MEADOWBROOK INSURANCE GROUP INC
Form 10-K
March 17, 2008

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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, 2007

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o Smaller reporting company o

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, 2007 was $334,600,690. As of March 3, 2008, there were 37,020,677 shares of the Company s common stock ($.01 par value) outstanding.

Documents Incorporated by Reference

Certain portions of the Registrant s Proxy Statement for the 2008 Annual Shareholders Meeting scheduled for May 9, 2008 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. and Preferred Insurance Company, Ltd (PICL). We also serve as a holding company for Meadowbrook, Crest Financial Corporation, and their subsidiaries. As of December 31, 2007, PICL was deregulated under Bermuda law and merged into Meadowbrook s subsidiary, Meadowbrook Risk Management, Ltd. On January 31, 2008, PICL was contemporaneously dissolved.

Pursuant to Financial Accounting Standards Board Interpretation Number (FIN) 46(R), we do not consolidate our subsidiaries, Meadowbrook Capital Trust I and II (the Trusts), as they are not variable interest entities and we are not the primary beneficiary of the Trusts. Our consolidated financial statements, however, include the equity earnings of the Trusts. In addition and in accordance with FIN 46(R), we do not consolidate our subsidiary American Indemnity Insurance Company, Ltd. (American Indemnity). While we and our subsidiary Star are the common shareholders, neither are the primary beneficiaries of American Indemnity. Our consolidated financial statements, however, include the equity earnings of American Indemnity.

Significant Acquisitions

On April 16, 2007, we acquired the business of U.S. Specialty Underwriters, Inc. (USSU). USSU is a specialty program manager that produces fee based income by underwriting excess workers compensation coverage for a select group of insurance companies.

In November 2005, we acquired 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.

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 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. As previously indicated, PICL was dissolved effective January 31, 2008.

In July 1998, we acquired Florida Preferred Administrators, Inc. (Florida Preferred), a third party administrator and Ameritrust Insurance Corporation (Ameritrust). In December 2002, Ameritrust became a wholly owned

subsidiary of Star. Florida Preferred provides a broad range of risk management services for Ameritrust and other third parties.

In July 1997, we acquired Crest Financial Corporation (Crest), a California-based holding company, which formerly owned Williamsburg National Insurance Company (Williamsburg). Crest provides

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risk management services primarily to Williamsburg. On December 31, 1999, Williamsburg became a wholly owned subsidiary of Star.

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

Proposed Merger with ProCentury Corporation

On February 20, 2008, we executed a definitive merger agreement with ProCentury Corporation (ProCentury) for a merger transaction valued at approximately $272.6 million in cash and stock to be paid to ProCentury shareholders. The combined entity will adopt and operate under the Meadowbrook name and will continue to trade on the NYSE under the ticker symbol MIG . Our Chief Executive Officer, Robert S. Cubbin, will continue in his current role in the post-merger combined entity and two ProCentury board members are expected to join Meadowbrook s Board of Directors.

The merger is expected to expand and complement our specialty lines capabilities with ProCentury s insurance professionals and product expertise in the excess and surplus lines market. We believe there are significant profitable revenue growth opportunities, as well as cost savings opportunities.

We expect to finance the cash portion of the purchase price through a combination of cash and debt. Completion of the transaction is subject to various closing conditions, including the receipt of required regulatory and shareholder approval. We expect to complete the merger in the third quarter of 2008.

Employees

At March 3, 2008, we employed approximately 643 associates to service our clients and provide management services to our *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, 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. Within the workers compensation line of business we have a regional focus in New England, Florida, and Nevada. Within the commercial auto and commercial multiple peril we have a regional focus in California. Our fee-for-service business is also on a regional basis with an emphasis in the Midwest and southeastern regions, as well as the self-insured market in Nevada. Our corporate strategy emphasizes a regional focus and diverse sources of revenue between underwritten premiums, service fee revenue, and commissions. This allows us to leverage fixed costs without sacrificing pricing of our insurance premiums. Currently, we manage over $800 million in gross written premiums.

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

For over thirty years, we have 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

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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 (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 a 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 remain committed to our long-term return on equity goal of 14% to 16%. While the equity offering in 2007 created a temporary dilutive impact on our return on equity, we expect to deploy the remaining capital and reach our targeted return on equity of 15% by the end of 2009 and beginning of 2010. Our targeted return on equity focuses on growing net commissions and fees and growing net investment leverage and income, while maintaining underwriting profitability. During 2008, we expect gross written premium to grow to between $385.0 million and $395.0 million, based upon premium volume growth from new programs implemented in 2007, as well as from the expansion of existing programs.

Company Segments

Agency Operations

We earn commission revenue through the operation of our retail property and casualty insurance agencies, located in Michigan, California, and Florida. Our agency operations produce commercial, personal lines, life,

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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, $12.3 million, and $11.3 million, for the years ended December 31, 2007, 2006, and 2005, respectively.

Specialty Risk Management Operations

Our specialty risk management operations segment, which includes insurance company specialty programs and fee-for-service specialty programs, focuses on specialty or niche insurance business. Specialty risk management operations provide services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention, and reinsurance placement, along with various types of property and casualty insurance coverage, including workers compensation, commercial multiple peril, general liability, commercial auto liability, 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

Fee-for-Service Specialty 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

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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;
- 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 or claim count.

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.

Insurance Company Programs:

We provide three broad types of insurance company programs, including fully insured, captives and client risk-sharing programs. 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. As part of its participation in a rent-a-captive, the client group purchases redeemable preferred stock of our unconsolidated subsidiary. These shares entitle the client group to participate in profits and losses of the program through a dividend or additional capital contribution. Dividends or additional capital contributions are determined and accrued on the basis of underwriting

profits or losses plus investment income on trust accounts less costs. 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

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addition, we may benefit from the fees our risk management subsidiary earns for services we perform on behalf of our Insurance Company Subsidiaries. These fees are eliminated upon consolidation. However, the fees associated with the captive s portion of the program are reimbursed through a ceding commission. For financial reporting purposes, ceding commissions are treated as a reduction in underwriting expenses.

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 adherence to stricter underwriting guidelines.

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 the analysis performed by an independent third party consultant they hire. The shareholders of the captive make the decision whether to invest and how much to invest in the captive. This decision may be based upon advice from third party consultants.

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

The captive administrator provides administrative services to the captive in exchange for a fee. This fee is usually a fixed amount, but can be a variable amount based upon premium volume, and is negotiated on an annual basis with the captive s board of directors. Such services may include bookkeeping, providing regulatory information, and other administrative services. We also may provide loss prevention, claims handling, underwriting, and other insurance services directly to certain of our captives. However, our risk

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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 is: (1) created based upon the experience of their portion of business directly written through our Insurance Company Subsidiaries and ceded to the captive on a quota share basis; and (2) absorbed by the captive s shareholders.

In general, the captive s common and/or preferred shareholders are either the agents or producers of the business, a sponsoring group or association, a group of policyholders, a policyholder, or a general agent. The captive s shareholders are not related parties of ours pursuant to either SFAS 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. Through a trust agreement, we protect ourselves from potential credit risk related to reinsurance recoverables from the captive by a collateral requirement of up to 110% of the estimated reserves for losses and unearned premiums. In addition, we monitor the capital adequacy and financial leverage ratios of the captive to mitigate future credit risk.

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

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.

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 in response to specific market opportunities and may evolve into a risk-sharing arrangement.

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 insureds in the form of premiums.

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

Underwriting Risk Selection and Policy Issuance. Through our risk management subsidiary, we perform underwriting services for our Insurance Company Subsidiaries that meet our corporate underwriting guidelines. We retain ultimate underwriting authority and monitor adherence to our corporate underwriting guidelines

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through a periodic audits. Our underwriting personnel help develop the proper criteria for selecting risks, while actuarial and reinsurance personnel evaluate and recommend the appropriate levels of rate and risk retention. The program is then tailored according to the requirements and qualifications of each client. With managed programs, we may also perform underwriting services based upon the profile of the specific program for a fee.

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

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

Administration of Risk-Bearing Entities. We generate fee revenue by assisting in the formation and administration of risk-bearing entities for clients and agents. We currently provide administrative services for approximately eleven captives and/or rent-a-captives and hold an insignificant minority interest in two of these captives. These services are provided by our subsidiaries in Bermuda and Barbados.

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

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

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

In 2000, we launched our Advantage System (Advantage). Advantage is an internet-based business processing system for quoting and binding workers compensation insurance policies. In addition to reducing our internal administrative processing costs, Advantage enhances underwriting practices by automating risk selection criteria.

Insurance Company Subsidiaries

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 multi-state basis; but more

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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 seek to avoid geographic concentration of risks that might lead to aggregation of exposure to losses from natural or intentionally caused catastrophic events. We also handle the majority of our claims through our regional offices based upon standards set forth by our corporate claims office and monitored through a series of self-audits and corporate claims audit, internal control audits, and executive claims monitoring reports. American Indemnity, which offers our clients a captive or rent-a-captive option, complements our Insurance Company Subsidiaries.

Star, Williamsburg and Ameritrust are domiciled in Michigan. Savers is domiciled in Missouri and American Indemnity is a Bermuda-based insurance company.

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 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. As of December 31, 2007, on a statutory consolidated basis, gross and net premium leverage ratios were 1.8 to 1.0 and 1.5 to 1.0, respectively.

Our Insurance Company Subsidiaries are authorized to write business, on either an admitted or surplus lines basis, in all fifty states. Star is admitted in all fifty states. Williamsburg is admitted in thirty-seven states, and is authorized to write business on a surplus lines basis in one state. Savers is admitted in five states and is authorized to write business on a surplus lines basis in forty-six states. Ameritrust is admitted in seven 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, 2007, the workers compensation line of business accounted for 33.7%, 38.1%, and 37.5% of gross written premiums, net earned premiums, and net written premiums, respectively.

In 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, 2007 and 2006 were $3.3 million and $5.6 million, respectively.

In April 2007, we received an upgrade of our financial strength rating by A.M. Best Company to A− (Excellent), from B++ (Very Good) for our Insurance Company Subsidiaries.

The following table summarizes gross written premiums, net earned premiums, and net written premiums for the years ended December 31, 2007, 2006, 2005, 2004, and 2003 (in thousands):

Premium	2007	%	2006	%	2005	%	2004	%	2003
pensation	$ 116,717	33.69%	$ 118,794	35.90%	$ 133,732	40.26%	$ 146,982	46.89%	$ 141,456

ulti-Peril	100,364	28.97%	94,355	28.52%	85,978	25.88%	71,715	22.88%	48,091
	11,629	3.36%	12,837	3.88%	12,467	3.75%	10,925	3.48%	9,758
	28,550	8.24%	20,001	6.04%	16,167	4.87%	15,248	4.86%	10,473
cial Auto									
	61,119	17.64%	59,308	17.92%	59,144	17.80%	48,070	15.33%	26,902
s	28,072	8.10%	25,577	7.73%	24,721	7.44%	20,553	6.56%	16,600
	$ 346,451	100.00%	$ 330,872	100.00%	$ 332,209	100.00%	$ 313,493	100.00%	$ 253,280

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Premium	2007	%	2006	%	2005	%	2004	%	2003
mpensation	$ 102,256	38.13%	$ 108,085	42.40%	$ 119,423	47.78%	$ 117,914	54.97%	$ 93,324
Multi-Peril	71,049	26.49%	63,138	24.77%	54,829	21.94%	43,701	20.37%	26,075
:	1,165	0.43%	1,528	0.60%	1,727	0.69%	1,628	0.76%	1,556
y	15,571	5.81%	10,433	4.09%	8,072	3.23%	6,416	2.99%	4,849
rcial Auto									
	53,469	19.94%	49,341	19.36%	45,374	18.15%	29,274	13.65%	12,940
es	24,687	9.20%	22,395	8.79%	20,534	8.21%	15,560	7.25%	12,461
	$ 268,197	100.00%	$ 254,920	100.00%	$ 249,959	100.00%	$ 214,493	100.00%	$ 151,205

Premium	2007	%	2006	%	2005	%	2004	%	2003
mpensation	$ 105,003	37.47%	$ 104,846	39.92%	$ 117,287	45.44%	$ 122,896	52.53%	$ 111,572
Multi-Peril	76,280	27.22%	67,504	25.70%	59,870	23.19%	46,351	19.81%	36,628
:	1,212	0.43%	1,271	0.48%	1,690	0.65%	1,630	0.70%	1,500
y	18,915	6.75%	12,384	4.71%	8,004	3.10%	7,568	3.23%	6,278
rcial Auto									
	52,798	18.84%	52,950	20.16%	49,122	19.03%	37,762	16.14%	19,599
es	26,003	9.28%	23,713	9.03%	22,161	8.59%	17,754	7.59%	14,250
	$ 280,211	100.00%	$ 262,668	100.00%	$ 258,134	100.00%	$ 233,961	100.00%	$ 189,827

Since 2004, there has been a shift in our mix of business, which was intended to diversify our product line and produce more predictable, stable results. The mix of business has impacted our expense ratio, as the percentage of workers compensation premium in relation to our other lines of business has declined from a high of approximately 56% in 2003 to approximately 34% in 2007. The decline in workers compensation premium from 2004 is primarily due to our decision to exit a limited number of small programs that were no longer meeting our pricing standards, an overall reduction in audit-related premiums, and a decline in the amount of residual market assignments we receive relative to workers compensation premiums. The residual market assignments are in essence a form of a tax whereby any workers compensation risk that cannot be written in the voluntary market is assigned to carriers underwriting workers compensation business in that state.

In addition, workers compensation has declined due to reduction of premium writings in the state of Florida as pricing competition has intensified and due to mandatory rate deceases in Florida, Massachusetts and Nevada. We do believe the benefit changes and other actions we have taken in those states have allowed us to maintain underwriting profitability even in these more competitive environments. The increase in premium volume in lines other than workers compensation has been driven by new programs we have implemented with both existing and new programs partners, all of which have a history of profitability and for which we believe we are receiving adequate pricing to produce our targeted return on equity. Overall, both net written premium and net earned premium have increased over the same time frame, largely as a result of the increase in the amount of premium we retain versus premium ceded to

excess of loss reinsurers.

Reserves

The following table shows the development of reserves for unpaid losses and loss adjustment expenses (LAE) from 1998 through 2007 for our Insurance Company Subsidiaries including PICL, and the deconsolidation impact of American Indemnity.

In accordance with SFAS 113, the bottom portion of the table shows the impact of reinsurance for the years 1998 through 2007, reconciling the net reserves shown in the upper portion of the table to gross reserves.

Additional information relating to our reserves is included within the *Losses and Loss Adjustment Expenses and Reinsurance Recoverables* section of Note 1 *Summary of Significant Accounting Policies* and Note 3 *Liability for Losses and Loss Adjustment Expenses* of the Notes to the Consolidated Financial

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Statements, as well as to the *Critical Accounting Policies* section and the *Reserves* section of Item 7, *Management s Discussion and Analysis*.

Analysis of Loss and Loss Adjustment Expense Development(1)

				Years Ended December 31,				
1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**200**
				(In thousands)				
$ 84,254	$ 127,500	$ 172,862	$ 198,653	$ 193,116	$ 192,019	$ 226,996	$ 271,423	$ 302
(147)	(1,425)	(3,744)	(5,572)	(2,973)	(2,989)			
$ 84,107	$ 126,075	$ 169,118	$ 193,081	$ 190,143	$ 189,030	$ 226,996	$ 271,423	$ 302
39,195	54,928	70,952	77,038	78,023	71,427	79,056	83,271	81
56,763	90,416	115,669	130,816	122,180	118,729	124,685	133,809	
76,776	116,001	146,548	157,663	151,720	145,279	153,780		
85,447	132,995	160,673	176,172	167,288	159,220			
93,009	139,939	171,992	186,847	174,778				
96,739	146,997	179,010	191,936					
101,433	150,514	182,954						
104,225	152,544							
105,569								
98,587	146,213	182,976	199,171	193,532	193,559	231,880	268,704	295
106,487	144,453	186,191	205,017	196,448	203,394	227,462	263,069	
102,075	152,630	189,632	207,379	202,126	205,650	226,437		
104,017	156,997	190,305	211,394	203,738	202,748			
106,668	158,287	196,158	213,802	202,028				
109,038	159,449	199,520	212,274					
110,541	161,376	198,500						
112,340	161,023							
111,935								
$ (27,828)	**$ (34,948)**	**$ (29,382)**	**$ (19,193)**	**$ (11,885)**	**$ (13,718)**	**$ 559**	**$ 8,354**	**$ 7**
33.1%	*27.7%*	*17.4%*	*9.9%*	*6.3%*	*7.3%*	**0.2%**	**3.1%**	
84,107	**126,075**	**169,118**	**193,081**	**190,143**	**189,030**	**226,996**	**271,423**	**302**

64,590	101,744	168,962	195,943	181,817	147,446	151,161	187,254	198
148,697	227,819	338,080	389,024	371,960	336,476	378,157	458,677	501
111,935	**161,023**	**198,500**	**212,274**	**202,028**	**202,748**	**226,437**	**263,069**	**295**
107,654	178,143	260,841	286,528	255,523	244,468	205,638	205,037	196
219,589	339,166	459,341	498,802	457,551	447,216	432,075	468,106	492
$ (70,892)	$ (111,347)	$ (121,261)	$ (109,778)	$ (85,591)	$ (110,740)	$ (53,918)	$ (9,429)	$ 8

(1) In accordance with FIN 46(R), we performed an evaluation of our business relationships and determined our wholly owned subsidiary, American Indemnity, did not meet the tests for consolidation, as neither us, nor our subsidiary Star, are the primary beneficiaries of American Indemnity. Therefore, 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):

	2007	2006
GAAP reserves for losses and LAE	$ 540,002	$ 501,077
Reinsurance recoverables for unpaid losses	(198,461)	(198,422)
Allowances against reinsurance recoverables*	(833)	(1,041)
Non-regulated foreign insurance subsidiary; PICL**		(1,273)
Statutory reserves for losses and LAE	$ 340,708	$ 300,341

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

** PICL offered clients captive or rent-a-captive options. It was a foreign insurance company and, therefore, was not included in the combined statutory financial statements filed with the National Association of Insurance Commissioners and state regulators. Effective September 30, 2007, Star entered into a novation agreement with PICL in which Star assumed a portion of PICL s assets and liabilities. PICL was dissolved effective January 31, 2008.

For the year ended December 31, 2007, we reported a decrease of $8.9 million in gross ultimate loss estimates for accident years 2006 and prior, or 1.8% of $501.1 million of gross losses and LAE reserves at January 1, 2007. We reported a $7.1 million decrease in net ultimate losses and LAE estimates for accident years 2006 and prior, or 2.3% of $302.7 million.

As a result of favorable development on prior accident years reserves, the provision for losses and loss adjustment expenses decreased by $7.1 million for calendar year 2007 and $2.7 million for calendar year 2006. As a result of adverse development on prior accident years reserves, the provision for losses and loss adjustment expenses increased by $4.9 million for calendar year 2005.

Investments

Information relating to our investment portfolio is included within Note 2 *Investments* of the Notes to the Consolidated Financial Statements and the *Investments* section of Item 7, Management s Discussion and Analysis, as well as Item 7A Quantitative and Qualitative Discloures about Market Risk.

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-

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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;
- underwriting and claims settlement practices;
- restrictions on the size of risks that may be insured by a single company;
- licensing of insurers and agents;
- deposits of securities for the benefit of policyholders; and
- the filing of periodic reports with respect to financial condition and other matters.

