processing system, which reduces our internal administrative costs. In addition to administrative processing efficiencies, Advantage enhances underwriting practices, by automating risk selection criteria.

Agents Edge™ is a specific application of Advantage utilizing an automated, predictable, profit-driven underwriting model to make workers compensation products available to select agencies through our regional branch offices. We have an active focus through Agents Edge™ in thirteen states for our workers compensation programs.

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Insurance Operations

Our Insurance Company Subsidiaries issue insurance policies. Through our Insurance Company Subsidiaries, we engage in specialty risk management programs where we assume underwriting risks in exchange for premium. Our Insurance Company Subsidiaries primarily focus on specialty programs designed specifically for trade groups and associations, whose members are homogeneous in nature. Members are typically small-to-medium sized businesses. 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 nationwide basis; but more generally, our programs operate on a regional or state-specific basis. We maintain underwriting authority through our regional offices based upon underwriting guidelines set forth by our corporate underwriting department, which we monitor through underwriting audits and a series of executive underwriting and rate monitor reports. We avoid geographic concentration of risks that might lead to 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. Our foreign captives, American Indemnity and PICL, which offer clients captive or rent-a-captive options, complement our Insurance Company Subsidiaries.

Star, Savers, Williamsburg and Ameritrust are domiciled in Michigan, Missouri, California, and Florida, respectively. American Indemnity and PICL are Bermuda-based insurance companies.

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

Our Insurance Company Subsidiaries are authorized to write business, on either an admitted or surplus lines basis, in all fifty states. Our Insurance Company Subsidiaries primarily offer workers compensation, commercial multiple peril, general liability, inland marine, and other liability coverages. For the year ended December 31, 2005, the workers compensation line of business accounted for 40.3%, 45.4%, and 47.8% of gross written premiums, net written premiums, and net earned premiums, respectively.

Within 2001, 2000, and 1999, we eliminated a limited group of unprofitable programs that were not aligned with our historic and present business strategy. The uncertainty of future reserve development on these discontinued programs has been reduced as a result of aggressive claims handling and reserve strengthening. However, while we believe we have adequate reserves, there can be no assurances that there will not be additional losses in the future relating to these programs. Outstanding reserves related to these discontinued programs as of December 31, 2005 and 2004, were $7.4 million and $10.1 million, respectively.

In September 2003, we issued $10.3 million of junior subordinated debentures to an unconsolidated subsidiary trust. We received a total of $9.7 million in net proceeds from the issuance of these debentures, of which $6.3 million was contributed to the surplus of our Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes.

In April and May 2004, we issued senior debentures in the amount of $13.0 million and $12.0 million, respectively. The senior debentures mature in thirty years. We contributed $9.9 million of the proceeds from the senior debentures to our Insurance Company Subsidiaries as of December 31, 2004. The remaining proceeds from the issuance of the senior debentures may be used to support future premium growth through further contributions to our Insurance Company Subsidiaries and general corporate purposes.

In September 2005, we issued $20.6 million of junior subordinated debentures to an unconsolidated subsidiary trust. We received a total of $19.4 million in net proceeds from the issuance of these debentures, of which $10.0 million was contributed to the surplus of our Insurance Company Subsidiaries and the remaining balance may be used for general corporate purposes.

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On April 19, 2005, we announced an upgrade from A.M. Best of certain of our Insurance Company Subsidiaries from B+ (Very Good), with a positive outlook to B++ (Very Good). The ratings upgrade applies to Star, Savers Property and Casualty Insurance Company, and Williamsburg National Insurance Company. Additionally, A.M. Best reaffirmed the rating for Ameritrust Insurance Corporation as B+ (Very Good), with a positive outlook.

The following table summarizes gross written premiums, net written premiums, and net earned premiums for the years ended December 31, 2005, 2004, 2003, 2002, and 2001 (in thousands):

Gross Written Premiums	**2005**	**2004**	**2003**	**2002**	**2001**
Workers Compensation	$ 133,732	$ 146,982	$ 141,456	$ 104,822	$ 147,654
Commercial Multiple Peril	85,978	71,715	48,091	33,072	44,513
Inland Marine	12,467	10,925	9,758	8,886	12,048
Other Liability	16,167	15,248	10,473	10,442	28,856
Other Commercial Auto Liability	59,144	48,070	26,902	9,894	38,191
Surety Bonds	89	42	5	2,998	7,377
All Other Lines	24,632	20,511	16,595	13,523	20,465
Total	$ 332,209	$ 313,493	$ 253,280	$ 183,637	$ 299,104

Net Written Premiums	**2005**	**2004**	**2003**	**2002**	**2001**
Workers Compensation	$ 117,287	$ 122,896	$ 111,572	$ 90,979	$ 80,232
Commercial Multiple Peril	59,870	46,351	36,628	22,375	31,019
Inland Marine	1,690	1,630	1,500	1,587	3,783
Other Liability	8,004	7,568	6,278	4,296	19,982
Other Commercial Auto Liability	49,122	37,762	19,599	9,125	35,502
Surety Bonds	30	11	73	119	180
All Other Lines	22,191	17,743	14,177	11,314	15,385
Total	$ 258,194	$ 233,961	$ 189,827	$ 139,795	$ 186,083

Net Earned Premiums	**2005**	**2004**	**2003**	**2002**	**2001**
Workers Compensation	$ 119,423	$ 117,914	$ 93,324	$ 80,795	$ 69,360
Commercial Multiple Peril	54,829	43,701	26,075	23,462	27,004
Inland Marine	1,727	1,628	1,556	1,716	3,782
Other Liability	8,072	6,416	4,849	9,325	22,539
Other Commercial Auto Liability	45,373	29,274	12,940	17,548	27,535
Surety Bonds	5	38	73	97	173
All Other Lines	20,530	15,522	12,388	12,440	13,272

Total	$ 249,959	$ 214,493	$ 151,205	$ 145,383	$ 163,665

Reserves

The information required by this item is incorporated by reference to the *Losses and Loss Adjustment Expenses and Reinsurance Recoverables* section of Note 1 *Summary of Significant Accounting Policies* and Note 3 *Liability for Losses and Loss Adjustment Expenses* of the Notes to the Consolidated Financial Statements, as well as to the *Critical Accounting Estimates* section and the *Reserves* section of Item 7, Management s Discussion and Analysis.

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The following table shows the development of reserves for unpaid losses and loss adjustment expenses (LAE) from 1996 through 2005 for our Insurance Company Subsidiaries including PICL, and the deconsolidation impact of American Indemnity.

Due to our adoption of SFAS 113, the bottom portion of the table shows the impact of reinsurance for the years 1996 through 2005, reconciling the net reserves shown in the upper portion of the table to gross reserves.

Analysis of Loss and Loss Adjustment Expense Development(1)

	Years Ended December 31,									
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	
	(In thousands)									
for l nd	$ 65,775	$ 60,786	$ 84,254	$ 127,500	$ 172,862	$ 198,653	$ 193,116	$ 192,019	$ 226,996	$
idation ary			(147)	(1,425)	(3,744)	(5,572)	(2,973)	(2,989)		
or l nd	$ 65,775	$ 60,786	$ 84,107	$ 126,075	$ 169,118	$ 193,081	$ 190,143	$ 189,030	$ 226,996	$
ve										
	31,626	31,368	39,195	54,928	70,952	77,038	78,023	71,427	79,056	
ater	49,930	47,313	56,763	90,416	115,669	130,816	122,180	118,729		
ater	58,362	56,848	76,776	116,001	146,548	157,663	151,720			
ater	64,018	65,517	85,447	132,995	160,673	176,172				
ater	67,928	68,138	93,009	139,939	171,992					
ater	69,503	72,063	96,739	146,997						
ater	72,337	74,002	101,433							
ater	73,992	76,421								
ater	75,831									
ted of										
	67,010	69,012	98,587	146,213	182,976	199,171	193,532	193,559	231,880	
ater	69,536	73,591	106,487	144,453	186,191	205,017	196,448	203,394		
ater	74,796	74,009	102,075	152,630	189,632	207,379	202,126			
ater	74,439	77,771	104,017	156,997	190,305	211,394				
ater	76,025	78,490	106,668	158,287	196,158					
ater	77,239	80,084	109,038	159,449						
ater	79,142	80,626	110,541							
ater	79,580	81,282								
ater	80,017									

re y:									
	$ (14,242)	**$ (20,496)**	**$ (26,434)**	**$ (33,374)**	**$ (27,040)**	**$ (18,313)**	**$ (11,983)**	**$ (14,364)**	**$ (4,884)**
ge	**(21.7)%**	**(33.7)%**	**(31.4)%**	**(26.5)%**	**(16.0)%**	**(9.5)%**	**(6.3)%**	**(7.6)%**	**(2.2)%**
ves	**65,775**	**60,786**	**84,107**	**126,075**	**169,118**	**193,081**	**190,143**	**189,030**	**226,996**
	26,615	38,193	64,590	101,744	168,962	195,943	181,817	147,446	151,161
	92,390	98,979	148,697	227,819	338,080	389,024	371,960	336,476	378,157
ted	**80,017**	**81,282**	**110,541**	**159,449**	**196,158**	**211,394**	**202,126**	**203,394**	**231,880**
ted	43,892	60,716	104,304	175,586	253,659	272,647	242,215	231,282	187,650
ted	123,909	141,998	214,845	335,035	449,817	484,041	444,341	434,676	419,530
re y	$ (31,519)	$ (43,019)	$ (66,148)	$ (107,216)	$ (111,737)	$ (95,017)	$ (72,381)	$ (98,200)	$ (41,373)

(1) In accordance with FIN 46(R), we performed an evaluation of our business relationships and determined that 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, effective January 1, 2004, we deconsolidated American Indemnity on a prospective basis in accordance with the provisions of FIN 46(R). Accordingly, we have adjusted the reserves and development within the above table. The adoption of FIN 46(R) and the deconsolidation of American Indemnity did not have a material impact on our consolidated balance sheet or consolidated statement of income.

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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):

	2005	2004
GAAP reserves for losses and LAE	$ 458,677	$ 378,157
Reinsurance recoverables for unpaid losses	(187,254)	(151,161)
Allowances against reinsurance recoverables**	(1,080)	(1,479)
Non-regulated foreign insurance subsidiary; PICL***	(1,230)	(1,800)
Statutory reserves for losses and LAE	$ 269,113	$ 223,717

* For the year ended December 31, 2005, we reported an increase of $41.4 million in gross ultimate loss estimates for accident years 2004 and prior, or 10.9% of $378.2 million of gross losses and LAE reserves at January 1, 2005. We reported a $4.9 million increase in net ultimate losses and LAE estimates for accident years 2004 and prior, or 2.2% of $227.0 million. The change in gross ultimate loss estimates for accident years 2004 and prior is greater than the change in net ultimate loss estimates as a result of gross development on a small number of large workers compensation claims.

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

*** PICL is a foreign captive, which offers clients captive or rent-a-captive options. It is not a domestic insurance company and, therefore, is not included in the combined statutory financial statements filed with the National Association of Insurance Commissioners and state regulators.

As a result of adverse development on prior accident years reserves, the provision for losses and loss adjustment expenses increased by $4.9 million, $4.5 million, and $2.9 million in calendar years 2005, 2004, and 2003, respectively.

Investments

Certain information required by this item is incorporated by reference to Note 2 *Investments* of the Notes to the Consolidated Financial Statements, and the *Investments* section of Item 7, Management s Discussion and Analysis.

Competition and Pricing

We compete with other providers of risk management programs and services, as well as, with traditional providers of commercial insurance. Both the risk management and the traditional property and casualty insurance markets are highly competitive. Our risk management programs and services compete with products and services offered by insurance companies, other providers of risk management 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.

The market for risk management 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, and general economic conditions. 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. Principle 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, 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 by government agencies in the states in which they do business. The nature and extent of such regulation varies from jurisdiction to jurisdiction but typically 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 which 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;

- 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. Such regulation is generally intended for the protection of policyholders, rather than security holders.

Holding Company Regulatory Acts

In addition to the regulatory oversight of our Insurance Company Subsidiaries, we are subject to regulation under the Michigan, Missouri, California, and Florida Insurance Holding Company System Regulatory Acts (the Holding Company Acts). The Holding Company Acts contain certain reporting requirements including those that require us to file information relating to our capital structure, ownership, and financial condition and general business operations of our Insurance Company Subsidiaries. The Holding Company Acts contain special reporting and prior approval requirements with respect to transactions among affiliates.

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.

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.

Insurance Regulation Concerning Change or Acquisition of Control

Star, Savers, Williamsburg and Ameritrust are domestic property and casualty insurance companies organized, respectively, under the insurance laws (the Insurance Codes) of Michigan, Missouri, California, and Florida. 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, Missouri, California, and Florida, 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, California, and Florida 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. Assessments from insolvency funds were $664,000, $784,000, and $783,000, respectively, for 2005, 2004, and 2003. Most of these payments are recoverable through future policy surcharges and premium tax reductions.

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 effect us. Total assessments paid to all such facilities were $3.0 million, $2.3 million, and $2.4 million, respectively, for 2005, 2004, and 2003.

Restrictions on Dividends and Risk-Based Capital

The information required by this item is incorporated by reference to Note 8 *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.

Effect of Federal Legislation

The Terrorism Risk Insurance Act (TRIA) was signed into law on November 26, 2002, and provides government support for businesses that suffer damages as a result of acts of foreign-based terrorism. TRIA serves as an additional high layer of reinsurance against losses that may arise from a domestic incident by foreign groups. The impact to us resulting from TRIA is minimal as we 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.

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.

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 reasonable practicable after we electronically file such material with, or furnished to, the United States Securities and Exchange Commission (SEC). You may read and copy materials we file with the SEC at the SEC s Public Reference Room at 450 Fifth Street, NW, 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

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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 Guidelines, Code of Conduct, and our Business Conduct Policy are available on our website, or in print to any shareholder who requests this information.

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

If our 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, and statutory surplus, along with ability to pay dividends.

We establish reserves for losses and expenses related to the adjustment of losses under the insurance policies we write. 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. Our Insurance Company Subsidiaries obtain an annual statement of opinion from an independent actuary firm on these reserves. While we believe that 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;
- legislative activity; and
- changes in inflation and economic conditions.

Actual losses and the costs we incur related to the adjustment of losses under insurance policies may be different from the amount of reserves we establish. When we increase reserves, our net income for the period will decrease by a corresponding amount.

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. 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, and results of operations. We have existing employment agreements with some of our executive officers. We maintain key person life insurance policies on our key personnel.

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 intense 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. Our failure to attract and retain the necessary personnel and agents could have a material adverse effect on our business, financial condition, and 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. If we are unable to renew our expiring facilities or to obtain new reinsurance, 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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We cannot guarantee that our reinsurers will pay in a timely fashion, if at all, and, as a result, we could experience losses.

We transfer some of the risk we have assumed to reinsurance companies in exchange for a portion of the premium we receive in connection with the risk. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred, it does not relieve us of our original liability to the policyholders. Our reinsurers may not pay the reinsurance recoverables they owe us or they may not pay on a timely basis. If our reinsurers fail to pay us or fail to pay us on a timely basis, our financial results could be adversely affected.

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
- 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. These fluctuations in demand and competition could produce underwriting results that would have a negative impact on our financial condition and results of operations.

We face competitive pressures in our business that could cause demand for our products to fall 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 to competitors offering similar or better products at or below our prices. In addition, a number of new, proposed or potential legislative or industry developments could further increase competition in our industry. New competition from these developments could cause the demand for our products to fall, which could adversely affect our profitability.

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 or other alternative market types of coverage; and
- changing practices created by the internet, which has increased competition within the insurance business.

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These developments could make the property and casualty insurance marketplace more competitive by increasing the supply of insurance capacity. In that event, recent favorable industry trends could be reversed and 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.

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, 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;
- reserves for unearned premiums, losses and other purposes; and
- potential 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.

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.

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

We believe that 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 payments to our insureds. Since we carry debt securities 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.

Because our investment portfolio consists primarily of fixed income securities, our investment income could suffer as a result of fluctuations in interest rates.

We currently maintain and intend to continue to maintain an investment portfolio consisting primarily of fixed income securities. The fair value of these securities fluctuates depending on changes in interest rates. Generally, the fair market value of these investments increases or decreases in an inverse relationship with changes in interest rates, while net investment income earned by us from future investments in fixed income securities will generally increase or decrease with interest rates. Changes in interest rates may result in

fluctuations in the income derived from, and the valuation of, our fixed income investments, which could have an adverse effect on our financial condition and results of operations.

