MERCURY GENERAL CORP
Form 10-Q
May 04, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarter Ended March 31, 2011

Commission File No. 001-12257

MERCURY GENERAL CORPORATION

(Exact name of registrant as specified in its charter)

California	**95-2211612**
(State or other jurisdiction of	**(I.R.S. Employer**

incorporation or organization)	**Identification No.)**

4484 Wilshire Boulevard, Los Angeles, California	**90010**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (323) 937-1060

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

Indicate by check mark whether the Registrant is a shell company (as defined in the Rule 12b-2 of the Exchange Act). Yes ¨ No x

At April 29, 2011, the Registrant had issued and outstanding an aggregate of 54,817,677 shares of its Common Stock.

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MERCURY GENERAL CORPORATION

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

MERCURY GENERAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands)

ASSETS	March 31, 2011 (unaudited)	December 31, 2010
Investments, at fair value:		
Fixed maturities trading (amortized cost $2,494,428; $2,617,656)	$ 2,519,549	$ 2,652,280
Equity securities trading (cost $341,450; $336,757)	394,687	359,606
Short-term investments (cost $111,618; $143,378)	111,618	143,371
Total investments	3,025,854	3,155,257
Cash	334,290	181,388
Receivables:		
Premiums	296,321	280,980
Accrued investment income	35,712	36,885
Other	10,669	10,076
Total receivables	342,702	327,941
Deferred policy acquisition costs	170,645	170,579
Fixed assets, net	190,325	196,505
Current income taxes	5,292	25,719
Deferred income taxes	28,619	26,499
Goodwill	42,850	42,850
Other intangible assets, net	58,486	60,124
Other assets	9,512	16,502
Total assets	$ 4,208,575	$ 4,203,364
LIABILITIES AND SHAREHOLDERS EQUITY		
Losses and loss adjustment expenses	$ 990,719	$ 1,034,205
Unearned premiums	853,114	833,379
Notes payable	265,592	267,210
Accounts payable and accrued expenses	98,026	106,662
Other liabilities	180,247	167,093
Total liabilities	2,387,698	2,408,549
Commitments and contingencies		
Shareholders equity:		
Common stock without par value or stated value: Authorized 70,000 shares; issued and outstanding 54,818; 54,803	74,822	74,188
Additional paid-in capital	78	78
Accumulated other comprehensive loss	(647)	(740)
Retained earnings	1,746,624	1,721,289

Total shareholders equity		1,820,877		1,794,815
Total liabilities and shareholders equity	$	4,208,575	$	4,203,364

See accompanying Condensed Notes to Consolidated Financial Statements.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(unaudited)

	Three Months Ended March 31, 2011	2010
Revenues:		
Net premiums earned	$ 638,487	$ 640,614
Net investment income	35,096	35,886
Net realized investment gains	28,690	22,044
Other	3,270	1,293
Total revenues	705,543	699,837
Expenses:		
Losses and loss adjustment expenses	446,461	430,622
Policy acquisition costs	121,804	128,982
Other operating expenses	58,672	57,324
Interest	1,695	1,619
Total expenses	628,632	618,547
Income before income taxes	76,911	81,290
Income tax expense	18,685	20,111
Net income	$ 58,226	$ 61,179
Net income per share:		
Basic	$ 1.06	$ 1.12
Diluted	$ 1.06	$ 1.12
Weighted average shares outstanding:		
Basic	54,809	54,783
Diluted	54,831	54,805
Dividends declared per share	$ 0.60	$ 0.59

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(unaudited)

	Three Months Ended March 31,	
	2011	**2010**
Net income	$ 58,226	$ 61,179
Other comprehensive income (loss), before tax:		
Gains (losses) on hedging instrument	143	(153)
Other comprehensive income (loss), before tax	143	(153)
Income tax expense (benefit) related to gains (losses) on hedging instrument	50	(54)
Comprehensive income, net of tax	$ 58,319	$ 61,080

See accompanying Condensed Notes to Consolidated Financial Statements.