In addition, state regulatory examiners perform periodic examinations of insurance companies. 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 certain 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

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

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

Any future transactions that would constitute a change in control would also generally require prior approval by the Insurance Departments of Michigan and Missouri 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

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by a member in that state. Assessments from insolvency funds were $156,000, $306,000, and $664,000, respectively, for 2007, 2006, and 2005. 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 affect us. Total assessments paid to all such facilities were $2.6 million, $3.1 million, and $3.0 million, respectively, for 2007, 2006, and 2005.

Restrictions on Dividends and Risk-Based Capital

For information on Restrictions on Dividends and Risk-based Capital which affect us please refer 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.

NAIC-IRIS Ratios

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

Effect of Federal Legislation

The Terrorism Risk Insurance Act of 2002 (TRIA) established a program under which the United States federal government will provide governmental support for businesses that suffer damages from certain acts of international terrorism. In December 2005 under the Terrorism Risk Insurance Extension Act of 2005, TRIA was modified and extended through December 31, 2007. On December 26, 2007, Congress extended and expanded TRIA beyond 2007. The terms of the legislation enacted now also include domestic terrorist acts. TRIA serves as an additional high layer of reinsurance against losses that may arise from a terrorist incident. The impact to us resulting from TRIA is minimal as we generally do not underwrite risks that are considered targets for terrorism; avoid concentration of exposures in both property and workers compensation; and have terrorism coverage included in our reinsurance treaties to cover the most likely exposure.

Recently, as a result of comments made related to claims handling practices by insurers in the wake of the 2005 hurricanes that struck the gulf coast states, Congress has examined a possible repeal of the McCarran-Ferguson Act, which allows insurers to compile and share loss data, develop standard policy forms and manuals and predict future loss costs with greater reliability, among other things. The ability of the industry, under the exemption permitted in the

McCarran-Ferguson Act, to collect loss cost data and build a credible database as a means of predicting future loss costs is an important part of cost-based pricing. If the ability to collect this data were removed, the predictability of future loss costs and the reliability of pricing could be undermined. We are unable to predict whether the McCarran-Ferguson Act will be repealed, or that any such repeal, if enacted, would not have a material adverse effect on our business and results of operations.

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Available Information

Our Internet address is www.meadowbrook.com. There we make available, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, statements of beneficial ownership (Forms 3, 4, and 5), and any amendments to those reports, as soon as reasonably practicable after we electronically file such material with, or furnish to, the 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 101 F 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 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.

Corporate Governance Listing Standards

On June 5, 2007, we submitted to the New York Stock Exchange a certificate signed by our Chief Executive Officer certifying that he was not aware of any violation by us of New York Stock Exchange s corporate governance listing standards.

Item 1A. *Risk Factors*

We face risks related to our proposed merger with ProCentury Corporation

There are significant risks and uncertainties associated with our proposed merger with ProCentury Corporation. For example, the merger may not be consummated, or may not be consummated in the third quarter of 2008 as anticipated, as a result of a number of factors, including, but not limited to, the inability to obtain required regulatory and shareholder approvals. In addition, the integration of the combined businesses into the combined entity may not be integrated successfully or such integration may be more difficult, time-consuming or costly than expected; expected revenue synergies and cost savings from the merger may not be fully realized or realized within the expected time frame; revenues following the merger may be lower than expected; and customer and employee relationships and business operations may be disrupted by the merger.

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

We establish reserves for losses and expenses related to the adjustment of losses for 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. While we believe our reserves are adequate, we base these reserves on assumptions about past and future events. The following factors could have a substantial impact on our future loss experience:

the amounts of claims settlements and awards

legislative activity

changes in inflation and economic conditions

accuracy and timely reporting of claim information

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

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

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

Our ability to write business is most influenced by our rating from A.M. Best. A.M. Best ratings are designed to assess an insurer s financial strength and ability to meet continuing obligations to policyholders. Currently, our financial strength rating from A.M. Best is A− (Excellent) for our Insurance Company Subsidiaries. There can be no assurance that A.M. Best will not change 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.

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

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

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

Star, as the lead insurance company under the Inter-Company Reinsurance Agreement, cedes insurance to other insurers under pro rata and excess-of-loss contracts. These reinsurance arrangements diversify our business and reduce our exposure to large losses or from hazards of an unusual nature. 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, the ceding of insurance does not discharge us of our primary liability to our policyholder. If all or any of the reinsuring companies fail to pay or pay on a timely basis, we would be liable for such defaulted amounts. Therefore, we are subject to credit risk with respect to the obligations of our reinsurers. If our reinsurers fail to pay us or fail to pay on a timely basis, our financial results and financial condition could be adversely affected. In order to minimize our exposure to significant losses from reinsurer insolvencies, we evaluate the financial condition of our reinsurers and monitor the economic characteristics of the reinsurers on an ongoing basis and, if appropriate, we may require trust agreements to collateralize the

reinsurers financial obligation to us. As of December 31, 2007, our reinsurance recoverables on paid and unpaid losses was $199.5 million.

In addition, with our risk-sharing programs, we are subject to credit risk with respect to the payment of claims by our clients captive, rent-a-captive, large deductible programs and indemnification agreements, as

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

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

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

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

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

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

- changing practices created by the internet, which has increased competition within the insurance business

These developments could make the property and casualty insurance marketplace more competitive by increasing the supply of insurance capacity. In that event, the current softer market (a market of declining or stable pricing and generally lower profit or underwriting margins) could continue or be accelerated it may negatively influence our ability to maintain or increase rates. Accordingly, these developments could have an adverse effect on our business, financial condition and results of operations.

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

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

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

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

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

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

increases in medical costs beyond historic or expected annual inflationary levels

The demand for property and casualty insurance can also vary significantly, rising as the overall level of economic activity increases and falling as that activity decreases. The property and casualty insurance industry historically is cyclical in nature, with periods of reduced underwriting capacity and favorable premium rates alternating with periods of excess underwriting capacity and flat or falling premium rates. These fluctuations

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

Negative developments within the workers compensation insurance industry may adversely affect our financial condition and results of operations.

Although we engage in other businesses, approximately 34% of our premium was attributable to workers compensation insurance for the year ended December 31, 2007. As a result, negative developments within the economic, competitive or regulatory conditions affecting the workers compensation insurance industry may have an adverse effect on our financial condition and results of operations. For example, if legislators in one of our larger markets, such as Florida, Nevada, or Massachusetts, were to enact legislation to increase the scope or amount of benefits for employees under workers compensation insurance policies without related premium increases or loss control measures, this could negatively affect the workers compensation insurance industry. In some states, workers compensation insurance premium rates are determined by regulation, and changes in mandated rates could reduce our profitability. Negative developments within the workers compensation insurance industry could have a greater effect on us than on more diversified insurance companies with more diversified lines of insurance.

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

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

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

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. 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.

Our investment portfolio includes mortgage-backed securities. As of December 31, 2007, mortgage and asset-backed securities constituted approximately 24.2% of our invested assets. As with other fixed income investments, the fair market value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose us to prepayment risks on these investments. When interest rates fall, mortgage-backed securities are prepaid more quickly than expected and the holder must reinvest the proceeds at lower interest rates. Our mortgage-backed securities currently consist of securities with features that

reduce the risk of prepayment, but there is no guarantee that we will not invest in other mortgage-backed securities that lack this protection. In periods of increasing interest rates, mortgage-backed securities are prepaid more slowly, which may require us to receive interest payments that are below the prevailing interest rates for longer than expected.

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

We believe we maintain adequate amounts of cash and short-term investments to pay claims, and do not expect to have to sell securities prematurely for such purposes. We may, however, decide to sell securities as a result of changes in interest rates, credit quality, the rate or repayment or other similar factors. A significant increase in market interest rates could result in a situation in which we are required to sell securities at depressed prices to fund 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 we are heavily regulated by the states in which we operate, we may be limited in the way we operate.

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

- standards of solvency, including risk-based capital measurements
- restrictions on the nature, quality and concentration of investments
- restrictions on the types of terms that we can include in the insurance policies we offer
- required methods of accounting
- required reserves for unearned premiums, losses and other purposes
- permissible underwriting and claims settlement practices
- 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.

Also, the insurance industry has recently become the focus of increased scrutiny by regulatory authorities relating to the placement of insurance, as well as claims handling by insurers in the wake of recent hurricane losses. Some states have adopted new disclosure requirements relating to the placement of insurance business, while other states are

considering what additional regulatory oversight might be required with regard to claims handling activities of insurers. It is difficult to predict the outcome of these regulatory activities, whether they will expand into other areas of the business not yet contemplated, whether activities and practices currently thought of to be lawful will be characterized as unlawful and what form of additional or new regulations may be finally adopted and what impact, if any, such increase regulatory actions may have on our business. We have received general industry-wide requests for information from a few state insurance departments regarding compensation with insurance agents. We responded to these inquires. Subsequent to our responses, we have not received any further inquiries or comments from the state insurance departments.

MEADOWBROOK INSURANCE GROUP, INC.

Our reliance on producers subjects us to their credit risk.

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

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

The Michigan Business Corporation Act contains anti-takeover provisions. Chapters 7A (the Fair Price Act) and 7B (the Control Share Act) 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.

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

The Control Share Act establishes procedures governing control share acquisitions of large public Michigan corporations. A control share acquisition is defined as an acquisition of shares by an acquiror which, when combined with other shares held by that person or entity, would give the acquiror voting power, alone or as part of a group, at or above any of the following thresholds: 20%, 331/3% or 50%. Under the Control Share Act, an acquiror may not vote control shares unless the company s disinterested shareholders (defined to exclude the acquiring person, officers of the target company, and directors of the target company who are also employees of the company) vote to confer voting rights on the control shares. The Control Share Act does not affect the voting rights of shares owned by an acquiring person prior to the control share acquisition. The Control Share Act entitles corporations to redeem control shares

from the acquiring person under certain circumstances. In other cases, the Control Share Act confers dissenters right upon all of the corporation s shareholders except the acquiring person.

MEADOWBROOK INSURANCE GROUP, INC.

Our articles of incorporation allow our Board of Directors to issue one or more classes or series of preferred stock with voting rights, preferences and other privileges as the Board of Directors may determine. 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 and Missouri, 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 acquirer s financial stability, the competence of its management, and whether competition in that state would be reduced. These laws may prevent, delay or defer a change of control of us or our Insurance Company Subsidiaries.

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

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

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

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

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 or severance agreements with Merton J. Segal, Robert S. Cubbin, Karen M. Spaun, Michael G. Costello, Stephen Belden, Joseph E. Mattingly, James M. Mahoney, Robert C. Spring, Archie S. McIntyre, and Kenn R. Allen. We maintain a key person life insurance policy on Robert S. Cubbin, our President and CEO.

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 and other producers. Our

MEADOWBROOK INSURANCE GROUP, INC.

failure to attract and retain the necessary personnel and producers could have a material adverse effect on our business, 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.

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

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

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.

The unaffiliated third party had until July 2007 to pay the principal balance. We have negotiated an extension through May 1, 2009. The unaffiliated third party continues to pay interest during the extension period and has the option to pay the principal balance, or $750,000 less in exchange for granting us an ownership interest in the building.

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.

MEADOWBROOK INSURANCE GROUP, INC.

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 is provided for the costs to resolve these claims in our consolidated financial statements. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. With the assistance of outside counsel, we adjust such provisions according to new developments or changes in the strategy in dealing with such matters. On the basis of current information, we do not expect the outcome of the claims, lawsuits and proceedings to which we are subject to, either individually, or in the aggregate, will have a material adverse effect on our financial condition. However, it is possible that future results of operations or cash flows for any particular quarter or annual period could be materially affected by an unfavorable resolution of any such matters.

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

None.

MEADOWBROOK INSURANCE GROUP, INC.

PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

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
Corporate Trust Shareholder Services
P.O. Box 3319
South Hackensack, NJ 07606-1919

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 9, 2008

Corporate Headquarters
26255 American Drive
Southfield, MI

Shareholder Relations and Form 10-K

A copy of our 2007 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 A. 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 1-800-442-8134

Share Price and Dividend Information

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

December 31, 2007	High	Low	Dividends
First Quarter	$ 11.68	$ 9.10	
Second Quarter	12.45	9.94	
Third Quarter	11.57	8.02	
Fourth Quarter	10.00	8.40	

MEADOWBROOK INSURANCE GROUP, INC.

December 31, 2006	High	Low	Dividends
First Quarter	$ 7.00	$ 5.63	
Second Quarter	8.91	6.68	
Third Quarter	11.83	8.32	
Fourth Quarter	12.48	8.78	

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

When evaluating the declaration of a dividend, our Board of Directors considers a variety of factors, including but not limited to, our cash flow, liquidity needs, results of operations strategic plans, industry conditions, 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 2007 or 2006.

Shareholders of Record

As of March 3, 2008, there were approximately 249 shareholders of record of our common stock. For purposes of this determination, Cede & Co., the nominee for the Depositary Trust Company is treated as one holder.

Recent Sales of Unregistered Securities and Use of Proceeds from Registered Securities

On July 19, 2007, we sold 6,437,500 shares of common stock in a secondary public offering at a price of $9.65 per share pursuant to a Registration Statement on Form S-3 (Registration No. 333-143244), which was declared effective by the Securities and Exchange Commission on July 6, 2007. The net proceeds we received from the offering were approximately $58.6 million, reflecting gross proceeds of $62.1 million, net of underwriting fees of approximately $3.0 million and other offering costs of approximately $500,000. During the period from the offering through December 31, 2007, we used a portion of the proceeds to reduce our outstanding line of credit balance from $22.0 million to zero and for other general corporate purposes.

Purchase of Equity Securities by the Issuer

During the year ended December 31, 2007, we did not purchase any of our securities.

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MEADOWBROOK INSURANCE GROUP, INC.

Performance Graph

The following graph sets forth, for the five year period ended December 31, 2007, the cumulative total stockholder return for the Company s common stock, the Russell 2000 Index, and a Peer Group index. The graph assumes the investment of $100 on December 31, 2002 in Common Stock of the Company, the Russell 2000 Index, and a Peer Group index. The stock price performance represented on the following graph is not necessarily indicative of future stock price performance.

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

Comparison of Five Year Cumulative Total Return

	Period Ending					
Index	**12/31/2002**	**12/31/2003**	**12/31/2004**	**12/31/2005**	**12/31/2006**	**12/31/2007**
Meadowbrook Insurance Group, Inc.	100.00	170.56	201.21	235.48	398.79	379.44
Russell 2000	100.00	147.25	174.24	182.18	215.64	212.26
SNL Insurance $500M-$1B Index	100.00	138.64	168.56	152.61	167.02	159.80

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

MEADOWBROOK INSURANCE GROUP, INC.
SELECTED CONSOLIDATED FINANCIAL DATA

	For the Years Ended December 31,				
	2007	2006	2005	2004	2003
	(In thousands, except per share and ratio data)				
Income Statement Data:					
Gross written premiums	$ 346,451	$ 330,872	$ 332,209	$ 313,493	$ 253,280
Net written premiums	280,211	262,668	258,134	233,961	189,827
Net earned premiums	268,197	254,920	249,959	214,493	151,205
Net commissions and fees	45,988	41,172	35,916	40,535	45,291
Net investment income	26,400	22,075	17,975	14,911	13,484
Net realized gains	150	69	167	339	823
Total revenue	340,735	318,236	304,017	270,278	210,803
Net losses and LAE	150,969	146,293	151,542	135,938	98,472
Policy acquisition and other underwriting expenses	53,717	50,479	44,439	33,424	23,606
Other administrative expenses	32,269	28,824	26,810	25,588	22,879
Salaries and employee benefits	56,433	54,569	51,331	52,297	48,238
Amortization expense	1,930	590	373	376	353
Interest expense	6,030	5,976	3,856	2,281	977
Income before income taxes and equity earnings of affiliates	39,387	31,505	25,666	20,374	16,278
Equity earnings of affiliates	331	128	1	39	3
Net income	27,992	22,034	17,910	14,061	10,099
Earnings per share Diluted	$ 0.85	$ 0.75	$ 0.60	$ 0.48	$ 0.35
Balance Sheet Data:					
Total investments and cash and cash equivalents	$ 651,601	$ 527,600	$ 460,233	$ 402,156	$ 324,235
Total assets	1,113,966	969,000	901,344	801,696	692,266
Loss and LAE reserves	540,002	501,077	458,677	378,157	339,465
Debt		7,000	7,000	12,144	17,506
Debentures	55,930	55,930	55,930	35,310	10,310
Shareholders equity	301,894	201,693	177,365	167,510	155,113
Book value per share	$ 8.16	$ 6.93	$ 6.19	$ 5.76	$ 5.34
Other Data:					
GAAP ratios (insurance companies only):					
Net loss and LAE ratio(1)	61.2%	62.3%	65.2%	67.9%	70.1%
Expense ratio(1)	34.2%	34.5%	33.5%	33.5%	34.3%
Combined ratio	95.4%	96.8%	98.7%	101.4%	104.4%

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

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MEADOWBROOK INSURANCE GROUP, INC.

Unconsolidated GAAP data Ratio Calculation Table:

	For the Years Ended December 31,				
	2007	2006	2005	2004	2003
Net earned premiums	$ 268,197	$ 254,920	$ 249,959	$ 214,493	$ 151,205
Consolidated net losses and LAE	$ 150,969	$ 146,293	$ 151,542	$ 135,938	$ 98,472
Intercompany claim fees	13,058	12,553	11,523	9,691	7,514
Unconsolidated net losses and LAE	$ 164,027	$ 158,846	$ 163,065	$ 145,629	$ 105,986
GAAP net loss and LAE ratio	61.2%	62.3%	65.2%	67.9%	70.1%
Consolidated policy acquisition and other underwriting expenses	$ 53,717	$ 50,479	$ 44,439	$ 33,424	$ 23,606
Intercompany administrative and other underwriting fees	37,890	37,442	39,231	38,359	28,296
Unconsolidated policy acquisition and other underwriting expenses	$ 91,607	$ 87,921	$ 83,670	$ 71,783	$ 51,902
GAAP expense ratio	34.2%	34.5%	33.5%	33.5%	34.3%
GAAP combined ratio	95.4%	96.8%	98.7%	101.4%	104.4%

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.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS

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

Forward-Looking Statements

This Form 10-K may provide information including certain statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These include statements regarding the intent, belief, or current expectations of management, including, but not limited to, those statements that use the words believes, expects, anticipates, estimates, or similar expressions. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties, and results could differ materially from those indicated by such forward-looking statements. Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements are: the frequency and severity of claims; uncertainties inherent in reserve estimates; catastrophic events; a change in the demand for, pricing of, availability or collectibility of reinsurance; increased rate pressure on premiums; ability to obtain rate increases in current market conditions; investment rate of return; changes in and adherence to insurance regulation; actions taken by regulators, rating agencies or lenders; attainment of certain processing efficiencies; changing rates of inflation; general economic conditions and other risks identified in our reports and registration statements filed with the Securities and Exchange Commission. We are not under any obligation to (and expressly disclaim any such obligation to) update or alter our forward-looking statements whether as a result of new information, future events or otherwise.

Description of Business

We are a publicly traded specialty risk management organization offering a full range of insurance products and services, focused on niche and specialty program business, which we believe is under served by the standard insurance market. Program business refers to an aggregation of individually underwritten risks that have some unique characteristic and are distributed through a select group of focused general agencies, retail agencies and program administrators. We perform the majority of underwriting and claims services associated with these programs. We also provide property and casualty insurance coverage and services through programs and specialty risk management solutions for agents, professional and trade associations, public entities and small to medium-sized insureds. In addition, 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 July 2007, we completed an offering of 6,437,500 additional shares of newly issued common stock at $9.65 per share. The gross proceeds of the offering were $62.1 million. The net proceeds were $58.6 million. The net proceeds from the offering are being utilized to support organic growth within our underwriting operations, to fund select acquisitions and other general corporate purposes. Upon receipt of the net proceeds, we also reduced our outstanding line of credit balance from $22.0 million to zero.