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

Our Insurance Company Subsidiaries cede insurance to other insurers under pro rata and excess-of-loss contracts. These reinsurance arrangements diversify our business and minimize our exposure to large losses or from hazards of an unusual nature. The ceding of insurance does not discharge the original insurer from its primary liability to its policyholder. If all or any of the reinsuring companies are unable to meet their obligations, we would be liable for such defaulted amounts. Therefore, we are subject to a credit risk with respect to the obligations of our reinsurers. 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.

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, indemnification agreements, or on the portion of risk either ceded to the captives, or retained by our 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. 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. 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 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.

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

The Michigan Business Corporation Act contains anti-takeover provisions. Chapter 7A and 7B of the Business Corporation Act apply to us and may have an anti-takeover effect and may delay, defer 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.

Our articles of incorporation allow the 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. Also, we have adopted a shareholder rights plan which if triggered would significantly dilute the stock ownership percentage of anyone who acquires more than fifteen percent of our shares without the approval of our Board of Directors. The existence of our shareholder rights plan and 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 various states, such as Michigan, Missouri, California, and Florida, governing 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 acquiror 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.

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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 rating from A.M. Best is B++ (Very Good) for Star Insurance Company, Savers Property and Casualty Insurance Company, and Williamsburg National Insurance Company. The A.M. Best rating for Ameritrust Insurance Corporation is B+ (Very Good), with a positive outlook. We believe as a result of our improved balance sheet and operating performance our rating will remain at least at its current level, if not at an upgraded level. However, there can be no assurance that A.M. Best will not change its rating in the future. A rating downgrade from A.M. Best could materially adversely affect the business we write and our results of operations.

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 1% 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 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. Either of these circumstances could have a material adverse effect upon our financial condition, operations or reputation.

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. In December 2004, we relocated to the new office building. This new building is 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. Previously, we leased our corporate offices from an unaffiliated third party.

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.

Through our subsidiaries, we are also a party to various leases for 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 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 SFAS No. 5, *Accounting for Contingencies*, if it is probable that an asset has been impaired or a liability has been incurred as of the date of the financial statements and the amount of loss is estimable; an accrual for the costs to resolve these claims is recorded and is included in our consolidated balance sheets. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. 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. ***Submission of Matters to a Vote of Security Holders***

None.

MEADOWBROOK INSURANCE GROUP, INC.
PART II

Item 5. ***Market for Registrant s Common Equity, Related Stockholder Matters, and Issuer Purchase of Equity Securities***

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

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

Corporate Counsel
Howard & Howard Attorneys, P.C.
Bloomfield Hills, MI

Transfer Agent & Registrar
LaSalle Bank National Association
Shareholder Services Division
135 South LaSalle Street,
Suite 1811
Chicago, IL 60603

Stock Listing
New York Stock Exchange
Symbol: MIG

Annual Meeting
The Annual Meeting of Meadowbrook Shareholders will be held at:
2:00 p.m.
May 10, 2006

Corporate Headquarters
26255 American Drive
Southfield, MI

Shareholder Relations and Form 10-K

A copy of our 2005 Annual Report and Form 10-K, as filed with the Securities and Exchange Commission, may be obtained upon written request to our Investor Relations Department at our corporate headquarters, or contact:

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

Holly Moltane, Director of External Financial Reporting
(248) 204-8590 holly.moltane@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:

LaSalle Bank National Association 1-800-246-5761, option 2.

Share Price and Dividend Information

The following table sets forth for the periods indicated, the high and low closing sale prices of our common shares as reported on the NYSE Composite Tape, and quarterly dividends paid for the years ended:

December 31, 2005	**High**	**Low**	**Dividends**
First Quarter	$ 5.89	$ 4.98	
Second Quarter	$ 5.53	$ 5.02	
Third Quarter	$ 5.72	$ 5.05	
Fourth Quarter	$ 6.77	$ 5.31	

MEADOWBROOK INSURANCE GROUP, INC.

December 31, 2004	High	Low	Dividends
First Quarter	$ 5.35	$ 4.15	
Second Quarter	$ 5.86	$ 4.90	
Third Quarter	$ 5.50	$ 4.34	
Fourth Quarter	$ 5.24	$ 4.32	

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 and our overall financial condition. As a holding company, the ability to pay cash dividends is partially dependent on dividends and other permitted payments from its subsidiaries. We did not receive any dividends from our Insurance Company Subsidiaries in 2005 or 2004.

As of March 3, 2006, there were approximately 254 holders 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.

Issuer Repurchases of Common Stock

The following table presents information with respect to repurchases of our common stock made during the quarterly period ending December 31, 2005:

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 31,2005	75,000	$ 5.50	75,000	290,100
November 1 - November 30,2005	25,000	$ 5.98	25,000	975,000
December 1 - December 31,2005	38,000	$ 5.77	38,000	937,000
Total	138,000	$ 5.85	138,000	

In November 2004, our Board of Directors authorized the repurchase of up to 1,000,000 shares of our common stock in market transactions for a period not to exceed twenty-four months. In October 2005, our Board of Directors authorized the repurchase of up to 1,000,000 shares, or approximately 3%, of our common stock in market transactions for a period not to exceed twenty-four months, and therefore replacing our current share repurchase program originally authorized in November 2004.

MEADOWBROOK INSURANCE GROUP, INC.

Item 6. ***Selected Financial Data***

Selected Consolidated Financial Data

	For the Years Ended December 31,				
	2005	**2004**	**2003**	**2002**	**2001**
	(In thousands, except per share and ratio data)				
Income Statement Data:					
Gross written premiums	$ 332,209	$ 313,493	$ 253,280	$ 183,637	$ 299,104
Net written premiums	258,134	233,961	189,827	139,795	186,083
Net earned premiums	249,959	214,493	151,205	145,383	163,665
Net commissions and fees	35,916	40,535	45,291	37,581	40,675
Net investment income	17,975	14,911	13,484	13,958	14,228
Net realized gains	167	339	823	666	735
Gain (loss) of sale of subsidiary				199	(1,097)
Total revenue	304,017	270,278	210,803	197,787	218,206
Net losses and LAE(1)	151,542	135,938	98,472	98,734	125,183
Policy acquisition and other underwriting expenses(1)	44,439	33,424	23,606	33,573	31,216
Other administrative expenses	27,183	25,964	23,232	22,612	23,531
Salaries and employee benefits	51,331	52,297	48,238	37,659	44,179
Interest expense	3,856	2,281	977	3,021	4,516
Gain on debt reduction				(359)	
Income (loss) before income taxes and equity earnings	25,666	20,374	16,278	2,547	(10,419)
Equity earnings of affiliates	1	39	3		
Net income (loss)	17,910	14,061	10,099	1,650	(6,510)
Earnings per share Diluted	$ 0.60	$ 0.48	$ 0.35	$ 0.08	$ (0.76)
Dividends declared per share	$	$	$	$	$ 0.09
Balance Sheet Data:					
Total investments and cash and cash equivalents	$ 460,233	$ 402,156	$ 324,235	$ 286,050	$ 233,723
Total assets	901,344	801,696	692,266	674,839	687,888
Loss and LAE reserves	458,677	378,157	339,465	374,933	394,596
Debt	7,000	12,144	17,506	32,497	54,741
Debentures	55,930	35,310	10,310		
Shareholders equity	177,365	167,510	155,113	147,395	80,316
Book value per share	$ 6.19	$ 5.76	$ 5.34	$ 4.98	$ 9.44
Other Data:					
GAAP ratios (insurance companies only):					
Net loss and LAE ratio	65.2%	67.9%	70.1%	72.1%	81.1%
Expense ratio	33.5%	33.5%	34.3%	36.5%	35.8%
Combined ratio	98.7%	101.4%	104.4%	108.6%	116.9%
Statutory combined ratio	97.9%	101.2%	101.9%	109.7%	113.0%

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

MEADOWBROOK INSURANCE GROUP, INC.

Unconsolidated GAAP data Ratio Calculation Table:

	For the Years Ended December 31,				
	2005	**2004**	**2003**	**2002**	**2001**
Net earned premiums	$ 249,959	$ 214,493	$ 151,205	$ 145,383	$ 163,665
Consolidated net losses and LAE	$ 151,542	$ 135,938	$ 98,472	$ 98,734	$ 125,183
Intercompany claim fees	11,523	9,691	7,514	6,154	7,520
Unconsolidated net losses and LAE	$ 163,065	$ 145,629	$ 105,986	$ 104,888	$ 132,703
GAAP net loss and LAE ratio	65.2%	67.9%	70.1%	72.1%	81.1%
Consolidated policy acquisition and other underwriting expenses	$ 44,439	$ 33,424	$ 23,606	$ 33,573	$ 31,216
Intercompany administrative and other underwriting fees	39,231	38,359	28,296	19,445	27,309
Unconsolidated policy acquisition and other underwriting expenses	$ 83,670	$ 71,783	$ 51,902	$ 53,018	$ 58,525
GAAP expense ratio	33.5%	33.5%	34.3%	36.5%	35.8%
GAAP combined ratio	98.7%	101.4%	104.4%	108.6%	116.9%

Management uses the GAAP combined ratio and its components to assess and benchmark underwriting performance.

The GAAP combined ratio is the sum of the GAAP loss and loss adjustment expense ratio and the GAAP expense ratio. The GAAP loss and loss adjustment expense ratio is the unconsolidated net loss and loss adjustment expense in relation to net earned premiums. The GAAP expense ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. The statutory combined ratio is the sum of the statutory loss and loss adjustment expense ratio and the statutory expense ratio. The statutory loss and loss adjustment expense ratio is the statutory net loss and loss adjustment expense in relation to net earned premiums. The statutory expense ratio is the statutory policy acquisition and other underwriting expenses in relation to net written premiums.

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; obtainment of certain rate increases in current market conditions; investment rate of return; changes in and adherence to insurance regulation; actions taken by regulators, rating agencies or lenders; obtainment of certain processing efficiencies; changing rates of inflation; general economic conditions and other risks identified in our reports and registration statements filed with the Securities and Exchange Commission. We are not under any obligation to (and expressly disclaim any such obligation to) update or alter our forward-looking statements whether as a result of new information, future events or otherwise.

Description of Business

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

In June 2002, we sold 18,500,000 shares of newly issued common stock at $3.10 per share in a public offering. In conjunction, the underwriters exercised their over-allotment option to acquire 2,775,000 of additional shares of our common stock. After deducting underwriting discounts, commissions, and expenses, we received net proceeds from the offering of $60.5 million. We utilized $57.5 million of the $60.5 million raised in the public offering to pay down our line of credit by $20.0 million and contributed $37.5 million to the surplus of our Insurance Company Subsidiaries. The remaining proceeds were used for general corporate purposes.

In September 2003, an unconsolidated subsidiary trust issued $10.0 million of mandatory redeemable trust preferred securities to a trust formed by an institutional investor. Contemporaneously, we issued $10.3 million in junior subordinated debentures, which includes our $310,000 investment in the trust. We received a total of $9.7 million in net proceeds from the issuance of these debentures, of which $6.3 million was contributed to the surplus of our Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

In April and May 2004, we issued senior debentures in the amount of $13.0 million and $12.0 million, respectively. We contributed $9.9 million of the proceeds from the senior debentures to our Insurance Company Subsidiaries and the remainder was used for general corporate purposes.

In September 2005, an unconsolidated subsidiary trust issued $20.0 million of mandatory redeemable trust preferred securities to a trust formed by an institutional investor. Contemporaneously, we issued $20.6 million in junior subordinated debentures, which includes our $620,000 investment in the trust. We received a total of $19.4 million in net proceeds from the issuance of these debentures. We contributed $10.0 million of the proceeds to our Insurance Company Subsidiaries and the remaining balance will be used for general corporate purposes.

Specialty Risk Management Operations

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

We categorize our programs into three categories: managed, risk-sharing, and fully insured. With managed programs, we earn service fee revenue by providing management and other services to a client s risk-bearing entity, but generally do not share in the operating results. With risk-sharing programs, we share the operating results with the client through a reinsurance agreement with captive or rent-a-captive. The captive and rent-a-captive structures are licensed 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. These primary beneficiaries have their own equity at risk, decision making authority, and the ability to absorb losses and are accounted for under the provisions of Statement of Financial Accounting Standards (SFAS) No. 113 *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.* 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 ceding commissions and other 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 the 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 a specific market opportunity and when we believe there is potential to evolve into a risk-sharing mechanism.

Agency Operations

We earn commission revenue through the operation of our retail property and casualty insurance agency, which was formed in 1955. The agency has grown to be one of the largest agencies in Michigan and, with acquisitions, has expanded into California and Florida. The agency operations produce commercial, personal

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

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,		
	2005	2004	2003
Revenues			
Net earned premiums	$ 249,959	$ 214,493	$ 151,205
Management fees	16,741	16,253	18,751
Claims fees(3)	7,113	13,207	14,756
Loss control fees	2,260	2,174	2,303
Reinsurance placement	660	420	308
Investment income	17,692	14,887	13,471
Net realized gains	85	339	823
Specialty risk management	294,510	261,773	201,617
Agency operations(1)	11,304	9,805	9,378
Reconciling items(2)	365	24	13
Intersegment revenue(1)	(2,162)	(1,324)	(205)
Consolidated revenue	$ 304,017	$ 270,278	$ 210,803

(1) We reclassified 2004 and 2003 revenues related to the conversion of a west-coast commercial transportation program, which was converted to a specialty risk program with one of our subsidiaries, from the agency operations segment to the specialty risk management operations segment. Accordingly, the agency operations revenue and intersegment revenue have been reclassified. As a result, $7.9 million and $5.6 million were reclassified within the agency operations segment and the intersegment revenue for the years ended December 31, 2004 and 2003, respectively.

(2) In December 2003, we entered into a Purchase and Sale Agreement with an unaffiliated third party for the sale of land. In July 2004, a land contract was executed and the transaction closed in escrow subject to the conveyance of certain land by the city to both parties. In May 2005, the settlement of the land contract was completed. The sale of this land resulted in a total gain of approximately $464,000. In accordance with SFAS No. 66 *Accounting for Sales of Real Estate,* we recorded this transaction based on the installment method of accounting. Accordingly, we recorded a gain of $82,000, as of June 30, 2005, which reflects a portion of the total gain allocated proportionately based on the down payment to the total purchase price. The remaining $382,000 will be deferred until the land contract is paid in full, or as principal payments are received. In addition, we received $121,000 in interest income related to the land contract, which has been included in reconciling items. The remaining $162,000 in reconciling items relates to miscellaneous interest income.

(3) During 2004, we accelerated the recognition of $3.5 million in deferred claim revenue, as a result of an earlier than anticipated termination of two limited duration administrative services and multi-state claims run-off contracts.

These contracts had been terminated by the liquidator for the companies during the third quarter of 2004. Had the contract not been terminated, we would have received additional claims fee revenue for continued claims handling services.

Critical Accounting Estimates

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.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

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 represent case base 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, 2005 and 2004, we have accrued $458.7 million and $378.2 million of gross loss and LAE reserves, respectively.

The following table sets forth our gross and net reserves for losses and LAE based upon an underlying source of data, at December 31, 2005 (in thousands):

	Case	IBNR	Total
Direct	$ 186,080	$ 208,595	$ 394,675
Assumed Directly Managed(1)	7,442	27,164	34,606
Assumed Residual Markets(2)	8,318	16,121	24,439
Assumed Retroceded	1,231	518	1,749
Assumed Other	2,037	1,171	3,208
Gross	205,108	253,569	458,677
Less Ceded	89,796	97,458	187,254
Net	$ 115,312	$ 156,111	$ 271,423

(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 based upon an individual company s market share by state.

In reference to the above table, the reserves related to our direct business and assumed business which we manage directly, 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 backlog, 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 and include an estimated reserve based upon actuarial methods for this lag. Assumed business which is subsequently 100% retroceded to participating reinsurers relates to business previously discontinued and now is in run-off. Lastly, in relation 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 by 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.

To date, in the aggregate, there have been no material disputes with our reinsurers. No assurance can be given, however, regarding the future willingness or ability of any of our reinsurers to meet their obligations.

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, 2005 (in thousands):

	Net Case	Net IBNR	Total
Workers Compensation	$ 59,749	$ 69,053	$ 128,802
Residual Markets	8,318	16,122	24,440
Commercial Multiple Peril/ General Liability	16,185	36,321	52,506
Commercial Automobile	21,692	22,690	44,382
Other	9,368	11,925	21,293
Total	$ 115,312	$ 156,111	$ 271,423

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, 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.

Our reserves are reviewed by internal and independent actuaries for adequacy on a quarterly basis. When reviewing reserves, we analyze historical data and estimate the impact of various factors such as: (1) per claim information; (2) industry and our historical loss experience; (3) legislative enactments, judicial decisions, legal developments in the imposition of damages, and changes in political attitudes; and (4) trends in general economic conditions, including the effects of inflation. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. There is no precise method, however, 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 we use in our selection of ultimate reserves include 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, 2005 and 2004.

