

MERCHANTS GROUP INC

Form 10-Q

August 10, 2006

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
Form 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
For the quarterly period ended **June 30, 2006**

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.  
**Commission File Number 1-9640**

**MERCHANTS GROUP, INC.**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of incorporation or organization)*

16-1280763

*(I.R.S. Employer Identification No.)*

**250 Main Street, Buffalo, New York**

*(Address of principal executive offices)*

**14202**

*(Zip Code)*

**716-849-3333**

*(Registrant's telephone number, including area code)*

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

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  Accelerated filer  Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of August 8, 2006:  
**2,145,652 shares of Common Stock.**

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

Item 1. Financial Statements

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

Item 3 Quantitative and Qualitative Disclosures About Market Risk

Item 4 Controls and Procedures

**PART II OTHER INFORMATION**

1 Item 1 Legal Proceedings

1 Item 1A Risk Factors

1 Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

1 Item 3 Defaults Upon Senior Securities.

1 Item 4 Submission of Matters to a Vote of Security Holders

1 Item 5 Other Information

1 Item 6 Exhibits

**SIGNATURES**

EX-31(A)

EX-31(B)

EX-32(A)

---

**Table of Contents**

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

MERCHANTS GROUP, INC.  
CONSOLIDATED BALANCE SHEET  
(in thousands)

| Assets  | June 30,<br>2006<br>(unaudited) | December<br>31,<br>2005 |
|---|---------------------------------|-------------------------|
| Investments:  |                                 |                         |
| Fixed maturities:   |                                 |                         |
| Available for sale at fair value (amortized cost \$168,755 in 2006 and \$169,666 in 2005)                     | \$ 162,762                      | \$ 166,593              |
| Preferred stock at fair value   | 3,466                           | 4,312                   |
| Other long-term investments at fair value   | 84                              | 734                     |
| Short-term investments  | 7,962                           | 10,650                  |
| <br>Total investments   | <br>174,274                     | <br>182,289             |
| <br>Cash  | <br>36                          | <br>82                  |
| Interest due and accrued  | 1,152                           | 998                     |
| Premiums receivable from affiliate, net of allowance for doubtful accounts of \$135 in 2006 and \$158 in 2005 | 12,879                          | 13,540                  |
| Deferred policy acquisition costs from affiliate  | 5,612                           | 6,527                   |
| Reinsurance recoverable on unpaid losses  | 12,440                          | 13,807                  |
| Prepaid reinsurance premiums from affiliate   | 4,097                           | 4,559                   |
| Income taxes receivable   |                                 | 109                     |
| Deferred income taxes   | 6,108                           | 5,367                   |
| Other assets  | 6,552                           | 6,700                   |
| <br>Total assets  | <br>\$ 223,150                  | <br>\$ 233,978          |

See Notes to the Consolidated Financial Statements

**Table of Contents**

MERCHANTS GROUP, INC.  
CONSOLIDATED BALANCE SHEET  
(in thousands except share amounts)

|  | June 30,<br>2006<br>(unaudited) | December<br>31,<br>2005 |
|--|---------------------------------|-------------------------|
| Liabilities and Stockholders' Equity   |                                 |                         |
| Liabilities:   |                                 |                         |
| Reserve for losses and loss adjustment expenses (affiliate \$49,568 and \$50,239)  | \$ 106,515                      | \$ 115,191              |
| Unearned premiums from affiliate   | 25,681                          | 29,662                  |
| Payable to affiliate   | 532                             | 113                     |
| Income taxes payable   | 428                             |                         |
| Retrospective commission payable to affiliate  | 4,464                           | 2,590                   |
| Other liabilities (affiliate \$2,904 and \$5,044)  | 8,392                           | 10,528                  |
| <br>   |                                 |                         |
| Total liabilities  | 146,012                         | 158,084                 |
| <br>   |                                 |                         |
| Stockholders' equity:  |                                 |                         |
| Common stock, 10,000,000 shares authorized, 2,145,652 and 2,132,652 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively | 33                              | 33                      |
| Additional paid in capital   | 36,540                          | 36,267                  |
| Treasury stock, 1,139,700 shares at June 30, 2006 and December 31, 2005  | (22,766)                        | (22,766)                |
| Accumulated other comprehensive loss   | (4,368)                         | (2,540)                 |
| Accumulated earnings   | 67,699                          | 64,900                  |
| <br>   |                                 |                         |
| Total stockholders' equity   | 77,138                          | 75,894                  |
| <br>   |                                 |                         |
| Commitments and contingent liabilities   |                                 |                         |
| <br>   |                                 |                         |
| Total liabilities and stockholders' equity   | \$ 223,150                      | \$ 233,978              |

See Notes to the Consolidated Financial Statements

**Table of Contents**

MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF OPERATIONS  
(in thousands except per share amounts)

|  | Three Months<br>Ended June 30, |                 | Six Months<br>Ended June 30, |                 |
|--|--------------------------------|-----------------|------------------------------|-----------------|
|  | 2006                           | 2005            | 2006                         | 2005            |
|  | (unaudited)                    |                 |                              |                 |
| Revenues:  |                                |                 |                              |                 |
| Net premiums earned from affiliate   | \$ 10,019                      | \$ 12,767       | \$ 20,045                    | \$ 24,744       |
| Net investment income  | 2,002                          | 1,908           | 3,946                        | 3,844           |
| Net investment gains (losses)  | 42                             |                 | (68)                         |                 |
| Other revenues from affiliate  | 77                             | 114             | 210                          | 250             |
| <b>Total revenues</b>  | <b>12,140</b>                  | <b>14,789</b>   | <b>24,133</b>                | <b>28,838</b>   |
| Expenses:  |                                |                 |                              |                 |
| Net losses and loss adjustment expenses (\$5,639, \$5,277, \$10,054 and \$11,473 from affiliate) | 4,952                          | 4,617           | 9,265                        | 11,911          |
| Amortization of deferred policy acquisition costs from affiliate                                 | 2,605                          | 3,319           | 5,212                        | 6,433           |
| Other underwriting expenses (\$1,825, \$2,039, \$3,399 and \$3,903 from affiliate)               | 2,411                          | 2,321           | 4,189                        | 4,363           |
| <b>Total expenses</b>  | <b>9,968</b>                   | <b>10,257</b>   | <b>18,666</b>                | <b>22,707</b>   |
| <b>Income before income taxes</b>  | <b>2,172</b>                   | <b>4,532</b>    | <b>5,467</b>                 | <b>6,131</b>    |
| Income tax provision   | 638                            | 1,354           | 1,595                        | 1,765           |
| <b>Net income</b>  | <b>\$ 1,534</b>                | <b>\$ 3,178</b> | <b>\$ 3,872</b>              | <b>\$ 4,366</b> |
| Earnings per share:  |                                |                 |                              |                 |
| Basic  | \$ .71                         | \$ 1.50         | \$ 1.81                      | \$ 2.07         |
| Diluted  | \$ .71                         | \$ 1.50         | \$ 1.81                      | \$ 2.06         |
| Weighted average shares outstanding:   |                                |                 |                              |                 |
| Basic  | 2,146                          | 2,114           | 2,144                        | 2,114           |
| Diluted  | 2,146                          | 2,119           | 2,144                        | 2,119           |

See Notes to the Consolidated Financial Statements

**Table of Contents**

MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)  
(in thousands)

|  | Three Months<br>Ended June 30, |                     | Six Months<br>Ended June 30, |          |
|--|--------------------------------|---------------------|------------------------------|----------|
|  | 2006                           | 2005<br>(unaudited) | 2006                         | 2005     |
| Net income   | \$ 1,534                       | \$ 3,178            | \$ 3,872                     | \$ 4,366 |
| Other comprehensive income (loss) before taxes:                              |                                |                     |                              |          |
| Unrealized gains (losses) on securities                                      | (1,511)                        | 1,815               | (2,838)                      | (295)    |
| Reclassification adjustment for gains (losses) included in net income        | 42                             |                     | (68)                         |          |
| Other comprehensive income (loss) before taxes                               | (1,553)                        | 1,815               | (2,770)                      | (295)    |
| Income taxes (benefit) related to items of other comprehensive income (loss) | (528)                          | 617                 | (942)                        | (100)    |
| Other comprehensive income (loss)  | (1,025)                        | 1,198               | (1,828)                      | (195)    |
| Comprehensive income   | \$ 509                         | \$ 4,376            | \$ 2,044                     | \$ 4,171 |