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MERCURY GENERAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three Months Ended March 31, 2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 58,226	$ 61,179
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,420	8,562
Net realized investment gains	(28,690)	(22,044)
Bond amortization (accretion), net	1,277	(434)
Excess tax benefit from exercise of stock options	(20)	(25)
Increase in premiums receivables	(15,341)	(14,795)
Decrease in current and deferred income taxes	18,277	28,866
(Increase) decrease in deferred policy acquisition costs	(66)	1,075
Decrease in unpaid losses and loss adjustment expenses	(43,486)	(30,613)
Increase in unearned premiums	19,735	11,909
(Decrease) increase in accounts payable and accrued expenses	(5,411)	5,119
Share-based compensation	116	209
Increase (decrease) in other payables	9,195	(24,315)
Other, net	11,344	8,188
Net cash provided by operating activities	35,576	32,881
CASH FLOWS FROM INVESTING ACTIVITIES		
Fixed maturities available-for-sale in nature:		
Purchases	(57,182)	(112,172)
Sales	96,707	58,457
Calls or maturities	82,925	73,137
Equity securities available-for-sale in nature:		
Purchases	(125,551)	(27,070)
Sales	125,673	38,397
Net (decrease) increase in payable for securities	(3,264)	11,507
Net decrease in short-term investments	31,760	21,872
Purchase of fixed assets	(5,956)	(7,431)
Sale and write-off of fixed assets	554	10
Other, net	4,033	(473)
Net cash provided by investing activities	149,699	56,234
CASH FLOWS FROM FINANCING ACTIVITIES		
Dividends paid to shareholders	(32,891)	(32,323)
Excess tax benefit from exercise of stock options	20	25
Proceeds from stock options exercised	498	189
Net cash used in financing activities	(32,373)	(32,109)
Net increase in cash	152,902	57,006
Cash:		
Beginning of the year	181,388	185,505

End of period	$	334,290	$	242,511
SUPPLEMENTAL CASH FLOW DISCLOSURE				
Interest paid	$	2,129	$	2,086
Income taxes paid (received)	$	409	$	(8,757)
Net realized gains from sale of investments	$	7,776	$	3,178

See accompanying Condensed Notes to Consolidated Financial Statements.

MERCURY GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. General

Consolidation and Basis of Presentation

The condensed consolidated financial statements include the accounts of Mercury General Corporation and its subsidiaries (referred to herein collectively as the Company). For the list of the Company s subsidiaries, see Note 1 Summary of Significant Accounting Policies of Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

The condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (GAAP), which differ in some respects from those filed in reports to insurance regulatory authorities. All intercompany transactions have been eliminated.

The financial data of the Company included herein has been prepared without audit. In the opinion of management, all material adjustments of a normal recurring nature necessary to present fairly the Company s financial position at March 31, 2011 and the results of operations, comprehensive income, and cash flows for the periods presented have been made. Operating results and cash flows for the three months ended March 31, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates require the Company to apply complex assumptions and judgments, and often the Company must make estimates about effects of matters that are inherently uncertain and will likely change in subsequent periods. The most significant assumptions in the preparation of these condensed consolidated financial statements relate to reserves for losses and loss adjustment expenses. Actual results could differ from those estimates (See Note 1 Summary of Significant Accounting Policies of Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2010).

Earnings per Share

For the three month periods ended March 31, 2011 and 2010, potential common shares of 102,000 and 89,000 shares, respectively, were excluded from the computation of diluted earnings per share because their inclusion would have had an antidilutive effect.

2. Recently Issued Accounting Standards

In December 2010, the Financial Accounting Standards Board (FASB) issued a new standard which modifies step 1 of the goodwill impairment test for entities with a zero or negative carrying value to require entities to assess, considering qualitative factors, whether it is more likely than not that a goodwill impairment exists. If an entity concludes that it is more likely than not that goodwill impairment exists, the entity must perform step 2 of the goodwill impairment test. The new standard allows an entity to use either the equity or the enterprise valuation premise to determine the carrying amount of a reporting unit. The Company adopted the new accounting standard which became effective for impairment tests performed during the interim reporting period ended March 31, 2011. The adoption of the new standard did not have a material impact on the Company s condensed consolidated financial statements.

In October 2010, the FASB issued a new standard to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The new standard defines acquisition costs as those related directly to the successful acquisition of new or renewal insurance contracts, and will be effective for fiscal years and interim periods beginning after December 15, 2011. The Company is evaluating the impact of adoption on the Company s condensed consolidated financial statements.