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

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

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, 2005 and 2004, reinsurance recoverables on paid and unpaid losses were $202.6 million and $169.1 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 are in litigation. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. At December 31, 2005, 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 any of our risk-sharing partners to meet their obligations.

Investments and Other Than Temporary Impairments of Securities and Unrealized Losses on 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 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. However, if there is a decline in the fair value of an investment below its cost and the decline is considered other than temporary, the amount of decline below cost is charged to earnings.

Our investment portfolio is primarily invested in debt securities classified as available for sale, with a concentration in fixed income securities of a high quality. Our investment philosophy is to maximize after-tax earnings and maintain significant investments in tax-exempt bonds. Our policy for the valuation of temporarily impaired securities is to determine impairment based on analysis of, but not limited to, the following factors: (1) rating downgrade or other credit event (e.g., failure to pay interest when due); (2) financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment; (3) prospects for the issuer s industry segment; and (4) intent and ability to retain the investment for a period of time sufficient to allow for anticipated recovery in market value. We evaluate our investments in securities to determine other than temporary impairment, no less than quarterly. Investments that are deemed other than temporarily impaired are written down to their estimated net fair value and the related losses recognized in income. There were no impaired investments written down in 2005, 2004, and 2003. There can be no assurance, however, that significant changes in the above factors in relation to our investment portfolio, will not result in future impairment charges.

At December 31, 2005 and 2004, we had 267 and 124 securities that were in an unrealized loss position, respectively. These investments all had unrealized losses of less than ten percent. At December 31, 2005, thirty-nine of those investments, with an aggregate $29.9 million and $1.2 million fair value and unrealized loss, respectively, have been in an unrealized loss position for more than eighteen months. At December 31, 2004, two investments, with an aggregate $2.7 million and $75,000 fair value and unrealized loss, respectively,

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were in an unrealized loss position for more than eighteen months. As of December 31, 2005 and 2004, gross unrealized losses on available for sale securities were $5.5 million and $1.3 million, respectively.

Revenue Recognition

We recognize premiums written 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 an in force policy. Provisions for unearned premiums on reinsurance assumed from others are made on the basis of ceding reports when received and actuarial estimates.

For the year ending December 31, 2005, total assumed written premiums were $67.7 million, of which $56.0 million, relates to assumed business we manage directly, and therefore, no estimation is involved. The related transactions of this business are processed through our internal systems and related controls and therefore, the assumed written premiums are on a current basis and no estimate is required. Furthermore, commission and related expenses are recorded on a current basis through our internal systems and controls. The remaining $11.7 million of assumed written premiums represents $10.9 million related to residual markets, of which $148,000 relates to the change in lag estimate, which is estimated utilizing actuarial methods, and $800,000 related to other business.

Assumed premium estimates are specifically related to the mandatory assumed pool business from the National Council on Compensation Insurance (NCCI), or residual market business. The 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. The expenses related to residual markets are recorded based upon actual data received by the states and an estimate for expenses related to the two quarter lag is developed utilizing actuarial methods. As of December 31, 2005, assumed premium receivables related to the estimated amount were $7.6 million. This primarily relates to the national pool, which is largely impacted by various state market share of individual companies. 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.

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

Fee income, which includes risk management consulting, loss control, and claims administration services, is recognized in the period the services are provided. 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 contractually defined termination date of the related contracts, fees are deferred in an amount equal to an estimate of our obligation to continue to provide services.

Commission income, which includes reinsurance placement, is recorded on the later of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of any sub-producer commission expense. Commission and other adjustments are recorded when they occur and we maintain an allowance for estimated policy cancellations and commission returns. 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, 2005 and 2004, the allowance for uncollectibles on receivables was $3.9 million and $4.3 million, respectively.

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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 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 SFAS No. 5, *Accounting for Contingencies,* if it is probable that an asset has been impaired or a liability has been incurred as of the date of the financial statements and the amount of loss is estimable; an accrual for the costs to resolve these claims is recorded in our consolidated balance sheets. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. 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

Goodwill represents the excess of the purchase price over the fair value of net assets of subsidiaries acquired. As required by SFAS No. 142 *Goodwill and Other Intangible Assets,* we no longer amortize goodwill and, at least annually, we test all existing goodwill for impairment using a fair value approach, on a reporting unit basis. Our annual assessment date for goodwill impairment testing is October 1st. We test for impairment more frequently if events or changes in circumstances indicate that there may be an impairment to goodwill. We carry goodwill on two reporting units within the agency operations segment in the amount of $5.8 million and three reporting units within the specialty risk management operations segment in the amount of $25.0 million. Based on our most recent evaluation of goodwill impairment, we determined that no impairment to goodwill exists.

Results of Operations

Executive Overview

During 2005, we experienced continued overall improvement in underwriting results in comparison to 2004. This improvement is primarily the result of our controlled growth of premiums written and the impact of rate increases in 2004 and 2005. Growth of net income demonstrates our ongoing commitment to strong underwriting discipline, our consistent focus on growing our profitable specialty and fee-for-service programs, the leveraging of fixed costs, as well as our overall expense reduction initiatives. In addition, we continued to achieve operational efficiencies and enhancements in 2005. As a result, our generally accepted accounting principles (GAAP) combined ratio improved 2.7 percentage points to 98.7% in 2005 from 101.4% in 2004.

In April 2005, we announced an upgrade to the rating from A.M. Best of certain of our Insurance Company Subsidiaries from B+ (Very Good), with a positive outlook to B++ (Very Good). The ratings upgrade applies to Star Insurance Company (Star), Savers Property and Casualty Insurance Company, and Williamsburg National Insurance Company. Additionally, A.M. Best reaffirmed the rating for Ameritrust Insurance Corporation as B+ (Very Good), with a positive outlook.

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In September 2005, we raised $19.4 million from the issuance of junior subordinated debentures. In 2004, we had raised $24.3 million from the issuance of senior debentures. With our capital raising efforts, we have remained focused on a systematic deployment of proceeds from these transactions. As a result of our controlled growth of premiums written and the impact of rate increases in 2004, our net earned premiums increased $35.5 million, or 16.5% in comparison to 2004. Our gross written premiums increased $18.7 million, or 6.0% in comparison to 2004. We continue to be selective on new programs we implement and focus on those which are in line with our underwriting discipline and have historically been profitable. In addition, we increased our retention levels on certain reinsurance treaties. We continue to remain focused on the leveraging of fixed costs, as well as maximizing statutory surplus and cash flows. Statutory surplus increased to $141.1 million in 2005, from $120.7 million in 2004. In 2005, we had positive cash flow from operations of $81.9 million, compared to $70.7 million in 2004.

2005 compared to 2004:

Net income improved $3.8 million, or 27.4%, to $17.9 million, or $0.60 per diluted share, in 2005, from net income of $14.1 million, or $0.48 per diluted share, in 2004. This improvement is primarily the result of our controlled growth of premiums written, the impact from rate increases in 2004 and 2005, overall expense initiatives, and the continued leveraging of fixed costs. As previously indicated, we increased our retention levels on certain reinsurance treaties, which favorably impacted net earned premiums and net income. These year over year improvements manifested, despite the favorable effect in the third quarter of 2004, from the acceleration of $3.5 million in deferred revenue, less approximately $500,000 in expenses and $1.0 million in taxes, relating to the early termination of a specific multi-state claims run-off contract. In addition, net income was favorably impacted by approximately $814,000 from profit-sharing commissions received in 2005, partially offset by continuing expenses primarily related to implementation and compliance with Section 404 of the Sarbanes-Oxley Act. Net income was also favorably impacted as a result of a $386,000 increase in the deferred tax asset relating to the increase in the statutory federal tax rate from 34% to 35%.

Revenues increased $33.7 million, or 12.5%, to $304.0 million for the year ended December 31, 2005, from $270.3 million for the comparable period in 2004. This increase reflects a $35.5 million, or 16.5%, increase in net earned premiums. The increase in net earned premiums is the result of our controlled growth in written premiums from various existing programs and new programs implemented in 2004, a higher retention on certain reinsurance treaties effective in 2005, and the impact of an overall 8.4% rate increase in 2004. Partially offsetting these increases in revenue was an approximate $5.5 million decrease in managed fee revenue, which was primarily the result of an acceleration of $3.5 million in deferred claim fee revenue recognized in the third quarter of 2004. This comparative decrease in managed fee revenue in 2005 is due to the acceleration of deferred claim fee revenue in 2004, as the result of the earlier than anticipated termination of two limited duration administrative services and multi-state claims run-off contracts. These contracts had been terminated by the liquidator for the companies during the third quarter of 2004. Therefore, the revenues that we anticipated earning in the first nine months of 2005 were accelerated into the third quarter of 2004. In addition, the increase in revenue reflects a $3.1 million increase in investment income, primarily the result of an increase in average invested assets and a slight increase in yield.

2004 compared to 2003:

Net income improved $4.0 million, or 39.2%, to $14.1 million, or $0.48 per diluted share, in 2004, from a net income of $10.1 million, or $0.35 per diluted share, in 2003. This improvement reflects an improvement in underwriting results, as a result of the controlled growth of written premiums in profitable programs written in 2004, continued rate increases, growth in agency commission, control over expenses, and leveraging of fixed costs. In addition, this improvement in net income reflects an after-tax benefit of approximately $1.4 million from the acceleration of deferred claim fee revenue, net of expenses, as the result of the earlier than

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anticipated termination of two limited duration administrative services and multi-state claims run-off contracts.

Revenues increased $59.5 million, or 28.2%, to $270.3 million for the year ended December 31, 2004, from $210.8 million for the comparable period in 2003. This increase reflects a $63.3 million, or 41.9%, increase in net earned premiums. The growth in net earned premiums primarily reflects the earning pattern of programs written in 2004, which include the conversion of an existing west-coast commercial transportation program to one of our insurance subsidiaries, the impact of a renewal rights contract for a select group of association-endorsed workers compensation programs which had over twenty years of profitable underwriting experience, the implementation of an excess liability program for public entities with a twenty-year profitable track record, the return of profitable programs, the impact of an overall 13.6% rate increase achieved in 2003, and an overall 8.4% rate increase in 2004. This increase was partially offset by the anticipated reduction in managed fee revenue from two limited duration or closed end administrative services and claims contracts.

As previously indicated, during 2004, we accelerated the recognition of $3.5 million in deferred claim revenue related to a multi-state claims run-off service contract. The acceleration of this revenue was a result of the earlier than anticipated termination of the contracts. These contracts were terminated by the liquidator for the companies during the third quarter of 2004. At the time of termination, we had $3.5 million of deferred revenue related to the claims contract. The revenue had been paid to us pursuant to an agreed upon schedule. However, we had previously adopted a more conservative revenue recognition pattern, which was consistent with our historically claims handling pattern; therefore, resulting in the establishment of deferred revenue. At the termination of the contract, pursuant to the contract terms, we were no longer obligated to handle the related claims.

Specialty Risk Management Operations

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

	For the Years Ended December 31,		
	2005	**2004**	**2003**
Revenue:			
Net earned premiums	$ 249,959	$ 214,493	$ 151,205
Management fees	16,741	16,253	18,751
Claims fees(3)	7,113	13,207	14,756
Loss control fees	2,260	2,174	2,303
Reinsurance placement	660	420	308
Investment income	17,692	14,887	13,471
Net realized gains	85	339	823
Total revenue	$ 294,510	$ 261,773	$ 201,617
Pre-tax income			
Specialty risk management operations(1) & (2)	$ 29,444	$ 23,205	$ 16,703

(1) Our specialty risk management operations now exclude an allocation of corporate overhead, which is attributable to our agency operations. Prior to January 1, 2005, corporate overhead was only reflected in the specialty risk management operations segment. This reclassification for the allocation of corporate overhead more accurately presents our segments as a result of improved cost allocation information. As a result, the segment information for

the years ended December 31, 2004 and 2003 have been adjusted to reflect this allocation. For the years ended December 31, 2005, 2004, and 2003, the allocation of corporate overhead from the specialty risk management operations to the agency operations segment was $3.1 million, $3.5 million, and $2.8 million, respectively.

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(2) In addition to the reclassification for the allocation of corporate overhead as described above, we reclassified 2004 and 2003 revenues related to the conversion of a west-coast commercial transportation program, which was converted to a specialty risk program with one of our subsidiaries, from the agency operations segment to the specialty risk management operations segment. Accordingly, the agency operations revenue and intersegment revenue have been reclassified. In addition, the overall net income related to this subsidiary was reclassified from the agency operations to the specialty risk management operations segment. As a result, pre-tax net income of $3.2 million and $2.0 million related to this subsidiary was reclassified to the specialty risk management operations pre-tax income from the agency operations segment for the years ended December 31, 2004 and 2003, respectively.

(3) During 2004, we accelerated the recognition of $3.5 million in deferred claim revenue, as a result of an earlier than anticipated termination of two limited duration administrative services and multi-state claims run-off contracts. These contracts had been terminated by the liquidator for the companies during the third quarter of 2004. Had the contract not been terminated, we would have received additional claims fee revenue for continued claims handling services.

2005 compared to 2004:

Revenues from specialty risk management operations increased $32.7 million, or 12.5%, to $294.5 million for the year ended December 31, 2005, from $261.8 million for the comparable period in 2004.

Net earned premiums increased $35.5 million, or 16.5%, to $250.0 million for the year ended December 31, 2005, from $214.5 million in the comparable period in 2004. This increase primarily reflects our controlled growth of premiums written, as well as the favorable impact from an increase in our retention levels on certain reinsurance treaties.

Management fees increased $488,000, or 3.0%, to $16.8 million, for the year ended December 31, 2005, from $16.3 million for the comparable period in 2004. Management fees were impacted by an anticipated shift in fee-for-service revenue previously generated from a third party contract to internally generated fee revenue from a specific renewal rights agreement that is eliminated upon consolidation. Due to the earlier than anticipated termination of this third party contract, the revenues that we anticipated earning in 2005 were accelerated into the third quarter of 2004. Excluding revenue generated from this third party contract, management fee revenue increased approximately $1.7 million, or 11.1%, in comparison to 2004. This increase is primarily the result of a new Florida based program implemented in the second quarter of 2005, as well as growth in a specific existing New England based program.

Claim fees decreased $6.1 million, or 46.1%, to $7.1 million, from $13.2 million for the comparable period in 2004. This decrease reflects a similar anticipated shifting of revenue previously generated from a multi-state claims run-off service contract, to internally generated fee revenue from a specific renewal rights agreement that is eliminated upon consolidation. Also impacting this comparison was the effect of the earlier than anticipated termination of the third party contract, which caused the revenues that we anticipated earning in 2005 to be accelerated into the third quarter of 2004. Excluding revenue generated from this third party contract, claim fee revenue would have remained relatively consistent in comparison to 2004.

Net investment income increased $3.1 million, or 20.5%, to $18.0 million in 2005, from $14.9 million in 2004. Average invested assets increased $65.6 million, or 18.3%, to $424.3 million in 2005, from $358.7 million in 2004. The increase in average invested assets reflects cash flows from underwriting activities and growth in gross written premiums during 2004 and 2005, as well as net proceeds from capital raised in 2004 and 2005 through the issuances of debentures. The average investment yield for 2005 was 4.24%, compared to 4.16% in 2004. The current pre-tax book yield was 4.17% and current after-tax book yield was 3.06%.

Specialty risk management operations generated pre-tax income of $29.4 million for the year ended December 31, 2005, compared to pre-tax income of $23.2 million for the year ended December 31, 2004. This increase in pre-tax income demonstrates a continued improvement in underwriting results as a result of our controlled growth in premium

volume and our continued focus on leveraging of fixed costs. Offsetting a portion of this year over year improvement, was a $3.0 million pre-tax benefit, recognized in the third quarter of 2004, from the previously mentioned acceleration of revenue recognition, net of expenses, relating to the

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termination of a specific multi-state claims run-off contract. The GAAP combined ratio was 98.7% for the year ended December 31, 2005, compared to 101.4% for the comparable period in 2004.