In June 2002, we sold 21,275,000 shares of newly issued common stock at $3.10 per share in a public offering. 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.

Since 2003, we have issued $30.9 million and $25.0 million in junior subordinated debentures and senior debentures, respectively. We received a total of $53.3 million in net proceeds from the issuances of these debentures, of which $26.2 million was contributed to the surplus of our Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes. These debentures are callable after five years

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

from the date of issuance. Since the junior subordinated debentures issued in 2003 are callable in 2008, we will be reviewing the capital strategy associated with refinancing at lower costs through debentures or equity.

Specialty Risk Management Operations

Our specialty risk management operations segment, which includes insurance company specialty programs and fee-for-service specialty programs, focuses on specialty or niche insurance business. Specialty risk management operations provide services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention, and reinsurance placement, along with various types of property and casualty insurance coverage, including workers compensation, commercial multiple peril, general liability, commercial auto liability, 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 the specialty risk management operations provides within seven categories: net earned premiums, management fees, claims fees, loss control fees, reinsurance placement, investment income, and net realized gains (losses).

With a fee-for-service program, or 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. The fees we receive from these programs are generally either a fixed amount or based on a percentage of premium serviced or claim count.

We provide three broad types of insurance company programs, including fully insured, captives and client risk-sharing programs. 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. As part of its participation in a rent-a-captive, the client group purchases redeemable preferred stock of our unconsolidated subsidiary. These shares entitle the client group to participate in profits and losses of the program through a dividend or additional capital contribution. Dividends or additional capital contributions are determined and accrued on the basis of underwriting profits or losses plus investment income on trust accounts less costs. 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 a ceding commission. For financial reporting purposes, ceding commissions are treated as a reduction in underwriting expenses.

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MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

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

Agency Operations

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

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

	For the Years Ended December 31,		
	2007	**2006**	**2005**
Revenues			
Net earned premiums	$ 268,197	$ 254,920	$ 249,959
Management fees	23,963	18,714	16,741
Claims fees	9,025	8,776	7,113
Loss control fees	2,151	2,216	2,260
Reinsurance placement	929	735	660
Investment income	25,487	21,115	17,692
Net realized gains	150	69	85
Specialty risk management	329,902	306,545	294,510
Agency operations	11,316	12,285	11,304
Holding Company interest income earned	913	960	365
Intersegment revenue	(1,396)	(1,554)	(2,162)
Consolidated revenue	$ 340,735	$ 318,236	$ 304,017

Critical Accounting Policies

General

In certain circumstances, we are required to make estimates and assumptions that affect amounts reported in our consolidated financial statements and related footnotes. We evaluate these estimates and assumptions on an on-going basis based on a variety of factors. There can be no assurance, however, the actual results will not be materially different than our estimates and assumptions, and that reported results of operation will not be affected by accounting adjustments needed to reflect changes in these estimates and assumptions. We believe the following policies are the most sensitive to estimates and judgments.

Losses and Loss Adjustment Expenses

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

We establish a liability for losses and LAE, which represent case based estimates of reported unpaid losses and LAE and actuarial estimates of incurred but not reported losses (IBNR) and LAE. Such liabilities, by necessity, are based upon estimates and, while we believe the amount of our reserves is adequate, the

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ultimate liability may be greater or less than the estimate. As of December 31, 2007 and 2006, we have accrued $540.0 million and $501.1 million of gross loss and LAE reserves, respectively.

Components of Losses and Loss Adjustment Expense

The following table sets forth our gross and net reserves for losses and LAE based upon an underlying source of data, at December 31, 2007 (in thousands):

	Case	IBNR	Total
Direct	$ 168,979	$ 252,186	$ 421,165
Assumed-Directly Managed(1)	25,313	61,123	86,436
Assumed-Residual Markets(2)	9,697	15,730	25,427
Assumed-Retroceded	1,372	356	1,728
Assumed-Other	3,272	1,974	5,246
Gross	208,633	331,369	540,002
Less Ceded	79,412	119,049	198,461
Net	$ 129,221	$ 212,320	$ 341,541

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

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

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

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

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The following table sets forth our net case and IBNR reserves for losses and LAE by line of business at December 31, 2007 (in thousands):

	Net Case	Net IBNR	Total
Workers Compensation	$ 58,665	$ 82,694	$ 141,359
Residual Markets	9,697	15,731	25,428
Commercial Multiple Peril/General Liability	25,972	61,840	87,812
Commercial Automobile	30,081	39,345	69,426
Other	4,806	12,710	17,516
Total	$ 129,221	$ 212,320	$ 341,541

Claim Reserving Process and Methodology

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

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

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

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

Paid Development Method,
Incurred Development Method,
Paid Bornhuetter-Ferguson Method,
Reported Bornhuetter-Ferguson Method,
Initial Expected Loss Method,

MEADOWBROOK INSURANCE GROUP, INC.

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Paid Roll-forward Method, and
Incurred Roll-forward Method

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Claims for short-tail lines of business settle more quickly than long-tail lines of business, and in general, loss development factors for short-tail lines are smaller than long-tail lines. For long-tail lines, we tend to rely on initial expected loss methods throughout the current accident year then move to development factor based methods for older accident years. Development methods on short-tail lines are generally reliable in the third and fourth quarter of the initial accident year and recorded loss ratios reflect a blend of the development and forecast methods. Short-tail lines represent two percent of our total reserves at December 31, 2007.

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

Each of the methods listed above requires the selection and application of parameters and assumptions. For all but the initial expected loss method, the key assumptions are the patterns with which our aggregate claims data will be paid or will emerge over time (development patterns). These patterns incorporate inherent assumptions of claims cost

inflation rates and trends in the frequency of claims, both overall and by severity of claim. These are affected by underlying loss trends, rate changes, benefit changes, reinsurance structure and cost changes and other pertinent adjustments which are explicit key assumptions underlying the initial expected loss method. Each of these key assumptions is discussed in the following paragraphs.

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

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made by industry rating bureaus regarding the effect of legislative benefit changes on such patterns, may be used to supplement, adjust, or replace patterns based on our insurance companies historical data.

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

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

This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. In particular, the development factor based methods all have as a key assumption that the development of losses in the future will follow a pattern similar to those measured by past experience and as adjusted either explicitly or by actuarial judgment. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of reserves, because the eventual deficiency or redundancy is affected by multiple and varied factors. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the years ended December 31, 2007 and 2006.

Variability of Claim Reserve Estimates

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

One implicit assumption underlying development patterns is that the claims inflation trends will continue into the future similar to their past patterns. To estimate the sensitivity of the estimated ultimate loss and settlement expense payments to an unexpected change in inflationary trends, the actuarial department derived expected payment patterns separately for each major line of business. These patterns were applied to the December 31, 2007 loss and settlement expense reserves to generate estimated annual incremental loss and settlement expense payments for each subsequent calendar year. Then, for the purpose of sensitivity testing, an explicit annual inflationary variance of one percent was added to the inflationary trend that is implicitly embedded in the estimated payment pattern, and revised incremental loss and settlement expense payments were calculated. General inflation trends have been fairly stable over the past several years but there have been fluctuations of one to two percent over the past ten years and therefore we used a

one percent annual inflation variance factor. The effect differed by line of business but overall was a three percent change in reserve adequacy or approximately $6.8 million effect on after tax net income. A variance of this type would

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typically be recognized in loss and settlement expense reserves and, accordingly, would not have a material effect on liquidity because the claims have not been paid.

An explicit assumption used in the analysis is the set of initial expected loss ratios (IELRs) used in the current accident year reserve projections and in some of the prior accident year ultimate loss indications. To estimate the sensitivity of the estimated ultimate loss to a change in IELRs, the actuarial department recasted the loss reserve indications using a set of IELRs all one percent higher than the final IELRs. The effect differed by line of business but overall was less than a one percent change in reserve adequacy or a $2.2 million effect on after tax net income. Often the loss ratios by line of business will vary from the IELR in different directions causing them to partially offset each other. A variance of this type would typically be recognized in loss and settlement expense reserves and, accordingly, would not have a material effect on liquidity because the claims have not been paid.

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

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

Our range of estimates table shows that presently we evaluate it as going from favorable development of 7.8% to unfavorable of 6.1%. The range was evaluated based on the ultimate loss estimates from the actuarial methods described above.

Pre-tax Impact on Earnings from a Variance in Future Loss Payments and Case Reserves as of December 31, 2007
(in thousands)

Line of Business	Minimum Reserve Range		Maximum Reserve Range	
Workers Compensation (including Residual Markets)	$ (10,959)	(6.6)%	$ 5,672	3.4%
Commercial Multiple Peril/General Liability	(8,894)	(10.1)%	9,694	11.0%
Commercial Automobile	(4,892)	(7.0)%	3,116	4.5%
Other	(2,057)	(11.7)%	2,368	13.5%
Total	$ (26,802)	(7.8)%	$ 20,850	6.1%

The sensitivity around our workers compensation reserves primarily reflects the size and the maturity of the underlying book of business. Our workers compensation reserves represent 49% percent of our total reserves at December 31, 2007. Workers compensation was our first line of business and is still our largest.

The sensitivity around our commercial multiple peril/general liability reserves primarily reflects the longer duration of reserves relating to our liability excess program which started in 2003 and currently represents 49% of the $87.8 million reserves in this line of business, as of December 31, 2007.

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

The sensitivity around the other lines of business primarily reflects the size of the underlying book of business. Our other reserves represent 5% of total reserves at December 31, 2007. The majority of these reserves represent professional liability programs which tend to be claims-made and reinsured at lower limits, therefore reducing the volatility that is inherent in a smaller book of business.

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

Reinsurance Recoverables

Reinsurance recoverables represent (1) amounts currently due from reinsurers on paid losses and LAE, (2) amounts recoverable from reinsurers on case basis estimates of reported losses and LAE, and (3) amounts recoverable from reinsurers on actuarial estimates of IBNR losses and LAE. Such recoverables, by necessity, are based upon estimates. Reinsurance does not legally discharge us from our legal liability to our insureds, but it does make the assuming reinsurer liable to us to the extent of the reinsurance ceded. Instead of being netted against the appropriate liabilities, ceded unearned premiums and reinsurance recoverables on paid and unpaid losses and LAE are reported separately as assets in our consolidated balance sheets. Reinsurance recoverable balances are also subject to credit risk associated with the particular reinsurer. In our selection of reinsurers, we continually evaluate their financial stability. While we believe our reinsurance recoverables are collectible, the ultimate recoverable may be greater or less than the amount accrued. At December 31, 2007 and 2006, reinsurance recoverables on paid and unpaid losses were $199.5 million and $202.7 million, respectively.

In our risk-sharing programs, we are subject to credit risk with respect to the payment of claims by our clients captive, rent-a-captive, large deductible programs, indemnification agreements, or on the portion of risk either ceded to the captives, or retained by the clients. The capitalization and credit worthiness of prospective risk-sharing partners is one of the factors we consider upon entering into and renewing risk-sharing programs. We collateralize balances due from our risk-sharing partners through funds withheld trusts or stand-by letters of credit issued by highly rated banks. We have historically maintained an allowance for the potential uncollectibility of certain reinsurance balances due from some risk-sharing partners, some of which may be in dispute. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. At December 31, 2007, 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

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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 2007, 2006, and 2005. 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.

Our investment portfolio includes investments in mortgage-backed and agency-backed securities, however we do not have any direct exposure to any sub-prime risks. Our asset-backed securities sector comprises only 4.2%, or $26.6 million of our investment portfolio. Within this sector, $2.8 million relates to home equity loans, of which $1.2 million is insured. The remaining $23.8 million primarily relates to credit cards, auto loans, and utility and equipment loans. These asset-backed securities are adequately collateralized, AAA- rated investment quality that we currently expect will continue to perform. Our mortgage-backed securities have no exposure to any sub-prime risks.

At December 31, 2007 and 2006, we had 160 and 293 securities that were in an unrealized loss position, respectively. These investments all had unrealized losses of less than ten percent. At December 31, 2007, 128 of those investments, with an aggregate $122.2 million and $1.3 million fair value and unrealized loss, respectively, have been in an unrealized loss position for more than eighteen months. At December 31, 2006, 128 of those investments, with an aggregate $127.3 million and $3.1 million fair value and unrealized loss, respectively, have been in an unrealized loss position for more than eighteen months. As of December 31, 2007 and 2006, gross unrealized losses on available for sale securities were $1.9 million and $5.1 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, 2007, total assumed written premiums were $39.2 million, of which $31.0 million, relates to assumed business we manage directly, and therefore, no estimation is involved. The remaining $8.2 million of assumed written premiums includes $6.9 million related to residual markets.

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

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

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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. Any commission adjustments that occur subsequent to the earnings process are recognized upon notification from the insurance companies. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

We review, on an ongoing basis, the collectibility of our receivables and establish an allowance for estimated uncollectible accounts. As of December 31, 2007 and 2006, the allowance for uncollectibles on receivables was $2.7 million and $2.9 million, respectively.

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 is provided for the costs to resolve these claims in our consolidated financial statements. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. 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 $6.5 million and three reporting units within the specialty risk management operations segment in the amount of $37.0 million. Based on our most recent evaluation of goodwill impairment, we determined that no impairment to goodwill exists.

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Results of Operations

Executive Overview

Our overall results in 2007 continued to reflect growth of net income in comparison to prior year. These improvements reflect our commitment to selective growth, as well as our adherence to strict corporate underwriting guidelines and price adequacy. We continue to maintain strong underwriting discipline and growth within our profitable programs. Our generally accepted accounting principles (GAAP) combined ratio improved 1.4 percentage points to 95.4% in 2007 from 96.8% in 2006. We also continue to experience solid growth in our fee-based operations. Net operating income, excluding amortization, increased 32.1% to $29.8 million, or $0.90 per diluted share, compared to $22.6 million, or $0.76 per diluted share in 2006.

Gross written premium increased $15.6 million, or 4.7%, to $346.5 million in 2007, compared to $330.9 million in 2006. Our existing underwritten business, which excludes residual market premium, was up $18.8 million, or 5.9% in comparison to 2006. This growth included business from new programs implemented in 2006. The growth in existing business was slightly offset by a reduction in residual market premiums that are assigned to us as a result of a decrease in the estimate of the overall size of the residual market.

We continue to follow pricing guidelines mandated by our corporate underwriting guidelines. Overall, our year-to-date rate change was down 1.7%, compared to industry average price decreases of approximately 15%. We anticipate that rates will continue to remain slightly down into 2008. We continue to be selective on new program implementation by focusing only on those programs that meet our underwriting guidelines and have a proven history of profitability. Our statutory surplus increased by $23.3 million in 2007 to $188.4 million, from $165.1 million in 2006. Currently, our earned surplus is $33.7 million, which represents our ability to dividend from the Insurance Company Subsidiaries to our holding company for capital strategies, such as acquisitions, dividends, debt repayments, and share repurchases.

In April 2007, we received an upgrade of our financial strength rating by A.M. Best Company to A− (Excellent), from B++ (Very Good) for our Insurance Company Subsidiaries. This rating upgrade validates our commitment to create value through excellent underwriting and consistent operating performance. We are continuing to implement new insurance programs as a result of this upgrade from A.M. Best and other business development strategies. We have a comprehensive due diligence process that incorporates an entity wide risk analysis, as well as an operational review. While this process can be lengthy, we believe the initial work leads to long term relationships with solid longer term favorable underwriting performance. We believe we are in a good position to achieve our top-line and bottom-line growth objectives in 2008. In addition, subsequent to the A.M. Best upgrade, we have renewed policies formerly written on a fronted basis by a non-affiliated insurance company and assumed by our Insurance Company Subsidiaries in exchange for a 5.5% fronting fee. As this renewal process continues and we earn the premium previously fronted, we expect to see this reduction in cost reflected within our expense ratio.

In April 2007, we purchased certain business assets of U.S. Specialty Underwriters, Inc. (USSU) for a purchase price of $23.0 million. This purchase price was comprised of $13.0 million in cash and $10.0 million in our common stock. USSU is based in Cleveland, Ohio, and is a specialty program manager that produces fee based income by underwriting excess workers compensation coverage for a select group of insurance companies. The total shares issued for the $10.0 million portion of the purchase price was 907,935 shares. Under the terms of the Agreement, we

acquired the excess workers compensation business and other related assets. In addition, we entered into a Management Agreement with the shareholders of USSU. Under the terms and conditions of the Management Agreement, the shareholders were responsible for certain aspects of the administration and management of the acquired business. The shareholders consideration for the performance of their duties was in the form of a Management Fee payable by us based on a share of net income before interest, taxes, depreciation, and amortization. In addition, we retained the option to terminate the Management Agreement, at our discretion, based on a multiple of the Management Fee calculated for the trailing twelve

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months. On January 31, 2008, we exercised our option to purchase the remainder of the economics related to the acquisition of the USSU business, by eliminating the Management Agreement for a payment of $21.5 million, which now completes the transaction.

In July 2007, we completed an offering of 6,437,500 additional shares of newly issued common stock at $9.65 per share. The gross proceeds of the offering were $62.1 million. The net proceeds were $58.6 million. The net proceeds from the offering are being utilized to support organic growth within our underwriting operations, to fund select acquisitions and for other general corporate purposes. Upon receipt of the net proceeds, we reduced our outstanding line of credit balance from $22.0 million to zero.

On February 8, 2008, our Board of Directors declared a quarterly dividend of $0.02 per common share. This is the first quarterly dividend since the third quarter of 2001. Our Board of Directors determined that reinstating the dividend best serves shareholder interests by creating long-term value and is part of our capital management strategy.

On February 20, 2008, we executed a definitive merger agreement with ProCentury Corporation (ProCentury) for a merger transaction valued at approximately $272.6 million in cash and stock to be paid to ProCentury shareholders. The combined entity will adopt and operate under the Meadowbrook name and will continue to trade on the NYSE under the ticker symbol MIG . Our Chief Executive Officer, Robert S. Cubbin, will continue in his current role in the post-merger combined entity and two ProCentury board members are expected to join Meadowbrook s Board of Directors.

The merger is expected to expand and complement our specialty lines capabilities with ProCentury s insurance professionals and product expertise in the excess and surplus lines market. We believe there are significant profitable revenue growth opportunities, as well as cost savings opportunities.

We expect to finance the cash portion of the purchase price through a combination of cash and debt. Completion of the transaction is subject to various closing conditions, including the receipt of required regulatory and shareholder approval. We expect to complete the merger in the third quarter of 2008.

2007 compared to 2006:

Net income improved $6.0 million, or 27.0%, to $28.0 million, or $0.85 per diluted share, in 2007, from net income of $22.0 million, or $0.75 per diluted share, in 2006. This improvement primarily reflects growth in underwriting profits and an increase in net investment income. Net investment income increased primarily from an overall increase in average invested assets. Improvements in our overall underwriting results reflect continued favorable development on prior year losses and a slight reduction in the expense ratio. These improvements were partially offset by amortization of intangibles and interest expense associated with our acquisition of the USSU business.