See Notes to the Consolidated Financial Statements

**Table of Contents**

MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
(in thousands)

|   | Six Months<br>Ended June 30,<br>2006                  2005<br>(unaudited) |           |
|---|---|-----------|
| Common stock beginning and end:                         | \$ 33   | \$ 33     |
| Additional paid in capital:                             |   |           |
| Beginning of period                                     | 36,267  | 35,878    |
| Exercise of common stock options                        | 273   |           |
| End of period   | 36,540  | 35,878    |
| Treasury stock beginning and end:                       | (22,766)  | (22,766)  |
| Accumulated other comprehensive loss:                   |   |           |
| Beginning of period                                     | (2,540)   | (536)     |
| Other comprehensive loss                                | (1,828)   | (195)     |
| End of period   | (4,368)   | (731)     |
| Accumulated earnings:                                   |   |           |
| Beginning of period                                     | 64,900  | 59,365    |
| Net income  | 3,872   | 4,366     |
| Dividends to shareholders (to affiliate \$128 and \$51) | (1,073)   | (424)     |
| End of period   | 67,699  | 63,307    |
| Total stockholders' equity                              | \$ 77,138   | \$ 75,721 |

See Notes to the Consolidated Financial Statements



**Table of Contents**

MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(in thousands)

|  | Six Months<br>Ended June 30,<br>2006                  2005<br>(unaudited) |           |
|--|---|-----------|
| Cash flows from operations:  |   |           |
| Collection of premiums from affiliate  | \$ 16,900   | \$ 21,917 |
| Payment of losses and loss adjustment expenses (affiliate (\$10,725) and (\$11,598)) | (16,540)  | (18,393)  |
| Payment of other underwriting expenses (affiliate (\$7,562) and (\$8,290))           | (8,347)   | (8,921)   |
| Investment income received   | 3,764   | 4,024     |
| Investment expenses paid   | (149)   | (207)     |
| Income taxes paid  | (857)   | (259)     |
| Other from affiliate   | 210   | 250       |
| Net cash used in operations  | (5,019)   | (1,589)   |
| Cash flows from investing activities:  |   |           |
| Proceeds from fixed maturities sold or matured                                       | 19,965  | 29,678    |
| Purchase of fixed maturities   | (18,949)  | (24,882)  |
| Net (increase) decrease in preferred stock   | 1,000   | (850)     |
| Net decrease in other long-term investments  | 650   | 2,072     |
| Net (increase) decrease in short-term investments                                    | 2,688   | (2,816)   |
| Increase in payable for securities   |   | 6,258     |
| Net cash provided by investing activities  | 5,354   | 9,460     |
| Cash flows from financing activities:  |   |           |
| Settlement of affiliate balances, net  | 419   | (6,562)   |
| Exercise of common stock options   | 273   |           |
| Cash dividends (to affiliate \$128 and \$51)   | (1,073)   | (424)     |
| Net cash used in financing activities  | (381)   | (6,986)   |
| Increase (decrease) in cash  | (46)  | 885       |
| Cash:  |   |           |
| Beginning of period  | 82  | 145       |
| End of period  | \$ 36   | \$ 1,030  |

See Notes to the Consolidated Financial Statements

**Table of Contents**

MERCHANTS GROUP, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
RECONCILIATION OF NET INCOME TO NET CASH  
USED IN OPERATIONS  
(in thousands)

|   | Six Months<br>Ended June 30, |            |
|---|------------------------------|------------|
|   | 2006                         | 2005       |
|   | (unaudited)                  |            |
| Net income  | \$ 3,872                     | \$ 4,366   |
| Adjustments:  |                              |            |
| Net discount accretion on investments   | (177)                        | (66)       |
| Realized investment gains (losses)  | 68                           |            |
| Deferred income taxes   | 201                          | 304        |
| (Increase) decrease in assets:  |                              |            |
| Interest due and accrued  | (154)                        | 39         |
| Premiums receivable from affiliate  | 661                          | 707        |
| Deferred policy acquisition costs from affiliate                                  | 915                          | 984        |
| Reinsurance recoverable on unpaid losses  | 1,367                        | 394        |
| Prepaid reinsurance premiums from affiliate                                       | 462                          | (343)      |
| Income taxes receivable   | 109                          |            |
| Other assets  | 148                          | 1,214      |
| Increase (decrease) in liabilities:   |                              |            |
| Reserve for losses and loss adjustment expenses (affiliate (\$671) and (\$1,606)) | (8,676)                      | (7,984)    |
| Unearned premiums from affiliate  | (3,981)                      | (3,415)    |
| Income taxes payable  | 428                          | 1,204      |
| Retrospective commission payable to affiliate                                     | 1,874                        | 1,863      |
| Other liabilities (affiliate \$(2,141) and \$(685))                               | (2,136)                      | (856)      |
| Net cash used in operations   | \$ (5,019)                   | \$ (1,589) |

See Notes to the Consolidated Financial Statements

**Table of Contents**

MERCHANTS GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**1. Principles of Consolidation and Basis of Presentation**

The consolidated balance sheet as of June 30, 2006 and the related consolidated statements of operations and comprehensive income for the three and six month periods ended June 30, 2006 and 2005, and changes in stockholders' equity and cash flows for the six months ended June 30, 2006 and 2005, respectively, are unaudited. In the opinion of management, these interim financial statements reflect all adjustments necessary for a fair presentation of financial position and results of operations. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results for a full year.

The consolidated financial statements include the accounts of Merchants Group, Inc. (the Company), its wholly-owned subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and M.F.C. of New York, Inc., an inactive premium finance company which is a wholly-owned subsidiary of MNH. The accompanying consolidated financial statements should be read in conjunction with the following notes and the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which differ in some respects from those followed in reports to insurance regulatory authorities. All significant intercompany balances and transactions have been eliminated.

**2. Related Party Transactions**

The Company and MNH operate and manage their business in conjunction with Merchants Mutual Insurance Company (Mutual) under a services agreement (the Services Agreement) that became effective January 1, 2003. At June 30, 2006 Mutual owned 11.9% of the Company's issued and outstanding common stock. The Company and MNH do not have any operating assets or employees. Under the Services Agreement, Mutual provides the Company and MNH with the facilities, management and personnel required to operate their day-to-day business. The Services Agreement covers substantially the same services previously provided under a management agreement among the Company, MNH and Mutual from 1986 to 2002. The Services Agreement provides for negotiated fees (subject to periodic adjustment) for administrative, underwriting, claims and investment management services.

As of January 1, 2003 MNH and Mutual entered into a reinsurance pooling agreement (the Reinsurance Pooling Agreement) that provides for the pooling, or sharing, of the insurance business traditionally written by Mutual and MNH. The Reinsurance Pooling Agreement applies to premiums earned and losses incurred on or after its effective date.

**Table of Contents**

The Financial Statements include supplemental disclosure of affiliate balances, which represent the effects of the Services Agreement and the Reinsurance Pooling Agreement. In certain instances, particularly for Net losses and loss adjustment expenses, the affiliate amount may exceed the amount presented in the line item, because of changes in estimates for reserves for losses and loss adjustment expenses (LAE) prior to the effective date of the Reinsurance Pooling Agreement.

The terms of these agreements are more fully described under the heading Administration in Part I, Item 1, Business, in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. In accordance with the terms of the Services Agreement in June 2005 the Company and MNH issued notice to Mutual to terminate the Investment and Cash Management Services Annex of the Services Agreement as of June 30, 2006. In June 2006, the Company and Mutual agreed that Mutual would continue to provide Investment and Cash Management Services to the Company on a month-to-month basis, subject to a thirty-day cancellation notice effective at the end of any calendar month.

**3. Earnings Per Share**

Basic and diluted earnings per share were computed by dividing net income by the weighted average number of shares of common stock outstanding during each period.

For diluted earnings per share, the weighted average number of shares outstanding was increased by the assumed exercise of options for the three and six month periods ended June 30, 2005. The effect on the number of shares outstanding assumed the proceeds to the Company from exercise were used to purchase shares of the Company's common stock at its average market value per share during the period. The number of options assumed to be exercised and the incremental effect on average shares outstanding for purposes of calculating diluted earnings per share are shown below:

|                                | Three Months<br>Ended June 30, |        | Six Months<br>Ended June 30, |        |
|--------------------------------|--------------------------------|--------|------------------------------|--------|
|                                | 2006                           | 2005   | 2006                         | 2005   |
| Options assumed exercised      |                                | 31,500 |                              | 31,500 |
| Incremental shares outstanding |                                | 5,022  |                              | 4,988  |

There were no options outstanding at June 30, 2006.