Net losses and loss adjustment expenses (LAE) increased $15.6 million, or 11.5%, to $151.5 million for the year ended December 31, 2005, from $135.9 million for the same period in 2004. Our loss and LAE ratio decreased 2.7 percentage points to 65.2% for the year ended December 31, 2005, from 67.9% for the same period in 2004. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. This overall improvement in the loss and LAE ratio reflects the impact of earned premiums from the controlled growth of profitable programs which have had favorable underwriting experience, as well as our intended shift in the balance from workers compensation to the general liability line of business. Historically, the general liability line of business has a lower loss ratio and a higher external producer commission. Additional discussion of our reserve activity is described below within the *Other Items Reserves* section. In addition, there was a 0.8 percentage point decrease in the net loss and LAE ratio as a result of efficiencies realized within our claims handling activities. Development on prior accident year reserves, added $4.9 million, or 2.0 percentage points, to net loss and LAE in 2005, compared to $4.5 million or 2.1 percentage points in 2004. The development on prior accident years in comparison to 2004 was the result of an increase of $900,000, or 0.4 percentage points, related to one specific 2003 workers compensation claim. This claim exceeded our then applicable $5.0 million per claimant limit in our 2003 workers compensation treaty and is now reserved at $5.9 million. In addition, the development on prior accident years was also attributable to an increase to an exposure allowance of $1.5 million, specific to reinsurance recoverables for a discontinued surety program and a discontinued workers compensation program. During 2005, in relation to the discontinued surety program, we received updated financial information from the liquidator of the reinsurer on that program. Based upon this information, we increased the allowance to 100% of the uncollateralized exposure as of June 30, 2005. In relation to the discontinued workers compensation program, we received updated information relating to the collectibility of this asset. As a result, we increased our exposure allowance to 75% of the uncollateralized exposure as of December 31, 2005. Although, we increased our allowance for these specific exposures, the actual exposures did not increase. The remaining $3.4 million of development represents 1.5% of net reserves at December 31, 2004. Our accident year loss ratio improved 2.5 percentage points to 63.3% for the year ended December 31, 2005, from 65.8% for the same period in 2004. The accident year loss and LAE ratio is the unconsolidated GAAP loss and LAE ratio, excluding development on prior accident years.

Our expense ratio for the years ended December 31, 2005 and 2004 was 33.5%. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. Our expense ratio was impacted by an anticipated increase in gross external commissions, due to the shift in the balance between workers compensation and general liability. The general liability line of business has a higher external producer commission rate and, as previously indicated, a lower loss ratio. Offsetting these increases to the expense ratio was the impact of the leveraging of fixed costs.

2004 compared to 2003:

Revenues from specialty risk management operations increased $60.2 million, or 29.9%, to $261.8 million for the year ended December 31, 2004, from $201.6 million for the comparable period in 2003.

Net earned premiums increased $63.3 million, or 41.9%, to $214.5 million in the year ended December 31, 2004, from $151.2 million in the comparable period in 2003. This increase primarily reflects the earning pattern resulting from the controlled growth of programs written in 2004.

Management fees decreased $2.5 million, or 13.3%, to $16.3 million for the year ended December 31, 2004, from $18.8 million for the comparable period in 2003. The decrease in management fees reflects an anticipated shift in fee-for-service revenue previously generated from a third party contract to internally generated fee revenue from a specific renewal rights agreement that is eliminated upon consolidation.

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Excluding revenue generated from this third party contract, management fee revenue increased approximately $1.5 million in comparison to 2003. This increase is primarily the result of growth in specific programs in Nebraska, Minnesota, and New England.

Claim fees decreased $1.6 million, or 10.5%, to $13.2 million, from $14.8 million for the comparable period in 2003. This decrease reflects a similar anticipated shifting of revenue previously generated from a multi-state claims run-off service contract, to internally generated fee revenue from a specific renewal rights agreement that is eliminated upon consolidation. Offsetting this anticipated reduction is the previously mentioned $3.5 million in deferred revenue recognized during the third quarter of 2004 related to the multi-state claims run-off service contract. Excluding revenue previously generated from this contract and the revenue recognized due to the termination of this contract, claim fee revenue increased $547,000 in comparison to 2003. This increase is primarily the result of growth in claims handling revenue in New England.

Net investment income increased $1.4 million, or 10.5%, to $14.9 million in 2004, from $13.5 million in 2003. Average invested assets increased $57.1 million, or 19.0%, to $358.7 million in 2004, from $301.6 million in 2003. The increase in average invested assets reflects cash flows from underwriting activities and growth in gross written premiums during 2003 and 2004, as well as, net proceeds from capital raised through the issuance of debentures in 2004 and 2003. The average investment yield for 2004 was 4.2%, compared to 4.5% in 2003. The current pre-tax book yield was 3.9% and current after-tax book yield was 2.9%. The decline in investment yield reflects the accelerated prepayment speeds in mortgage-backed securities and the reinvestment of cash flows in municipal bonds and other securities with lower interest rates. Over the past two years, the reinvestment of cash flows has shifted from maturing securities with higher yields being replaced by securities with lower yields in a declining interest rate environment. In addition, the decline in investment yield reflects the timing of investing the proceeds from the capital raised in 2004.

Specialty risk management operations generated pre-tax income of $23.2 million for the year ended December 31, 2004, compared to pre-tax income of $16.7 million for the comparable period in 2003. This increase in pre-tax income demonstrates improvement in underwriting results and the further leveraging of fixed costs as we continue to experience controlled growth of premium volume. In addition, this improvement in pre-tax income reflects an approximate $2.1 million pre-tax favorable impact in relation to the previously mentioned acceleration of deferred claim revenue, net of related expenses, relating to the termination of a specific multi-state claims run-off contract. The GAAP combined ratio was 101.4% for the year ended December 31, 2004, compared to 104.4% for the comparable period in 2003.

Net losses and LAE increased $37.4 million, or 38.0%, to $135.9 million for the year ended December 31, 2004, from $98.5 million for the same period in 2003. Our loss and LAE ratio decreased 2.2 percentage points to 67.9% for the year ended December 31, 2004, from 70.1% for the same period in 2003. This ratio is the unconsolidated net loss and LAE in relation to net earned premium. The improvement in the loss and LAE ratio reflects the impact of earned premium on profitable programs from the controlled growth in programs with profitable underwriting experience, the impact of rate increases in 2003 and 2004, and to a lesser extent, a reduction in reinsurance costs. These improvements were partially offset by the effect of a commutation of the 2000 and 2001 surplus relief reinsurance agreement and a reclassification between losses and expenses on one inactive program. The impact of these settlements resulted in an increase to the loss and LAE ratio of 0.8 percentage points and a corresponding 0.8 percentage point decrease to the GAAP expense ratio. The 2004 loss ratio reflects an increase in net ultimates of $4.5 million, of which $1.7 million is from the previously mentioned commutation and reclassification. The remaining $2.8 million, or 1.5% of $192.0 million, is from a small number of old claims in an isolated group of programs.

Our expense ratio improved 0.8 percentage points to 33.5% for the year ended December 31, 2004, from 34.3% for the same period in 2003. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premium. As mentioned above, the commutation and the reclassification

had a favorable impact of 0.8 percentage points. Partially offsetting this favorable impact was the anticipated increase in gross outside commissions. This is a result of a shift in the balance between workers compensation and general liability. The general liability line of business has a higher commission rate and a lower loss ratio.

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,		
	2005	2004	2003
Net commission(1)	$ 11,304	$ 9,805	$ 9,378
Pre-tax income(1) & (2)	$ 3,343	$ 2,257	$ 2,064

(1) We reclassified 2004 and 2003 revenues related to the conversion of a west-coast commercial transportation program, which was converted to a specialty risk program with one of our subsidiaries, from the agency operations segment to the specialty risk management operations segment. Accordingly, the agency operations revenue and intersegment revenue have been reclassified. In addition, the overall net income related to this subsidiary was reclassified from the agency operations to the specialty risk management operations segment. As a result, pre-tax net income of $3.2 million and $2.0 million related to this subsidiary was reclassified to the specialty risk management operations pre-tax income from the agency operations segment for the years ended December 31, 2004 and 2003, respectively.

(2) 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. Prior to January 1, 2005, corporate overhead was only reflected in the specialty risk management operations segment. This reclassification for the allocation of corporate overhead more accurately presents our segments as a result of improved cost allocation information. As a result, the segment information for the years ended December 31, 2004 and 2003 have been adjusted to reflect this allocation. For the years ended December 31, 2005, 2004, and 2003, the allocation of corporate overhead to the agency operations segment was $3.1 million, $3.5 million, and $2.8 million, respectively.

2005 compared to 2004:

Revenue from agency operations, which consists primarily of agency commission revenue, increased $1.5 million, or 15.3%, to $11.3 million for the year ended December 31, 2005, from $9.8 million for the comparable period in 2004. This increase is primarily the result of profit sharing commissions received in the first and third quarter of 2005. In addition, the agency operations experienced an increase in new business and renewal retentions in comparison to 2004, which was partially offset by a reduction in renewal rates.

Agency operations generated pre-tax income, after the allocation of corporate overhead, of $3.3 million for the year ended December 31, 2005, compared to $2.3 million for the comparable period in 2004. The improvement in the pre-tax margin is primarily attributable to the overall increase in commissions and leveraging of fixed costs. Excluding fixed costs and the allocation of corporate overhead, all other expenses remained relatively consistent.

2004 compared to 2003:

Revenue from agency operations, which consists primarily of agency commissions, increased $427,000, to $9.8 million for the year ended December 31, 2004, from $9.4 million for the comparable period in 2003. This increase is primarily the result of increases in new business, rate increases, higher retention levels, and profit sharing

commissions.

Agency operations generated pre-tax income, after the allocation of corporate overhead, of $2.3 million for the year ended December 31, 2004, compared to $2.1 million for the comparable period in 2003. The improvement in the pre-tax margin is primarily attributable to the overall increase in revenue.

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Other Items

Reserves

At December 31, 2005, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was $271.4 million. We established a reasonable range of reserves of approximately $251.4 million to $288.9 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)	$ 143,398	$ 163,247	$ 153,242
Commercial Multiple Peril/ General Liability	48,345	56,343	52,506
Commercial Automobile	40,570	46,550	44,382
Other	19,109	22,802	21,293
Total Net Reserves	$ 251,422	$ 288,942	$ 271,423

(1) Includes Residual Markets

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

The key assumptions used in our selection of ultimate reserves included the underlying actuarial methodologies, a review of current pricing and underwriting initiatives, an evaluation of reinsurance costs and retention levels, and a detailed claims analysis with an emphasis on how aggressive claims handling may be impacting the paid and incurred loss data trends embedded in the traditional actuarial methods. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the years ended December 31, 2005, 2004, and 2003.

For the year ended December 31, 2005, we reported an increase in net ultimate loss estimates for accident years 2004 and prior of $4.9 million, or 2.2% of $227.0 million of net loss and LAE reserves at December 31, 2004. The increase in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2005 that differed from the projected activity. There were no

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significant changes in the key assumptions utilized in the analysis and calculations of our reserves during 2005. The major components of this change in ultimate loss estimates are as follows (in thousands):

		Incurred Losses			Paid Losses			
Line of Business	**Reserves at December 31, 2004**	**Current Year**	**Prior Years**	**Total Incurred**	**Current Year**	**Prior Years**	**Total Paid**	**Reserves at December 31, 2005**
Workers Compensation	$ 112,086	$ 63,219	$ 1,567	$ 64,786	$ 9,583	$ 38,487	$ 48,070	$ 128,802
Residual Markets	19,391	12,626	179	12,805	4,427	3,329	7,756	24,440
Commercial Multiple Peril/General Liability	44,217	21,375	392	21,767	707	12,771	13,478	52,506
Commercial Automobile	33,235	34,306	1,106	35,412	9,347	14,918	24,265	44,382
Other	18,067	15,132	1,640	16,772	3,995	9,551	13,546	21,293
Net Reserves	226,996	$ 146,658	$ 4,884	$ 151,542	$ 28,059	$ 79,056	$ 107,115	271,423
Reinsurance Recoverable	151,161							187,254
Consolidated	$ 378,157							$ 458,677

Line of Business	**Reserves at December 31, 2004**	**Re-estimated reserves at December 31, 2005 on prior years**	**Development as a percentage of prior year reserves**
Workers Compensation	$ 112,086	$ 113,653	1.4%
Commercial Multiple Peril/General Liability	44,217	44,609	0.9%
Commercial Automobile	33,235	34,341	3.3%
Other	18,067	19,707	9.1%
Sub-total	207,605	212,310	2.3%
Residual Markets	19,391	19,570	0.9%

Total Net Reserves	$	226,996	$	231,880	2.2%

Workers Compensation Excluding Residual Markets

The projected net ultimate loss estimate for the workers compensation line of business, excluding residual markets, increased $1.6 million, or 1.4% of net workers compensation reserves. This net overall increase reflects decreases of $3.0 million, $3.7 million, and $944,000 in the ultimate loss estimate for accident years 2004, 2001, and 1999, respectively. The decrease in the ultimate loss estimate reflects better than expected experience on most of our workers compensation programs. Average severity on reported claims did not increase as much as anticipated in the prior actuarial projections; therefore ultimate loss estimates were reduced. In addition, there was a reallocation of loss reserves of $2.8 million from accident year 2001 to accident year 2000 to align the incurred but not reported (IBNR) reserves with case reserves for a specific Tennessee program. These net overall decreases were more than offset by increases of $3.6 million, $1.6 million, and $2.9 million in accident years 2003, 2002, and 2000, respectively. These increases are the result of higher than expected emergence of claim activity primarily related to a specific workers compensation claim, as well as the aforementioned reallocation in the Tennessee program. The change in ultimate loss estimates for all other accident years was insignificant.

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Commercial Multiple Peril/General Liability

The commercial multiple peril line and general liability line of business had an increase in net ultimate loss estimates of $392,000, or 0.9% of net commercial multiple peril and general liability reserves. The net increase reflects a reduction of $662,000 in the ultimate loss estimate for accident year 2004. The improvement in the accident year reflected better than expected claim emergence on several programs. The decreases in the 2003 and 2002 accident years were $1.1 million and $237,000, respectively. These decreases reflect the impact of a reclassification from the general liability line of business to the commercial automobile line of business. This reclassification of $1.2 million was the result of actual claims emergence on three commercial automobile claims that are subject to our core casualty reinsurance program. Prior to the actual claims emergence the reserves for this exposure were carried in the general liability reinsurance line of business as IBNR. These decreases were offset by increases of $858,000, $827,000, and $499,000, in accident years 2001, 2000, and 1999, respectively. The increase in the 2001 accident year loss ratio reflects slightly higher than expected emergence of claim activity in several different programs. The increases in the 2000 and 1999 accident years reflect slightly higher than expected emergence of claim activity in two discontinued programs. The change in ultimate loss estimates for all other accident years was insignificant.

Commercial Automobile

The projected net ultimate loss estimate for the commercial automobile line of business increased $1.1 million, or 3.3% of net commercial automobile reserves. This net overall increase reflects increases of $402,000, $275,000, and $970,000, in accident years 2003, 2002, and 2001, respectively. These increases reflect the impact of the three claims mentioned in the above commercial multiple peril and general liability section, which also reflects a reallocation by accident year. The reserves also reflect higher than expected emergence of claim activity in an inactive program. These increases were partially offset by reductions of $891,000 and $100,000 in the ultimate loss estimates for accident years 2004 and 2000, respectively. The accident year 2004 reduction reflected better than expected claim emergence from a commercial automobile program in California. Average severity on reported claims did not increase as much as anticipated in the prior actuarial projections; therefore ultimate loss estimates were reduced. The accident year 2000 reduction reflects the reallocation in IBNR on a discontinued program mentioned above. The change in ultimate loss estimates for all other accident years was insignificant.

Other

The other lines of business had an increase in net ultimate loss estimates of $1.6 million, or 9.1% of net reserves on the other lines of business. This net increase reflects an increase in the exposure allowance for potential unrecoverable reinsurance of $789,000 related to a specific discontinued surety program. During the year, we received updated information from the liquidator of the reinsurer on that program. Based upon this information, we increased the allowance to cover all of the uncollateralized exposure as of June 30, 2005. The net increase also reflects an increase of $465,000 in accident year 2003 from higher than expected emergence of claim activity in a few different programs. The change in ultimate loss estimates for all other accident years was insignificant.

Residual Markets

The workers compensation residual market line of business had an increase in net ultimate loss estimates of $179,000, or 0.9% of net reserves on the workers compensation residual market line of business. The change reflects an increase of $545,000 in accident year 2003, offset by decreases of $212,000 and $357,000 in accident years 2004 and 2002, respectively. We record loss reserves as reported by the National Council on Compensation Insurance (NCCI), plus an estimate 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

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the lag incurred but not reported and the amounts reported by the NCCI in the quarter. The change in ultimate loss estimates for all other accident years was insignificant.

Salary and Employee Benefits and Other Administrative Expenses

Salary and employee benefits decreased $966,000, or 1.8%, to $51.3 million in 2005, from $52.3 million for the comparable period in 2004. This decrease primarily reflects a decrease in performance and profit-based variable compensation, as a result of raising the performance targets for achievement. This decrease was partially offset by merit increases for associates. In addition, this decrease was partially due to a slight reduction in staffing levels in comparison to 2004 as a result of our expense control initiatives.