In January 2010, the FASB issued a new standard related to fair value measurements and disclosures, which amends the earlier FASB standard to provide the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis, which became effective for the interim reporting period ended March 31, 2011. The Company adopted the new accounting standard, and the adoption of the new standard did not have a material impact on the Company s condensed consolidated financial statements.

3. Fair Value of Financial Instruments

The financial instruments recorded in the consolidated balance sheets include investments, receivables, interest rate swap agreements, accounts payable, equity contracts, and secured and unsecured notes payable. Due to their short-term maturity, the carrying value of receivables and accounts payable approximate their fair market values. The following table presents estimated fair values of financial instruments at March 31, 2011 and December 31, 2010.

	March 31, 2011	December 31, 2010
	(Amounts in thousands)	
Assets		
Investments	$ 3,025,854	$ 3,155,257
Interest rate swap agreements	$ 2,610	$ 4,240
Liabilities		
Interest rate swap agreements	$ 2,468	$ 3,042
Equity contracts	$ 3,149	$ 2,776
Secured notes	$ 138,205	$ 138,332
Unsecured note	$ 127,394	$ 128,280

Methods and assumptions used in estimating fair values are as follows:

Investments

The Company applies the fair value option to all fixed maturity and equity securities and short-term investments as of the time the eligible item is first recognized. For additional disclosures regarding methods and assumptions used in estimating fair values of these securities, see Note 5 of Condensed Notes to Consolidated Financial Statements.

Interest rate swap agreements

The fair value of interest rate swap agreements reflects the estimated amounts that the Company would pay or receive at March 31, 2011 and December 31, 2010 in order to terminate the contracts based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract. For additional disclosures regarding methods and assumptions used in estimating fair values of interest rate swap agreements, see Note 5 of Condensed Notes to Consolidated Financial Statements.

Equity contracts

The fair value of equity contracts is based on quoted prices for identical instruments in active markets. For additional disclosures regarding methods and assumptions used in estimating fair values of equity contracts, see Note 5 of Condensed Notes to Consolidated Financial Statements.

Secured notes

The fair value of the Company s $120 million and $18 million secured notes is estimated based on assumptions and inputs, such as reset rates, for similar termed notes that are observable in the market.

Unsecured note

The fair value of the Company s publicly traded $125 million unsecured note is based on the unadjusted quoted price for similar notes in active markets.

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4. Fair Value Option

Gains and losses due to changes in fair value for items measured at fair value pursuant to application of the fair value option are included in net realized investment gains in the Company s consolidated statements of operations, while interest and dividend income on the investment holdings are recognized on an accrual basis on each measurement date and are included in net investment income in the Company s consolidated statements of operations. The primary reasons for electing the fair value option were simplification and cost-benefit considerations as well as expansion of use of fair value measurement consistent with the long-term measurement objectives of the FASB for accounting for financial instruments.

The following table presents gains (losses) due to changes in fair value for items measured at fair value pursuant to application of the fair value option:

	Three Months Ended March 31,	
	2011	2010
	(Amounts in thousands)	
Fixed maturity securities	$ (9,503)	$ 13,267
Equity securities	30,388	5,725
Short-term investments	19	(53)
Total	$ 20,904	$ 18,939

5. Fair Value Measurement

The Company employs a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value of a financial instrument is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date using the exit price. Accordingly, when market observable data is not readily available, the Company s own assumptions are set to reflect those that market participants would be presumed to use in pricing the asset or liability at the measurement date. Assets and liabilities recorded on the consolidated balance sheets at fair value are categorized based on the level of judgment associated with inputs used to measure their fair value and the level of market price observability, as follows:

Level 1 Unadjusted quoted prices are available in active markets for identical assets or liabilities as of the reporting date.

Level 2 Pricing inputs are other than quoted prices in active markets, which are based on the following:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in non-active markets; or
- Either directly or indirectly observable inputs as of the reporting date and fair value is determined through the use of models or other valuation.

Level 3 Pricing inputs are unobservable and significant to the overall fair value measurement, and the determination of fair value requires significant management judgment or estimation.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is

significant to the fair value measurement in its entirety. Thus, a Level 3 fair value measurement may include inputs that are observable (Level 1 or Level 2) and unobservable (Level 3). The Company s assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and consideration of factors specific to the asset or liability.