The Company is not affected by Statement of Financial Accounting Standards No. 123(R) entitled Share Based Payment as no shared based payments were outstanding at June 30, 2006.

**Table of Contents**4. Reserve for Loss and Loss Adjustment Expenses

The following table presents the liability for reserves for losses and LAE separated into case reserves, reserves for losses incurred but not reported (IBNR) and reserves for LAE by major product:

|                                  | June 30,<br>2006 | December<br>31,<br>2005 |
|----------------------------------|------------------|-------------------------|
|                                  | (in thousands)   |                         |
| Case reserves:                   |                  |                         |
| Private passenger auto liability | \$ 6,074         | \$ 6,072                |
| Homeowners                       | 1,423            | 1,899                   |
| Commercial auto liability        | 4,368            | 5,384                   |
| Workers compensation             | 13,729           | 14,531                  |
| Commercial package               | 11,072           | 12,739                  |
| General liability                | 563              | 505                     |
| Other                            | 203              | 308                     |
| Total case reserves              | 37,432           | 41,438                  |
| IBNR:                            |                  |                         |
| Private passenger auto liability | 3,080            | 4,372                   |
| Homeowners                       | 385              | 228                     |
| Commercial auto liability        | 7,198            | 6,396                   |
| Workers compensation             | 7,317            | 8,074                   |
| Commercial package               | 15,522           | 16,965                  |
| General liability                | 3,364            | 2,581                   |
| Other                            | (303)            | (407)                   |
| Total IBNR                       | 36,563           | 38,209                  |
| Reserve for LAE:                 |                  |                         |
| Private passenger auto liability | 1,640            | 2,004                   |
| Homeowners                       | 500              | 604                     |
| Commercial auto liability        | 1,602            | 1,622                   |
| Workers compensation             | 1,858            | 2,104                   |
| Commercial package               | 10,344           | 11,493                  |
| General liability                | 3,962            | 3,668                   |
| Other                            | 174              | 242                     |
| Total reserve for LAE            | 20,080           | 21,737                  |
| Subtotal                         | 94,075           | 101,384                 |
| Reinsurance recoverables         | 12,440           | 13,807                  |
| Reserve for losses and LAE       | \$ 106,515       | \$ 115,191              |



**Table of Contents**

Included in the reserve for losses and LAE at June 30, 2006 was \$14,888,000 of reserves for 1996 and prior accident years. Reserves related to workers compensation comprised \$9,237,000 of this amount at June 30, 2006. The following table presents workers compensation claim count and paid loss data for accident years older than ten years as of each date:

|   | For the<br>six<br>months<br>ended<br>June<br>30,<br>2006 | For the year<br>ended<br>December 31,<br>2005 |
|---|--|---|
|   | (dollars in thousands)                                   |   |
| Number of claims pending, beginning of period | 84   | 92  |
| Number of claims reported                     |  |   |
| Number of claims settled or dismissed         |  | (16)  |
| Number of claims pending, end of period       | 84   | 76  |
| Losses paid (\$000 s)                         | \$ 411   | \$ 599  |
| Loss settlement expenses paid (\$000 s)       | \$ 26  | \$ 33   |

The workers compensation claims consist primarily of reserves for the estimated cost of lifetime medical care for injured claimants. In developing the reserves for such claimants, the Company estimates the nature, frequency and duration of future medical treatments and pharmaceutical usage, in some instances for the lifetime of the claimant. Periodic reevaluation of these factors, based on new information on the claimant or changes in medical procedures, devices or pharmaceuticals, may result in changes in estimates for individual claims that are significant to the Company.

**Table of Contents**

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

Results of Operations for the Six Months Ended June 30, 2006 As Compared to the Six Months Ended June 30, 2005

The following discussion should be considered in light of the statements under the heading "Safe Harbor Statement" under the Securities Litigation Reform Act of 1995, at the end of this Item. All capitalized terms used in this Item that are not defined in this Item have the meanings given to them in Notes to Consolidated Financial Statements contained in Item 1 of this Form 10-Q, which is incorporated herein by reference.

Results of operations for the six months ended June 30, 2006 and 2005 reflect the effects of the Services Agreement and the Reinsurance Pooling Agreement among the Company and its wholly-owned insurance subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and Merchants Mutual Insurance Company (Mutual), effective January 1, 2003. The Services Agreement calls for Mutual to provide underwriting, administrative, claims and investment services to the Company and MNH. The Reinsurance Pooling Agreement provides for the pooling, or sharing, of insurance business traditionally written by Mutual and MNH on or after the effective date. MNH's share of pooled (combined Mutual and MNH) premiums earned and losses and loss adjustment expenses (LAE) for 2006 in accordance with the Reinsurance Pooling Agreement is 25%, though not to exceed \$42,500,000 in net premiums written. MNH's share of pooled premiums earned and losses and LAE was 30% in 2005. The Reinsurance Pooling Agreement pertains to premiums earned and incurred losses and LAE. MNH's share of pooled premiums earned will be 25% in 2007, though not to exceed \$37,500,000 in net premiums written.

Total combined Mutual and MNH or group-wide direct premiums written (DWP) for the six months ended June 30, 2006 were \$100,638,000, substantially unchanged from \$100,538,000 in 2005. The Company's pro-forma share of combined direct premiums written in 2006, in accordance with the Reinsurance Pooling Agreement, was \$25,160,000 compared to \$30,161,000 in 2005. The table below shows a comparison of direct premiums written by major category in 2006 and 2005:

| Major Category                | Group-wide DWP<br>Six months ended<br>June 30, |            |        | MNH Pro-forma Share<br>Six months ended<br>June 30, |                |        |
|-------------------------------|--|------------|--------|---|----------------|--------|
|                               | 2006<br>(000's omitted)                        | 2005       | Change | 2006<br>(25%)*<br>(000's omitted)                   | 2005<br>(30%)* | Change |
| Voluntary Personal            | \$ 17,076                                      | \$ 19,505  | (12%)  | \$ 4,269  | \$ 5,852       | (27%)  |
| Voluntary Commercial          | 73,542   | 67,414     | 9%     | 18,386  | 20,224         | (9%)   |
| Umbrella Program              | 9,391  | 12,011     | (22%)  | 2,348   | 3,603          | (35%)  |
| Involuntary                   | 629  | 1,608      | (61%)  | 157   | 482            | (67%)  |
| Total Direct Written Premiums | \$ 100,638                                     | \$ 100,538 |        | \$ 25,160   | \$ 30,161      | (17%)  |

\* Pooling  
Percentages

The 12% (or \$2,429,000) decrease in group-wide voluntary personal DWP resulted from a 19% (or \$2,266,000) decrease in private passenger automobile (PPA) DWP. The decrease in PPA direct premiums written is the result of the companies' decision, implemented in 2002, not to write new policies in certain jurisdictions and to increased availability of this product from other competitors. As a result, voluntary PPA policies in force at June 30, 2006 were 13,529, a decrease of 17% from 16,365 at June 30, 2005.



**Table of Contents**

The monoline commercial umbrella program (the Umbrella Program) resulted in \$9,391,000 of DWP in the six months ended June 30, 2006 compared to \$12,011,000 in the six months ended 2005. This decrease resulted from increased competition from property casualty companies that have expanded their underwriting appetite to include commercial umbrella policies written in conjunction with the underlying property and liability policies. The Umbrella Program is marketed exclusively through one independent agent and approximately 95% of the premiums related to Umbrella Program Policies are reinsured with an A rated national reinsurer through a quota share reinsurance treaty. Group-wide voluntary commercial DWP increased \$6,128,000, or 9%, to \$73,542,000 for the six months ended June 30, 2006, from \$67,414,000 for the six months ended June 30, 2005. This increase resulted from period-to-period increases in every group-wide commercial product. The average premium per group-wide, non-Umbrella Program commercial lines policy increased 2% from the year earlier period. Total non-Umbrella Program commercial lines policies in force at June 30, 2006 were 37,259, an increase of 6% from 35,197 at June 30, 2005.

The 61% decrease in group-wide involuntary DWP resulted primarily from a decrease in assignments from the New York Automobile Insurance Plan (NYAIP). DWP related to policies assigned from the NYAIP decreased to \$373,000 for the six months ended June 30, 2006, compared to \$1,338,000 for the six months ended June 30, 2005. The NYAIP provides coverage for individuals who are unable to obtain auto insurance in the voluntary market. Assignments from the NYAIP vary depending upon a company's PPA market share and the size of the NYAIP. The Company is unable to predict the volume of future assignments from the NYAIP.