Salary and employee benefits increased $4.1 million, or 8.4%, to $52.3 million in 2004, from $48.2 million for the comparable period in 2003. This increase primarily reflects both merit increases and the accrual of anticipated variable compensation, which is directly tied to performance and profitability. These increases were partially offset by a slight reduction in staffing levels.

Other administrative expenses increased $1.2 million, or 4.7%, to $27.2 million in 2005, from $26.0 million in 2004. This increase is primarily attributable to consulting and audit expenses associated with Section 404 of the Sarbanes-Oxley Act, as well as increases in expenses as the result of information technology enhancements. Offsetting these increases was a decrease in bad debt expense as a result of overall refinements in our estimation for allowances on bad debt. The increase in other administrative expenses was also offset by our overall expense control initiatives.

Other administrative expenses increased $2.8 million, or 11.8%, to $26.0 million in 2004, from $23.2 million in 2003. This increase is primarily attributable to an increase in policyholder dividends for 2004 as opposed to a $1.8 million reduction in anticipated policyholder dividends reflected in 2003, due to management s evaluation of the appropriateness of dividend payments in conjunction with overall underwriting results. Partially offsetting this decrease was a reduction in overall bad debt expense in 2004 as compared to increases in related allowances recorded in 2003 on previously discontinued programs.

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

Interest Expense

Interest expense for 2005, 2004, and 2003 was $3.9 million, $2.3 million, and $977,000, respectively. Interest expense is primarily attributable to our debentures and current lines of credit, which are described within the *Liquidity and Capital Resources* section of Management s Discussion and Analysis. Interest expense increased $1.7 million as a result of the senior debentures issued in the second quarter of 2004 and the junior subordinated debentures issued in the third quarter of 2005, as well as an overall increase in the average interest rates. Interest expense related to our lines of credit remained relatively consistent in comparison to 2004. This is the result of a decrease in the average outstanding balance, offset by an increase in the average interest rate. The average outstanding balance was $9.0 million, $14.8 million, and $26.0 million in 2005, 2004, and 2003, respectively. The average interest rate, excluding the debentures, was approximately 4.8%, 5.2%, and 4.0%, in 2005, 2004, and 2003, respectively.

Income Taxes

Income tax expense, which includes both federal and state taxes, for 2005, 2004 and 2003, was $7.8 million, $6.4 million, and $6.2 million, or 30.2%, 31.2% and 38.0% of income before taxes, respectively. The effective tax rate was favorably impacted by a $386,000 increase in the deferred tax asset relating to the increase in the statutory federal tax rate from 34% to 35%. In addition, our effective tax rate differs from the 35% statutory rate primarily due to a shift towards increasing investments in tax-exempt securities in an effort

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to maximize after-tax investment yields. Our current taxes are calculated using a 35% statutory rate based upon taxable income greater than $18.3 million. Deferred taxes are calculated based on a 35% statutory rate.

Liquidity and Capital Resources

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

	For the Years Ended December 31,		
	2005	**2004**	**2003**
Net income	$ 17,910	$ 14,061	$ 10,099
Regulated Subsidiaries:			
Net income	$ 13,508	$ 6,973	$ 3,928
Depreciation and amortization			6
Interest			8
Net income, excluding interest, depreciation, and amortization	13,508	6,973	3,942
Adjustments to reconcile net income to net cash provided by operating activities	3,003	6,866	5,517
Changes in operating assets and liabilities	59,784	48,270	20,166
Total adjustments	62,787	55,136	25,683
Depreciation and amortization			(6)
Interest			(8)
Net cash provided by operating activities	$ 76,295	$ 62,109	$ 29,611

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	For the Years Ended December 31,		
	2005	2004	2003
Non-regulated Subsidiaries:			
Net income	$ 4,402	$ 7,088	$ 6,171
Depreciation and amortization	2,650	1,967	1,765
Interest	3,856	2,535	1,229
Net income, excluding interest, depreciation, and amortization	10,908	11,590	9,165
Adjustments to reconcile net income to net cash provided by operating activities	4,444	(1,063)	2,365
Changes in operating assets and liabilities	(3,194)	2,540	9,383
Total adjustments	1,250	1,477	11,748
Depreciation and amortization	(2,650)	(1,967)	(1,765)
Interest	(3,856)	(2,535)	(1,229)
Net cash provided by operating activities	$ 5,652	$ 8,565	$ 17,919
Consolidated total adjustments	64,037	56,613	37,431
Consolidated net cash provided by operating activities	$ 81,947	$ 70,674	$ 47,530

Cash flow provided by operations was $81.9 million in 2005, compared to $70.7 million in 2004. Cash flow provided by operations in 2003 was $47.5 million.

2005 compared to 2004:

Regulated subsidiaries cash flow provided by operations for the year ended December 31, 2005, was $76.3 million, compared to $62.1 million for the comparable period in 2004. This increase was the result of improved underwriting results and an increase in investment income, offset by a tax benefit reduction from the utilization of the net operating loss carryforward in 2004.

Non-regulated subsidiaries cash flow provided by operations for the year ended December 31, 2005, was $5.7 million, compared to $8.6 million for the comparable period in 2004. The decrease in non-regulated cash flow from operations reflects the decrease in net income, which was primarily the result of the previously mentioned acceleration of revenue, recognized in the third quarter of 2004. In addition, the decrease in net income was the result of an increase in administrative costs related to compliance with Section 404 of the Sarbanes-Oxley Act, offset by an increase in revenue associated with profit-sharing commissions. In addition, the decrease in cash flow from operations is the result of variable compensation payments made in the first quarter of 2005, related to 2004 performance and profitability and a decrease in cash as a result of tax payments.

In addition to the changes described above in relation to our cash provided by operations, we had an increase in cash used in investing activities as a result of an $11.6 million cash payment for our new corporate headquarters in the first quarter of 2005. The proceeds from the 2004 issuance of debentures, which are described below, were used for

the purchase of our new building. On January 1, 2005, we entered into a lease agreement for our furniture and phone system in relation to our new building. As of December 31, 2005, the total liability in relation to this lease was $858,000. Total lease payments made for the year ended December 31, 2005, were approximately $272,000.

We anticipate a temporary increase in cash outflows related to investments in technology as we continue to enhance our operating systems and controls.

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2004 compared to 2003:

Regulated subsidiaries cash flow provided by operations for the year ended December 31, 2004, was $62.1 million, compared to $29.6 million for the comparable period in 2003. The increase in regulated cash flow from operations primarily reflects growth in written premiums and overall improved underwriting results.

Non-regulated subsidiaries cash flow provided by operations for the year ended December 31, 2004, was $8.6 million, compared to $17.9 million for the comparable period in 2003. The decrease in non-regulated cash flow from operations primarily reflects the inflow of cash related to the previously mentioned limited duration administrative services and multi-state claims run-off contracts, which were entered into at the beginning of 2003. At inception, these contracts resulted in a higher inflow of cash. As anticipated, for the duration of the remaining life of the contracts, there would be a decrease in the associated inflow of cash in comparison to prior periods. In addition, the decrease in cash flow from operations was the result of intercompany tax payments made during 2004 to the regulated subsidiaries in accordance with the tax sharing agreement. These intercompany tax payments were made to compensate the regulated subsidiaries for the utilization of our net operating loss carryforward. These intercompany tax payments also contributed to the increase in regulated cash flow from operations. Although the non-regulated cash flow from operations significantly decreased in comparison to 2003, which was mainly the result of timing variances associated with the inflow of cash; net income, excluding interest, depreciation, and amortization, increased $2.4 million in comparison to 2003. This improvement reflects the acceleration of the previously mentioned deferred revenue recognition, net of expenses, relating to the earlier than anticipated termination of the two limited duration administrative services and claims run-off contracts. In addition, this improvement reflects an increase in intercompany fees from growth in risk bearing programs.

Other Items

In September 2003, an unconsolidated subsidiary trust issued $10.0 million of mandatory redeemable trust preferred securities to a trust formed by an institutional investor. Contemporaneously, we issued $10.3 million in junior subordinated debentures, which includes our $310,000 investment in the trust. We received a total of $9.7 million in net proceeds, after the deduction of approximately $300,000 of commissions paid to the placement agents in the transaction. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense. We contributed $6.3 million of the proceeds to our Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes. The debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.05%. At December 31, 2005, the interest rate was 8.07%.

In April 2004, we issued senior debentures in the amount of $13.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.0%, which is non-deferrable. At December 31, 2005, the interest rate was 8.33%. The senior debentures are callable at par after five years from the date of issuance. Associated with this transaction, we incurred $390,000 of commissions paid to the placement agents. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

In May 2004, we issued senior debentures in the amount of $12.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.2%, which is non-deferrable. At December 31, 2005, the interest rate was 8.59%. The senior debentures are callable at par after five years from the date of issuance. Associated with this transaction, we incurred $360,000 of commissions paid to the placement agents. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

We contributed $9.9 million of the proceeds from the senior debentures to our Insurance Company Subsidiaries in December 2004. The remaining proceeds from the issuance of the senior debentures may be

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used to support future premium growth through further contributions to our Insurance Company Subsidiaries and general corporate purposes.

In September 2005, an unconsolidated subsidiary trust issued $20.0 million of mandatory redeemable trust preferred securities to a trust formed by an institutional investor. Contemporaneously, we issued $20.6 million in junior subordinated debentures, which includes our $620,000 investment in the trust. We received a total of $19.4 million in net proceeds, after the deduction of approximately $600,000 of commissions paid to the placement agents in the transaction. These issuance costs have been capitalized and are included in other assets on the balance sheet, which will be amortized over seven years as a component of interest expense. We contributed $10.0 million of the proceeds to our Insurance Company Subsidiaries and the remaining balance will be used for general corporate purposes. The debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 3.58%. At December 31, 2005, the interest rate was 8.07%.

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

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

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

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

In relation to the above interest rate swaps, the net interest expense incurred for the year ended December 31, 2005, was approximately $4,000. The total fair value of the interest rate swaps as of December 31, 2005, was approximately $14,000. Accumulated other comprehensive income at December 31, 2005 included the accumulated income on the cash flow hedge, net of taxes, of $9,100.

In November 2004, we entered into a revolving line of credit for up to $25.0 million. The revolving line of credit replaced our former term loan and line of credit and expires in November 2007. We had drawn approximately $9.0 million on this new revolving line of credit to pay off our former term loan. We now use the revolving line of credit to meet short-term working capital needs. Under the revolving line of credit, we and certain of our non-regulated subsidiaries pledged security interests in certain property and assets of named subsidiaries.

At December 31, 2005 and 2004, we had an outstanding balance of $5.0 million and $9.0 million, respectively, on the revolving line of credit.

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The revolving line of credit provides for interest at a variable rate based, at our option, upon either a prime based rate or LIBOR-based rate. In addition, the revolving line of credit also provides for an unused facility fee. On prime based borrowings, the applicable margin ranges from 75 to 25 basis points below prime. On LIBOR-based borrowings, the applicable margin ranges from 125 to 175 basis points above LIBOR. The margin for all loans is dependent on the sum of non-regulated earnings before interest, taxes, depreciation, amortization, and non-cash impairment charges related to intangible assets for the preceding four quarters, plus dividends paid or payable to us from subsidiaries during such period (Adjusted EBITDA). As of December 31, 2005, the average interest rate for LIBOR-based borrowings was 4.7%.

Debt covenants consist of: (1) maintenance of the ratio of Adjusted EBITDA to interest expense of 2.0 to 1.0, (2) minimum net worth of $130.0 million and increasing annually, commencing June 30, 2005, by fifty percent of the prior year s positive net income, (3) minimum A.M. Best rating of B , and (4) on an annual basis, a minimum Risk Based Capital Ratio for Star of 1.75 to 1.00. As of December 31, 2005, we were in compliance with these covenants.

In addition, our non-insurance premium finance subsidiary maintains a line of credit with a bank, which permits borrowings up to 75% of the accounts receivable, which collateralize the line of credit. At December 31, 2005 and 2004, this line of credit had an outstanding balance of $2.0 million and $3.1 million, respectively. On April 26, 2005, the terms of this line of credit were modified. The modifications included a decrease in the line of credit from $8.0 million to $6.0 million. The interest terms of this line of credit provide for interest at the prime rate minus 0.5%, or a LIBOR-based rate, plus 2.0%. At December 31, 2005, the average interest rate on this line of credit was 5.2%.

At December 31, 2005, there were no letters of credit outstanding. At December 31, 2004, one letter of credit was outstanding in the amount of $100,000, which was provided as collateral for an insurance subsidiary s obligations under a reinsurance agreement. The letter of credit was collateralized by a certificate of deposit for the same amount.

As of December 31, 2005 and 2004, the recorded values of our investment portfolio, including cash and cash equivalents, were $460.2 million and $402.2 million, respectively. The debt securities in the investment portfolio, at December 31, 2005, were 96.4% investment grade A or above bonds as defined by Standard and Poor s.

Shareholders equity increased to $177.4 million, or a book value of $6.19 per common share, at December 31, 2005, compared to $167.5 million, or a book value of $5.76 per common share, at December 31, 2004.

In November 2004, our Board of Directors authorized us to repurchase up to 1,000,000 shares of our common stock in market transactions for a period not to exceed twenty-four months. At our regularly scheduled board meeting on October 28, 2005, our Board of Directors authorized us to purchase up to 1,000,000 shares, or approximately 3% of our common stock in market transactions for a period not to exceed twenty-four months, replacing our current share repurchase program originally authorized in November 2004. For the year ended December 31, 2005, we purchased and retired 772,900 shares of common stock for a total cost of approximately $4.2 million. We did not repurchase any common stock during 2004. As of December 31, 2005, the cumulative amount we have repurchased and retired under the current share repurchase plan was 772,900 shares of common stock for a total cost of approximately $4.2 million**.**

Our Board of Directors did not declare a dividend in 2005 or 2004. 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 and our overall financial condition. As a holding company, the ability to pay cash dividends is partially dependent on dividends and other permitted payments from our subsidiaries. We did not receive any dividends from our Insurance Company Subsidiaries in 2005 or 2004.

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A significant portion of our consolidated assets represent assets of our Insurance Company Subsidiaries that at this time, without prior approval of the State of Michigan Office of Financial and Insurance Services (OFIS), cannot be transferred to us in the form of dividends, loans or advances. The restriction on the transferability to us from the Insurance Company Subsidiaries is regulated by Michigan insurance statutes which, in general, are as follows: the maximum discretionary dividend that may be declared, based on data from the preceding calendar year, is the greater of each insurance company s net income (excluding realized capital gains) or ten percent of the insurance company s surplus (excluding unrealized gains). These dividends are further limited by a clause in the Michigan law that prohibits an insurer from declaring dividends except out of surplus earnings of the company. Earned surplus balances are calculated on a quarterly basis. Since Star is the parent insurance company, its maximum dividend calculation represents the combined Insurance Company Subsidiaries surplus. Based upon the 2005 statutory financial statements, Star may only pay dividends to us during 2006 with the prior approval of OFIS. Star s earned surplus position at December 31, 2005 was negative $7.2 million. At December 31, 2004, earned surplus was negative $13.7 million. No dividends were paid in 2004 or 2005.

Our Insurance Company Subsidiaries are required to maintain certain deposits with regulatory authorities, which totaled $128.7 million and $109.5 million at December 31, 2005 and 2004, respectively.

Contractual Obligations and Commitments

The following table is a summary of our contractual obligations and commitments as of December 31, 2005 (in thousands):

	Payments due by period				
	Total	Less than one year	One to three years	Three to five years	More than five years
Non-regulated companies:					
Lines of credit(1)	$ 7,000	$ 7,000	$	$	$
Senior debentures, excluding interest	25,000				25,000
Junior subordinated debentures, excluding interest	30,930				30,930
Operating lease obligations(2)	13,375	2,442	4,061	3,133	3,739
Regulated companies:					
Losses and loss adjustment expenses(3)	458,677	153,617	179,900	68,134	57,026
Total	$ 534,982	$ 163,059	$ 183,961	$ 71,267	$ 116,695

(1) Relates to revolving lines of credit (excludes interest).

(2) Consists of rental obligations under real estate leases related to branch offices. In addition, includes amounts related to equipment leases.