Revenues increased $22.5 million, or 7.1%, to $340.7 million for the year ended December 31, 2007, from $318.2 million for the comparable period in 2006. This increase reflects a $13.3 million, or 5.2%, increase in net earned premiums. The increase in net earned premiums was the result of selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy, partially offset by a reduction in residual market premiums that are assigned to us as a result of a decrease in the estimate of the overall size of the residual market. The increase in revenue was also due to an overall increase in fee-for-service revenue, primarily as a result of

our acquisition of the USSU business. Total fees received in 2007 as a result of this acquisition were $5.5 million. In addition, the increase in revenue reflects a $4.3 million increase in investment income, primarily the result of overall positive cash flow, a slight increase in yield and to a lesser extent the cash received from our equity offering in July 2007.

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2006 compared to 2005:

Net income improved $4.1 million, or 23.0%, to $22.0 million, or $0.75 per diluted share, in 2006, from net income of $17.9 million, or $0.60 per diluted share, in 2005. This improvement was primarily the result of our selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy. In addition, during 2005 we increased our retention levels on certain reinsurance treaties, which favorably impacted net earned premiums and net income for 2006, compared to 2005. Growth in our fee-for-service programs also contributed to the overall improvement in net income in comparison to 2005.

Revenues increased $14.2 million, or 4.7%, to $318.2 million for the year ended December 31, 2006, from $304.0 million for the comparable period in 2005. This increase reflects a $4.9 million, or 2.0%, increase in net earned premiums. The increase in net earned premiums was the result of our selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy, as well as the favorable impact from an increase in our retention levels on certain reinsurance treaties effective in 2005. Offsetting the overall increase in net earned premiums for the year ended December 31, 2006, was a reduction in audit related premiums in comparison to 2005. The increase in revenue was also the result of an overall increase in fee-for-service revenue, primarily as a result of new managed programs. In addition, the increase in revenue reflects a $4.1 million increase in investment income, primarily due to an increase in average invested assets as a result of improved cashflow from favorable underwriting results, an increase in the duration of our reserves, and proceeds from the junior subordinated debentures issued in the third quarter of 2005. The increase in investment income was also the result of a slight increase in yield.

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,		
	2007	**2006**	**2005**
Revenue:			
Net earned premiums	$ 268,197	$ 254,920	$ 249,959
Management fees	23,963	18,714	16,741
Claims fees	9,025	8,776	7,113
Loss control fees	2,151	2,216	2,260
Reinsurance placement	929	735	660
Investment income	25,487	21,115	17,692
Net realized gains	150	69	85
Total revenue	$ 329,902	$ 306,545	$ 294,510
Pre-tax income Specialty risk management operations	$ 47,898	$ 38,292	$ 29,546

2007 compared to 2006:

Revenues from specialty risk management operations increased $23.4 million, or 7.6%, to $329.9 million for the year ended December 31, 2007, from $306.5 million for the comparable period in 2006.

Net earned premiums increased $13.3 million, or 5.2%, to $268.2 million for the year ended December 31, 2007, from $254.9 million in the comparable period in 2006. As previously indicated, this increase was the result of selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy, partially offset by the reduction in residual market premiums and mandatory rate decreases in the Nevada, Florida and Massachusetts workers compensation lines of business.

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Management fees increased $5.3 million, or 28.0%, to $24.0 million, for the year ended December 31, 2007, from $18.7 million for the comparable period in 2006. This increase was related to fees received as a result of our acquisition of the USSU business. Total fees received in 2007 as a result of the USSU acquisition were $5.5 million. Slightly offsetting these fees was a slight decrease in fees in our Northeast operations. This decrease in fees primarily related to a decrease in premium volume due to reduced rates in the self-insured markets on which the fees are based, because of mandatory rate reductions and an increase in competition.

Claim fees remained relatively flat for 2007 compared to 2006.

Net investment income increased $4.4 million, or 20.7%, to $25.5 million in 2007, from $21.1 million in 2006. Average invested assets increased $79.2 million, or 16.0%, to $573.1 million in 2007, from $493.9 million in 2006. The increase in average invested assets primarily relates to the cash flows from operations, resulting from continued favorable underwriting results, increased fee revenue, and the lengthening of the duration of our reserves. The increase in the duration of our reserves reflects the impact of growth in our excess liability business, which was implemented at the end of 2003. This type of business has a longer duration than the average reserves on our other programs and is now a larger proportion of reserves. In addition, the increase in average invested assets reflects cash flows from our equity offering in July. The invested proceeds from the equity offering added approximately $600,000 to the overall net investment income for the year. The average investment yield for 2007 was 4.61%, compared to 4.47% in 2006. The current pre-tax book yield was 4.5%. The current after-tax book yield was 3.41%, compared to 3.28% in 2006. This increase is primarily the result of the increase in market interest rates, and the purchase of assets of longer duration to take advantage of higher yields. The duration of the investment portfolio is 4.3 years at December 31, 2007, compared to 3.9 years at December 31, 2006.

Specialty risk management operations generated pre-tax income of $47.9 million for the year ended December 31, 2007, compared to pre-tax income of $38.3 million for the year ended December 31, 2006. This increase in pre-tax income primarily reflects expansion of cash margins on our fee revenue, an increase in net investment income, increased underwriting profits, favorable development in prior accident year reserves, and a slightly lower expense ratio. The GAAP combined ratio was 95.4% for the year ended December 31, 2007, compared to 96.8% for the comparable period in 2006.

Net losses and loss adjustment expenses (LAE) increased $4.7 million, or 3.2%, to $151.0 million for the year ended December 31, 2007, from $146.3 million for the same period in 2006. Our loss and LAE ratio improved 1.1 percentage points to 61.2% for the year ended December 31, 2007, from 62.3% for the same period in 2006. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. This improvement reflects the impact of overall favorable development on prior accident year reserves of 1.5 percentage points from the December 31, 2006 reserves. The improvement was primarily within the workers compensation and professional liability lines of business, partially offset by an increase in the ultimate loss projections within the general liability line of business. The unfavorable development within the general liability line of business reflects a claim reserving process change for an excess liability program. Additional discussion of our reserve activity is described below within the *Other Items Reserves* section.

Our expense ratio for the year ended December 31, 2007 was 34.2%, compared to 34.5% in 2006. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums.

2006 compared to 2005:

Revenues from specialty risk management operations increased $12.0 million, or 4.1%, to $306.5 million for the year ended December 31, 2006, from $294.5 million for the comparable period in 2005.

Net earned premiums increased $4.9 million, or 2.0%, to $254.9 million for the year ended December 31, 2006, from $250.0 million in the comparable period in 2005. This increase was primarily the result of selective

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growth consistent with our corporate underwriting guidelines and our controls over price adequacy, as well as the favorable impact from an increase in our retention levels on certain reinsurance treaties. Offsetting these increases was an overall decrease in audit related premiums in comparison to 2005, reflecting improvements in the estimation of exposures during the underwriting cycle.

Management fees increased $2.0 million, or 11.8%, to $18.7 million, for the year ended December 31, 2006, from $16.7 million for the comparable period in 2005. This increase was primarily the result of a Florida-based program implemented in the second quarter of 2005. In addition, this increase was the result of growth in a specific New England-based program. Also contributing to the overall increase in management fees was the recognition of $250,000 from a profit-based revenue sharing payment related to a specific managed program.

Claim fees increased $1.7 million, or 23.4%, to $8.8 million, from $7.1 million for the comparable period in 2005. This increase was primarily the result of our 2006 entry into the self-insured workers compensation market in Nevada. In addition, this increase was the result of increases in revenue related to a specific Minnesota-based program, as well as a Florida-based program, which was implemented in the second quarter of 2005.

Net investment income increased $4.1 million, or 22.8%, to $22.1 million in 2006, from $18.0 million in 2005. Average invested assets increased $69.6 million, or 16.4%, to $493.9 million in 2006, from $424.3 million in 2005. The increase in average invested assets reflects cash flows from underwriting activities primarily from favorable underwriting results and an increase in the duration of our reserves. The increase in the duration of our reserves reflects the impact of our public entity excess program, which was implemented at the end of 2003. This program has a longer duration than the average reserves on our remaining programs and is a larger proportion of reserves. In addition, the $19.4 million in net proceeds received from capital raised in 2005 through the issuances of debentures increased average invested assets. The average investment yield for 2006 was 4.47%, compared to 4.24% in 2005. The current pre-tax book yield was 4.35%. The current after-tax book yield was 3.28%, compared to 3.06% in 2005. This increase is primarily the result of the shift in our investment portfolio to tax-exempt investments. The duration of the investment portfolio is 3.9 years.

Specialty risk management operations generated pre-tax income of $38.3 million for the year ended December 31, 2006, compared to pre-tax income of $29.5 million for the year ended December 31, 2005. 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. The GAAP combined ratio was 96.8% for the year ended December 31, 2006, compared to 98.7% for the comparable period in 2005.

Net losses and loss adjustment expenses (LAE) decreased $5.2 million, or 3.5%, to $146.3 million for the year ended December 31, 2006, from $151.5 million for the same period in 2005. Our loss and LAE ratio improved 2.9 percentage points to 62.3% for the year ended December 31, 2006, from 65.2% for the same period in 2005. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. The accident year loss ratio remained flat at 63.4% for 2006, compared to 63.3% in 2005. The favorable development in our loss ratio was primarily the result of improvement in frequency and claim settlements within the professional liability line of business. In addition, workers compensation residual market experience improved as a result of lower market share assessments and lower loss reserves on the industry pooled experience. Both 2006 and 2005, were adversely impacted by a single large workers compensation claim. The increase was $1.5 million and $900,000 in 2006 and 2005, respectively. Excluding the adverse impact of this claim, overall workers compensation reflected improvement in claim settlements relative to

their collective case reserves. The experience within the general liability line of business also improved due to favorable case reserve settlements in 2006, in comparison to 2005. These improvements were partially offset by a single property claim of $1.9 million within a California-based agricultural program. Allowances within other reserve categories, collectively, did not contribute to the development in 2006, compared to 2005 where

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we experienced approximately $1.3 million in adverse development related to allowances on reinsurance recoverables.

Our expense ratio for the year ended December 31, 2006 was 34.5%, compared to 33.5% in 2005. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. The increase in our expense ratio in comparison to 2005 reflects a reduction in an accrual for estimated profit-based ceding commissions on an excess reinsurance treaty for a specific commercial transportation program. This decrease was the result of unfavorable loss development on a limited number of excess of loss claims from prior accident years and added $1.6 million to our expenses, or 0.6 percentage points to our expense ratio for the year, as compared to a favorable impact on the 2005 expense ratio of $1.1 million, or 0.5 percentage points. As of December 31, 2006, the remaining accrual was less than $150,000; therefore, we do not anticipate any further unfavorable adjustments. Offsetting this increase in the expense ratio was a reduction in insurance related assessments primarily related to the guaranty fund in Florida and Nevada.

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,		
	2007	**2006**	**2005**
Net commission	$ 11,316	$ 12,285	$ 11,304
Pre-tax income(1)	$ 2,087	$ 2,609	$ 3,241

(1) Our agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate overhead allocation excludes those expenses specific to the holding company. For the years ended December 31, 2007, 2006, and 2005, the allocation of corporate overhead to the agency operations segment was $2.8 million, $3.3 million, and $3.2 million, respectively. These balances include an allocation to our Insurance & Benefit Consultants agency business that was previously allocated to specialty risk management operations. For the years ended December 31, 2006 and 2005, pre-tax income for agency operations was overstated and specialty risk management was understated by $342,000 and $102,000, respectively.

2007 compared to 2006:

Revenue from agency operations, which consists primarily of agency commission revenue, decreased $969,000, or 7.9%, to $11.3 million for the year ended December 31, 2007, from $12.3 million for the comparable period in 2006. This decrease was primarily the result of a reduction in premium on client renewals due to a more competitive pricing environment primarily on larger Michigan accounts.

Agency operations generated pre-tax income, after the allocation of corporate overhead, of $2.1 million for the year ended December 31, 2007, compared to $2.6 million for the comparable period in 2006. The decrease in the pre-tax income was primarily attributable to the decrease in agency commission revenue mentioned above.

2006 compared to 2005:

Revenue from agency operations, which consists primarily of agency commission revenue, increased $1.0 million, or 8.7%, to $12.3 million for the year ended December 31, 2006, from $11.3 million for the comparable period in 2005. This increase was primarily the result of the November 2005 acquisition of a Florida-based retail agency and an increase in profit sharing commissions in comparison to 2005. Offsetting these increases was a decrease in commission revenue as a result of a reduction in premium on client renewals due to a more competitive pricing environment.

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Agency operations generated pre-tax income, after the allocation of corporate overhead, of $2.6 million for the year ended December 31, 2006, compared to $3.2 million for the comparable period in 2005. This decrease in pre-tax income in comparison to 2005 was primarily the result of a slight increase in operating expenses coupled with the decrease in commission revenue, as noted above, offset by the favorable impact from the Florida-based retail agency acquisition.

Other Items

Reserves

At December 31, 2007, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was $341.5 million. We established a reasonable range of reserves of approximately $314.7 million to $362.4 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)	$ 155,828	$ 172,459	$ 166,787
Commercial Multiple Peril / General Liability	78,918	97,506	87,812
Commercial Automobile	64,534	72,542	69,426
Other	15,459	19,884	17,516
Total Net Reserves	$ 314,739	$ 362,391	$ 341,541

(1) Includes Residual Markets

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

The key assumptions used in our selection of ultimate reserves included the underlying actuarial methodologies, a review of current pricing and underwriting initiatives, an evaluation of reinsurance costs and retention levels, and a

detailed claims analysis with an emphasis on how aggressive claims handling may be impacting the paid and incurred loss data trends embedded in the traditional actuarial methods. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the years ended December 31, 2007, 2006, and 2005.

For the year ended December 31, 2007, we reported a decrease in net ultimate loss estimates for accident years 2006 and prior of $7.1 million, or 2.3% of $302.7 million of net loss and LAE reserves at December 31, 2006. The decrease in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2007 that differed from the projected activity. There were no significant

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changes in the key assumptions utilized in the analysis and calculations of our reserves during 2007 and 2006. The major components of this change in ultimate loss estimates are as follows (in thousands):

Line of Business	Reserves at December 31, 2006	Incurred Losses Current Year	Incurred Losses Prior Years	Total Incurred	Paid Losses Current Year	Paid Losses Prior Years	Total Paid	Reserves at December 31 2007
Workers Compensation	$ 137,113	$ 58,965	$ (11,428)	$ 47,537	$ 8,150	$ 35,141	$ 43,291	$ 141,359
Residual Markets	26,098	9,678	(3,053)	6,625	3,451	3,844	7,295	25,428
Commercial Multiple Peril/General Liability	63,056	28,721	12,509	41,230	683	15,791	16,474	87,812
Commercial Automobile	54,642	45,820	847	46,667	11,691	20,192	31,883	69,426
Other	21,746	14,876	(5,966)	8,910	6,328	6,812	13,140	17,516
Net Reserves	302,655	$ 158,060	$ (7,091)	$ 150,969	$ 30,303	$ 81,780	$ 112,083	341,541
Reinsurance Recoverable	198,422							198,461
Consolidated	$ 501,077							$ 540,002

Line of Business	Reserves at December 31, 2006	Re-Estimated Reserves at December 31, 2007 on Prior Years	Development as a Percentage of Prior Year Reserves
Workers Compensation	$ 137,113	$ 125,685	(8.3)%
Commercial Multiple Peril/General Liability	63,056	75,565	19.8%
Commercial Automobile	54,642	55,489	1.6%
Other	21,746	15,780	(27.4)%
Sub-total	276,557	272,519	(1.5)%
Residual Markets	26,098	23,045	(11.7)%
Total Net Reserves	$ 302,655	$ 295,564	(2.3)%

Workers Compensation Excluding Residual Markets

The projected net ultimate loss estimate for the workers compensation line of business, excluding residual markets, decreased $11.4 million, or 8.3% of net workers compensation reserves. This net overall decrease reflects decreases of $1.1 million, $3.8 million, $2.9 million, $557,000, and $1.1 million in accident years 2006, 2005, 2004, 2003, and 2000, respectively. These decreases reflect better than expected experience for many of our workers compensation programs, including those in Nevada, Florida, and a multi-state association program. The actual losses on reported claims were less than the prior actuarial projections and, therefore, ultimate loss estimates were reduced. The change in ultimate loss estimates for all other accident years was insignificant.

Commercial Multiple Peril/General Liability

The commercial multiple peril and general liability line of business had an increase in net ultimate loss estimates of $12.5 million, or 19.8% of net commercial multiple peril and general liability reserves. The net increase reflects increases of $2.8 million, $1.6 million, $5.6 million, and $811,000 in the ultimate loss estimates for accident years 2006, 2005, 2004 and 2003, respectively, which were primarily due to larger than

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expected claim emergence in a Florida-based program. The larger than expected claim emergence within this Florida-based program was the result of accelerated claim activity on a handful of incurred losses and greater claims frequency from a claim reserving process change. This may be attributable to more aggressive investigation on possible losses and more dedicated resources on claim handling, resulting in case reserving changes, rather than worsening results. While this program had unfavorable development in prior accident year reserves, the current and inception to date profits remain positive and within our corporate guidelines for return on surplus. 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 $847,000, or 1.6% of net commercial automobile reserves. This net overall increase reflects increases of $2.3 million and $1.5 million in accident years 2005 and 2004, respectively. These increases primarily reflect higher than expected emergence of claim activity in a Southeast-based and West coast-based program. These increases were offset by a decrease of $2.5 million in accident year 2006. The decrease in this accident year reflects favorable development within a West coast-based program and a Southeast-based program. The change in ultimate loss estimates for all other accident years was insignificant.

Other

The projected net ultimate loss estimate for the other lines of business decreased $6.0 million, or 27.4% of net reserves. This net decrease reflects decreases of $1.6 million, $2.2 million, $1.2 million, and $771,000, in the net ultimate loss estimate for accident years 2006, 2005, 2004 and 2003, respectively. These decreases were due to better than expected case reserve development during the calendar year in the professional liability 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 a decrease in net ultimate loss estimates of $3.1 million, or 11.7% of net reserves. This decrease reflects reductions of $1.8 million, $958,000, and $490,000 in accident years 2005, 2004 and 2003, respectively. We record loss reserves as reported by the NCCI, plus a provision for the reserves incurred but not yet analyzed and reported to us due to a two quarter lag in reporting. These changes reflect a difference between our estimate of the lag incurred but not reported and the amounts reported by the NCCI in the quarter. The change in ultimate loss estimates for all other accident years was insignificant.

Salaries and Employee Benefits

Salaries and employee benefits increased $1.8 million, or 3.4%, to $56.4 million in 2007, from $54.6 million for the comparable period in 2006. This increase was primarily due to merit increases, our acquisition of the USSU business, and variable compensation attributable to our performance. Overall, our headcount remained flat for 2007.

Salaries and employee benefits increased $3.3 million, or 6.3%, to $54.6 million in 2006, from $51.3 million for the comparable period in 2005. This increase primarily reflects an increase in variable compensation. In addition, this increase was the result of an increase in staffing levels, primarily as a result of the additions of our Florida-based retail

agency and our entry into the self-insured workers compensation market in Nevada. Excluding those additions, overall staffing levels for 2006 were slightly higher in comparison to 2005.

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

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Other Administrative Expenses

Other administrative expenses increased $3.5 million, or 12.0%, to $32.3 million in 2007, from $28.8 million in 2006. Other administrative expenses increased in comparison to 2006 as a result of our acquisition of the USSU business, primarily due to the management fee associated with this acquisition. In addition, this increase was the result of information technology initiatives. Offsetting the increases related to the USSU business were decreases related to policyholder dividends, as well as various decreases in other general operating expenses in comparison to 2006.