Group-wide pooled net premiums written for 2006 were \$82,839,000, a decrease of \$970,000, or 1%, from \$83,809,000 for the six months ended June 30, 2005. This decrease in group-wide net premiums written is primarily the result of a \$1,483,000 (51%) decrease in assumed written premiums. The Company assumes premiums from various involuntary facilities, though it is unable to predict the volume of assumed premiums from these facilities. The Company's share of 2006 pooled net premiums written was \$16,526,000, a decrease of \$4,461,000, or 21%, from \$20,987,000 in 2005. The decrease in the Company's share of net premiums written resulted from the Company's decreased percentage participation in the Reinsurance Pooling Agreement for 2006 as compared to 2005 and from the decrease in assumed written premiums.

Total revenues for the six months ended June 30, 2006 were \$24,133,000, a decrease of \$4,705,000, or 16%, from \$28,838,000 for the six months ended June 30, 2005.

The Company's share of pooled net premiums earned in accordance with the Reinsurance Pooling Agreement for the six months ended June 30, 2006 was \$20,045,000, compared to \$24,744,000 for the six months ended June 30, 2005. This \$4,699,000, or 19%, decrease in net premiums earned resulted primarily from the 5 percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement.

Net investment income was \$3,946,000 for the six months ended June 30, 2006, an increase of 3% from \$3,844,000 for the six months ended June 30, 2005 primarily due to a 16 basis point (4%) increase in average portfolio yield.

**Table of Contents**

Net losses and LAE were \$9,265,000 for the six months ended June 30, 2006, a decrease of \$2,646,000, or 22%, from \$11,911,000 for the six months ended June 30, 2005. The decrease in net losses and LAE was due to the 19% decrease in net premiums earned, which reduced net losses and LAE by \$2,260,000, and a 1.9 percentage point decrease in the loss and LAE ratio to 46.2% for the six months ended June 30, 2006 from 48.1% for the six months ended June 30, 2005.

The 1.9 percentage point decrease in the loss and LAE ratio was due to a \$2,915,000 decrease in the Company's estimate of losses and LAE occurring in prior accident years, which reduced the loss and LAE ratio by 14.5 percentage points. During the six months ended June 30, 2005, the Company recorded a \$2,879,000 decrease to its estimate of losses and LAE occurring in prior years, which reduced the loss and LAE ratio by 11.6 percentage points. The loss and LAE ratio for the current accident year was 60.8% in 2006 compared to 59.8% in 2005.

The reserve development for each product and for each accident year during 2006 was within the range of reasonably likely reserves by product as of December 31, 2005. It is not appropriate to project future increases or decreases in the estimate of losses and LAE for prior accident years from past experience. See *Critical Accounting Policies* for a further discussion of the Company's Reserves for Losses and LAE. The following table documents the changes in the estimate of losses and LAE related to prior accident years recorded in 2006 for the Company's primary products:

| Accident Year                        | Home-owners | PPA Liability | Commercial     | Workers'     | Commercial Package | General Liability | All Other | Total      |
|--------------------------------------|-------------|---------------|----------------|--------------|--------------------|-------------------|-----------|------------|
|                                      |             |               | Auto Liability | Compensation |                    |                   |           |            |
| Increases (decreases) (in thousands) |             |               |                |              |                    |                   |           |            |
| Prior to                             |             |               |                |              |                    |                   |           |            |
| 2003                                 | \$ 242      | \$ (60)       | \$ 273         | \$ (1,059)   | \$ (900)           | \$ 524            | \$ 41     | \$ (939)   |
| 2003                                 | 67          | (212)         | 44             | 208          | (765)              | (87)              | 16        | (729)      |
| 2004                                 | (15)        | (246)         | 298            | (531)        | (745)              | 152               |           | (1,087)    |
| 2005                                 | 213         | (166)         | 190            | (97)         | (502)              | 209               | (7)       | (160)      |
| Total                                | \$ 507      | \$ (684)      | \$ 805         | \$ (1,479)   | \$ (2,912)         | \$ 798            | \$ 50     | \$ (2,915) |

The Company experienced \$2,912,000 of favorable loss development during 2006 related to its commercial package product. The Company made no significant changes to its procedures for processing or reserving its claims during 2006, and attributes the changes to its prior year reserves to the inherent uncertainty in estimating ultimate costs in circumstances that involve complex and changing conditions.

The Company experienced \$1,479,000 of favorable loss development during 2006 related to its workers' compensation product. This decrease in loss estimates for workers' compensation business is consistent with changes initiated by the Company in 2001 to reduce the concentration in its workers' compensation policy portfolio of classes of risk that are subject to high severity losses. Those underwriting changes have continued through 2006. The Company believes that it took several years for the absence of severe losses to become apparent, as the severity of such losses, if they were to occur, typically do not become apparent for several years.

The Company's reduction in its estimate of losses and LAE related to prior accident years during the six months ended June 30, 2006 represented less than 3% of the recorded reserve for losses and LAE at December 31, 2005.

**Table of Contents**

The Company made no changes to the key assumptions used in evaluating the adequacy of its reserves for losses and LAE during the first six months of 2006. A reasonable possibility exists in any reporting period that relatively minor fluctuations in the estimate of reserves for losses and LAE may have a significant impact on the Company's net income. This is due primarily to the size of the Company's reserves for losses and LAE (\$106,515,000 at June 30, 2006) relative to its net income. See "Critical Accounting Policies and Estimates" for a further discussion of the Company's Reserves for Losses and LAE.

The ratio of amortization of deferred policy acquisition costs and other underwriting expenses to net premiums earned was 46.9% for the six months ended June 30, 2006 compared to 43.6% for the six months ended June 30, 2005.

Amortization of deferred acquisition costs decreased \$1,221,000 or 19% compared to the year earlier period. Other underwriting expenses as a percentage of net premiums earned increased by 3.3 percentage points to 20.9% in 2006 from 17.6% in 2005. Other underwriting expenses include retrospective commissions related to the Reinsurance Pooling Agreement, which provides for retrospective commission income or expense due from or to Mutual based on the estimated experience compared to a targeted loss and LAE ratio. Retrospective commission expense totaled \$1,873,000 (9.3 percentage points of the expense ratio) for the six months ended June 30, 2006 compared to \$1,863,000 (7.5 percentage points of the expense ratio) for the six months ended June 30, 2005.

The Company plans to reduce its reliance on its traditional business by reducing its percentage participation in the Reinsurance Pooling Agreement and by seeking alternative opportunities in which to invest its capital. To the extent that the Company does not invest in such alternative opportunities, fixed expenses will become equal to a greater percentage of net premiums earned in future periods. Commissions (other than retrospective commissions under the Reinsurance Pooling Agreement), premium taxes and other state assessments that vary directly with the Company's premium volume represented 19.5% of net premiums earned in the six month period ended June 30, 2006 compared to 19.7% of net premiums earned in the six months ended June 30, 2005.

The Company's effective income tax rates were 29.2% and 28.8%, for the six month periods ended June 30, 2006 and 2005, respectively. These rates were calculated based upon the Company's estimate of its effective income tax rate for all of the applicable year. Non-taxable income, primarily tax-exempt income from fixed maturity investments, reduced the Company's effective income tax rate by approximately 5 percentage points in both 2006 and 2005.