(3)

The loss and loss adjustment expense payments do not have contractual maturity dates and the exact timing of payments cannot be predicted with certainty. However, based upon historical payment patterns, we have included an estimate of our gross losses and loss adjustment expenses. In addition, we have anticipated cash receipts on reinsurance recoverables on unpaid losses and loss adjustment expenses of $187.3 million, of which we estimate that these payments to be paid for losses and loss adjustment expenses for the periods less than one year, one to three years, three to five years, and more than five years, to be $51.8 million, $71.7 million, $32.9 million, and $30.8 million, respectively, resulting in net losses and loss adjustment expenses of $101.8 million, $108.2 million, $35.2 million, and $26.2 million, respectively.

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We maintain an investment portfolio with varying maturities that we believe will provide adequate cash for the payment of claims.

Regulatory and Rating Issues

Insurance operations are subject to various leverage tests (e.g. premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. Our targets for gross and net written premium to statutory surplus are 2.8 to 1.0 and 2.25 to 1.0, respectively. We contributed $10.0 million to the surplus of the Insurance Company Subsidiaries during the third quarter of 2005 and $9.9 million during the third quarter of 2004. As of December 31, 2005, on a statutory combined basis, the gross and net premium leverage ratios were 2.4 to 1.0 and 1.8 to 1.0, respectively.

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

The RBC Model Act provides for four different levels of regulatory attention depending on the ratio of the company s total adjusted capital, defined as the total of its statutory capital, surplus and asset valuation reserve, to its risk-based capital.

At December 31, 2005, all of the Insurance Company Subsidiaries were in compliance with RBC requirements. Star reported statutory surplus of $141.1 million and $120.7 million at December 31, 2005 and 2004, respectively. The calculated RBC was $37.3 million in 2005 and $28.4 million in 2004. The threshold requiring the minimum regulatory involvement was $74.5 million in 2005 and $56.9 million in 2004.

The NAIC s 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.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

In 2005, our Insurance Company Subsidiaries generated certain ratios that varied from the usual value range. The variations and reasons for these variations are set forth below:

Ratio	Usual Range	Value
Company: Star		
Investment Yield	<10% or > 4.5%	2.6%(1)
Liabilities to Liquid Assets	Under 105%	108%(2)
Company: Savers		
Change in Net Writings	<33% or > (33)%	151%(3)
Company: Williamsburg		
Change in Net Writings	<33% or> (33)%	453%(3)
Gross Agents Balances to Policyholders Surplus	Under 40%	50%(4)
Company: Ameritrust		
Change in Net Writings	<33% or> (33)%	82%(3)

(1) The low investment yield is affected by an interest environment where rates are still relatively low. During March 2005, Star transferred $84.0 million in invested assets to its subsidiaries pursuant to an Intercompany Reinsurance Agreement. As a result of this transfer, the average invested assets used in the calculation were higher than the monthly weighted average. Monthly weighted average invested assets would produce a yield of 3.02%. Also contributing to the low yield was a shift in investment strategy toward greater allocation to municipal bonds, which have lower yields than taxable bonds.

(2) The Liabilities to Liquid Assets ratio increase to 108% was primarily related to the transfer by Star of $84.0 million in invested bond assets to its subsidiaries pursuant to an Intercompany Reinsurance Agreement, which therefore reduced liquid assets. Ceded premium payables increased $18.9 million as a result of the intercompany pooling activity. Excluding the effect of intercompany pooling, the ratio would have been 99.5%, below the threshold of 105%. Also contributing to the high ratio was an increase in the provision for reinsurance of $3.7 million in 2005.

(3) Effective January 1, 2005, the Insurance Company Subsidiaries began participating in an Intercompany Reinsurance Agreement, whereby each participating affiliate cedes 100% of its business to Star. Thereafter, Star cedes to each participating affiliate based on their respective participation percentages, from which each affiliate has agreed to reinsure Star. Excluding the intercompany pooling activity, the Change in Net Writings ratio would have been within the normal range for 2005. In addition, Savers ratio was impacted by an increase of $4.4 million in commercial multi-peril written premium for 2005 as a result of retention of existing business and new business.

(4) The Gross Agents Balances to Policyholders Surplus on Williamsburg was impacted by the previously mentioned Intercompany Reinsurance Agreement. Williamsburg s assumed premium receivable increased $5.1 million as a result of intercompany pooling activity. Although Savers and Ameritrust experienced a significant increase in such balances, the results remained within the usual range. Excluding the intercompany pooling activity, this ratio would have been within the usual range for 2005.

In April 2005, we announced an upgrade from A.M. Best of certain of our Insurance Company Subsidiaries from B+ (Very Good), with a positive outlook to B++ (Very Good). The ratings upgrade applies to Star, Savers Property

and Casualty Insurance Company, and Williamsburg National Insurance Company. Additionally, A.M. Best reaffirmed the rating for Ameritrust Insurance Corporation as B+ (Very Good), with a positive outlook. We believe that as we continue to show improvement in our balance sheet and operating performance our rating will remain at least at its current level, if not at an upgraded level. However, there can be no assurance that A.M. Best will not change its rating of our Insurance Company Subsidiaries in the future.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

Reinsurance Considerations

We seek to manage the risk exposure of our Insurance Company Subsidiaries and our clients through the purchase of excess-of-loss and quota share reinsurance. Our reinsurance requirements are analyzed on a specific program basis to determine the appropriate retention levels and reinsurance coverage limits. We secure this reinsurance based on the availability, cost, and benefits of various reinsurance alternatives.

Reinsurance does not legally discharge an insurer from its primary liability for the full amount of risks assumed under insurance policies it issues, but it does make the assuming reinsurer liable to the insurer to the extent of the reinsurance ceded. Therefore, we are subject to credit risk with respect to the obligations of our reinsurers. We manage our credit risk on reinsurance recoverables by reviewing the financial stability, A.M. Best rating, capitalization, and credit worthiness of prospective and existing risk-sharing partners. We customarily collateralize reinsurance balances due from non-admitted reinsurers through funds withheld trusts or stand-by letters of credit issued by highly rated banks. To date, we have not, in the aggregate, experienced material difficulties in collecting reinsurance recoverables other than those balances related to Connecticut Surety Company (CSC) and HIH America Compensation & Liability Company (HIH), as well as, Reliance National Indemnity Company (Reliance), for which allowances have been established. The following table sets forth information relating to our five largest reinsurers (other than client captive quota-share reinsurers) as of December 31, 2005:

Reinsurer	Reinsurance Premium Ceded December 31, 2005 (In thousands)	Reinsurance Recoverable December 31, 2005 (In thousands)	A.M. Best Rating
Employers Reinsurance Corporation	$ 9,525	$ 93,349	A
Motors Insurance Company	5,469	12,451	A-
Aspen Insurance UK Ltd.	4,796	6,399	A
General Reinsurance Company	4,663	9,791	A++
Munich American Reinsurance	9,178	15,933	A+

We have historically maintained an allowance for the potential exposure to uncollectibility of certain reinsurance balances. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. The following table sets forth our exposure to uncollectible reinsurance and related allowances for the years ending December 31, 2005 and 2004 (in thousands):

	2005	2004
Gross Exposure	$ 14,046	$ 14,044
Collateral or other security	(2,749)	(3,323)
Allowance	(9,662)	(8,324)
Net Exposure	$ 1,635	$ 2,397

During 2005, in relation to a discontinued surety program, we received updated financial information from the liquidator of the reinsurer on that program. Based upon this information, we increased the allowance to 100% of the uncollateralized exposure as of June 30, 2005. In relation to a discontinued workers compensation program, we received updated information relating to the collectibility of the asset. As a result, we increased our exposure allowance to 75% of the uncollateralized exposure as of December 31, 2005. Although, we increased our allowance

for these specific exposures, the actual exposures did not increase. While we believe this allowance to be adequate, no assurance can be given, however, regarding the future ability of any of our risk-sharing partners to meet their obligations.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

Intercompany Pooling Agreement

Intercompany pooling agreements are commonly entered into between affiliated insurance companies, so as to allow the companies to utilize the capital and surplus of all of the companies, rather than each individual company. Under pooling arrangements, companies share in the insurance business that is underwritten and allocate the combined premium, losses and related expenses between the companies within the pooling arrangement. Effective January 1, 2005, the Insurance Company Subsidiaries entered into an Inter-Company Reinsurance Agreement (the Pooling Agreement). This Pooling Agreement includes Star, Ameritrust Insurance Corporation (Ameritrust), Savers Property and Casualty Insurance Company (Savers) and Williamsburg National Insurance Company (Williamsburg). Pursuant to the Pooling Agreement, Savers, Ameritrust and Williamsburg have agreed to cede to Star and Star has agreed to reinsure 100% of the liabilities and expenses of Savers, Ameritrust and Williamsburg, relating to all insurance and reinsurance policies issued by them. In return, Star agrees to cede and Savers, Ameritrust and Williamsburg have agreed to reinsure Star for their respective percentages of the liabilities and expenses of Star. The Pooling Agreement was filed with the applicable regulatory authorities. Any changes to the Pooling Agreement must be submitted to the applicable regulatory authorities.

Off-Balance Sheet Arrangements

In June 2003, we entered into a guaranty agreement with a bank. We are guaranteeing payment of a $1.5 million term loan issued by the bank to an unaffiliated insurance agency. In the event of default on the term loan by the insurance agency, we are obligated to pay any outstanding principal (up to a maximum of $1.5 million), as well as any accrued interest on the loan, and any costs incurred by the bank in the collection process. In exchange for our guaranty, the president and member of the insurance agency pledged 100% of the common shares of two other insurance agencies that he wholly owns. In the event of default on the term loan by the insurance agency, we have the right to sell any or all of the pledged insurance agencies common shares and use the proceeds from the sale to recover any amounts paid under the guaranty agreement. Any excess proceeds would be paid to the president and member of the insurance agency who is the sole shareholder. As of December 31, 2005, no liability has been recorded with respect to our obligations under the guaranty agreement, since no premium exists in excess of the guaranteed amount. On January 30, 2006, the unaffiliated insurance agency paid off the term loan in full. As such, our legal obligations under the guaranty agreement terminated.

Convertible Note

In July 2005, we made a $2.5 million loan, at an effective interest rate equal to the three-month LIBOR, plus 5.2%, to an unaffiliated insurance agency. In December 2005, we loaned an additional $3.5 million to the unaffiliated insurance agency. The original $2.5 million demand note was replaced with a $6.0 million convertible note. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This agency has been a producer for us for over ten years. As security for the loan, the borrower granted us a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible upon our option based upon a pre-determined formula, beginning in 2007. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At December 31, 2005, the estimated fair value of the derivative is zero.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), which replaces SFAS No. 123, *Accounting for Stock Issued to Employees.* SFAS 123(R) requires all share-based payments to employees to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123, will no longer be an alternative to financial statement recognition. Commencing in the first quarter of 2003, we began expensing the fair value of all stock options granted since January 1, 2003 under the prospective method. We have not issued stock options to employees since 2003. Under SFAS 123(R), we must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded at the beginning of the first quarter of adoption of SFAS 123(R) for all unvested stock options and restricted stock based upon the previously disclosed SFAS 123 methodology and amounts. The retroactive methods would record compensation expense beginning with the first period restated for all unvested stock options and restricted stock. On April 14, 2005, the Securities and Exchange Commission adopted a new rule that delays the compliance dates for SFAS 123(R). Under the new rule, SFAS 123(R) is effective for public companies for annual, rather than interim periods, which begin after June 15, 2005. Therefore, we are required to adopt SFAS 123(R) in the first quarter of 2006, or beginning January 1, 2006. We have evaluated the requirements of SFAS 123(R) and have determined the impact on our financial statements related to existing stock options is immaterial.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3.* (SFAS 154). SFAS 154 replaces the mentioned pronouncements and changes the requirements for the accounting and reporting of a change in an accounting principle. This Statement applies to all voluntary changes in accounting principle, as well as changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. However, when a pronouncement includes specific transition provisions, those provisions should be followed. SFAS 154 requires retrospective application to prior period financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle should be recognized in the period of the accounting change. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. However, early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement was issued. We are required to adopt the provisions of SFAS 154, as applicable, beginning in 2006. The adoption of SFAS 154 will not have a material impact on our consolidated financial statements.

In September 2005, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts,* effective for contract replacements occurring in fiscal years beginning after December 15, 2006. The SOP 05-1 defines an internal replacement of an insurance contract as a modification in product features, rights, or coverages that occurs by the exchange of an existing contract for a new contract, or by amendment endorsement, or rider to a contract, or by the election of a feature or coverage with a contract. Insurance contracts meeting this replacement criteria should be accounted for as an extinguishment of the replaced contract. We will review the guidance during 2006 and determine the applicability to any of our various insurance contracts.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

Related Party Transactions

At December 31, 2005 and 2004, respectively, we held an $858,923 and $868,125 note receivable, including $198,134 of accrued interest at December 31, 2005, from one of our executive officers. Accrued interest at December 31, 2004 was $207,335. This note arose from a transaction in late 1998 in which we loaned the officer funds to exercise 64,718 common stock options to cover the exercise price and the taxes incurred as a result of the exercise. The note bears interest equal to our borrowing rate and is due on demand any time after January 1, 2002. The loan is partially collateralized by 64,718 shares of our common stock under a stock pledge agreement. For the years ended December 31, 2005 and 2004, $42,000 and $42,000, respectively, have been paid against the loan. On June 1, 2001, the officer entered into an employment agreement which provides the note is a non-recourse loan and our sole legal remedy in the event of a default is the right to reclaim the shares pledged under the stock pledge agreement. As of December 31, 2005, the cumulative amount that has been paid against this loan was $87,500. Refer to Note 16 *Related Party Transaction* for further information.

Item 7A. *Qualitative and Quantitative Disclosures About Market Risk*

Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates as well as other relevant market rate or price changes. The volatility and liquidity in the markets in which the underlying assets are traded directly influence market risk. The following is a discussion of our primary risk exposures and how those exposures are currently managed as of December 31, 2005. Our market risk sensitive instruments are primarily related to fixed income securities, which are available for sale and not held for trading purposes.

Interest rate risk is managed within the context of an asset and liability management strategy where the target duration for the fixed income portfolio is based on the estimate of the liability duration and takes into consideration our surplus. The investment policy guidelines provide for a fixed income portfolio duration of between three and five years. At December 31, 2005, our fixed income portfolio had a modified duration of 3.38, compared to 3.46 at December 31, 2004.

At December 31, 2005, the fair value of our investment portfolio was $402.2 million. Our market risk to the investment portfolio is interest rate risk associated with debt securities. Our exposure to equity price risk is not significant. Our investment philosophy is one of maximizing after-tax earnings and has historically included significant investments in tax-exempt bonds. During 2004 and 2005, we continue to increase our holdings of tax-exempt securities based on our return to profitability and our desire to maximize after-tax investment income. For our investment portfolio, there were no significant changes in our primary market risk exposures or in how those exposures are managed compared to the year ended December 31, 2004. We do not anticipate significant changes in our primary market risk exposures or in how those exposures are managed in future reporting periods based upon what is known or expected to be in effect.

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

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

model s estimate of changes in fair values given a change in interest rates. Dollar values are rounded and in thousands.

	Rates Down 100bps	Rates Unchanged	Rates Up 100bps
Market Value	$ 417,437	$ 402,195	$ 387,063
Yield to Maturity or Call	3.51%	4.51%	5.51%
Effective Duration	3.63	3.73	3.82

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

Our debentures are subject to variable interest rates. Thus, our interest expense on these debentures is directly correlated to market interest rates. At December 31, 2005, we had debentures of $55.9 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by $559,000. At December 31, 2004, we had debentures of $35.3 million. At this level, a 100 basis point (1%) change in market rates would have changed annual interest expense by $353,000.

In October 2005, we entered into two interest rate swap transactions with LaSalle Bank (LaSalle) to mitigate our interest rate risk on $5.0 million and $20.0 million of our senior debentures and trust preferred securities, respectively. We recognized these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities,* as subsequently amended. These interest rate swap transactions have been designated as a cash flow hedge and are deemed a highly effective transaction under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and any changes in their fair value are accounted for within other comprehensive income. The interest differential to be paid or received is being accrued and is being recognized as an adjustment to interest expense.

In addition, our revolving line of credit under which we can borrow up to $25.0 million is subject to variable interest rates. Thus, our interest expense on the revolving line of credit is directly correlated to market interest rates. At December 31, 2005, we had $5.0 million outstanding on this revolving line of credit. At this level, a 100 basis point (1%) change in market rates would have changed interest expense by $50,000. At December 31, 2004, we had $9.0 million outstanding. At this level, a 100 basis point (1%) change in market rates would have changed interest expense by $90,000.

Item 8. ***Financial Statements and Supplementary Data***

Refer to list of Financial Statement Schedules and Note 19 *Quarterly Financial Data (Unaudited)* of the Notes to the Consolidated Financial Statements.