The Company uses prices and inputs that are current as of the measurement date, including during periods of market disruption. In periods of market disruption, the ability to observe prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2, or from Level 2 to Level 3. The Company recognizes transfers between levels at either the actual date of the event or a change in circumstances that caused the transfer.

Summary of Significant Valuation Techniques for Financial Assets and Financial Liabilities

The Company s fair value measurements are based on a combination of the market approach and the income approach. The market approach utilizes market transaction data for the same or similar instruments. The income approach is based on a discounted cash flow methodology, where expected cash flows are discounted to present value.

The Company obtained unadjusted fair values on approximately 98% of its portfolio from an independent pricing service. For approximately 2% of its portfolio, the Company obtained specific unadjusted broker quotes from at least one knowledgeable outside security broker to determine the fair value.

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Level 1 Measurements Fair values of financial assets and financial liabilities are obtained from an independent pricing service, and are based on unadjusted quoted prices for identical assets or liabilities in active markets. Additional pricing services and closing exchange values are used as a comparison to ensure realistic fair values are used in pricing the investment portfolio.

U.S. government bonds and agencies: Valued using unadjusted quoted market prices for identical assets in active markets.

Common stock: Comprised of actively traded, exchange listed U.S. and international equity securities and valued based on unadjusted quoted prices for identical assets in active markets.

Money market instruments: Valued based on unadjusted quoted prices for identical assets.

Equity contracts: Comprised of free-standing exchange listed derivatives that are actively traded and valued based on quoted prices for identical instruments in active markets.

Level 2 Measurements Fair values of financial assets and financial liabilities are obtained from an independent pricing service or outside brokers, and are based on prices for similar assets or liabilities in active markets or valuation models whose inputs are observable, directly or indirectly, for substantially the full term of the asset or liability. Additional pricing services are used as a comparison to ensure reliable fair values are used in pricing the investment portfolio.

Municipal securities: Valued based on models or matrices using inputs including quoted prices for identical or similar assets in active markets.

Mortgage-backed securities: Comprised of securities that are collateralized by residential mortgage loans and valued based on models or matrices using multiple observable inputs, such as benchmark yields, reported trades and broker/dealer quotes, for identical or similar assets in active markets. At March 31, 2011 and December 31, 2010, the Company had no holdings in commercial mortgage-backed securities.

Corporate securities/Short-term bonds: Valued based on a multi-dimensional model using multiple observable inputs, such as benchmark yields, reported trades, broker/dealer quotes and issue spreads, for identical or similar assets in active markets.

Non-redeemable preferred stock: Valued based on observable inputs, such as underlying and common stock of same issuer and appropriate spread over a comparable U.S. Treasury security, for identical or similar assets in active markets.

Interest rate swap agreements: Valued based on models using inputs, such as interest rate yield curves, observable for substantially the full term of the contract.

Level 3 Measurements Fair values of financial assets are based on inputs that are both unobservable and significant to the overall fair value measurement, including any items in which the evaluated prices obtained elsewhere were deemed to be of a distressed trading level.

Municipal securities: Comprised of certain distressed municipal securities for which valuation is based on models that are widely accepted in the financial services industry and require projections of future cash flows that are not market observable. Included in this category are auction rate securities (ARS).

Collateralized debt obligations: Valued based on underlying debt instruments and the appropriate benchmark spread for similar assets in active markets; taking into consideration unobservable inputs related to liquidity assumptions.

The Company s total financial instruments at fair value are reflected in the consolidated balance sheets on a trade-date basis. Related unrealized gains or losses are recognized in net realized investment gains in the consolidated statements of operations. Fair value measurements are not adjusted for transaction costs.