**Table of Contents****Results of Operations for the Three Months Ended June 30, 2006 As Compared to the Three Months Ended June 30, 2005**

Total combined Mutual and MNH DWP for the three months ended June 30, 2006 were \$54,323,000, a decrease of \$928,000 from \$55,251,000 in 2005. The Company's pro-forma share of combined direct premiums written in 2006, in accordance with the Reinsurance Pooling Agreement, was \$13,581,000 compared to \$16,575,000 in 2005. The table below shows a comparison of direct premiums written by major category in 2006 and 2005:

| Major Category                       | Group-wide DWP<br>Three months ended<br>June 30, |                  |             | MNH Pro-forma Share<br>Three months ended<br>June 30, |                  |              |
|--------------------------------------|--|------------------|-------------|---|------------------|--------------|
|                                      | 2006<br>(000's omitted)                          | 2005             | Change      | 2006<br>(25%)*<br>(000's omitted)                     | 2005<br>(30%)*   | Change       |
| Voluntary Personal                   | \$ 8,995   | \$ 10,294        | (13%)       | \$ 2,249  | \$ 3,088         | (27%)        |
| Voluntary Commercial                 | 40,571   | 37,247           | 9%          | 10,143  | 11,174           | (9%)         |
| Umbrella Program                     | 4,506  | 6,795            | (34%)       | 1,126   | 2,039            | (45%)        |
| Involuntary                          | 251  | 915              | (73%)       | 63  | 274              | (77%)        |
| <b>Total Direct Written Premiums</b> | <b>\$ 54,323</b>                                 | <b>\$ 55,251</b> | <b>(2%)</b> | <b>\$ 13,581</b>                                      | <b>\$ 16,575</b> | <b>(18%)</b> |

\* Pooling  
Percentages

The 13% (or \$1,299,000) decrease in group-wide voluntary personal DWP resulted from a 21% (or \$1,230,000) decrease in private passenger automobile (PPA) direct premiums written. The decrease in PPA direct premiums written is the result of the company's decision, implemented in 2002, not to write new policies in certain jurisdictions. Group-wide voluntary commercial DWP increased \$3,324,000, or 9%, to \$40,571,000 for the three months ended June 30, 2006, from \$37,247,000 for the three months ended June 30, 2005. This increase resulted from period to period increases in every group-wide commercial product.

The Umbrella Program resulted in \$4,506,000 of DWP in the three months ended June 30, 2006 compared to \$6,795,000 in the three months ended June 30, 2005. This decrease in Umbrella Program DWP was due to the same factors that caused the decline in Umbrella Program DWP in the six months ended June 30, 2006 as compared to the six months ended June 30, 2005, discussed previously in this Item.

The 73% decrease in group-wide involuntary DWP resulted primarily from a decrease in assignments from the NYAIP. DWP related to policies assigned from the NYAIP decreased \$639,000 or 81% to \$146,000 for the six months ended June 30, 2006, compared to \$786,000 for the six months ended June 30, 2005.

Group-wide pooled net premiums written for the three months ended June 30, 2006 were \$45,374,000, a decrease of \$1,566,000, or 3% from \$46,940,000 for the three months ended June 30, 2005. This decrease in group-wide net premiums written is due to the decrease in group wide direct premiums written. The Company's share of 2006 pooled net premiums written was \$11,343,000, a decrease of \$2,739,000, or 19%, from \$14,082,000 in 2005. The decrease in the Company's net premiums written resulted primarily from the Company's decreased percentage participation in the Reinsurance Pooling Agreement for 2006 as compared to 2005.

**Table of Contents**

Total revenues for the three months ended June 30, 2006 were \$12,140,000, a decrease of \$2,649,000 or 18% from \$14,789,000 for the three months ended June 30, 2005.

The Company's share of pooled net premiums earned in accordance with the Reinsurance Pooling Agreement for the three months ended June 30, 2006 was \$10,019,000, compared to \$12,767,000 for the three months ended June 30, 2005. This \$2,748,000, or 22%, decrease in net premiums earned resulted from the five percentage point decrease in the Company's participation in the Reinsurance Pooling Agreement and the 3% decrease in pooled net premiums written.

Net investment income was \$2,002,000 for the three months ended June 30, 2006, an increase of 5% from \$1,908,000 for the three months ended June 30, 2005, primarily due to a 17 basis point or 4% increase in average portfolio yield. Net losses and LAE were \$4,952,000 for the three months ended June 30, 2006, an increase of \$335,000, or 7%, from \$4,617,000 for the three months ended June 30, 2005. The increase in net losses and LAE was due to the 22% decrease in net premiums earned being more than offset by a 13.2 percentage point increase in the loss and LAE ratio to 49.4% for the three months ended June 30, 2006 from 36.2% for the three months ended June 30, 2005. This 13.2 percentage point increase in the loss and LAE ratio was due to an .6 percentage point decrease in the 2006 accident year loss and LAE ratio to 58.0% for the second quarter of 2006 from 58.6% for the comparable period in 2005 and to a \$858,000 decrease in the Company's estimate of losses and LAE related to prior accident years, compared to a \$2,864,000 decrease in the estimate of losses and LAE related to prior accident years recorded in 2005. To enhance the statistical credibility of the Company's data, the Company performs its loss and LAE analysis for each new accident year on a year-to-date basis as of the end of each quarter of that year. As a result, the accident year loss and LAE ratio for each quarter is the difference between the current quarter year-to-date estimate and the prior quarter year-to-date estimate. Absent a significant individual loss or a loss-causing event (such as a storm) the Company cannot determine whether the quarter-to-quarter change is due to new losses occurring during the current quarter, or changes in estimates for losses occurring in prior quarters. Accordingly, differences in current accident year quarterly loss and LAE ratios may not be indicative of improvement or deterioration in the Company's business.

The Company recorded an \$858,000 decrease in the estimate of losses and LAE related to prior accident years in the second quarter of 2006, which reduced the second quarter 2006 loss and LAE ratio by 8.6 percentage points. The reasons for this decrease are discussed in the Results of Operations for the Six Months Ended June 30, 2006 As Compared to the Six Months Ended June 30, 2005 appearing earlier in this Item. During the second quarter of 2005, the Company recorded a \$2,864,000 decrease to its estimate of losses and LAE which decreased the loss and LAE ratio in the second quarter of 2005 by 22.4 percentage points.

The ratio of amortization of deferred policy acquisition costs and other underwriting expenses to net premiums earned increased to 50.1% for the three months ended June 30, 2006 from 44.2% for the three months ended June 30, 2005. Amortization of deferred acquisition costs decreased \$714,000 or 22% compared to the year earlier period. Other underwriting expenses as a percentage of net premiums earned increased by 5.9 percentage points due to an increase in retrospective commissions related to the Reinsurance Pooling Agreement. The commission is owed to Mutual based on a decrease during the second quarter of 2006 in the estimated cumulative loss and LAE ratio on the pooled business since the

**Table of Contents**

inception of the Reinsurance Pooling Agreement. Retrospective commission expense totaled \$971,000 (9.7 percentage points of the expense ratio) for the three months ended June 30, 2006 compared to \$1,007,000 (7.9 percentage points of the expense ratio) for the three months ended June 30, 2005. Commissions (other than retrospective commissions under the Reinsurance Pooling Agreement), premium taxes and other state assessments that vary directly with the Company's premium volume represented 19.4% of net premiums earned in the three month period ended June 30, 2006 compared to 19.1% of net premiums earned in the three months ended June 30, 2005.

The Company's effective income tax rate for the three months ended June 30, 2006 and 2005 was 29.4% and 29.9%, respectively. These rates were calculated based upon the Company's estimate of its effective income tax rate for all of the respective years. The effective income tax rates differed from the federal statutory rate of 34% primarily due to tax-exempt income from fixed maturity investments.

**Critical Accounting Policies**

**Reserve for Losses and LAE**

The Reserve for Losses and LAE is an estimate of the ultimate cost of settling all losses incurred and unpaid, including those losses not yet reported to the Company, and is stated net of reinsurance. The amount of loss reserves for reported claims is based upon a case-by-case evaluation of the circumstances pertaining to the claim and the policy provisions relating to the loss. Reserves for claims that have occurred but have not been reported (IBNR) to the Company and for the future costs of settling or adjusting claims are determined using commonly accepted actuarial techniques based on historical information for each of the Company's products, adjusted for current conditions.

The Company's primary assumption when determining its reserves is that past experience, adjusted for the effect of current developments and trends, is relevant in predicting future events. When establishing its loss reserves, the Company analyzes historical data and estimates the impact of various loss development factors such as the historical loss experience of the Company and of the industry, the mix of products sold, trends in claim frequency and severity, the Company's claim processing procedures, changes in legislation, judicial decisions, legal developments, including the prevalence of litigation in the areas served by the Company, and changes in general economic conditions including inflation.

Management determines the amount of reserves for losses and LAE to be recorded based upon analyses prepared by the Company's internal and external actuaries and management's assessment of a reasonable amount of reserves. The reasonable estimate is determined after considering the estimates produced using a variety of actuarial techniques for each of the Company's products. The following is a summary of the methods used:

**Paid Loss Development**

The paid loss development method is based on the assumption that past rates of claims payments are indicative of future rates of claims payments. An advantage of this method is that paid losses contain no case reserve estimates. Additionally, paid losses are not as greatly influenced by changes in claims reserving practices as are incurred losses. Estimates can be distorted if changes in claims handling practices or procedures cause an acceleration or deceleration in claims payments.