Other administrative expenses increased $2.0 million, or 7.5%, to $28.8 million in 2006, from $26.8 million in 2005. A portion of this increase was the result of the expenses associated with the additions of our Florida-based agency and our entry into the self-insured workers compensation market in Nevada. In addition, the increase in other administrative expenses was the result of information technology enhancements and various increases in other general operating expenses in comparison to 2005.

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

Amortization Expense

Amortization expense for 2007, 2006, and 2005 was $1.9 million, $590,000, and $373,000, respectively. Amortization expense per dilutive share for 2007, 2006, and 2005 was $0.06, $0.02, and $0.01, respectively. Amortization expense primarily relates to the customer relationships acquired with the Florida-based agency operation in 2005 and the acquisition of the USSU business in 2007. The increase in amortization expense in 2007 was related to our acquisition of the USSU business.

Interest Expense

Interest expense for 2007, 2006, and 2005 was $6.0 million, $6.0 million, and $3.9 million, respectively. Interest expense is primarily attributable to our debentures, which are described within the *Liquidity and Capital Resources* section of Management s Discussion and Analysis, as well as our line of credit. Interest expense for 2007 includes interest related to a temporary increase in our line of credit which was associated with borrowings to fund the cash portion of the USSU business acquisition. Upon receipt of the net proceeds from our capital raise in July, we reduced this outstanding balance to zero. The increase in interest expense in 2006, compared to 2005 was related to the issuance of the junior subordinated debentures issued in the third quarter of 2005, as well as an overall increase in the average interest rates.

The average outstanding balance on our line of credit was $8.8 million, $10.6 million, and $9.0 million in 2007, 2006, and 2005, respectively. The average interest rate, excluding our debentures, was approximately 6.7%, 6.5%, and 4.8%, in 2007, 2006, and 2005, respectively.

Income Taxes

Income tax expense, which includes both federal and state taxes, for 2007, 2006 and 2005, was $11.7 million, $9.6 million, and $7.8 million, or 29.8%, 30.5% and 30.2% of income before taxes, respectively. The decrease in our

tax rate from 2006 to 2007 primarily reflects a higher level of tax exempt securities in our investment portfolio, slightly offset by a higher level of income within our fee-based operations, which are taxed at a 35% rate. Our tax exempt securities as a percentage of total invested assets were 43.6%, 41.0%, and 29.9% for 2007, 2006, and 2005, respectively.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

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, shareholders 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. Our capital resources include both non-regulated cash flow and excess capital in our Insurance Company Subsidiaries, which is defined as the dividend Star may issue without prior approval from our regulators. We review the excess capital in aggregate to determine the use of such capital. The general uses are as follows, contributions to our Insurance Company Subsidiaries to support premium growth, make select acquisitions, service debt, pay shareholders dividends, repurchase shares, investments in technology, or other expenses of the holding company. 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,		
	2007	2006	2005
Net income	$ 27,992	$ 22,034	$ 17,910
Regulated Subsidiaries:			
Net income	$ 25,595	$ 19,712	$ 13,508
Adjustments to reconcile net income to net cash provided by operating activities	696	3,033	3,003
Changes in operating assets and liabilities	55,533	46,915	59,784
Total adjustments	56,229	49,948	62,787
Net cash provided by operating activities	$ 81,824	$ 69,660	$ 76,295
Non-regulated Subsidiaries:			
Net income	$ 2,397	$ 2,322	$ 4,402
Depreciation	3,147	2,553	2,452
Amortization	1,930	590	198
Interest	6,030	5,976	3,856
Net income, excluding interest, depreciation, and amortization	13,504	11,441	10,908
Adjustments to reconcile net income to net cash provided by operating activities	5,877	3,161	4,444

Changes in operating assets and liabilities	(1,491)	(852)	(3,194)
Total adjustments	4,386	2,309	1,250

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	For the Years Ended December 31,		
	2007	**2006**	**2005**
Depreciation	(3,147)	(2,553)	(2,452)
Amortization	(1,930)	(590)	(198)
Interest	(6,030)	(5,976)	(3,856)
Net cash provided by operating activities	$ 6,783	$ 4,631	$ 5,652
Consolidated total adjustments	60,615	52,257	64,037
Consolidated net cash provided by operating activities	$ 88,607	$ 74,291	$ 81,947

Cash flow provided by operations was $88.6 million in 2007, compared to $74.3 million in 2006. Cash flow provided by operations in 2005 was $81.9 million.

2007 compared to 2006:

Regulated subsidiaries cash flow provided by operations for the year ended December 31, 2007, was $81.8 million, compared to $69.7 million for the comparable period in 2006. This increase is the result of growth in our underwritten business and timing of premium and reinsurance recoverable collections. In addition, an increase in investment income as a result of growth in our investment portfolio contributed to the increase. Partially offsetting these improvements was an increase in payments related to policy acquisition costs and insurance related assessments.

Non-regulated subsidiaries cash flow provided by operations for the year ended December 31, 2007, was $6.8 million, compared to $4.6 million for the comparable period in 2006. The increase in cash flow from operations is primarily the result of an increase in the collection of commission and fees due to the USSU business acquisition. This increase in cash flow was partially offset by variable compensation payments related to our long-term incentive plan, which were made in the first quarter of 2007 and related to 2006 performance and profitability.

We continue to anticipate a temporary increase in cash outflows related to our investments in technology as we enhance our operating systems and controls. We believe these temporary increases will not affect our liquidity, debt covenants, or other key financial measures.

2006 compared to 2005:

Regulated subsidiaries cash flow provided by operations for the year ended December 31, 2006, was $69.7 million, compared to $76.3 million for the comparable period in 2005. This decrease was primarily the result of timing in relation to reinsurance payments. This decrease was slightly offset as a result of improved underwriting results, lower paid losses in proportion to incurred losses, and an increase in investment income.

Non-regulated subsidiaries cash flow provided by operations for the year ended December 31, 2006, was $4.6 million, compared to $5.7 million for the comparable period in 2005. This decrease in cash flow in comparison to 2005 was primarily the result of a decrease in net income. The decrease in net income was primarily attributable to an increase in interest expense related to the issuance of the junior subordinated debentures issued in the third quarter of 2005 and an overall increase in the average interest rates. In addition, the decrease in net income was the result of an increase in administrative costs related to the additions of our Florida-based agency and our entry into the self-insured workers compensation market in Nevada, as well as an increase due to information technology enhancements. These increases were offset by an overall increase in fee-for-service and agency commission revenue.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

Other Items

Long-term Debt

The following table summarizes the principal amounts and variables associated with our long-term debt (in thousands):

Year of Issuance	Description	Year Callable	Year Due	Interest Rate Terms	Interest Rate at 12/31/07	Principal Amount
2003	Junior subordinated debentures	2008	2033	Three-month LIBOR, plus 4.05%	9.28%	$ 10,310
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.00%	8.87%	13,000
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.20%	9.23%	12,000
2005	Junior subordinated debentures	2010	2035	Three-month LIBOR, plus 3.58%	8.57%	20,620
					Total	$ 55,930

We received a total of $53.3 million in net proceeds from the issuances of the above long-term debt, of which $26.2 was contributed to the surplus of our Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes. Associated with the issuance of the above long-term debt we incurred approximately $1.7 million in issuance costs for commissions paid to the placement agents in the transactions.

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

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

Since the junior subordinated debentures issued in 2003 are callable in 2008, we will be reviewing the capital strategy associated with refinancing at lower costs through debentures or equity.

Interest Rate Swaps

In October 2005, we entered into two interest rate swap transactions 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 Statement of Financial Accounting Standards (SFAS) No. 133 *Accounting for Derivative Instruments and Hedging Activities,* these interest rate swap transactions were recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and is 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 an ending date of May 24, 2009. We are required to make certain quarterly fixed rate payments calculated on a notional amount of $5.0 million, non-amortizing, based on a fixed annual interest rate of 8.925%. The counterparty is obligated to make

MEADOWBROOK INSURANCE GROUP, INC.

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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 calculated on a notional amount of $20.0 million, non-amortizing, based on a fixed annual interest rate of 8.34%. The counterparty 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 income received for the years ended December 31 2007 and 2006, was approximately $172,000 and $67,000, respectively. For the year ended December 31, 2005, the net interest expense incurred was approximately $4,000. The total fair value of the interest rate swaps as of December 31, 2007 and 2006, was approximately ($545,000) and $200,000, respectively. Accumulated other comprehensive income at December 31, 2007 and 2006, included accumulated (loss) income on the cash flow hedge, net of taxes, of approximately ($484,000) and $121,000, respectively.

Revolving Line of Credit

In April 2007, we executed an amendment to our current revolving credit agreement with our bank. The amendments included an extension of the term to September 30, 2010, an increase to the available borrowings of up to $35.0 million, and a reduction of the variable interest rate basis to a range between 75 to 175 basis points above LIBOR. We 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, 2007, we did not have an outstanding balance on the revolving line of credit. In July 2007, we completed a secondary equity offering in which we received net proceeds of approximately $58.6 million. Upon receipt of the net proceeds, we reduced our outstanding line of credit balance to zero. At December 31, 2006, we had an outstanding balance of $7.0 million on the revolving line of credit.

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 of 15 basis points on any unused balance. 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 75 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). At December 31, 2007, we did not have any LIBOR-based borrowings outstanding. At December 31, 2006, the weighted average interest rate for LIBOR-based borrowings outstanding was 6.7%.

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, 2007, we were in compliance with these covenants.

Investment Portfolio

As of December 31, 2007 and 2006, the recorded values of our investment portfolio, including cash and cash equivalents, were $651.6 million and $527.6 million, respectively. The debt securities in the investment

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

portfolio, at December 31, 2007, were 97.7% investment grade A– or above bonds as defined by Standard and Poor s.

While our investment portfolio includes investments in mortgage-backed and agency-backed securities, we do not have any direct exposure to any sub-prime risks. Our asset-backed securities sector comprises only 4.2%, or $26.6 million of our investment portfolio. Within this sector, $2.8 million relates to home equity loans, of which $1.2 million is insured. The remaining $23.8 million primarily relates to credit cards, auto loans, and utility and equipment loans. These asset-backed securities are adequately collateralized, AAA- rated investment quality that we currently expect will continue to perform. Our mortgage-backed securities have no exposure to any sub-prime risks.

Shareholders Equity

Shareholders equity increased to $301.9 million, or a book value of $8.16 per common share, at December 31, 2007, compared to $201.7 million, or a book value of $6.93 per common share, at December 31, 2006. This per share increase in book value primarily reflects the impact of our equity offering in July 2007, year-to-date earnings, and an increase in unrealized gains, net of deferred income tax, of $4.3 million. Return on beginning equity was 13.9% in 2007, compared to 12.4% in 2006.

On July 19, 2007, we completed a secondary offering of 6,437,500 additional shares of our common stock at a price of $9.65 per share. Including the underwriting discount associated with the offering and other related expenses, we received total net proceeds of approximately $58.6 million. These net proceeds are being utilized to support organic growth within our underwriting operations, to fund select acquisitions and for other general corporate purposes. Upon receipt of the net proceeds, we reduced our outstanding line of credit balance from $22.0 million to zero.

In April 2007, we purchased the business of USSU for a purchase price of $23.0 million. This purchased price was comprised of $13.0 million in cash and $10.0 million in our common stock. Total additional shares issued for the $10.0 million portion of the purchase price were 907,935 shares.

On February 8, 2007, our Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of our LTIP award for the 2004-2006 plan years, which included both a cash and stock award. The stock portion of the LTIP award was valued at $2.5 million, which resulted in the issuance of 579,496 shares of our common stock. Of the 579,496 shares issued, 191,570 shares were retired for payment of the participant s associated withholding taxes related to the compensation recognized by the participant. Refer to Note 2 *Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan* for further detail. The retirement of the shares for the associated withholding taxes reduced our paid in capital by $1.8 million.

On October 26, 2007, our Board of Directors authorized management 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. Our prior plan expired on October 27, 2007. For the years ended December 31, 2007 and 2006, we did not repurchase any common stock under either plan. As of December 31, 2007, we have available up to 1,000,000 shares to be purchased.

On February 8, 2008, our Board of Directors declared a quarterly dividend of $0.02 per common share. The dividend is payable on March 31, 2008, to shareholders of record as of March 14, 2008. Our Board of Directors did not declare any dividends in 2007 or 2006. 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 2007 or 2006.

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Acquisition

In April 2007, we acquired the business of USSU for a purchase price of $23.0 million. Under the terms of the Agreement, we acquired the excess workers compensation business and other related assets. USSU is based in Cleveland, Ohio, and is a specialty program manager that produces fee based income by underwriting excess workers compensation coverage for a select group of insurance companies.

Goodwill associated with this acquisition was approximately $12.0 million. In addition, we recorded an increase to other intangible assets of approximately $9.5 million. These other intangible assets related to customer relationships acquired with the acquisition. We determined that the estimated useful life of the other intangible assets to be approximately five years. As such, we will amortize the $9.5 million in other intangible assets over a five year period.

In addition, we entered into a Management Agreement with the former owners of USSU. Under the terms the Management Agreement, the former owners were responsible for certain aspects of the daily administration and management of the USSU business. Their consideration for the performance of these duties was in the form of a management fee payable by us based on a share of net income before interest, taxes, depreciation, and amortization. We retained the option to terminate the Management Agreement, at our discretion, based on a multiple of the management fee calculated for the trailing twelve months. On January 31, 2008, we exercised this option to purchase the remainder of the economics related to the acquisition of the USSU business, by eliminating the Management Agreement for a payment of $21.5 million, which now completes the transaction. As a result of this purchase, we recorded an increase to other intangible assets of approximately $11.4 million and an increase to goodwill of approximately $10.1 million.

Adjusted Expense Ratio

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

	For the Years Ended December 31,		
	2007	**2006**	**2005**
Net earned premiums	$ 268,197	$ 254,920	$ 249,959
Less: Consolidated net loss and LAE	150,969	146,293	151,542
Intercompany claim fees	13,058	12,553	11,523
Unconsolidated net loss and LAE	164,027	158,846	163,065
Consolidated policy acquisition and other underwriting expenses	53,717	50,479	44,439
Intercompany administrative and other underwriting fees	37,890	37,442	39,231

Unconsolidated policy acquisition and other underwriting expenses	91,607	87,921	83,670
Underwriting income	$ 12,563	$ 8,153	$ 3,224

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	For the Years Ended December 31,		
	2007	**2006**	**2005**
GAAP combined ratio as reported	95.4%	96.8%	98.7%
Specialty risk management operations pre-tax income	$ 47,898	$ 38,292	$ 29,546
Less: Underwriting income	12,563	8,153	3,224
Net investment income and capital gains	26,550	22,144	18,142
Fee-based operations pre-tax income	8,785	7,995	8,180
Agency operations pre-tax income	2,087	2,609	3,241
Total fee-for-service pre-tax income	$ 10,872	$ 10,604	$ 11,421
GAAP expense ratio as reported	34.2%	34.5%	33.5%
Adjustment to include pre-tax income from total fee-for-service income(1)	4.1%	4.2%	4.6%
GAAP expense ratio as adjusted	**30.1%**	**30.3%**	**28.9%**
GAAP loss and LAE ratio as reported	61.2%	62.3%	65.2%
GAAP combined ratio as adjusted	91.3%	92.6%	94.1%
Reconciliation of consolidated pre-tax income:			
Specialty risk management operations pre-tax income:			
Fee-based operations pre-tax income	$ 8,785	$ 7,995	$ 8,180
Underwriting income	12,563	8,153	3,224
Net investment income and capital gains	26,550	22,144	18,142
Total specialty risk management operations pre-tax income	47,898	38,292	29,546
Agency operations pre-tax income	2,087	2,609	3,241
Less: Holding company expenses	2,638	2,830	2,892
Interest expense	6,030	5,976	3,856
Amortization expense	1,930	590	373
Consolidated pre-tax income	$ 39,387	$ 31,505	$ 25,666

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

Regulatory

A significant portion of our consolidated assets represent assets of our Insurance Company Subsidiaries. The State of Michigan Office of Financial and Insurance Services (OFIS), restricts the amount of funds that may be transferred to us in the form of dividends, loans or advances. These restrictions 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. At December 31, 2007, Star s earned surplus position was positive $33.7 million. At December 31, 2006, Star had positive earned surplus of $13.2 million. Based upon Star s statutory financial statements as of December 31, 2007, Star would have the potential to pay a dividend of up to $18.8 million without the prior approval of OFIS. No statutory dividends were paid during 2007 or 2006.

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Our Insurance Company Subsidiaries are required to maintain certain deposits with regulatory authorities, which totaled $115.2 million and $148.8 million at December 31, 2007 and 2006, respectively.

Contractual Obligations and Commitments

The following table is a summary of our contractual obligations and commitments as of December 31, 2007 (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)	$	$	$	$	$
Note Payable, non-interest bearing	4,300	2,150	2,150		
Long-Term Debt(2):					
Senior debentures due 2034; issued $13.0 million, April 2004 with variable interest	13,000				13,000
Senior debentures due 2034; issued $12.0 million, May 2004 with variable interest	12,000				12,000
Junior subordinated debentures due 2035; issued $20.6 million, September 2005, with variable interest	20,620				20,620
Junior subordinated debentures due 2033; issued $10.3 million, September 2003, with variable interest	10,310				10,310
Total Long-Term Debt	60,230	2,150	2,150		55,930
Interest Payable(3)					
Interest on Lines of Credit					
Interest on Long-Term Debt:					
Senior debentures due 2034; issued $13.0 million, April 2004 with variable interest	8,071	1,153	2,306	2,306	2,306
Senior debentures due 2034; issued $12.0 million, May 2004 with variable interest	7,722	1,092	2,200	2,215	2,215
	12,231	1,721	3,442	3,534	3,534

Junior subordinated debentures due 2035;
issued $20.6 million, September 2005,
with variable interest

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		Payments Due by Period			
	Total	**Less Than One Year**	**One to Three Years**	**Three to Five Years**	**More Than Five Years**
Junior subordinated debentures due 2033; issued $10.3 million, September 2003, with variable interest	6,411	916	1,831	1,832	1,832
Total Interest Payable	34,435	4,882	9,779	9,887	9,887
Operating lease obligations(4)	16,797	4,904	6,892	3,444	1,557
Regulated companies:					
Losses and loss adjustment expenses(5)	540,002	139,109	192,243	100,231	108,419
Total	$ 651,464	$ 151,045	$ 211,064	$ 113,562	$ 175,793

(1) Relates to our revolving line of credit.

(2) Five year call feature associated with debentures, estimated seven year repayment.

(3) For interest rate terms and actual rates on long-term debt in effect as of December 31, 2007, refer to the *Long-term Debt* section within *Other Items* of the *Liquidity and Capital Resources* section of Management s Discussion and Analysis. Estimates of interest expense for future periods are based on the most current interest rates in effect: on $13.0 million senior debentures at 8.87%; on $12.0 million senior debentures at 9.23%; on $20.6 million junior subordinated debentures at 8.57%; and on $10.3 million junior subordinated debentures at 8.88%. The assumption that the loans will be repaid at the end of seven years is based on management s best estimate of the life of the debentures.

In addition, there are two interest rate swaps associated with our long-term debt. The first interest rate swap relates to $5.0 million of our $12.0 million of senior debentures, which has a fixed interest rate of 8.925% with an ending date of May 24, 2009. The second interest rate swap relates to $20.0 million of our $20.6 million junior subordinated debentures, which has a fixed interest rate of 8.34% with an ending date of September 16, 2010.