The following tables present information about the Company s assets and liabilities measured at fair value on a recurring basis as of March 31, 2011 and December 31, 2010, and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value:

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	March 31, 2011			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	$ 13,125	$ 0	$ 0	$ 13,125
Municipal securities	0	2,312,591	0	2,312,591
Mortgage-backed securities	0	48,858	0	48,858
Corporate securities	0	86,567	0	86,567
Collateralized debt obligations	0	0	58,408	58,408
Equity securities:				
Common stock:				
Public utilities	25,882	0	0	25,882
Banks, trusts and insurance companies	19,105	0	0	19,105
Industrial and other	337,912	0	0	337,912
Non-redeemable preferred stock	0	11,788	0	11,788
Short-term bonds	0	13,012	0	13,012
Money market instruments	98,600	0	0	98,600
Equity contracts	6	0		6
Interest rate swap agreements	0	2,610	0	2,610
Total assets at fair value	$ 494,630	$ 2,475,426	$ 58,408	$ 3,028,464
Liabilities				
Equity contracts	$ 3,149	$ 0	$ 0	$ 3,149
Interest rate swap agreements	0	2,468	0	2,468
Total liabilities at fair value	$ 3,149	$ 2,468	$ 0	$ 5,617

	December 31, 2010			
	Level 1	Level 2	Level 3	Total
	(Amounts in thousands)			
Assets				
Fixed maturity securities:				
U.S. government bonds and agencies	$ 8,805	$ 0	$ 0	$ 8,805
Municipal securities	0	2,433,589	1,624	2,435,213
Mortgage-backed securities	0	57,367	0	57,367
Corporate securities	0	95,203	0	95,203
Collateralized debt obligations	0	0	55,692	55,692
Equity securities:				
Common stock:				
Public utilities	27,214	0	0	27,214
Banks, trusts and insurance companies	20,521	0	0	20,521
Industrial and other	302,103	0	0	302,103
Non-redeemable preferred stock	0	9,768	0	9,768
Short-term bonds	0	17,043	0	17,043
Money market instruments	126,328	0	0	126,328
Interest rate swap agreements	0	4,240	0	4,240
Total assets at fair value	$ 484,971	$ 2,617,210	$ 57,316	$ 3,159,497
Liabilities				
Equity contracts	$ 2,776	$ 0	$ 0	$ 2,776
Interest rate swap agreements	0	3,042	0	3,042
Total liabilities at fair value	$ 2,776	$ 3,042	$ 0	$ 5,818

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The following tables provide a summary of changes in fair value of Level 3 financial assets and financial liabilities held at fair value at March 31, 2011 and 2010.

	Three Months Ended March 31,			
	2011		2010	
	Municipal Securities	Collateralized Debt Obligations	Municipal Securities	Collateralized Debt Obligations
	(Amounts in thousands)			
Beginning Balance	$ 1,624	$ 55,692	$ 3,322	$ 47,473
Realized gains included in earnings	39	2,716	65	7,058
Purchase	0	0	0	0
Sales	(1,663)	0	(1,590)	0
Issuances	0	0	0	0
Settlements	0	0	0	0
Ending Balance	$ 0	$ 58,408	$ 1,797	$ 54,531
The amount of total gains for the period included in earnings attributable to assets still held at March 31	$ 0	$ 2,716	$ 89	$ 7,058

There were no transfers between Levels 1, 2, and 3 of the fair value hierarchy during the three months ended March 31, 2011 and 2010.

At March 31, 2011, the Company did not have any nonrecurring measurements of nonfinancial assets or nonfinancial liabilities.

6. Derivative Financial Instruments

The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed by derivative instruments are equity price risk and interest rate risk. Equity contracts on various equity securities are intended to manage the price risk associated with forecasted purchases or sales of such securities. Interest rate swaps are intended to manage interest rate risk associated with the Company s loans with fixed or floating rates.

On February 6, 2009, the Company entered into an interest rate swap of its floating LIBOR rate on the $120 million credit facility, which was used for the acquisition of Auto Insurance Specialists LLC, resulting in a fixed rate of 3.18%. The purpose of the swap is to offset the variability of cash flows resulting from the variable interest rate. The swap is not designated as a hedge and changes in the fair value are adjusted through the consolidated statement of operations in the period of change.