**Table of Contents**

Furthermore, paid loss development may produce biased estimates for long-tailed products where paid loss development factors are large at early evaluation points.

**Incurred Loss Development**

The incurred loss development method is based on the assumption that the past relative adequacy of case reserves is consistent with the current relative adequacy of case reserves. Because incurred losses include payments and case reserves, a larger volume of data is considered in the estimate of ultimate losses. As a result, incurred loss data patterns may be less erratic than paid loss data patterns, particularly for coverages on which claims are reported relatively quickly but have a long payout pattern. Because this method assumes that the relative adequacy of case reserves has been consistent, changes in claims handling procedures or the occurrence or absence of large losses may cause estimates to be erratic.

**Bornhuetter-Ferguson with Premium and Paid Loss**

The Bornhuetter-Ferguson (BF) with premium and paid loss method is a combination of the paid loss development method and an expected loss ratio assumption. The expected loss ratios are modified to the extent actual loss payments differ from payments expected based on the selected paid loss development pattern. This method avoids possible distortions resulting from a large development factor being applied to a small base of paid losses in order to estimate ultimate losses. This method will react slowly if actual ultimate losses differ substantially from losses inherent in the expected loss ratio.

**Bornhuetter-Ferguson with Premium and Incurred Loss**

The Bornhuetter-Ferguson (BF) with premium and incurred loss method is a combination of the incurred loss development method and an expected loss ratio assumption. The expected loss ratios are modified to the extent actual incurred losses differ from expected incurred losses based on the selected incurred loss development pattern. This method avoids possible distortions resulting from a large development factor being applied to a small base of incurred losses in order to estimate ultimate loss. This method will react slowly if actual ultimate losses differ substantially from losses inherent in the expected loss ratio.

**Ultimate Claims and Average Loss**

This method multiplies the estimated number of ultimate claims by a selected ultimate average loss for each accident year to produce ultimate loss estimates. If loss development methods produce erratic or unreliable estimates, this method can provide more stable estimates, consistent with recent loss history. This method may produce erratic results if there has been a change in the way claims are counted or in the mix of types of loss. The occurrence or absence of large losses can also distort the average loss estimate.

ALAE are estimated separately from losses because ALAE payment patterns differ from loss payment patterns. The company employs the following methods to estimate ALAE reserves.

**Table of Contents**

**Paid ALAE Development**

This method is analogous to the paid loss development method except paid ALAE is developed instead of paid losses. Paid ALAE patterns often are more stable than paid loss patterns. However, paid ALAE typically develop more slowly than paid losses, resulting in a large leveraging impact on less mature accident years.

**Bornhuetter-Ferguson with Ultimate Loss and Paid ALAE**

The Bornhuetter-Ferguson (BF) with ultimate loss and paid ALAE method is a combination of the paid ALAE development method and an expected ratio of ultimate ALAE to ultimate loss. The expected ALAE to loss ratios are modified to the extent paid ALAE differ from expected based on the selected paid ALAE development pattern. This method avoids possible distortions resulting from a large development factor being applied to a small base of paid ALAE in order to estimate ultimate ALAE. This is a useful method for estimating ultimate ALAE for less mature accident years.

Estimated ultimate losses and LAE and the resulting reserve for losses and LAE are determined based on the results of the methods described above along with the following considerations:

How results of methods based on paid losses compare to methods based on incurred losses.

How results of paid and incurred development methods compare to results of paid and incurred BF methods.

Whether diagnostic tests cause management to favor the results of one or more methods over the results of other methods. Such tests include:

closed claim to reported claim ratios

average case reserves per open claim

paid loss per closed claim

paid loss to incurred loss ratios

the reasonableness of ultimate loss & ALAE ratios and ultimate severities

management's consideration of other factors such as premium and loss trends, large loss experience, legislative and judicial changes and changes in underwriting guidelines and practices.

To the extent these considerations result in changes to the Company's estimates of reserves for losses and LAE related to prior accident years, the Company recognizes such changes in the accounting period in which the change becomes known.

As stated previously, the above methods assume that past experience adjusted for the effects of current developments and trends is an appropriate basis for predicting future events. As a result of a number of factors, it is possible that ultimate actual payments for losses and LAE will differ from amounts contemplated in recorded reserves. A range of reasonably likely reserves by product as of June 30, 2006, net of reinsurance recoverables, developed by the Company's actuaries based on a variety of generally accepted actuarial methods is shown in the table below. Generally the low and the high values in the range represent reasonable minimum and maximum amounts of these actuarial indications using the methods described above.



**Table of Contents**

|                              | Range of Net Loss & LAE Reserves (\$000 s) |          |           |
|------------------------------|--|----------|-----------|
|                              | Low  | Recorded | High      |
| Products*                    |  |          |           |
| Personal Auto                | \$ 9,518                                   | \$10,830 | \$ 12,307 |
| Homeowners                   | \$ 1,731                                   | \$ 2,309 | \$ 2,960  |
| Commercial Auto              | \$ 9,891                                   | \$13,212 | \$ 16,578 |
| Workers Compensation         | \$19,045                                   | \$22,903 | \$ 27,170 |
| Commercial General Liability | \$32,214                                   | \$41,463 | \$ 53,667 |
| Commercial Property          | \$ 2,523                                   | \$ 3,364 | \$ 4,205  |
| Other                        | \$ (5)                                     | \$ (6)   | \$ (8)    |
| All Products                 | \$84,290                                   | \$94,075 | \$106,954 |

\* The products shown in this table are those used by the Company in its loss reserving process. The Company's reserve for unpaid losses and LAE as appears in Note 4. in Item 1., are segregated by product type as defined in the Company's Annual Statement filed with insurance department regulators.

Because the reserve estimates by product are independent of each other it is highly unlikely that the low estimate or the high estimate for each product will occur at the same time. Accordingly, the low and the high estimates for All Products shown above are greater than the sum of the low estimates and less than the sum of the high estimates, respectively, resulting in a narrower range.

Despite the many factors considered in the reserving process, it is reasonably possible that actual payments for losses & LAE will differ from those contemplated in the Company's reserves. Such fluctuations could have a significant impact on the Company's net income.

**Deferred Policy Acquisition Costs**

Policy acquisition costs, such as commissions (net of reinsurance commissions), premiums taxes and certain other underwriting expenses which vary directly with premium volume, are deferred and amortized over the terms of the related insurance policies. Deferred policy acquisition costs are evaluated on an aggregate basis at least annually, to determine if recorded amounts exceed estimated recoverable amounts after allowing for anticipated investment income. Premium deficiencies if any, are recorded as amortization of deferred policy acquisition costs. Actual amounts may vary from the Company's estimates.

**Investments**

Fixed maturity investments are classified as available for sale and are carried at fair value. Net unrealized holding gains or losses, net of taxes, are shown as accumulated other comprehensive income. Investment income is recognized when earned, and gains and losses are recognized when investments are sold and in instances when a decline in the fair value of a security is determined to be other-than-temporary.

The Company's investment committee, comprised of the Chief Operating Officer, the Chief Investment Officer and the Chief Financial Officer, meets monthly and monitors the Company's investment portfolio for declines in value that are other-than-temporary. This assessment requires significant judgment. The investment committee considers the nature of the investment, the severity and length of the decline in fair value, events specific to the issuer including valuation modeling, overall market conditions, and the

**Table of Contents**

Company's intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in market value. When a decline in the fair value of a security is determined to be other-than-temporary, the Company adjusts the cost basis of that security to fair value, and records a corresponding charge to earnings. Future increases in fair value and future decreases in fair value if not other-than-temporary, are included in other comprehensive income.

**Liquidity and Capital Resources**

In developing its investment strategy the Company determines a level of cash and short-term investments which, when combined with expected cash flow, is estimated to be adequate to meet expected cash obligations. Due to declining written premiums however, the Company's operating activities have resulted in a use of cash each year since 2001. The Company's decreasing participation percentage in the pooled business over the remaining period of the Reinsurance Pooling Agreement will likely result in continued negative cash flows from operations. Net cash used in operations during the six months ended June 30, 2006 was \$5,019,000. The Company believes that careful management of the relationship between assets and liabilities will minimize the likelihood that investment portfolio sales will be necessary to fund insurance operations, and that the effect of such sales, if any, on the Company's stockholders' equity will not be material.