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

On August 8, 2005, we dismissed PricewaterhouseCoopers LLP as our independent auditors effective upon the filing of our Form 10-Q for the quarter ended June 30, 2005. On August 8, 2005, we engaged Ernst & Young LLP as our independent auditors. The decision to change auditors was approved by the Audit Committee and the Board of Directors.

The audit reports of PricewaterhouseCoopers LLP on our consolidated financial statements as of and for the years ended December 31, 2004 and 2003 did not contain any adverse opinion or disclaimer of opinion, nor was it qualified or modified as to uncertainty, audit scope, or accounting principles.

In connection with the audits for the years ended December 31, 2003 and 2004 and through the six month period ending June 30, 2005, there have been no disagreements with PricewaterhouseCoopers LLP on

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of PricewaterhouseCoopers LLP would have caused them to make reference thereto in their report on financial statements for such years.

We had requested PricewaterhouseCoopers LLP furnish us with a letter addressed to the Securities and Exchange Commission stating whether or not they agree with the above statements. A copy of such letter, dated August 10, 2005, is incorporated by reference as Exhibit 16 to this Form 10-K.

Item 9A. ***Controls and Procedures***

Evaluation of Disclosure Controls and Procedures.

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

As of December 31, 2005, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of disclosure controls. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls were effective to ensure that material information relating to us is made known to management, including our Chief Executive Officer and Chief Financial Officer, particularly during the period when our periodic reports are being prepared.

Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act). Our internal control system was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Because of its inherent limitations, internal controls over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may be inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal controls over financial reporting as of December 31, 2005. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control Integrated Framework. Based on our assessment, we concluded that, as of December 31, 2005, our internal controls over financial reporting was effective based on those criteria.

Our management s assessment of the effectiveness of internal controls over financial reporting as of December 31, 2005, has been audited by Ernst & Young LLP, our independent registered public accounting firm, as stated in their report included herein.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting during the most recent quarter ended December 31, 2005, which have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Item 9B. ***Other Information***

None.

PART III

Certain information required by Part III is omitted from this Report in that the Registrant will file a definitive Proxy Statement pursuant to Regulation 14A (the Proxy Statement) not later than 120 days after the end of the fiscal year covered by this report and certain information included therein is incorporated herein by reference. Only those sections of the Proxy Statement that specifically address the items set forth herein are incorporated by reference.

Item 10. ***Directors and Executive Officers of the Registrant***

The information required by this Item is included under the captions Information about the Nominees, the Incumbent Directors and Other Executive Officers , Audit Committee Financial Expert , Code of Ethics , Report of the Audit Committee , and Section 16(a) Beneficial Ownership Reporting Compliance of our Proxy Statement relating to our Annual Meeting of Shareholders to be held on May 10, 2006, which is hereby incorporated by reference. A copy of our Code of Conduct can be found on our website (www.meadowbrook.com).

Item 11. ***Executive Compensation***

The information required by this Item is included under the captions *Executive Compensation* , *Compensation of Directors* , and *Employment Contracts* of our Proxy Statement relating to our Annual Meeting of Shareholders to be held on May 10, 2006, which are hereby incorporated by reference; information under the captions *Report of Compensation Committee of the Board on Executive Compensation* and *Performance Graph* are furnished pursuant to this Item 11 but shall not be deemed filed.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this Item is included under the caption Security Ownership of Certain Beneficial Owners and Management of our Proxy Statement relating to our Annual Meeting of Shareholders to be held on May 10, 2006, which is hereby incorporated by reference.

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities in column (a)) (c)
Equity compensation plans approved by security holders	1,605,901	$ 5.42	1,956,395
Equity compensation plans not approved by security holders			
Total	1,605,901	$ 5.42	1,956,395

Item 13. ***Certain Relationships and Related Transactions***

The information required by this Item is included under the caption *Certain Transactions with Management* of our Proxy Statement relating to our Annual Meeting of Shareholders to be held on May 10, 2006, which is hereby incorporated by reference.

Item 14. ***Principal Accountant Fees and Services***

The information required by this Item is included under the caption *The Second Proposal on Which You Are Voting Ratification of Appointment of Independent Accountants* of our Proxy Statement relating to our Annual Meeting of Shareholders to be held on May 10, 2006, which is hereby incorporated by reference.

MEADOWBROOK INSURANCE GROUP, INC.
MANAGEMENT S DISCUSSION AND ANALYSIS continued
MEADOWBROOK INSURANCE GROUP, INC.
PART IV

Item 15. ***Exhibits, Financial Statement Schedules***

(A) The following documents are filed as part of this Report:

		Page
1.	List of Financial Statements:	
	Report of Independent Registered Public Accounting Firm on Financial Statements	62
	Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting	63
	Report of Independent Registered Public Accounting Firm on Financial Statements	64
	Consolidated Balance Sheet December 31, 2005 and 2004	65
	Consolidated Statement of Income For Years Ended December 31, 2005, 2004, and 2003	66
	Consolidated Statement of Comprehensive Income For Years Ended December 31, 2005, 2004, and 2003	67
	Consolidated Statement of Shareholders Equity For Years Ended December 31, 2005, 2004, and 2003	68
	Consolidated Statement of Cash Flows For Years Ended December 31, 2005, 2004, and 2003	69
	Notes to Consolidated Financial Statements	70-100
2.	Financial Statement Schedules	
	Schedule I Summary of Investments Other Than Investments in Related Parties	101
	Schedule II Condensed Financial Information of Registrant	102
	Schedule III Supplementary Insurance Information	106
	Schedule IV Reinsurance	109
	Schedule V Valuation and qualifying accounts	110
	Schedule VI Supplemental Information Concerning Property and Casualty Insurance Operations	111
3.	Exhibits: The Exhibits listed on the accompanying Exhibit Index immediately following the financial statement schedule are filed as part of, or incorporated by reference into, this Form 10-K	

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Meadowbrook Insurance Group, Inc.:

We have audited the accompanying consolidated balance sheet of Meadowbrook Insurance Group, Inc. as of December 31, 2005 and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for the year then ended. Our audit also included the financial statement schedules listed in the Index at Item 15(a). These financial statements and schedules are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedules based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Meadowbrook Insurance Group, Inc. at December 31, 2005, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Meadowbrook Insurance Group, Inc. s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2006 expressed an unqualified opinion thereon.

Detroit, Michigan
March 10, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of
Meadowbrook Insurance Group, Inc.:

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that Meadowbrook Insurance Group, Inc. (Meadowbrook) maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Meadowbrook s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that Meadowbrook maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Meadowbrook maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Meadowbrook as of December 31, 2005, and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for the year then ended and our report dated March 10, 2006 expressed an unqualified opinion thereon.

Detroit, Michigan
March 10, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
Meadowbrook Insurance Group, Inc.:

In our opinion, the consolidated balance sheet as of December 31, 2004 and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for each of two years in the period ended December 31, 2004 listed in the index appearing under Item 15 (a) (1) present fairly, in all material respects, the financial position of Meadowbrook Insurance Group Inc. and its subsidiaries (the Company) at December 31, 2004, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the index appearing under Item 15 (a) (2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Chicago, Illinois
March 16, 2005

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED BALANCE SHEET

	December 31,	
	2005	2004
	(In thousands, except share data)	
ASSETS		
Investments		
Debt securities available for sale, at fair value (amortized cost of $403,947 and $324,966 in 2005 and 2004, respectively)	$ 402,195	$ 332,242
Equity securities available for sale, at fair value (cost of $0 in 2004)		39
Total investments	402,195	332,281
Cash and cash equivalents	58,038	69,875
Accrued investment income	4,953	4,331
Premiums and agent balances receivable (net of allowance of $3,901 and $4,336 in 2005 and 2004, respectively)	84,807	84,094
Reinsurance recoverable on:		
Paid losses	15,327	17,908
Unpaid losses	187,254	151,161
Prepaid reinsurance premiums	24,588	26,075
Deferred policy acquisition costs	26,371	25,167
Deferred federal income taxes, net	16,630	14,956
Goodwill	30,802	28,997
Other assets	50,379	46,851
Total assets	$ 901,344	$ 801,696
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities		
Losses and loss adjustment expenses	$ 458,677	$ 378,157
Unearned premiums	140,990	134,302
Debt	7,000	12,144
Debentures	55,930	35,310
Accounts payable and accrued expenses	26,667	38,837
Reinsurance funds held and balances payable	15,240	17,832
Payable to insurance companies	6,684	6,990
Other liabilities	12,791	10,614
Total liabilities	723,979	634,186
Commitments and contingencies (Note 14)		
Shareholders Equity		
Common stock, $0.01 stated value; authorized 50,000,000 shares; 28,672,009 and 29,074,832 shares issued and outstanding	287	290

Additional paid-in capital		124,819		126,085
Retained earnings		54,248		37,175
Note receivable from officer		(859)		(868)
Accumulated other comprehensive (loss) income		(1,130)		4,828
Total shareholders equity		177,365		167,510
Total liabilities and shareholders equity	$	901,344	$	801,696

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

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENT OF INCOME

	For the Years Ended December 31,		
	2005	**2004**	**2003**
	(In thousands, except per share data)		
Revenues			
Premiums earned			
Gross	$ 325,522	$ 288,868	$ 212,281
Ceded	(75,563)	(74,375)	(61,076)
Net earned premiums	249,959	214,493	151,205
Net commissions and fees	35,916	40,535	45,291
Net investment income	17,975	14,911	13,484
Net realized gains	167	339	823
Total revenues	304,017	270,278	210,803
Expenses			
Losses and loss adjustment expenses	237,775	212,337	150,998
Reinsurance recoveries	(86,233)	(76,399)	(52,526)
Net losses and loss adjustment expenses	151,542	135,938	98,472
Salaries and employee benefits	51,331	52,297	48,238
Policy acquisition and other underwriting expenses	44,439	33,424	23,606
Other administrative expenses	27,183	25,964	23,232
Interest expense	3,856	2,281	977
Total expenses	278,351	249,904	194,525
Income before taxes and equity earnings	25,666	20,374	16,278
Federal and state income tax expense	7,757	6,352	6,182
Equity earnings of affiliates	1	39	3
Net income	$ 17,910	$ 14,061	$ 10,099
Earnings Per Share			
Basic	$ 0.62	$ 0.48	$ 0.35
Diluted	$ 0.60	$ 0.48	$ 0.35
Weighted average number of common shares			
Basic	28,961,229	29,048,069	29,188,967
Diluted	29,653,067	29,420,508	29,268,799

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

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MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	For the Years Ended December 31,		
	2005	**2004**	**2003**
		(In thousands)	
Net income	$ 17,910	$ 14,061	$ 10,099
Other comprehensive income, net of tax:			
Unrealized losses on securities	(6,023)	(2,364)	(814)
Net deferred derivative gain-hedging activity	9		
Deconsolidation of subsidiary		(45)	
Less: reclassification adjustment for gains (losses) included in net income	56	(222)	(200)
Other comprehensive loss	(5,958)	(2,631)	(1,014)
Comprehensive income	$ 11,952	$ 11,430	$ 9,085

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

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

For the Years Ended December 31, 2005, 2004, and 2003

	Common Stock	Additional Paid-In Capital	Retained Earnings	Note Receivable from Officer	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
			(In thousands)			
Balances January 1, 2003	$ 296	$ 127,429	$ 12,073	$ (876)	$ 8,473	$ 147,395
Unrealized depreciation available for sale securities					(1,014)	(1,014)
Stock-based employee compensation		189				189
Retirement of 569,059 shares of common stock	(6)	(2,437)	897			(1,546)
Note receivable from an officer				(10)		(10)
Net income			10,099			10,099
Balances December 31, 2003	290	125,181	23,069	(886)	7,459	155,113
Unrealized depreciation on available for sale securities					(2,586)	(2,586)
Deconsolidation of subsidiary			45		(45)	
Long term incentive plan; restricted stock award		650				650
Stock-based employee compensation		78				78
Issuance of 54,500 shares of common stock		185				185
Retirement of 2,103 shares of common stock		(9)				(9)
Note receivable from an officer				(18)		(18)
Net income			14,061			14,061
Balances December 31, 2004	290	126,085	37,175	(868)	4,828	167,510
					(5,967)	(5,967)

Unrealized depreciation on available for sale securities						
Net deferred derivative gain hedging activity					9	9
Long term incentive plan; restricted stock award		923				923
Stock-based employee compensation		41				41
Issuance of 382,825 shares of common stock	4	1,193				1,197
Retirement of 785,648 shares of common stock	(7)	(3,423)	(837)			(4,267)
Note receivable from an officer				9		9
Net income			17,910			17,910
Balances December 31, 2005	$ 287	$ 124,819	$ 54,248	$ (859)	$ (1,130)	$ 177,365

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

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
Cash Flows From Operating Activities			
Net income	$ 17,910	$ 14,061	$ 10,099
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of other intangible assets	198	376	353
Amortization of deferred debenture issuance costs	175	110	11
Depreciation of furniture, equipment, and building	2,452	1,591	1,418
Net accretion of discount and premiums on bonds	2,395	1,856	1,798
Gain (loss) on sale of investments	86	(337)	(303)
Gain on sale of fixed assets	(170)	(98)	
Stock-based employee compensation	41	78	189
Long term incentive plan expense	923	650	
Deferred income tax expense	1,347	1,577	4,415
Changes in operating assets and liabilities:			
Decrease (increase) in:			
Premiums and agent balances receivable	(713)	(6,277)	(6,134)
Reinsurance recoverable on paid and unpaid losses	(33,513)	(2,445)	37,201
Prepaid reinsurance premiums	1,488	(5,157)	(2,377)
Deferred policy acquisition costs	(1,204)	(5,773)	(7,424)
Other assets	5,612	2,772	(3,747)
Increase (decrease) in:			
Losses and loss adjustment expenses	80,521	38,692	(35,468)
Unearned premiums	6,688	24,625	40,999
Payable to insurance companies	(307)	(863)	(505)
Reinsurance funds held and balances payable	(2,591)	3,659	(2,238)
Other liabilities	609	1,577	9,243
Total adjustments	64,037	56,613	37,431
Net cash provided by operating activities	81,947	70,674	47,530
Cash Flows From Investing Activities			
Purchase of debt securities available for sale	(203,789)	(115,954)	(89,433)
Proceeds from sale of equity securities available for sale	8	2,409	
Proceeds from sales and maturities of debt securities available for sale	122,317	47,362	59,483
Capital expenditures	(15,810)	(5,244)	(2,155)
Purchase of books of business	(3,557)	(446)	(738)
Proceeds from sale of assets	633	2,837	

Deconsolidation of subsidiary		(4,218)	
Loan receivable	(5,905)	174	1,002
Net cash deposited in funds held	501	2,315	1,208
Net cash used in investing activities	(105,602)	(70,765)	(30,633)
Cash Flows From Financing Activities			
Proceeds from lines of credit	14,307	10,489	18,957
Payment of lines of credit	(19,451)	(15,851)	(33,948)
Book overdraft	924	268	1,212
Net proceeds from debentures	19,400	24,250	9,700
Stock options exercised	1,092	145	
Share repurchases of common stock	(4,191)		(1,562)
Other financing activities	(263)	18	6
Net cash provided by (used in) financing activities	11,818	19,319	(5,635)
Net (decrease) increase in cash and cash equivalents	(11,837)	19,228	11,262
Cash and cash equivalents, beginning of year	69,875	50,647	39,385
Cash and cash equivalents, end of year	$ 58,038	$ 69,875	$ 50,647
Supplemental Disclosure of Cash Flow Information:			
Interest paid	$ 3,428	$ 1,902	$ 835
Net income taxes paid	$ 6,404	$ 5,578	$ 76
Supplemental Disclosure of Non Cash Investing and Financing Activities:			
Tax benefit from stock options	$ 105	$ 30	$
Stock-based employee compensation	$ 41	$ 78	$ 189
Accrued liability for purchase of building(1)	$	$ 11,583	$

(1) On January 19, 2005, the Company closed on the purchase of its new headquarters in Southfield, Michigan, with a cash settlement of $11.6 million paid to the developer.

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

MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP), which differ from statutory accounting practices prescribed or permitted for insurance companies by regulatory authorities. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.

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

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

Reclassifications

Certain amounts in the 2004 and 2003 financial statements and notes to consolidated financial statements have been reclassified to conform to the 2005 presentation. These amounts specifically relate to the allocation of corporate overhead and a reclassification of revenue and net income related to a specific subsidiary. The Company s segment information has been reclassified to include an allocation of corporate overhead from the specialty risk management operations segment to the agency operations segment. This reclassification for the allocation of corporate overhead more accurately presents the Company s segments as a result of improved cost allocation information. Previously, 100% of corporate overhead was allocated to specialty risk management operations. In addition, the Company reclassified revenues and the overall net income related to a specific subsidiary from the agency operations segment to the specialty risk management operations segment.