Effective January 2, 2002, the Company entered into an interest rate swap on the $125 million senior notes for a floating rate of LIBOR plus 107 basis points. The swap agreement terminates on August 15, 2011. The swap is designated as a fair value hedge and qualifies for the shortcut method as the hedge is deemed to have no ineffectiveness. The fair market value of the interest rate swap was $2.6 million as of March 31, 2011, and has been recorded in other assets in the consolidated balance sheets with a corresponding increase in notes payable. The Company includes the gain or loss on the hedged item in the same line item, other revenue, as the offsetting loss or gain on the related interest rate swaps as follows:

	Three Months Ended March 31,			
	2011		2010	
Income Statement Classification	Gain (Loss) on Swap	Gain (Loss) on Loan	Gain (Loss) on Swap	Gain (Loss) on Loan
	(Amounts in thousands)			
Other revenue	$ (1,630)	$ 1,630	$ (493)	$ 493

On March 3, 2008, the Company entered into an interest rate swap of its floating LIBOR rate on the $18 million bank loan for a fixed rate of 4.25%. The swap agreement terminates on March 1, 2013. The swap is designated as a cash flow hedge. The fair market value of the interest rate swap was $1.0 million as of March 31, 2011, and has been reported as a component of other comprehensive income and amortized into earnings

over the term of the hedged transaction. The interest rate swap was determined to be highly effective, and no amount of ineffectiveness was recorded in earnings during the three months ended March 31, 2011 and 2010.

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Fair value amounts, and gains and losses on derivative instruments

The following tables provide the location and amounts of derivative fair values in the consolidated balance sheets and derivative gains and losses in the consolidated statements of operations:

	Asset Derivatives		Liability Derivatives	
	March 31, 2011	December 31, 2010	March 31, 2011	December 31, 2010
	(Amounts in thousands)			
Hedging derivatives				
Interest rate contracts Other assets (liabilities)	$ 2,610	$ 4,240	$ (996)	$ (1,139)
Non-hedging derivatives				
Interest rate contracts Other liabilities	$ 0	$ 0	$ (1,472)	$ (1,903)
Equity contracts Short-term investments (Other liabilities)	6	0	(3,149)	(2,776)
Total non-hedging derivatives	$ 6	$ 0	$ (4,621)	$ (4,679)
Total derivatives	$ 2,616	$ 4,240	$ (5,617)	$ (5,818)

The Effect of Derivative Instruments on the Consolidated Statements of Operations

Derivatives Contracts for Fair Value Hedges	Loss Recognized in Income Three Months Ended March 31, 2011	2010
	(Amounts in thousands)	
Interest rate contract Interest expense	$ (1,768)	$ (1,841)

Derivatives Contracts for Cash Flow Hedges	Gain (Loss) Recognized in Other Comprehensive Income Three Months Ended March 31, 2011	2010
	(Amounts in thousands)	
Interest rate contract Other comprehensive income	$ 143	$ (153)

Derivatives Not Designated as Hedging Instruments	Gain (Loss) Recognized in Income Three Months Ended March 31, 2011	2010
	(Amounts in thousands)	
Interest rate contract Other revenue	$ 431	$ (664)
Equity contracts Net realized investment gains	2,472	576
Total	$ 2,903	$ (88)

There were no gains or losses on derivative instruments designated as cash flow hedges reclassified from accumulated other comprehensive income into earnings during the three months ended March 31, 2011 and 2010.

Most equity contracts consist of covered calls. The Company writes covered calls on underlying equity positions held as an enhanced income strategy that is permitted for the Company s insurance subsidiaries under statutory regulations. The Company manages the risk associated with covered calls through strict capital limitations and asset diversification throughout various industries. For additional disclosures regarding equity contracts, see Note 5 of Condensed Notes to Consolidated Financial Statements.

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7. Goodwill and Other Intangible Assets

There were no changes in the carrying amount of goodwill for the three months ended March 31, 2011. Goodwill is reviewed for impairment on an annual basis and more frequently if potential impairment indicators exist. No impairment indications were identified during any of the periods presented.

The following table presents the components of other intangible assets as of March 31, 2011 and December 31, 2010.