The Company's objectives with respect to its investment portfolio include maximizing total return within investment guidelines while protecting policyholders' surplus and maintaining flexibility. The Company relies on premiums as a major source of cash, and therefore liquidity. Cash flows from the Company's investment portfolio, in the form of interest or principal payments as well as from the maturity of fixed income investments, are an additional source of liquidity.

The Company designates newly acquired fixed maturity investments as available for sale and carries these investments at fair value. Unrealized gains and losses related to these investments are recorded as accumulated other comprehensive income (loss) within stockholders' equity. At June 30, 2006, the Company recorded as accumulated other comprehensive loss in its Consolidated Balance Sheet \$4,368,000 of unrealized losses, net of taxes, associated with its investments.

At June 30, 2006, the Company's portfolio of fixed maturity investments represented 93.4% of invested assets. Management believes that this level of fixed maturity investments is consistent with the Company's liquidity needs because it anticipates that cash receipts from net premiums written, investment income and maturing securities will enable the Company to satisfy its cash obligations. Furthermore, a portion of the Company's fixed maturity investments are invested in mortgage-backed and other asset-backed securities which, in addition to interest income, provide monthly paydowns of bond principal.

At June 30, 2006, \$87,294,000, or 53.6%, of the Company's fixed maturity portfolio was invested in mortgage-backed and other asset-backed securities. The Company invests in a variety of collateralized mortgage obligation ( CMO ) products but has not invested in the derivative type of CMO products such as interest only, principal only or inverse floating rate securities. All of the Company's CMO investments have a secondary market and their effect on the Company's liquidity does not differ from that of other fixed maturity investments.

At June 30, 2006 \$5,165,000, or 3%, of the Company's investment portfolio was invested in non-investment grade securities compared to \$6,123,000, or 3%, at December 31, 2005.

**Table of Contents**

The Company has arranged for a \$2,000,000 unsecured credit facility from a bank. Any borrowings under this facility are payable on demand and carry an interest rate which can be fixed or variable and is negotiated at the time of each advance. This facility is available for general working capital purposes and for repurchases of the Company's common stock. At June 30, 2006 no amount was outstanding on this loan.

As a holding company, the Company is dependent on cash dividends from MNH to meet its obligations and to pay any cash dividends. MNH is subject to New Hampshire insurance laws which place certain restrictions on its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer's statutory policyholders' surplus as of the preceding December 31st. The maximum amount of dividends that MNH could pay during any twelve month period ending in 2006 without the prior approval of the New Hampshire Insurance Commissioner is \$6,639,000. MNH paid \$800,000, \$1,200,000, \$800,000 and \$600,000 of dividends to the Company in February 2005, October 2005, November 2005, December 2005, respectively. The Company paid cash dividends to its common stockholders of \$.50 per share during the six months ended June 30, 2006 amounting to \$1,073,000. On August 8, 2006 the Company declared a quarterly cash dividend of \$.25 per share payable on September 1, 2006 to shareholders of record as of the close of business on August 22, 2006.

Under the Services Agreement, Mutual has provided services and facilities for MNH to conduct its insurance business. The balance in the payable to or receivable from affiliate account represents the amount owing to or owed by Mutual by or to the Company for the difference between premiums collected and payments made for losses, commissions (including retrospective commissions), employees, services and facilities by Mutual on behalf of MNH. Regulatory guidelines suggest that the ratio of a property-casualty insurer's annual net premiums written to its statutory surplus should not exceed 3 to 1. MNH has consistently followed a business strategy that would allow it to meet this 3 to 1 regulatory guideline. For the first six months of 2006, MNH's ratio of net premiums written to statutory surplus, annualized for a full year, was .5 to 1.

**Relationship with Mutual and Continuation of Operations**

The Company and MNH operate and manage their business in conjunction with Mutual under the terms of the Services Agreement and Reinsurance Pooling Agreement described above. Reference is made to the description of the termination provisions of the Services Agreement and the Reinsurance Pooling Agreement that is provided under the sub-caption "Administration" under Part I, Item 1, of the Company's Form 10-K Report for the year ended December 31, 2005, which is incorporated herein by reference.

On March 20, 2006, the Chairman of the Board of the Company received a letter from the Chairman of Mutual that indicated that Mutual was interested in acquiring the Company and was prepared to negotiate an all cash acquisition (by way of a tender offer and/or merger) for all of the outstanding common stock of the Company at \$29.00 per share. On April 4, 2006, the Board of Directors of the Company announced that it had formed a Special Committee to conduct discussions with Mutual and to consider other potential strategic transactions. The Special committee and its representatives have held discussions with Mutual concerning Mutual's expression of interest and with other third parties concerning their expressions of interest.

**Table of Contents**

On May 2, 2006, the Company entered into a management consulting agreement with David R. Bradley. Mr. Bradley's role as consultant will be to assist the Special Committee regarding operational matters in its discussions with Mutual and with third parties interested in a transaction with the Company. Mr. Bradley will also begin the process of transitioning the Company to an independently operated company in the event no transaction is consummated. Mr. Bradley has over 32 years experience in the insurance industry. Most recently, Mr. Bradley was Chief Executive Officer of United National Group Ltd. From 2003 to 2005 and prior to that served in various executive positions within The Hartford Financial Services Group, Inc.

Separately, the Special Committee appointed SFRi, LLC to act as its financial advisor in evaluating potential strategic transactions with interested parties, including its discussions with Mutual.

On June 12, 2006, the Company and MNH entered into an agreement with Mutual to extend the Investment and Cash Management Annex to the Services Agreement. The new agreement provides that the Annex, which would have terminated on June 30, 2006, will continue on a month to month basis and that either party may terminate the Annex on at least thirty days prior written notice.

**Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995:**

With the exception of historical information, the matters and statements discussed, made or incorporated by reference in this Quarterly Report on Form 10-Q constitute forward-looking statements and are discussed, made or incorporated by reference, as the case may be, pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, statements relating to the Company's plans, strategies, objectives, expectations and intentions. Words such as believes, forecasts, intends, possible, expects, anticipates, estimates, or plans and similar expressions are intended to identify forward looking statements. Such forward-looking statements involve certain assumptions, risks and uncertainties that include, but are not limited to, those associated with factors affecting the property-casualty insurance industry generally, including price competition, the Company's dependence on state insurance departments for approval of rate increases; size and frequency of claims, escalating damage awards, natural disasters, fluctuations in interest rates and general business conditions; the Company's dependence on investment income; the geographic concentration of the Company's business in the northeastern United States and in particular in New York, New Hampshire, New Jersey, Rhode Island, Pennsylvania and Massachusetts; the adequacy of the Company's loss reserves; the Company's dependence on the general reinsurance market; government regulation of the insurance industry; exposure to environmental claims; dependence of the Company on its relationship with Mutual; and the other risks and uncertainties discussed or indicated in all documents filed by the Company with the Securities and Exchange Commission.

There may be other risks and uncertainties that we have not identified that may affect whether our forward-looking statements will prove accurate. New factors may emerge from time to time that cause our business not to develop as we predict, and it is not possible for us to predict all of them. You should not place undue reliance on forward-looking statements. Further, any forward-looking statement speaks only as of the date on which it is made and, except as required by law, the Company undertakes no obligation to update any forward-looking statement to reflect events or other circumstances after the date on which it is made or to reflect the occurrence of anticipated or unanticipated events or circumstances.

**Table of Contents**

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

Market Risk

Market risk represents the potential for loss due to changes in the fair value of financial instruments. The market risk related to the Company's financial instruments primarily relates to its investment portfolio. The value of the Company's investment portfolio of \$174,274,000 at June 30, 2006 is subject to changes in interest rates and to a lesser extent on credit quality. Further, certain mortgage-backed and asset-backed securities are exposed to accelerated prepayment risk generally caused by interest rate movements. If interest rates were to decline, mortgage holders would be more likely to refinance existing mortgages at lower rates. Acceleration of future repayments could adversely affect future investment income, if reinvestment of the accelerated receipts was made in lower yielding securities.

The following table provides information related to the Company's fixed maturity investments at June 30, 2006. The table presents cash flows of principal amounts and related weighted average interest rates by expected maturity dates. The cash flows are based upon the maturity date or, in the case of mortgage-backed and asset-backed securities, expected payment patterns. Actual cash flows could differ from those shown in the table.