Business

The Company, through its subsidiaries, is engaged primarily in developing and managing alternative risk management programs for defined client groups and their members. These services include: risk management consulting, claims administration and handling, loss control and prevention, and reinsurance placement, along with various types of property and casualty insurance coverage, including workers compensation, commercial multiple peril, general liability, commercial auto liability, and inland marine. The Company, through its Insurance Company Subsidiaries, issues insurance policies for risk-sharing and fully insured programs. The Company retains underwriting risk in these insurance programs, which may result in fluctuations in earnings. The Company also operates retail insurance agencies, which primarily place commercial insurance as well as personal property, casualty, life and accident and health insurance, with multiple insurance carriers. The Company does not have significant exposures to environmental/asbestos and catastrophic coverages. Insur-

MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

ance coverage is primarily provided to associations or similar groups of members, commonly referred to as programs.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. While management believes the amounts included in the consolidated financial statements reflect management s best estimates and assumptions, actual results may differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid short-term investments. The Company considers all short-term investments purchased with an original maturity of three months or less to be cash equivalents.

Investments

The Company s investment securities at December 31, 2005 and 2004, are classified as available for sale. Investments classified as available for sale are available to be sold in the future in response to the Company s liquidity needs, changes in market interest rates, tax strategies and asset-liability management strategies, among other reasons. Available for sale securities 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.

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

Other Than Temporary Impairments of Securities and Unrealized Losses on Investments

The Company s investment portfolio is primarily invested in debt securities classified as available for sale, with a concentration in fixed income securities of a high quality. The Company s policy for the valuation of temporarily impaired securities is to determine impairment based on analysis of the following factors: (1) rating downgrade or other credit event (e.g., failure to pay interest when due); (2) financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment; (3) prospects for the issuer s industry segment, and (4) intent and ability of the Company to retain the investment for a period of time sufficient to allow for anticipated recovery in market value. The Company evaluates its investments in securities to determine other than temporary impairment, no less than quarterly. Investments that are deemed other than temporarily impaired are written down to their estimated net fair value and the related losses are recognized in income. There were no impaired investments written down in 2005, 2004, and 2003.

Losses and Loss Adjustment Expenses and Reinsurance Recoverables

The liability for losses and loss adjustment expenses (LAE) represent case base estimates of reported unpaid losses and LAE and actuarial estimates of incurred but not reported losses (IBNR) and LAE. In addition, the liability for losses and loss adjustment expenses represents estimates received from ceding

MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

reinsurers on assumed business. Such liabilities, by necessity, are based upon estimates and, while management believes the amount of its reserves is adequate, the ultimate liability may be greater or less than the estimate.

Reserves related to the Company s direct business and assumed business it manages directly, are established through transactions processed through the Company s internal systems and related controls. Accordingly, case reserves are established on a current basis, and therefore there is no backlog, 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 and include an estimated reserve based upon actuarial methods for this lag. Assumed business which is subsequently 100% retroceded to participating reinsurers relates to business previously discontinued and now is in run-off. Lastly, in relation to assumed business from other sources, the Company receives case and paid loss data within a forty-five day reporting period and develops estimates for IBNR based on current and historical data.

In addition to case reserves and in accordance with industry practice, the Company maintains estimates of reserves for losses and LAE incurred but not yet reported. The Company projects an estimate of ultimate losses and LAE expenses at each reporting date. The difference between the projected ultimate loss and LAE reserves and the case loss and LAE reserves, is carried as IBNR reserves. By using both estimates of reported claims and IBNR determined using generally accepted actuarial reserving techniques, the Company estimates the ultimate liability for losses and LAE, net of 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 incurred but not reported losses and LAE. Such recoverables, by necessity, are based upon estimates and, while management believes that the amount accrued is collectible, the ultimate recoverable may be greater or less than the amount accrued.

The methods for making such estimates and for establishing the loss reserves and reinsurance recoverables are continually reviewed and updated. There were no changes in key assumptions during 2005, 2004 and 2003.

Revenue Recognition

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

For the year ending December 31, 2005, total assumed written premiums were $67.7 million, of which $56.0 million, relates to assumed business we manage directly, and therefore, no estimation is involved. The remaining $11.7 million of assumed written premiums represents $10.9 million related to residual markets.

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

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

MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Commission income, which includes reinsurance placement, is recorded on the later of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of any sub-producer commission expense. Commission and other adjustments are recorded when they occur and the Company maintains an allowance for estimated policy cancellations and commission returns. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

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

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. The Company reduces these costs for premium deficiencies. There were no premium deficiencies for the years ending December 31, 2005, 2004 and 2003.

Participating Policyholder Dividends

The Company s method for determining policyholder dividends is a combination of subjective and objective decisions, which may include loss ratio analysis for the specific program and the Company s overall business strategy. The Company determines the total dividends to be paid and then obtains the approval of the Board of Directors to pay up to a certain amount. At December 31, 2005 and 2004, the Company had $596,000 and $350,000 accrued for policyholder dividends, respectively.

Furniture and Equipment

Furniture and equipment are stated at cost, net of accumulated depreciation, and are depreciated using the straight-line method over the estimated useful lives of the assets, generally three to ten years. Upon sale or retirement, the cost of the asset and related accumulated depreciation are eliminated from their respective accounts, and the resulting gain or loss is included in income. Repairs and maintenance are charged to operations when incurred.

Goodwill and Other Intangible Assets

The Company is required to test, at least annually, all existing goodwill for impairment using a fair value approach, on a reporting unit basis. The Company s annual assessment date for goodwill impairment testing is October 1st. Also pursuant to Statement of Financial Accounting Standards (SFAS) No. 142 *Goodwill and Other Intangible Assets,* the Company is required to test for impairment more frequently if events or changes in circumstances indicate that the asset might be impaired. In addition, the Company has an other intangible asset which has an indefinite life and is evaluated annually in accordance with SFAS No. 142. The Company s remaining other intangible assets are amortized over a five-year period.

MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Income Taxes

The Company accounts for its income taxes under the asset and liability method. Deferred federal income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities.

At December 31, 2005, the Company had a deferred tax asset of $16.6 million. Realization of the deferred tax asset is dependent upon generating sufficient taxable income to absorb the applicable reversing temporary differences. At December 31, 2005, management concluded the positive evidence supporting the generation of future taxable income sufficient to realize the deferred tax asset. This positive evidence includes cumulative pre-tax income of $62.3 million for the three years ended December 31, 2005. In addition, the Company continues to have alternative tax strategies, which could generate capital gains from the potential sale of assets and/or subsidiaries.

Stock Options

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

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

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

MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

If compensation cost for stock option grants had been determined based on a fair value method, net income and earnings per share on a pro forma basis for 2005, 2004, and 2003 would be as follows (in thousands):

	2005	2004	2003
Net income, as reported	$ 17,910	$ 14,061	$ 10,099
Add: Stock-based employee compensation expense included in reported income, net of related tax effects	27	52	125
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(108)	(220)	(443)
Pro forma net income	$ 17,829	$ 13,893	$ 9,781
Earnings per share:			
Basic as reported	$ 0.62	$ 0.48	$ 0.35
Basic pro forma	$ 0.62	$ 0.48	$ 0.34
Diluted as reported	$ 0.60	$ 0.48	$ 0.35
Diluted pro forma	$ 0.60	$ 0.47	$ 0.33

The Black-Scholes valuation model utilized the following annualized assumptions for 2003: (1) risk-free interest rate of 2.90%, (2) no dividends were declared, (3) the volatility factor for the expected market price of the Company s common stock was 0.586, and (4) the weighted-average expected life of options was 5.0. No options were granted in 2005 and 2004.

Compensation expense of $41,000, $78,000, and $189,000 has been recorded for stock options in 2005, 2004, and 2003 under SFAS No. 148, respectively.

Long Term Incentive Plan

In 2004, the Company approved the adoption of a Long Term Incentive Plan (the LTIP). The LTIP provides participants with the opportunity to earn cash and stock awards based upon the achievement of specified financial goals over a three-year performance period with the first performance period commencing January 1, 2004. At the end of the three-year performance period, and if the performance target is achieved, the Committee shall determine the amount of LTIP awards that are payable to participants in the LTIP. One-half of any LTIP award will be payable in cash and one-half of the award will be payable in the form of a restricted stock award. If the Company achieves the three-year performance target, payment of the award would be made in three annual installments, with the first payment being paid as of the end of the performance period and the remaining two payments to be paid in the fourth and fifth year. Any unpaid portion of a cash award is subject to forfeiture if the participant voluntarily leaves the Company or is discharged for cause. The portion of the award to be paid in the form of stock will be issued as of the end of the performance period. The number of shares of Company s common stock subject to the restricted stock award shall equal the dollar amount of one-half of the LTIP award divided by the fair market value of Company s common stock on the first date of the performance period. The restricted stock awards shall be made subject to the terms and conditions of the LTIP and Plans. The Company accrues awards based upon the criteria set forth and approved by the Committee, as included in the LTIP.

Earnings Per Share

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

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Outstanding options of 534,201, 936,502, and 1,693,119 for the periods ended December 31, 2005, 2004, and 2003, respectively, have been excluded from the diluted earnings per share as they were anti-dilutive. Shares issuable pursuant to stock options included in diluted earnings per share were 298,851, 300,531, and 71,154 for the years ended December 31, 2005, 2004, and 2003, respectively. Restricted shares related to the LTIP included in diluted earnings per share were 392,988 for the year ended December 31, 2005. There were no shares related to the LTIP included in diluted earnings per share for the years ended December 31, 2004 and 2003. In addition, shares issuable pursuant to outstanding warrants included in diluted earnings per share were 71,908 and 8,678 for the years ended December 31, 2004 and 2003, respectively. There were no outstanding warrants as of December 31, 2005.

Comprehensive Income

Comprehensive income (loss) encompasses all changes in shareholders equity (except those arising from transactions with shareholders) and includes net income, net unrealized capital gains or losses on available-for-sale securities, and net deferred derivative gains or losses on hedging activity.

Derivative Instruments

The Company entered into two interest rate swap transactions in order to mitigate its interest rate risk. The Company recognized these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities,* as subsequently amended. These interest rate swap transactions have been designated as a cash flow hedge and are deemed a highly effective transaction under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and any changes in their fair value are accounted for within other comprehensive income. Any portion of the hedge deemed to be ineffective is recognized within the consolidated statements of income. The Company does not use interest rate swaps for trading or other speculative purposes.

In December 2005, the Company entered into a $6.0 million convertible note receivable with an unaffiliated insurance agency. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This note is convertible at the option of the Company based upon a pre-determined formula, beginning in 2007. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At December 31, 2005, the estimated fair value of the derivative is zero.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)), which replaces SFAS No. 123, *Accounting for Stock Issued to Employees.* SFAS 123(R) requires all share-based payments to employees to be recognized in the financial statements based on their fair values. The pro forma disclosures previously permitted under SFAS 123, will no longer be an alternative to financial statement recognition. Commencing in the first quarter of 2003, the Company began expensing the fair value of all stock options granted since January 1, 2003 under the prospective method. The Company has not issued stock options to employees since 2003. Under SFAS 123(R), the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded at the beginning of the first quarter of adoption of SFAS 123(R) for all unvested stock options and restricted stock based upon the previously disclosed SFAS 123 methodology and amounts. The retroactive methods would record compensation expense beginning with the first period restated for all unvested stock options and restricted

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stock. On April 14, 2005, the Securities and Exchange Commission adopted a new rule that delays the compliance dates for SFAS 123(R). Under the new rule, SFAS 123(R) is effective for public companies for annual, rather than interim periods, which begin after June 15, 2005. Therefore, the Company is required to adopt SFAS 123(R) in the first quarter of 2006, or beginning January 1, 2006. The Company has evaluated the requirements of SFAS 123(R) and has determined the impact on its financial statements related to existing stock options is immaterial.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3.* SFAS No. 154 replaces the mentioned pronouncements and changes the requirements for the accounting and reporting of a change in an accounting principle. This Statement applies to all voluntary changes in accounting principle, as well as changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. However, when a pronouncement includes specific transition provisions, those provisions should be followed. SFAS No. 154 requires retrospective application to prior period financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. Indirect effects of a change in accounting principle should be recognized in the period of the accounting change. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. However, early adoption is permitted for accounting changes and corrections of errors made in fiscal years beginning after the date this Statement was issued. The Company is required to adopt the provisions of SFAS No. 154, as applicable, beginning in 2006. The adoption of SFAS No. 154 will not have a material impact on the Company s consolidated financial statements.

In September 2005, the American Institute of Certified Public Accountants issued Statement of Position (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts,* effective for contract replacements occurring in fiscal years beginning after December 15, 2006. The SOP 05-1 defines an internal replacement of an insurance contract as a modification in product features, rights, or coverages that occurs by the exchange of an existing contract for a new contract, or by amendment endorsement, or rider to a contract, or by the election of a feature or coverage with a contract. Insurance contracts meeting this replacement criteria should be accounted for as an extinguishment of the replaced contract. The Company will review the guidance during 2006 and determine the applicability to any of its various insurance contracts.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. Investments

The estimated fair value of investments in securities is determined based on published market quotations and broker/dealer quotations. The cost or amortized cost and estimated fair value of investments in securities at December 31, 2005 and 2004 are as follows (in thousands):

	December 31, 2005			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt Securities:				
Debt securities issued by the U.S. government and agencies	$ 57,026	$ 498	$ (720)	$ 56,804
Obligations of states and political subdivisions	143,093	1,054	(1,493)	142,654
Corporate securities	107,761	2,106	(1,722)	108,145
Mortgage and asset-backed securities	96,067	127	(1,602)	94,592
Total Debt Securities available for sale	$ 403,947	$ 3,785	$ (5,537)	$ 402,195

	December 31, 2004			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Debt Securities:				
Debt securities issued by the U.S. government and agencies	$ 56,492	$ 1,234	$ (288)	$ 57,438
Obligations of states and political subdivisions	104,009	1,857	(271)	105,595
Corporate securities	99,784	4,813	(446)	104,151
Mortgage and asset-backed securities	64,681	673	(296)	65,058
Total Debt Securities available for sale	324,966	8,577	(1,301)	332,242
Equity Securities:				
Common Stocks		39		39
Total Equity Securities available for sale		39		39
Total Securities available for sale	$ 324,966	$ 8,616	$ (1,301)	$ 332,281

Gross unrealized appreciation and depreciation on available for sale securities were as follows (in thousands):

	December 31,	
	2005	**2004**
Unrealized appreciation	$ 3,785	$ 8,616
Unrealized depreciation	(5,537)	(1,301)
Net unrealized (depreciation) appreciation	(1,752)	7,315
Deferred federal income tax benefit (expense)	613	(2,487)
Net unrealized (depreciation) appreciation on investments, net of deferred federal income taxes	$ (1,139)	$ 4,828

The gross realized gains and gross realized losses on the sale of available for sale debt securities were $47,059 and $141,751, respectively, for the year ended December 31, 2005. The gross realized gains and gross

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realized losses on the sale of available for sale equity securities were $8,482 and $0, respectively, for the year ended December 31, 2005. The proceeds from the sale of debt securities and equity securities were $95.1 million and $8,482, respectively.

The gross realized gains and gross realized losses on the sale of available for sale debt securities were $97,279 and $189,766, respectively, for the year ended December 31, 2004. The gross realized gains and gross realized losses on the sale of available for sale equity securities were $429,288 and $0, respectively, for the year ended December 31, 2004. The proceeds from the sale of debt securities and equity securities were $7.0 million and $2.4 million, respectively.

The gross realized gains and gross realized losses on the sale of available for sale debt securities were $406,200 and $103,700, respectively, for the year ended December 31, 2003. There were no sales of available for sale equity securities for the year ended December 31, 2003. The proceeds from the sale of debt securities and equity securities were $13.7 million and $0, respectively.

At December 31, 2005, the amortized cost and estimated fair value of available for sale debt securities, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands):

	Available for Sale	
	Amortized Cost	**Estimated Fair Value**
Due in one year or less	$ 26,862	$ 26,842
Due after one year through five years	155,095	154,740
Due after five years through ten years	114,172	114,050
Due after ten years	11,750	11,970
Mortgage-backed securities	96,068	94,593
	$ 403,947	$ 402,195

Net investment income for the three years ended December 31, 2005, 2004, and 2003 was as follows (in thousands):

	2005	**2004**	**2003**
Net Investment Income On:			
Debt securities	$ 16,080	$ 13,559	$ 12,481
Equity securities	37	149	182
Cash and cash equivalents	2,291	1,657	1,425