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

(5) 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 $198.5 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 $31.5 million, $69.9 million, $46.1 million, and $51.0 million, respectively, resulting in net losses and loss adjustment expenses of $107.6 million, $122.4 million, $54.1 million, and $57.4 million, respectively.

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

Variable Compensation

We have established two variable compensation plans as an incentive for performance of our management team. They consist of an Annual Bonus Plan (Bonus Plan) and a Long-Term Incentive Plan (LTIP). The

MEADOWBROOK INSURANCE GROUP, INC.

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Bonus Plan is a discretionary cash bonus plan premised upon a targeted growth in net after-tax earnings on a year over year basis. Each year, the Compensation Committee and our Board of Directors establish a new target based upon prior year performance and the forecasted performance levels anticipated for the following year. The amount of the bonus pool is established by aggregating the individual targets for each participant, which is a percentage of salary. At the end of the year, the Compensation Committee and the Board of Directors review our performance in relation to performance targets and then establish the total bonus pool to be utilized to pay cash bonuses to the management team based upon overall corporate and individual participant goals.

The LTIP is intended to provide an incentive to management to improve our performance over a three year period, thereby increasing shareholder value. The LTIP is not discretionary and is based upon a target for an average three year return on beginning equity. If the targets are met and all other terms and conditions are satisfied, the LTIP awards are paid. The LTIP is paid 50% in cash and 50% in stock. A participant s percentage is established by the Compensation Committee and the Board of Directors in advance of any new three year LTIP award. The stock component of the LTIP is paid based upon the closing stock price at the beginning of the three year LTIP performance period, in accordance with the terms and conditions of the LTIP.

Both the Bonus Plan and the LTIP are administered by the Compensation Committee and all awards are reviewed and approved by the Board of Directors at both inception and at distribution.

Regulatory and Rating Issues

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.

At December 31, 2007, each of our Insurance Company Subsidiaries was in excess of any minimum threshold at which corrective action would be required.

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. As of December 31, 2007, on a statutory consolidated basis, gross and net premium leverage ratios were 1.8 to 1.0 and 1.5 to 1.0, respectively.

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. In 2007, our Insurance Company Subsidiaries did not generate any ratios that departed from the usual value range.

In April 2007, we received an upgrade of our financial strength rating by A.M. Best Company to A− (Excellent), from B++ (Very Good) for our Insurance Company Subsidiaries.

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.

In regard to our excess-of-loss reinsurance, we manage our credit risk on reinsurance recoverables by reviewing the financial stability, A.M. Best rating, capitalization, and credit worthiness of prospective or existing reinsurers. We generally do not seek collateral where the reinsurer is rated A− or better by A. M. Best, has $500 million or more in surplus, and is admitted in the state of Michigan. The following table sets forth information relating to our five largest unaffiliated excess-of-loss reinsurers based upon ceded premium as of December 31, 2007:

Reinsurer	Reinsurance Premium Ceded December 31, 2007 (In thousands)	Reinsurance Recoverable December 31, 2007 (In thousands)	A.M. Best Rating
Employers Reinsurance Corporation	$ 4,582	$ 84,880	A+
Munich American Reinsurance	5,653	12,269	A+
Aspen Insurance UK Ltd.	5,140	11,125	A
Motors Insurance Company	4,213	11,948	A−
Lloyds Syndicate Number 4472	3,832	5,324	A

In regard to our risk-sharing partners (client captive or rent-a-captive quota-share non-admitted reinsurers), we manage credit risk on reinsurance recoverables by reviewing the financial stability, capitalization, and credit worthiness of prospective or existing reinsures or 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.

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 years ending December 31, 2007 and 2006 (in thousands):

December 31, 2007	December 31, 2006
Risk	Risk

	Non Risk Sharing(1)	Sharing(2)	Total	Non Risk Sharing(1)	Sharing(2)	Total
Gross exposure	$ 4,959	$ 7,150	$ 12,109	$ 6,863	$ 7,952	$ 14,815
Collateral or other security	(1)	(3,114)	(3,115)	(170)	(3,453)	(3,623)
Allowance	(4,873)	(3,268)	(8,141)	(6,693)	(3,038)	(9,731)
Net exposure	$ 85	$ 768	$ 853	$	$ 1,461	$ 1,461

(1) Balances related to three unaffiliated insurance companies, which are under regulatory liquidation or control, for which allowances have been established; all other admitted reinsurers have an A.M. Best rating of A− or better.

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

(2) Balances related to risk-sharing partners, which have either captive or rent-a-captive quota-share reinsurance contracts with us.

Intercompany Pooling Agreement

Intercompany pooling or reinsurance 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. 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 agreed to cede and Savers, Ameritrust and Williamsburg have agreed to reinsure Star for their respective percentages of the liabilities and expenses of Star. Annually, we examine the Pooling Agreement for any changes to the ceded percentage for the liabilities and expenses. Any changes to the Pooling Agreement must be submitted to the applicable regulatory authorities for approval.

Off-Balance Sheet Arrangements

As of December 31, 2007, we have no off-balance sheet arrangements as defined in Item 303(a) (4) of Regulation S-K.

Convertible Note

In December 2005, we entered into a $6.0 million convertible note receivable with an unaffiliated insurance agency. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This agency has been a producer for us for over ten years. As security for the loan, the borrower granted us a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible upon our option based upon a pre-determined formula, beginning in 2008. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At December 31, 2007, the estimated fair value of the derivative is not material to the financial statements.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements.* SFAS No. 157 defines fair value and establishes a framework for measuring fair value in accordance with generally accepted accounting principles. SFAS No. 157 also requires expanded disclosures about (1) the extent to which companies measure assets and liabilities at fair value, (2) the methods and assumptions used to measure fair value and (3) the effect of fair value measures on earnings.

SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We will adopt SFAS No. 157 on January 1, 2008. We do not believe the adoption of SFAS No. 157 will have a material impact on our consolidated financial condition or results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115.* SFAS No. 159 permits entities the option to measure many financial instruments and certain other assets and liabilities at fair value on an

MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

instrument-by-instrument basis as of specified election dates. This election is irrevocable. The objective of SFAS No. 159 is to improve financial reporting and reduce the volatility in reported earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We did not elect the fair value option for existing eligible items under SFAS No. 159; therefore there will be no impact to our consolidated financial condition or results of operations.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*. SFAS No. 141(R) provides revised guidance on how an acquirer recognizes and measures in its financial statements, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. In addition, it provides revised guidance on the recognition and measurement of goodwill acquired in the business combination. SFAS No. 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141(R) is effective for business combinations completed on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, or January 1, 2009. We do not expect the provisions of SFAS No. 141(R) to have a material effect on our consolidated financial condition or results of operations.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51.* SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. We will evaluate the impact of SFAS No. 160, but believe the adoption of SFAS No. 160 will not impact our consolidated financial statements.

Related Party Transactions

At December 31, 2007 and 2006, respectively, we held an $870,000 and $871,000 note receivable, including $209,000 of accrued interest at December 31, 2007, from one of our executive officers. Accrued interest at December 31, 2006 was $210,000. 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 the rate charged pursuant to our revolving credit agreement and is due on demand any time after January 1, 2002. As of December 31, 2007, the rate was 6.2%. The loan is partially collateralized by 64,718 shares of our common stock under a stock pledge agreement. For the years ended December 31, 2007 and 2006, $43,800 and $31,500, respectively, have been paid against the accrued interest on 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, 2007, the cumulative amount that has been paid against this loan was $162,800. Refer to Note 16 *Related Party Transaction* for further information.

Subsequent Events

U.S. Specialty Underwriters, Inc.

In April 2007, we entered into an agreement to acquire the excess workers compensation business of U.S. Specialty Underwriters, Inc. (USSU) for a purchase price of $23.0 million. In addition, we entered into a Management Agreement with the former owners of USSU. Under the terms the Management Agreement, the former owners were responsible for certain aspects of the daily administration and management of the USSU business. Their consideration

for the performance of these duties was in the form of a management fee payable by us based on a share of net income before interest, taxes, depreciation, and amortization. We retained the option to terminate the Management Agreement, at our discretion, based on a multiple of the management fee calculated for the trailing twelve months.

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MEADOWBROOK INSURANCE GROUP, INC.

MANAGEMENT S DISCUSSION AND ANALYSIS continued

Effective January 31, 2008, we exercised this option to purchase the remainder of the economics related to the acquisition of the USSU business, by eliminating the Management Agreement for a payment of $21.5 million, which now completes the transaction. As a result of this purchase, we recorded an increase to other intangible assets of approximately $11.4 million and an increase to goodwill of approximately $10.1 million.

Merger Agreement with ProCentury Corporation

On February 20, 2008, we executed a definitive merger agreement with ProCentury Corporation (ProCentury) for a merger transaction valued at approximately $272.6 million in cash and stock to be paid to ProCentury shareholders. The combined entity will adopt and operate under the Meadowbrook name and will continue to trade on the NYSE under the ticker symbol MIG .

Each ProCentury shareholder will have the option to elect to receive cash or Meadowbrook stock, subject to proration so that the maximum total cash consideration will not exceed 45% of the total consideration paid in order to preserve the tax-free exchange of the stock consideration. As long as Meadowbrook s 30-day volume-weighted average price preceding the election date, which will be at least five days before the closing of the transaction, is between $8.00 and $10.50, the exchange ratio will vary such that the stock consideration equals $20.00 per share based on such 30-day average price. Above or below this range for Meadowbrook s stock price, the exchange ratio will be fixed as if the 30-day volume-weighted average price preceding the election date equaled $10.50 or $8.00, as applicable. Outstanding options to purchase ProCentury common shares will become fully vested and option holders can either exercise such options and, in connection with the closing, elect to receive the form of merger consideration described above for the ProCentury shares acquired on exercise or agree to have their options cancelled in exchange for a per share cash payment equal to the difference between $20.00 and the exercise price of their options.

We expect to finance the cash portion of the purchase price through a combination of cash and debt. Completion of the transaction is subject to various closing conditions, including the receipt of required regulatory and shareholder approvals. The transaction is expected to be completed in the third quarter of 2008.

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MEADOWBROOK INSURANCE GROUP, INC.

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, 2007. 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 a half and five and a half years. At December 31, 2007, our fixed income portfolio had a modified duration of 4.22, compared to 3.93 at December 31, 2006.

At December 31, 2007, the fair value of our investment portfolio was $610.8 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. We continued 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, 2006. We do not anticipate significant changes in our primary market risk exposures or in how those exposures are managed in future reporting periods based upon what is known or expected to be in effect.

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

	Rates Down 100bps	Rates Unchanged	Rates Up 100bps
Market Value	$ 637,372	$ 610,682	$ 582,995
Yield to Maturity or Call	3.28%	4.28%	5.28%
Effective Duration	4.14	4.42	4.68

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, 2007 and 2006, 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.

In October 2005, we entered into two interest rate swap transactions to mitigate our interest rate risk on $5.0 million and $20.0 million of our senior debentures and trust preferred securities, respectively. We accrue for these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities,* as subsequently amended. These interest rate swap transactions have been designated as a cash flow hedges and are deemed highly effective hedges under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of

MEADOWBROOK INSURANCE GROUP, INC.

any changes in 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 $35.0 million is subject to variable interest rates. Thus, our interest expense on the revolving line of credit is directly correlated to market interest rates. At December 31, 2007, we did not have an outstanding balance on this revolving line of credit. At December 31, 2006, we had $7.0 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 $70,000.

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***

None.

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, 2007, 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 and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures 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

MEADOWBROOK INSURANCE GROUP, INC.

over financial reporting as of December 31, 2007. 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, 2007, our internal controls over financial reporting was effective based on those criteria.

The attestation report of Ernst & Young LLP, our independent registered public accounting firm, regarding internal control over financial reporting is set forth in Item 8 of this Annual Report on Form 10-K under the caption Report of Independent Registered Public Accounting Firm and incorporated herein by reference.

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, 2007, 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, Executive Officers, and Corporate Governance***

The information required by this item is included under the captions *Information about the Nominees, the Incumbent Directors and Other Executive Officers, Corporate Governance, Code of Conduct,, 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 9, 2008, which is hereby incorporated by reference. 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 *Compensation of Executive Officers, Director Compensation, Report of the Compensation Committee of the Board on Executive Compensation,* and *Compensation Committee Interlocks and Insider Participation* of our Proxy Statement relating to our Annual Meeting of Shareholders to be held on May 9, 2008, which is hereby incorporated by reference.

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 9, 2008, which is hereby incorporated by reference.

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MEADOWBROOK INSURANCE GROUP, INC.

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	132,052	$ 14.51	771,468
Equity compensation plans not approved by security holders			
Total	132,052	$ 14.51	771,468

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

The information required by this item is included under the captions Certain *Relationships and Related Party Transactions* and *Independence Determination* of our Proxy Statement relating to our Annual Meeting of Shareholders to be held on May 9, 2008, 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 on Ratification of Appointment of Independent Registered Public Accounting Firm* of our Proxy Statement relating to our Annual Meeting of Shareholders to be held on May 9, 2008, which is hereby incorporated by reference.

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	72
	Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting	73
	Consolidated Balance Sheet December 31, 2007 and 2006	74
	Consolidated Statement of Income For Years Ended December 31, 2007, 2006, and 2005	75
	Consolidated Statement of Comprehensive Income For Years Ended December 31, 2007, 2006, and 2005	76
	Consolidated Statement of Shareholders Equity For Years Ended December 31, 2007, 2006, and 2005	77
	Consolidated Statement of Cash Flows For Years Ended December 31, 2007, 2006, and 2005	78
	Notes to Consolidated Financial Statements	79-109
2.	Financial Statement Schedules	
	Schedule I Summary of Investments Other Than Investments in Related Parties	110
	Schedule II Condensed Financial Information of Registrant	111-114
	Schedule III Supplementary Insurance Information	115-117
	Schedule IV Reinsurance	118
	Schedule V Valuation and Qualifying accounts	119
	Schedule VI Supplemental Information Concerning Property and Casualty Insurance Operations	120
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	

Management Services Agreement
Management Services Agreement
Land Contract Amendment
Compliance Program/Code of Conduct
List of Subsidiaries
Consent of Independent Registered Public Accounting Firm
Power of Attorney
Certification of Robert S. Cubbin, Chief Executive Officer, pursuant to Rule 13a-14(a)
Certification of Karen M. Spaun, Chief Financial Officer, pursuant to Rule 13-14(a)
Certification pursuant to Section 906, signed by Robert S. Cubbin, Chief Executive Officer
Certification pursuant to Section 906, signed by Karen M. Spaun, Chief Financial Officer

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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 sheets of Meadowbrook Insurance Group, Inc. as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2007. Our audits 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 audits.

We conducted our audits 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 audits provide 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, 2007 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2007, 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), Meadowbrook Insurance Group, Inc. s internal control over financial reporting as of December 31, 2007, 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 14, 2008 expressed an unqualified opinion thereon.

Detroit, Michigan
March 14, 2008

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited Meadowbrook Insurance Group, Inc. s internal control over financial reporting as of December 31, 2007 based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Meadowbrook Insurance Group, Inc. 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 included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on 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, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, 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, Meadowbrook Insurance Group, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, 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 sheets of Meadowbrook Insurance Group, Inc. as of December 31, 2007 and 2006, and the related consolidated statements of income, comprehensive income, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2007 and our report dated March 14, 2008 expressed an unqualified opinion thereon.

Detroit, Michigan
March 14, 2008

MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED BALANCE SHEET

	December 31, 2007	2006
	(In thousands, except share data)	
ASSETS		
Investments		
Debt securities available for sale, at fair value (amortized cost of $604,829 and $486,213 in 2007 and 2006, respectively)	$ 610,756	$ 484,724
Cash and cash equivalents	40,845	42,876
Accrued investment income	6,473	5,884
Premiums and agent balances receivable (net of allowance of $2,747 and $2,948 in 2007 and 2006, respectively)	87,341	85,578
Reinsurance recoverable on:		
Paid losses	1,053	4,257
Unpaid losses	198,461	198,422
Prepaid reinsurance premiums	17,763	20,425
Deferred policy acquisition costs	26,926	27,902
Deferred income taxes, net	14,936	15,732
Goodwill	43,497	31,502
Other assets	65,915	51,698
Total assets	$ 1,113,966	$ 969,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities		
Losses and loss adjustment expenses	$ 540,002	$ 501,077
Unearned premiums	153,927	144,575
Debt		7,000
Debentures	55,930	55,930
Accounts payable and accrued expenses	22,604	25,384
Reinsurance funds held and balances payable	16,416	15,124
Payable to insurance companies	6,231	5,442
Other liabilities	16,962	12,775
Total liabilities	812,072	767,307
Shareholders Equity		
Common stock, $0.01 stated value; authorized 75,000,000 shares; 36,996,287 and 29,107,818 shares issued and outstanding	370	291
Additional paid-in capital	194,621	126,828

Retained earnings	104,274	76,282
Note receivable from officer	(870)	(871)
Accumulated other comprehensive income (loss)	3,499	(837)
Total shareholders equity	301,894	201,693
Total liabilities and shareholders equity	$ 1,113,966	$ 969,000

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

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MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENT OF INCOME

	For the Years Ended December 31,		
	2007	2006	2005
	(In thousands, except share and per share data)		
Revenues			
Premiums earned			
Gross	$ 337,099	$ 327,287	$ 325,522
Ceded	(68,902)	(72,367)	(75,563)
Net earned premiums	268,197	254,920	249,959
Net commissions and fees	45,988	41,172	35,916
Net investment income	26,400	22,075	17,975
Net realized gains	150	69	167
Total revenues	340,735	318,236	304,017
Expenses			
Losses and loss adjustment expenses	191,885	212,383	237,775
Reinsurance recoveries	(40,916)	(66,090)	(86,233)
Net losses and loss adjustment expenses	150,969	146,293	151,542
Salaries and employee benefits	56,433	54,569	51,331
Policy acquisition and other underwriting expenses	53,717	50,479	44,439
Other administrative expenses	32,269	28,824	26,810
Amortization expense	1,930	590	373
Interest expense	6,030	5,976	3,856
Total expenses	301,348	286,731	278,351
Income before taxes and equity earnings	39,387	31,505	25,666
Federal and state income tax expense	11,726	9,599	7,757
Equity earnings of affiliates	331	128	1
Net income	$ 27,992	$ 22,034	$ 17,910
Earnings Per Share			
Basic	$ 0.85	$ 0.76	$ 0.62
Diluted	$ 0.85	$ 0.75	$ 0.60
Weighted average number of common shares			
Basic	33,007,200	28,963,228	28,961,229
Diluted	33,101,965	29,566,141	29,653,067

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

MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	For the Years Ended December 31,		
	2007	2006	2005
		(In thousands)	
Net income	$ 27,992	$ 22,034	$ 17,910
Other comprehensive income, net of tax:			
Unrealized gains (losses) on securities	4,810	152	(6,023)
Net deferred derivative (loss) gain hedging activity	(484)	121	9
Less: reclassification adjustment for gains included in net income	10	20	56
Other comprehensive income (loss)	4,336	293	(5,958)
Comprehensive income	$ 32,328	$ 22,327	$ 11,952

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, 2007, 2006, and 2005					
	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, 2005	$ 290	$ 126,085	$ 37,175	$ (868)	$ 4,828	$ 167,510
Unrealized depreciation on available for sale securities					(5,967)	(5,967)
Deconsolidation of subsidiary					9	9
Long term incentive plan; 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
Unrealized depreciation on available for sale securities					172	172
Net deferred derivative gain hedging activity					121	121
Long term incentive plan; stock award		897				897
Stock-based employee compensation		121				121
Issuance of 791,038 shares of common stock	8	4,153				4,161
Retirement of 355,229 shares of common stock	(4)	(3,162)				(3,166)
Note receivable from an officer				(12)		(12)
Net income			22,034			22,034
Balances December 31, 2006	291	126,828	76,282	(871)	(837)	201,693
					4,820	4,820