Fixed Maturities

Expected Cash Flows of Principal Amounts (\$in 000's):

|  | 2006      | 2007      | 2008      | 2009      | 2010      | There-<br>after | TOTAL<br>Amor-<br>tized<br>Cost | Esti-<br>mated<br>Market<br>Value |
|--|-----------|-----------|-----------|-----------|-----------|-----------------|---------------------------------|-----------------------------------|
| Available for Sale<br>U.S. Treasury<br>securities and<br>obligations of U.S.<br>Government<br>corporations and<br>agencies | \$ 0      | \$ 0      | \$ 3,003  | \$ 2,998  | \$ 4,244  | \$ 0            | \$ 10,245                       | \$ 10,008                         |
| Average interest<br>rate   | 0.0%      | 0.0%      | 3.2%      | 4.9%      | 4.8%      | 0.0%            |                                 |                                   |
| Obligations of<br>states and political<br>subdivisions   | 2,005     | 5,851     | 15,729    | 5,914     | 7,434     | 5,257           | 42,190                          | 41,169                            |
| Average interest<br>rate   | 4.2%      | 4.6%      | 3.9%      | 4.5%      | 5.0%      | 4.9%            |                                 |                                   |
| Corporate<br>securities  | 0         | 0         | 3,245     | 7,750     | 5,157     | 8,854           | 25,006                          | 24,291                            |
| Average interest<br>rate   | 0.0%      | 0.0%      | 3.7%      | 4.8%      | 5.0%      | 5.9%            |                                 |                                   |
| Mortgage & asset<br>backed securities  | 16,009    | 25,056    | 16,533    | 11,513    | 4,485     | 17,718          | 91,314                          | 87,294                            |
| Average interest<br>rate   | 4.8%      | 4.8%      | 4.8%      | 4.9%      | 4.9%      | 5.0%            |                                 |                                   |
| Total  | \$ 18,014 | \$ 30,907 | \$ 38,510 | \$ 28,175 | \$ 21,320 | \$ 31,829       | \$ 168,755                      | \$ 162,762                        |

The discussion and the estimated amounts referred to above include forward-looking statements of market risk which involve certain assumptions as to market interest rates and the credit quality of the fixed maturity investments. Actual future market conditions may differ materially from such assumptions. Accordingly, the forward-looking statements should not be considered projections of future events by the Company.

**Table of Contents**

Item 4. Controls and Procedures

The Company's chief executive officer and chief financial officer, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report, concluded that the Company's disclosure controls and procedures were designed to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

There was no change in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rules 13a-15 or 15d-15 under the Securities Exchange Act of 1934 that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.



**Table of Contents**

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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

None.

Item 3. Defaults Upon Senior Securities.

None.

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

On June 7, 2006 the Company held its annual meeting of stockholders. During the meeting Henry P. Semmelhack was re-elected a Director of the Company for a three year term to expire at the annual meeting in 2009. Andrew A. Alberti, Brent D. Baird, Frank J. Colantuono, and Thomas E. Kahn are Directors of the Company whose terms of office as Director continue beyond the date of the meeting. Mr. Baird's and Mr. Kahn's terms expire in 2007 and Mr. Alberti's and Mr. Colantuono's terms expire in 2008.

A summary of stockholder voting with respect to the election of Directors is as follows:

|          |                                       |
|----------|---------------------------------------|
|          | Election of<br>Henry P.<br>Semmelhack |
| For      | 1,619,038                             |
| Withheld | 254,433                               |

Item 5. Other Information.

None.

Item 6. Exhibits

(a) Exhibits.

Exhibits required by Item 601 of Regulation S-K.

3(a) Restated Certificate of Incorporation (incorporated by reference to Exhibit No. 3C to Amendment No. 1 to the Company's Registration Statement No. 33-9188 on Form S-1 Filed on November 7, 1986.

(b) Restated By-laws (incorporated by reference to Exhibit 3D to Amendment No. 1 to the Company's Registration Statement No. 33-9188 on Form S-1 filed on November 7, 1986.

4 Instruments defining the rights of security holders, including indentures N/A.

**Table of Contents**

- 5 Opinion re legality N/A.
- 10(a) Management Agreement dated as of September 29, 1986 by and among Merchants Mutual Insurance Company, Registrant and Merchants Insurance Company of New Hampshire, Inc. (incorporated by reference to Exhibit No. 10(a) to the Company's Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).
- (b) Services Agreement Among Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and Merchants Group, Inc. dated January 1, 2003 (incorporated by reference to Exhibit No. 10(b) to the Company's 2003 Quarterly Report on Form 10-Q filed on May 14, 2003).
- (c) Reinsurance Pooling Agreement between Merchants Insurance Company of New Hampshire, Inc. and Merchants Mutual Insurance Company effective January 1, 2003 (incorporated by reference to Exhibit No. 10(c) to the Company's 2003 Quarterly Report on Form 10-Q filed on May 14, 2003).
- (d) Endorsement to the Casualty Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company dated February 23, 2004 (incorporated by reference to Exhibit 10(d) to the Company's 2004 Annual Report on Form 10-K filed on March 31, 2005).
- (e) Property Per Risk Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company dated April 16, 2004 (incorporated by reference to Exhibit 10(f) to the Company's 2004 Quarterly Report on Form 10-Q filed on November 10, 2004).
- (f) Property Catastrophe Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and the various reinsurers as identified by the Interest and Liabilities Agreements attaching to and forming part of this Agreement (incorporated by reference to Exhibit 10(f) to the Company's Annual Report on Form 10-K filed on March 31, 2006).
- (g) Quota Share Reinsurance Treaty Agreement between Merchants Insurance Company of New Hampshire, Inc. and The Subscribing Underwriting Members of Lloyd's, London specifically identified on the schedules attached to this agreement dated January 1, 2000 (incorporated by reference to Exhibit 10(h) to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- \*(h) Form of Amended Indemnification Agreement entered into by Registrant with each director and executive officer of Registrant (incorporated by reference to Exhibit No. 10(n) to Amendment No. 1 to the Company's Registration Statement on (No. 33-9188) Form S-1 filed on November 7, 1986).

**Table of Contents**

- \* (i) Merchants Mutual Insurance Company Adjusted Return on Equity Incentive Compensation Plan January 1, 2000 (incorporated by reference to Exhibit 10(p) to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- \* (j) Merchants Mutual Insurance Company Adjusted Return on Equity Long Term Incentive Compensation Plan January 1, 2000 (incorporated by reference to Exhibit 10(q) to the Company's 2000 Annual Report on Form 10-K filed on March 28, 2001).
- \* (k) Amendment No. 1 to Employee Retention Agreement between Robert M. Zak and Merchants Mutual Insurance Company originally dated as of May 1, 1999, dated February 6, 2002 (incorporated by reference to Exhibit 10(s) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2003).
- \* (l) Amendment No. 1 to Employee Retention Agreement between Edward M. Murphy and Merchants Mutual Insurance Company originally dated as of March 1, 1999, dated February 6, 2002 (incorporated by reference to Exhibit 10(t) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2003).
- \* (m) Amendment No. 1 to Employee Retention Agreement between Kenneth J. Wilson and Merchants Mutual Insurance Company originally dated as of March 1, 1999, dated February 6, 2002 incorporated by reference to Exhibit 10(u) to the Company's 2002 Annual Report on Form 10-K filed on March 31, 2003.
- (n) Amendment to Services Agreement, dated June 12, 2006, among Merchants Group, Inc., Merchants Insurance Company of New Hampshire, Inc., and Merchants Mutual Insurance Company (incorporated by reference to Exhibit 99.1 to the Company's Form 8-K Report dated June 12, 2006).
- 11 Statement re computation of per share earnings N/A.
- 12 Statement re computation of ratios N/A.
- 15 Letter re unaudited interim financial information N/A.
- 18 Letter re change in accounting principles N/A.
- 19 Report furnished to security holder N/A.
- 22 Published report regarding matters submitted to vote of security holders N/A.
- 23 Consents of experts and counsel N/A.
- 24 Power of attorney N/A.
- 31 Rule 13a-14(a)/15d-14(a) Certifications (filed herewith)

**Table of Contents**

32(a) Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code) (filed herewith).

\* Indicates a management contract or compensation plan or arrangement.

**SIGNATURES**

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

MERCHANTS GROUP, INC.  
(Registrant)

Date: August 10, 2006

By: /s/ Kenneth J. Wilson

Kenneth J. Wilson  
Chief Financial Officer and  
Treasurer (duly authorized  
officer of the registrant and  
chief accounting officer)

31