	Gross Carrying Amount	Accumulated Amortization (Amounts in thousands)	Net Carrying Amount
As of March 31, 2011:			
Customer relationships	$ 51,755	$ (10,994)	$ 40,761
Trade names	15,400	(1,444)	13,956
Software and technology	4,850	(1,517)	3,333
Favorable leases	1,725	(1,289)	436
Total intangible assets, net	$ 73,730	$ (15,244)	$ 58,486
As of December 31, 2010:			
Customer relationships	$ 51,755	$ (9,767)	$ 41,988
Trade names	15,400	(1,283)	14,117
Software and technology	4,850	(1,410)	3,440
Favorable leases	1,725	(1,146)	579
Total intangible assets, net	$ 73,730	$ (13,606)	$ 60,124

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Intangible assets are amortized on a straight-line basis over their useful lives. Intangible assets amortization expense was $1.6 million for the three months ended March 31, 2011. The following table presents the estimated future amortization expense related to intangible assets as of March 31, 2011:

Year Ending December 31,		Amortization Expense (Amounts in thousands)
Remainder of 2011	$	4,737
2012		6,160
2013		5,986
2014		5,980
2015		5,980
Thereafter		29,643
Total	$	58,486

8. Share-Based Compensation

The Company accounts for share-based compensation using the modified prospective transition method. Under this method, share-based compensation expense includes compensation expense for all share-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the estimated grant-date fair value. Share-based compensation expense for all share-based payment awards granted or modified on or after January 1, 2006 is based on the estimated grant-date fair value. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is the option vesting term of four or five years for options granted prior to 2008 and four years for options granted subsequent to January 1, 2008, for only those shares expected to vest. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with inputs for grant-date assumptions and weighted-average fair values.

Under its 2005 Equity Participation Plan (the Plan), the Compensation Committee of the Company s Board of Directors granted performance vesting restricted stock units to the Company s senior management and key employees on March 9, 2011. The restricted stock units vest at the end of a three-year performance period, and then only if, and to the extent that, the Company s cumulative underwriting income during such three-year performance period ending December 31, 2013 achieves the 2011 defined threshold performance levels established by the Compensation Committee. The target number of shares of common stock for which the restricted stock units may vest is 80,000. However, the restricted stock units may vest for up to 120,000 shares of common stock based upon the extent to which the Company s three-year performance exceeds the target established by the Compensation Committee. The Compensation Committee granted 55,000 restricted stocks and restricted stock units in 2010 which will vest at the end of a three-year performance period ending December 31, 2012 if, and to the extent that, the Company s cumulative underwriting income during the three-year performance period ending December 31, 2012 achieves the 2010 defined threshold performance levels.

The fair value of the restricted share grant was determined based on the market price on the date of grant. Compensation cost has been recognized based on management s best estimates that performance goals will be achieved. If such goals are not met as of the end of the three-year performance period, no compensation cost would be recognized and any recognized compensation cost would be reversed.

9. Income Taxes

The Company recognizes tax benefits related to positions taken, or expected to be taken, on a tax return once a more-likely-than-not threshold has been met. For a tax position that meets the recognition threshold, the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement is recognized in the financial statements.

There was a $1 million net increase to the total amount of unrecognized tax benefits related to tax uncertainties during the three months ended March 31, 2011. The net increase was the result of tax positions taken in the current period based on management s best judgment given the facts, circumstances, and information available at the reporting date. The Company does not expect any further changes in such unrecognized tax benefits to have a significant impact on its consolidated financial statements within the next 12 months.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states. Tax years that remain subject to examination by major taxing jurisdictions are 2005 through 2009 for federal taxes and 2001 through 2009 for California state taxes. Tax years 2005 through 2009 are currently under examination by the Internal Revenue Service.

The Company has been examined by the California Franchise Tax Board (FTB) for tax years 2001 through 2005. The FTB has issued Notices of Proposed Assessment to the Company. Management disagrees with the assessments and believes that the resolution will not have a material impact on the condensed consolidated financial statements.

Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial reporting basis and the respective tax basis of the Company s assets and liabilities, and expected benefits of utilizing net

operating loss, capital loss, and tax-credit carryforwards. The Company assesses the likelihood that its deferred tax assets will be realized and, to the extent management does not believe these assets are more likely than not to be realized, a valuation allowance is established.

At March 31, 2011, the Company s deferred income taxes were in a net asset position which included a combination of ordinary and capital deferred tax benefits. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon generating sufficient taxable income of the appropriate nature within the carryback and carryforward periods available under the tax law. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income of an appropriate nature, and tax-planning strategies in making this assessment. The Company believes that through the use of prudent tax planning strategies and the generation of capital gains, sufficient income will be realized in order to maximize the full benefits of its deferred tax assets. Although realization is not assured, management believes it is more likely than not that the Company s deferred tax assets will be realized.