Unrealized appreciation on available for sale securities						
Net deferred derivative gain hedging activity					(484)	(484)
Long term incentive plan; stock award for 2007-2009 plan years		772				772
Long term incentive plan; stock award for 2004-2006 plan years	4	(1,845)				(1,841)
Stock-based employee compensation		2				2
Issuance of 244,574 shares of common stock	3	1,373				1,376
Retirement of 89,466 shares of common stock	(1)	(1,020)				(1,021)
Equity offering issuance of 6,437,500 shares of common stock	64	58,520				58,584
Issuance of 907,935 shares of common stock for acquisition of business of USSU	9	9,991				10,000
Note receivable from an officer				1		1
Net income			27,992			27,992
Balances December 31, 2007	$ 370	$ 194,621	$ 104,274	$ (870)	$ 3,499	$ 301,894

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

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MEADOWBROOK INSURANCE GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Years Ended December 31,		
	2007	2006	2005
	(In thousands)		
Cash Flows From Operating Activities			
Net income	$ 27,992	$ 22,034	$ 17,910
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of other intangible assets	1,930	590	198
Amortization of deferred debenture issuance costs	353	236	175
Depreciation of furniture, equipment, and building	3,147	2,553	2,452
Net accretion of discount and premiums on bonds	2,707	2,646	2,395
Gain on sale of investments	16	30	86
Gain on sale of fixed assets	(88)	(88)	(170)
Stock-based employee compensation	2	121	41
Incremental tax benefits from stock options exercised	(728)	(1,532)	
Long term incentive plan expense	772	897	923
Deferred income tax expense	(1,538)	741	1,347
Changes in operating assets and liabilities:			
Decrease (increase) in:			
Premiums and agent balances receivable	2,111	(771)	(713)
Reinsurance recoverable on paid and unpaid losses	3,166	(98)	(33,513)
Prepaid reinsurance premiums	2,662	4,162	1,488
Deferred policy acquisition costs	976	(1,531)	(1,204)
Other assets	13	(1,044)	5,612
Increase (decrease) in:			
Losses and loss adjustment expenses	38,925	42,400	80,521
Unearned premiums	9,352	3,585	6,688
Payable to insurance companies	789	(1,242)	(307)
Reinsurance funds held and balances payable	1,292	(116)	(2,591)
Other liabilities	(5,244)	718	609
Total adjustments	60,615	52,257	64,037
Net cash provided by operating activities	88,607	74,291	81,947
Cash Flows From Investing Activities			
Purchase of debt securities available for sale	(393,676)	(201,920)	(203,789)
Proceeds from sale of equity securities available for sale			8
Proceeds from sales and maturities of debt securities available for sale	272,337	116,978	122,317
Capital expenditures	(3,109)	(4,850)	(15,810)
Purchase of books of business	(3,344)	(834)	(3,557)

Acquisition of U.S. Specialty Underwriters, Inc.	(12,644)		
Proceeds from sale of assets			633
Loan receivable	(310)	(202)	(5,905)
Net cash deposited in funds held	344	529	501
Net cash used in investing activities	(140,402)	(90,299)	(105,602)
Cash Flows From Financing Activities			
Proceeds from lines of credit	19,025	14,078	14,307
Payment of lines of credit	(26,025)	(14,078)	(19,451)
Book overdrafts	(39)	142	924
Cash payment for payroll taxes associated with long-term incentive plan net stock issuance	(1,841)		
Net proceeds from debentures			19,400
Stock options exercised	(374)	(538)	1,092
Share repurchases of common stock			(4,191)
Incremental tax benefits from stock options exercised	728	1,532	
Net proceeds received from public equity offering	58,585		
Other financing activities	(295)	(290)	(263)
Net cash provided by financing activities	49,764	846	11,818
Net decrease in cash and cash equivalents	(2,031)	(15,162)	(11,837)
Cash and cash equivalents, beginning of year	42,876	58,038	69,875
Cash and cash equivalents, end of year	$ 40,845	$ 42,876	$ 58,038
Supplemental Disclosure of Cash Flow Information:			
Interest paid	$ 5,894	$ 5,616	$ 3,428
Net income taxes paid	$ 11,557	$ 9,159	$ 6,404
Supplemental Disclosure of Non Cash Investing and Financing Activities:			
Tax benefit from stock options	$ 728	$ 1,532	$ 105
Stock-based employee compensation	$ 2	$ 121	$ 41
Common stock portion of purchase price for acquisition of U.S. Specialty Underwriters, Inc.	$ 10,000	$	$

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

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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. (PICL). The consolidated financial statements also include Meadowbrook, Inc., Crest Financial Corporation, and their subsidiaries. As of December 31, 2007, PICL was deregulated under Bermuda law and merged into Meadowbrook, Inc s subsidiary, Meadowbrook Risk Management, Ltd.

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 Insurance Company, Ltd. (American Indemnity). While the Company and its subsidiary Star are the common shareholders, they are not the primary beneficiaries of American Indemnity. The consolidated financial statements, however, include the equity earnings of American Indemnity.

Business

The Company, through its subsidiaries, is engaged primarily in developing and managing specialty 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 client 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. Insurance 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.

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Reclassifications

The Company s Note 5 *Segment Information* of the Notes to Consolidated Financial Statements for the years ended December 31, 2006 and 2005, previously reported, had a change in allocation. The agency operations of the Company s segment information include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The Company s agency Insurance & Benefits Consultants allocation was previously included in specialty risk management operations. The effect of this reclassification was a reduction in agency operations and an increase in specialty risk management operations pre-tax income for the years ended December 31, 2006 and 2005 of $342,000 and $102,000, respectively. The Company s Note 5 *Segment Information* has been restated to reflect this reclassification.

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, 2007 and 2006, 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.

The Company s investment portfolio includes investments in mortgage-backed and agency-backed securities, however the Company does not have any direct exposure to any sub-prime risks. The Company s asset-backed securities sector comprises only 4.2%, or $26.6 million of its investment portfolio. Within this sector, $2.8 million relates to home equity loans, of which $1.2 million is insured. The remaining $23.8 million primarily relates to credit cards, auto loans, and utility and equipment loans. These asset-backed securities are adequately collateralized, AAA- rated investment quality that the Company currently expects will continue to perform. The Company s mortgage-backed securities have no exposure to any sub-prime risks.

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

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

other than temporarily impaired are written down to their estimated net fair value and the related losses are recognized in operations. There were no impaired investments written down in 2007, 2006, and 2005.

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 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, therefore there is no delay or lag in reporting of losses from a ceding company, and IBNR is determined utilizing various actuarial methods based upon historical data. Ultimate reserve estimates related to assumed business from residual markets are provided by individual states on a two quarter lag 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 both 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 significant changes in key assumptions during 2007, 2006 and 2005.

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, 2007, total assumed written premiums were $39.2 million, of which $31.0 million, relates to assumed business the Company manages directly. The remaining $8.2 million of assumed written premiums relates to residual markets and mandatory assumed pool 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 pool cedes workers compensation business to participating companies based upon the individual company s market share by state.

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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.

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. Any commission adjustments that occur subsequent to the earnings process are recognized upon notification from the insurance companies. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

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

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, 2007, 2006 and 2005.

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, 2007 and 2006, the Company had $1.3 million and $996,000 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

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 being amortized over a five-year period.

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, 2007, the Company had a net deferred tax asset of $14.9 million. Realization of the deferred tax asset is dependent upon generating sufficient taxable income to absorb the applicable reversing temporary differences. At December 31, 2007, management concluded the positive evidence supporting the generation of future taxable income sufficient to recognize the deferred tax asset, without a valuation allowance. This positive evidence includes cumulative pre-tax income of $96.6 million for the three years ended December 31, 2007.

Stock Options

Effective January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment,* using the modified prospective application transition method. The Company previously adopted the requirements of recording stock options consistent with SFAS 123 and accounting for the change in accounting principle using the prospective method in accordance with SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123.* Under the prospective method, stock-based compensation expense was recognized for awards granted after the beginning of the fiscal year in which the change is made, or January 1, 2003. Upon implementation of SFAS No. 148 in 2003, the Company recognized 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 APB Opinion No. 25. Under the intrinsic value method, compensation expense is determined on the measurement date, which is the first date when both the number of shares the employee is entitled to receive, and the exercise price are known. Compensation expense for each quarter resulting from stock options granted by the Company was determined based upon 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.

Upon adoption of SFAS No. 123(R) on January 1, 2006, the Company was required to recognize as an expense in the financial statements all share-based payments to employees based on their fair values. SFAS No. 123(R) requires forfeitures to be estimated in calculating the expense relating to the share-based payments, as opposed to recognizing any forfeitures and the corresponding reduction in expense as they occur. In addition, SFAS No. 123(R) requires any tax savings resulting from tax deductions in excess of compensation expense be reflected in the financial statements as a cash inflow from financing activities, rather than as an operating cash flow as in prior periods. The pro forma disclosures previously permitted under SFAS 123, are no longer an alternative to financial statement recognition. As indicated, the Company adopted the requirements of SFAS 123(R) using the modified prospective application transition method. The prospective method requires compensation expense to be recorded for all unvested stock

options and restricted stock, based upon the previously disclosed SFAS 123 methodology and amounts.

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

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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. The Company has not issued any new stock options to employees since 2003.

Results for the year ended 2005 have not been restated. 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, would have been as follows (in thousands):

	2005
Net income, as reported	$ 17,910
Add: Stock-based employee compensation expense included in reported income, net of related tax effects	27
Deduct: Total stock-based employee compensation expense determined under fair-value-based methods for all awards, net of related tax effects	(108)
Pro forma net income	$ 17,829
Earnings per share:	
Basic as reported	$ 0.62
Basic pro forma	$ 0.62
Diluted as reported	$ 0.60
Diluted pro forma	$ 0.60

Compensation expense of $2,000 and $121,000 has been recorded for the years ended December 31, 2007 and 2006 under SFAS 123(R), respectively. Compensation expense of $41,000 was recorded for the years ended December 31, 2005 under SFAS 148, respectively.

Long Term Incentive Plan

In 2004, the Company adopted 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 a three-year performance period, and if the performance targets for that period are achieved, the Compensation Committee of the Board of Directors shall determine the amount of LTIP awards that are payable to participants in the LTIP for the current performance period. One-half of any LTIP award will be payable in cash and one-half of the award will be payable in the form of a stock award. If the Company achieves the performance targets for the three-year performance period, payment of the cash portion of the award would be made in three annual installments, with the first payment being paid as of the end of the that performance period and the remaining two payments to be paid in the subsequent two years. Any unpaid portion of a cash award is subject to forfeiture if the participant voluntarily leaves the Company or is discharged for cause. The portion of the award to be paid in the form of stock will be issued as of the end of that performance period. The number of shares of Company s common stock subject to the stock award shall

equal the dollar amount of one-half of the LTIP award divided by the fair market value of Company s common stock on the first date of the beginning of the performance period. The stock awards shall be made subject to the terms and conditions of the LTIP and Plans. The Company accrues awards based upon the criteria set-forth and approved by the Compensation Committee of the Board of Directors, as included in the LTIP.

Deferred Compensation Plan

In 2006, the Company adopted an Executive Nonqualified Excess Plan (the Excess Plan). The Excess Plan is intended to be a nonqualified deferred compensation plan that will comply with the provisions of

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Section 409A of the Internal Revenue Code. The Company adopted the Excess Plan to provide a means by which certain key management employees may elect to defer receipt of current compensation from the Company in order to provide retirement and other benefits, as provided for in the Excess Plan. The Excess Plan is intended to be an unfunded plan maintained primarily for the purpose of providing deferred compensation benefits for eligible employees.

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.

Outstanding options of 98,807, 112,959, and 534,201 for the periods ended December 31, 2007, 2006, and 2005, 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 16,495, 126,660, and 298,851 for the years ended December 31, 2007, 2006, and 2005, respectively. Shares related to the LTIP included in diluted earnings per share were 78,270, 476,252, and 392,988 for the years ended December 31, 2007, 2006 and 2005, respectively.

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

During 2005, the Company entered into two interest rate swap transactions in order to mitigate its interest rate risk. The Company accounts for these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities,* as subsequently amended. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges under SFAS No. 133. Under SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. 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, 2007, the estimated fair value of the derivative was not material to the financial statements.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements.* SFAS No. 157 defines fair value and establishes a framework for measuring fair value in accordance with generally accepted accounting principles. SFAS No. 157 also requires expanded disclosures about (1) the extent to which companies measure assets and liabilities at fair value, (2) the methods and assumptions used to measure fair value and (3) the effect of fair value measures on earnings.
SFAS No. 157 is effective for fiscal years beginning after November 15, 2007.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company will adopt SFAS No. 157 on January 1, 2008. The Company does not believe the adoption of SFAS No. 157 will have a material impact on its consolidated financial condition or results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115.* SFAS No. 159 permits entities the option to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis as of specified election dates. This election is irrevocable. The objective of SFAS No. 159 is to improve financial reporting and reduce the volatility in reported earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company did not elect the fair value option for existing eligible items under SFAS No. 159; therefore there will be no impact to its consolidated financial condition or results of operations.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*. SFAS No. 141(R) provides revised guidance on how an acquirer recognizes and measures in its financial statements, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. In addition, it provides revised guidance on the recognition and measurement of goodwill acquired in the business combination. SFAS No. 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141(R) is effective for business combinations completed on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, or January 1, 2009. The Company does not expect the provisions of SFAS No. 141(R) to have a material effect on its consolidated financial condition or results of operations.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51.* SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The Company will evaluate the impact of SFAS No. 160, but believes the adoption of SFAS No. 160 will not impact its consolidated financial condition or results of operations.

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, 2007 and 2006 are as follows (in thousands):

	December 31, 2007			
	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	$ 53,436	$ 1,541	$ (29)	$ 54,948
Obligations of states and political subdivisions	287,392	3,329	(323)	290,398

Corporate securities	116,406	1,941	(928)	117,419
Mortgage and asset-backed securities	147,595	1,011	(615)	147,991
Total Debt Securities available for sale	$ 604,829	$ 7,822	$ (1,895)	$ 610,756

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	December 31, 2006			
	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	$ 52,991	$ 282	$ (521)	$ 52,752
Obligations of states and political subdivisions	221,296	1,840	(1,460)	221,676
Corporate securities	102,365	1,368	(1,515)	102,218
Mortgage and asset-backed securities	109,561	143	(1,626)	108,078
Total Debt Securities available for sale	$ 486,213	$ 3,633	$ (5,122)	$ 484,724

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

	December 31,	
	2007	2006
Unrealized appreciation	$ 7,822	$ 3,633
Unrealized depreciation	(1,895)	(5,122)
Net unrealized appreciation (depreciation)	5,927	(1,489)
Deferred federal income tax (expense) benefit	(2,075)	521
Net unrealized appreciation (depreciation) on investments, net of deferred federal income taxes	$ 3,852	$ (968)

The gross realized gains and gross realized losses on the sale of available for sale debt securities were $88,000 and $252,000, respectively, for the year ended December 31, 2007. The proceeds from the sale of debt securities were $222.4 million.

The gross realized gains and gross realized losses on the sale of available for sale debt securities were $0 and $30,000, respectively, for the year ended December 31, 2006. The proceeds from the sale of debt securities were $77.3 million.

The gross realized gains and gross realized losses on the sale of available for sale debt securities were $47,000 and $142,000, respectively, for the year ended December 31, 2005. The gross realized gains and gross realized losses on the sale of available for sale equity securities were $8,000 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 $8,000, respectively.

At December 31, 2007, 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

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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	$ 35,891	$ 35,893
Due after one year through five years	172,396	174,508
Due after five years through ten years	184,612	187,294
Due after ten years	64,365	65,100
Mortgage-backed securities	147,565	147,961
	$ 604,829	$ 610,756

Net investment income for the three years ended December 31, 2007, 2006, and 2005 was as follows (in thousands):

	2007	2006	2005
Net Investment Income Earned From:			
Debt securities	$ 23,746	$ 19,376	$ 16,080
Equity securities	25		37
Cash and cash equivalents	3,224	3,279	2,291
Total gross investment income	26,995	22,655	18,408
Less investment expenses	595	580	433
Net investment income	$ 26,400	$ 22,075	$ 17,975

United States government obligations, municipal bonds, and bank certificates of deposit aggregating $115.2 million and $148.8 million were on deposit at December 31, 2007 and 2006, respectively, with state regulatory authorities or otherwise pledged as required by law or contract.

Other Than Temporary Impairments of Securities and Unrealized Losses on Investments

At December 31, 2007 and 2006, the Company had 160 and 293, securities that were in an unrealized loss position, respectively. These investments each had unrealized losses of less than ten percent of the amortized cost of the investment. At December 31, 2007, 128 of those investments, with an aggregate $122.2 million and $1.3 million fair value and unrealized loss, respectively, have been in an unrealized loss position for more than eighteen months. At December 31, 2006, 128 of those investments, with an aggregate $127.3 million and $3.1 million fair value and

unrealized loss, respectively, have been in an unrealized loss position for more than eighteen months. Positive evidence considered in reaching the Company s conclusion that the investments in an unrealized loss position are not other than temporarily impaired consisted of: 1) there were no specific events which caused concerns; 2) there were no past due interest payments; 3) there has been a rise in market prices; 4) the Company s ability and intent to retain the investment for a sufficient amount of time to allow an anticipated recovery in value; and 5) changes in market value were considered normal in relation to overall fluctuations in interest rates.

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	December 31, 2007					
	Less than 12 months		Greater than 12 months		Total	
	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses
Debt Securities:						
Debt securities issued by U.S. government and agencies	$	$	$ 5,963	$ (29)	$ 5,963	$ (29)
Obligations of states and political subdivisions	19,400	(68)	45,177	(255)	64,577	(323)
Corporate securities	15,564	(415)	30,601	(513)	46,165	(928)
Mortgage and asset backed securities	9,116	(95)	47,963	(520)	57,079	(615)
Totals	$ 44,080	$ (578)	$ 129,704	$ (1,317)	$ 173,784	$ (1,895)

	December 31, 2006					
	Less than 12 months		Greater than 12 months		Total	
	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses
Debt Securities:						
Debt securities issued by U.S. government and agencies	$ 14,586	$ (61)	$ 27,076	$ (460)	$ 41,662	$ (521)
Obligations of states and political subdivisions	45,726	(210)	68,958	(1,250)	114,684	(1,460)
Corporate securities	7,646	(61)	55,520	(1,454)	63,166	(1,515)
Mortgage and asset backed securities	20,462	(91)	67,495	(1,535)	87,957	(1,626)

Totals	$	88,420	$	(423)	$	219,049	$	(4,699)	$	307,469	$	(5,122)

During 2006 the Company issued 143,845 shares of common stock as a result of warrant exercises for total proceeds of $8,857.

During 2006, pursuant to the Merger (see Note 2), the Company acquired a total of 885,351 warrants for common stock which were outstanding at the time of the Merger. Additionally, in connection with the Merger, certain stockholders of TPTX, Inc. received 1,500,000 warrants to purchase TorreyPines common stock at an exercise price of $8.32. In accordance with EITF 00-19, Accounting for Derivative Financial

TorreyPines Therapeutics, Inc.
Notes to Consolidated Financial Statements (Continued)
December 31, 2006

9. Stockholders (Deficit) Equity (Continued)

Instruments Indexed to, and Potentially Settled in, a Company s Own Stock , the Company has classified the warrants as liability, and has valued the warrants using the Black-Scholes model as of the date of issuance. The fair value of the warrants is remeasured quarterly and a warrant valuation adjustment is recorded to the income statement.

As of December 31, 2006, the warrants were recorded as a current liability at a fair value of $4,815,000. The warrants were valued using the Black-Scholes model assuming a risk free interest rate at 4.7%, an expected dividend yield of 0%, expected volatility of 69% and an expected life of the warrants of 2.75 years. For the year ended December 31, 2006, we recorded $240,000 in expense as a warrant valuation adjustment.

As of December 31, 2006, outstanding warrants to acquire shares of the Company s common stock are as follows:

Number of Shares	Exercise Price	Expiration Date
54,139	$ 5.50	December 31, 2007
25,000	8.00	January 15, 2008
316,078	28.00	September 11, 2008
370,916	58.00	January 8, 2009
119,218	68.00	May 3, 2009
1,500,000	8.32	October 3, 2009
12,992	9.24	July 1, 2010
6,246	5.60	December 7, 2010
59,544	9.24	September 26, 2015
2,464,133		

The weighted average exercise price of warrants outstanding at December 31, 2006 was $21.16 and the weighted average remaining contractual life of the warrants was 2.59 years.

Stock Options and Restricted Stock Units

Various employees, directors, and consultants have been granted options to purchase common shares under an equity incentive plans adopted in 2000 and 2006 (the 2000 Plan and the 2006 Plan). The 2000 Plan provides for the grant of up to 973,588 stock options. Options granted under this plan generally expire no later than 10 years from the date of grant (five years for a 10% stockholder). Options generally vest and become fully exercisable over a period of four years. The exercise price of incentive stock options must be equal to at least the fair market value of the Company s common stock on the date of grant, and the exercise price of nonstatutory stock options may be no less than 85% of the fair value of the Company s common stock on the date of grant. The exercise price of any option granted to a 10% stockholder may be no less than 110% of the fair value of the Company s common stock on the date of grant.

TorreyPines Therapeutics, Inc.
Notes to Consolidated Financial Statements (Continued)
December 31, 2006

9. Stockholders (Deficit) Equity (Continued)

The 2006 Plan provides for the grant of up to 1,875,000 stock options. Options granted under this plan generally expire no later than 10 years from the date of grant (five years for a 10% stockholder). Options generally vest and become fully exercisable over a period of four years. The exercise price of stock options must be equal to at least the fair market value of the Company s common stock on the date of grant. The exercise price of any option granted to a 10% stockholder may be no less than 110% of the fair value of the Company s common stock on the date of grant. Restricted stock units granted under the 2006 Plan are generally performance based awards and vest upon the achievement of defined performance targets over a specified period.

At December 31, 2006, stock options to purchase 1,001,902 shares of common stock were vested and exercisable and 1,554,256 shares remain available for future grant under the 2006 Plan. There are no shares available for future grant under the 2000 Plan.

The following table summarizes the Company s stock option activity and related information through December 31, 2006:

	Shares	Price per share	Weighted Average Exercise Price Per Share
Outstanding at December 31, 2003	483,612	$0.62 1.24	$ 0.87
Granted	146,647	1.24	1.24
Exercised	(10,826)	0.62 0.93	0.81
Canceled	(4,797)	0.62 1.24	1.08
Outstanding at December 31, 2004	614,636	0.62 1.24	0.96
Granted	288,419	1.24	1.24
Exercised	(31,447)	0.62 1.23	0.96
Canceled	(15,484)	0.93 1.24	1.19
Outstanding at December 31, 2005	856,124	0.62 1.24	1.05
Granted	216,250	1.48 6.37	5.23
Exercised	(329,965)	0.62 1.24	1.01
Canceled	(6,362)	1.24	1.24
Acquired in the Merger	671,530	0.16 92.00	29.97
Outstanding at December 31, 2006	1,407,577	$0.16 92.00	$ 15.50
Vested and exercisable at December 31, 2006	1,001,902		$ 20.41

The weighted-average remaining contractual life of options outstanding and exercisable was 6.6 and 5.7 years as of December 31, 2006 and 2005, respectively. The weighted-average grant-date fair value of options during the years ended December 31, 2006, 2005 and 2004, were $3.45, $0.12 and $0.12, per share, respectively.

TorreyPines Therapeutics, Inc.
Notes to Consolidated Financial Statements (Continued)
December 31, 2006

9. Stockholders (Deficit) Equity (Continued)

The following table summarizes information concerning outstanding and exercisable stock options as of December 31, 2006:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Number Outstanding	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price
$0.16-$0.62	41,710	3.3	$ 0.55	41,710	$ 0.55
$0.93-$0.93	206,987	5.3	0.93	206,987	0.93
$1.24-$1.24	277,350	8.1	1.24	79,805	1.24
$1.48-$1.48	50,506	9.2	1.48	8,120	1.48
$6.37-$6.37	165,744	10.0	6.37		
$6.60-$9.44	146,491	7.7	7.98	146,491	7.98
$9.68-$23.12	141,450	4.7	17.11	141,450	17.11
$24.48-$33.92	165,217	5.6	28.38	165,217	28.38
$36.16-$57.60	141,497	5.4	47.71	141,497	47.71
$63.28-$92.00	70,625	3.6	72.14	70,625	72.14
$0.16-$92.00	1,407,577	6.6	$ 15.50	1,001,902	20.41

During the year ended December 31, 2006 the Company granted 185,000 restricted stock units to management and a consultant, of which 30,000 units were canceled (see Note 10).

The following shares of common stock are reserved for future issuance at December 31, 2006:

Warrants	2,464,133
Stock options and restricted stock units:	
Stock options issued and outstanding	1,407,577
Restricted stock units issued and outstanding	155,000
Available for grant	1,554,256
Total common stock reserved for future issuance	5,580,966

TorreyPines Therapeutics, Inc.
Notes to Consolidated Financial Statements (Continued)
December 31, 2006

10. Stock-Based Compensation

For the year ended December 31, 2006, the application of SFAS No. 123R resulted in the following adjustments to amounts that would have been reported under previous accounting standards:

	Year Ended December 31, 2006 Under Previous Accounting	SFAS No. 123R Adjustments	As Reported Under SFAS No. 123R
Operating expenses:			
Research and development	22,277,312	75,095	22,352,407
General and administrative	3,907,063	63,952	3,971,015
Loss from operations	(24,662,734)	(139,047)	(24,801,781)
Net loss attributable to common stockholders	(25,237,900)	(139,047)	(25,376,947)
Basic and diluted net loss per share attributable to common stockholders	$ (8.14)	$ (0.04)	$ (8.18)

Stock Options

For purposes of calculating the stock-based compensation under SFAS No. 123R, the Company estimates the fair value of stock options using a Black-Scholes option-pricing model which is consistent with the model used for pro forma disclosures under SFAS No. 123 prior to the adoption of SFAS No. 123R. The Black-Scholes option-pricing model incorporates various and highly sensitive assumptions including expected volatility, expected term and interest rates. In accordance with SFAS No. 123R share-based compensation expense recognized in the consolidated statement of operations for 2006 is based on awards ultimately expected to vest and is reduced for estimated forfeitures. The assumptions used to estimate the fair value of stock options granted to employees and directors are listed below for the twelve months ended December 31, 2006.

	Twelve Months Ended December 31, 2006
Expected Volatility	69.0 %
Risk-Free Interest Rate	4.55-5.00 %
Forfeitures	0.00-11.81 %
Dividend Yield	
Expected Term (in years)	6.1

The estimated volatility reflects the application of the SEC s SAB No. 107, *Share-Based Payment*, incorporating the historical volatility of comparable companies whose share prices are publicly available. The weighted average expected life of options was calculated using the simplified method as prescribed by SAB No. 107. This decision was based on the lack of relevant historical data due to the Company s limited historical experience. The risk-free interest rate assumption was based on the U.S. Treasury s rates for U.S. Treasury securities with maturities similar to those of the expected term of the award being valued. The assumed dividend yield was based on the Company s expectation of not paying dividends in the foreseeable future.

TorreyPines Therapeutics, Inc.
Notes to Consolidated Financial Statements (Continued)
December 31, 2006

10. Stock-Based Compensation (Continued)

The total intrinsic value of options exercised for the three years ended December 31, 2006 was $223,014, $0 and $0, respectively. The intrinsic value of options exercised represents the difference between the market price of the stock on the date of the exercise and the exercise price multiplied by the number of options. The intrinsic value of vested and unvested stock options as of December 31, 2006 was $2,190,423 and $1,630,406, respectively; the aggregate intrinsic value of all options outstanding as of December 31, 2006 was $3,820,829. The aggregate intrinsic value represents the difference between the fair market value of our common stock as of December 31, 2006, which was $7.38 per share, and the weighted exercise price of all in-the-money options multiplied by the number of options outstanding. The total fair value of shares vested during 2006 was $128,074.

Restricted Stock Units

On December 14, 2006, the Company granted 185,000 restricted stock units with market conditions. As of December 31, 2006 there were 155,000 restricted stock units that were outstanding. These restricted stock units will vest on March 31, 2009, provided that the Company s average closing stock price for the 6-month period ending on March 31, 2009 is at or above $10.36 per share. The restricted stock units are also subject to forfeiture if the individual officers do not meet the service requirements. The restricted stock unit activity for 2006 is summarized as follows:

	Shares	Weighted Average Grant Date Fair Value
Restricted stock units outstanding at December 31, 2005		$
Granted	185,000	3.14
Vested		
Canceled	(30,000)	3.14
Restricted stock units outstanding at December 31 2006	155,000	$ 3.14

These awards will result in a maximum number of 155,000 additional outstanding shares of the Company s common stock on March 31, 2009 if the market conditions and service requirements are met. The awards were valued using a Monte Carlo simulation option-pricing model as they have a market price condition. The assumptions used to value restricted stock units were as follows:

	Twelve months ended December 31, 2006
Expected volatility	59% to 75%
Expected term (in years)	2.33
Risk-free interest rate	4.7% to 5.1%
Dividend yield	0%

TorreyPines Therapeutics, Inc.
Notes to Consolidated Financial Statements (Continued)
December 31, 2006

10. Stock-Based Compensation (Continued)

The Company recognized $139,047 in total stock-based compensation expense for its share-based awards during the twelve-month period ended December 31, 2006 of which $119,062 are related to employee and director awards valued under SFAS No. 123R. Stock-based compensation expense was allocated among the following expense categories:

	Twelve Months Ended December 31, 2006
Research and development	$ 75,095
General and administrative	63,952
Stock-based compensation expense	$ 139,047
Stock-based compensation expense per share, basic and diluted	$ 0.04

As of December 31, 2006, the total unrecognized stock-based compensation expense related to non-vested stock options was $888,179. This expense is expected to be recognized on a straight-line basis over a weighted average period of approximately 2.9 years.

Equity instruments issued to non-employees are recorded at their fair values as determined in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*, and Emerging Issues Task Force (EITF) 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods and Services*, and are periodically revalued as the options vest and are recognized as expense over the related service period. During the twelve months ended December 31, 2006, 2005 and 2004, the Company recognized $19,985, $8,074 and $7,181 respectively, for stock options and warrants issued to non-employees.

Pro Forma Information under SFAS 123 for Periods Prior to 2006

The following table illustrates the effect on net losses as if the Company had applied the fair value recognition provisions of SFAS No. 123 to determine stock-based compensation for the twelve months ending December 31, 2005 and 2004:

	Twelve Months Ended December 31, 2005	2004
Net loss attributable to common stockholders, as reported	$ (15,976,382)	$ (12,948,721)
Add: Share-based compensation expense for consultants included in reported net loss attributable to common stockholders	8,074	7,181
Deduct: Share-based compensation expense for employees determined under fair value based method for all awards	(103,076)	(83,737)
Pro forma net loss attributable to common stockholders	(16,071,384)	(13,025,277)
Pro forma net loss per share attributable to common stockholders, basic and diluted	$ (30.87)	$ (26.15)

TorreyPines Therapeutics, Inc.
Notes to Consolidated Financial Statements (Continued)
December 31, 2006

10. Stock-Based Compensation (Continued)

The fair value of these options was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Twelve Months Ended December 31, 2005	2004
Expected Volatility	65.0 %	65.0 %
Risk-Free Interest Rate	5.6 %	5.6 %
Forfeitures	0.0 %	0.0 %
Dividend Yield		
Expected Term (in years)	5.0	5.0

11. Income Taxes

Significant components of the Company s deferred tax assets as of December 31, 2006 and 2005, are shown below. A valuation allowance of $31,809,000 has been recognized to offset the net deferred tax assets as of December 31, 2006, as realization of such assets is uncertain.

	December 31, 2006	2005
Deferred tax assets:		
Capitalized research and development expenses	$ 1,137,000	$ 576,000
Net operating loss carryforwards	24,307,000	14,075,000
Research and development and manufacturers investment credits	4,697,000	3,029,000
Deferred revenue	870,000	3,660,000
Stock based compensation	11,000	7,000
Investment in OXIS	2,202,000	
Other	36,000	171,000
Total deferred tax assets	33,260,000	21,518,000
Deferred tax liabilities		
Acquired patents	(1,404,000)	
Depreciation	(47,000)	(98,000)
Total deferred tax liabilities	(1,451,000)	(98,000)
Net deferred tax assets and liabilities	31,809,000	21,420,000
Valuation allowance for deferred tax assets	(31,809,000)	(21,420,000)
Net deferred tax assets	$	$

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TorreyPines Therapeutics, Inc.
Notes to Consolidated Financial Statements (Continued)
December 31, 2006

11. Income Taxes (Continued)

Reconciliation of the statutory federal income tax to the Company s effective tax rate as of December 31, 2006 and 2005 is shown below:

	December 31, 2006	2005
Tax at federal statutory rate	$ (8,628,162)	$ (4,039,701)
State tax benefit, net of federal effect	(1,472,647)	(737,288)
Non deductible in-process research and development	2,831,642	
Research and development credit	(733,920)	(111,150)
Change in valuation allowance	7,892,896	4,881,110
Non deductible warrant valuation adjustment	81,600	
Other	28,591	7,029
Provision for taxes	$	$

A significant portion of TorreyPines deferred tax assets acquired in the Merger (see Note 2) are limited and are not recorded in these financial statements due to Section 382 and 383 limitations. Additionally a valuation allowance of $3,022,000 has been recorded on the deferred tax assets that were recognized at the date of the Merger. In the event the Company reduces the valuation allowance on the deferred tax assets acquired in the Merger, an off-setting adjustment would be required to the goodwill.

Pursuant to Internal Revenue Code Sections 382 and 383, use of the Company s net operating loss and tax credit carryforwards may be limited if a cumulative change in ownership of more than 50% occurs within a three-year period. The Company plans to pursue a net operating loss study to determine any such limitations. Pending completion of this study, the Company has estimated that federal and California tax net operating loss carryforwards of approximately $65,610,000 and $34,272,000 should be allowable under the limitation. These federal and state carryforwards will begin to expire in 2020 and 2012, respectively, unless previously utilized. The Company has federal research credit carryforwards of approximately $3,127,000, which will begin expiring in 2020 unless previously utilized, and state research credit carryforwards of $2,275,000, which carryforward indefinitely. The Company also has state manufacturers investment tax credit carryforwards of approximately $103,000, which will begin expiring in 2011.

12. Employee Benefit Plan

Effective January 1, 2001, the Company adopted a defined contribution 401(k) Plan covering substantially all employees that meet certain age requirements. Employees may contribute up to 60% of their compensation per year, subject to a maximum limit by federal law. The Company is not required to, and has not, matched any portion of the employee contributions through December 31, 2006.

13. Related-Party Transactions

For the three years ended December 31, 2006, two directors provided consulting services to the Company. Combined total payments for these services were $40,000, $90,000 and $90,000 for 2006, 2005 and 2004, respectively.

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14. Selected Quarterly Data (Unaudited)

The following tables set forth certain unaudited quarterly information for each of the eight fiscal quarters in the two-year period ended December 31, 2006. This quarterly financial data has been prepared on a consistent basis with the audited financial statements and, in the opinion of management, includes all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the information for the periods presented. The Company s quarterly operating results may fluctuate significantly as a result of a variety of factors and operating results for any quarter are not necessarily indicative of results for a full fiscal year or future quarters.

2006 Quarter Ended

	March 31	June 30	September 30	December 31
Total revenue	$ 2,462,500	$ 2,462,500	$ 2,462,500	$ 2,462,500
Operating expenses	6,331,261	8,145,133	5,150,023	15,025,364
Net loss attributable to common stockholders	$ (4,948,039)	$ (6,880,411)	$ (3,944,631)	$ (9,603,866)
Basic and diluted net loss per share attributable to common stockholders	$ (9.24)	$ (12.83)	$ (7.18)	$ (0.89)

2005 Quarter Ended

	March 31	June 30	September 30	December 31
Total revenue	$ 1,279,167	$ 2,112,500	$ 2,112,500	$ 2,462,500
Operating expenses	3,778,238	4,580,174	4,486,564	7,059,994
Net loss attributable to common stockholders	$ (3,498,930)	$ (3,396,559)	$ (3,340,814)	$ (5,740,079)
Basic and diluted net loss per share attributable to common stockholders	$ (6.88)	$ (6.62)	$ (6.35)	$ (10.73)

15. Contingencies

Several lawsuits were filed against us in February 2005 in the U.S. District Court for the Southern District of New York asserting claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, or the Exchange Act and Rule 10b-5 thereunder on behalf of a class of purchasers of Axonyx common stock during the period from June 26, 2003, through and including February 4, 2005, referred to as the class period. Dr. Marvin S. Hausman, M.D., a current director and our former Chief Executive Officer, and Dr. Gosse B. Bruinsma, M.D., also a former Chief Executive Officer, were also named as defendants in the lawsuits. These actions were consolidated into a single class action lawsuit in January 2006. On April 10, 2006, the class action plaintiffs filed an amended consolidated complaint. The Company filed its answer to that complaint on May 26, 2006. The Company s motion to dismiss the consolidated amended complaint was filed on May 26, 2006 and was submitted to the court for a decision in September 2006. The motion to dismiss is pending.

The class action plaintiffs allege generally that the Company s Phase III phenserine development program was subject to alleged errors of design and execution which resulted in the failure of the first Phase III phenserine trial to show efficacy. Plaintiffs allege the defendants failure to disclose the alleged defects resulted in the artificial inflation of the price of the Company s shares during the class period.

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15. Contingencies (Continued)

There is also a shareholder derivative suit pending in New York Supreme Court, New York County, against our current and former directors and officers. The named defendants are Marvin S. Hausman, M.D., Gosse B. Bruinsma, M.D., S. Colin Neill, Louis G. Cornacchia, Steven H. Ferris, Ph.D., Gerard J. Vlak, Ralph Snyderman, M.D. and Michael A. Griffith. Defendants are alleged to have breached their duties to the Company and misused inside information regarding clinical trials of phenserine. This action has been stayed pending further developments in the federal class action.

The complaints seek unspecified damages. Management believes the claims are without merit and plans to defend the claims vigorously. The Company has determined that a loss in connection with these matters is possible, but not probable. Accordingly, the Company has not recorded any liability relating to these matters.

16. Subsequent Event

In February 2007 Eisai exercised its right to extend the original term of the February 2005 collaboration agreement for a period of twelve months. In connection with this extension, we will receive a cash payment of $5,000,000.