10. Contingencies

The Company is, from time to time, named as a defendant in various lawsuits incidental to its insurance business. In most of these actions, plaintiffs assert claims for punitive damages, which are not insurable under judicial decisions. The Company has established reserves for lawsuits in which the Company is able to estimate its potential exposure and the likelihood that the court will rule against the Company is probable. Additionally, from time to time, regulators may take actions to challenge the Company s business practices. The Company vigorously defends these actions, unless a reasonable settlement appears appropriate. An unfavorable ruling against the Company in the actions currently pending may have a material impact on the Company s quarterly results of operations in the period of such ruling; however, none is expected to be material to the Company s financial position. For a discussion of the Company s pending material litigation, see the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

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

Cautionary Statements

Certain statements in this Quarterly Report on Form 10-Q or in other materials the Company has filed or will file with the SEC (as well as information included in oral statements or other written statements made or to be made by the Company) contain or may contain 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 forward-looking statements may address, among other things, the Company s strategy for growth, business development, regulatory approvals, market position, expenditures, financial results, and reserves. Forward-looking statements are not guarantees of performance and are subject to important factors and events that could cause the Company s actual business, prospects, and results of operations to differ materially from the historical information contained in this Quarterly Report on Form 10-Q and from those that may be expressed or implied by the forward-looking statements contained in this Quarterly Report on Form 10-Q and in other reports or public statements made by the Company.

Factors that could cause or contribute to such differences include, among others: the competition currently existing in the automobile insurance markets in California and other states in which the Company operates; the cyclical and general competitive nature of the property and casualty insurance industry and general uncertainties regarding loss reserve or other estimates, the accuracy and adequacy of the Company s pricing methodologies; the Company s success in managing its business in states outside of California; the impact of potential third party bad-faith legislation, changes in laws, regulations or new interpretation of existing laws and regulations, tax position challenges by the FTB, and decisions of courts, regulators and governmental bodies, particularly in California; the Company s ability to obtain and the timing of the approval of premium rate changes for insurance policies issued in states where the Company operates; the Company s reliance on independent agents and brokers to market and distribute its policies; the investment yields the Company is able to obtain with its investments in comparison to recent yields and the market risks associated with the Company s investment portfolio; uncertainties related to assumptions and projections generally, inflation and changes in economic conditions; changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions, trends in litigation, and health care and auto repair costs; adverse weather conditions or natural disasters in the markets served by the Company; the stability of the Company s information technology systems and the ability of the Company to execute on its information technology initiatives; the Company s ability to realize current deferred tax assets or to hold certain securities with current loss positions to recovery or maturity; and other uncertainties, all of which are difficult to predict and many of which are beyond the Company s control. GAAP prescribes when a Company may reserve for particular risks including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain periods.

The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise. Investors are cautioned not to place undue reliance on any forward-looking statements,

which speak only as of the date of this Quarterly Report on Form 10-Q or, in the case of any document the Company incorporates by reference, any other report filed with the SEC or any other public statement made by the Company, the date of the document, report, or statement. Investors should also understand that it is not possible to predict or identify all factors and should not consider the risks set forth above to be a complete statement of all potential risks and uncertainties. If the expectations or assumptions underlying the Company s forward-looking statements prove inaccurate or if risks or uncertainties arise, actual results could differ materially from those predicted in any forward-looking statements. The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements. Any forward-looking statements should also be considered in light of the information provided in Item 1A. Risk Factors in the Company s Annual Report on Form 10-K for the year ended December 31, 2010 and in Item 1A. Risk Factors in Part II Other Information of this Quarterly Report on Form 10-Q.

OVERVIEW

A. General

The operating results of property and casualty insurance companies are subject to significant quarter-to-quarter and year-to-year fluctuations due to the effect of competition on pricing, the frequency and severity of losses, the effect of natural disasters on losses, general economic conditions, the general regulatory environment in those states in which an insurer operates, state regulation of premium rates, changes in fair value of investments, and other factors such as changes in tax laws. The property and casualty industry has been highly cyclical, with periods of high premium rates and shortages of underwriting capacity followed by periods of severe price competition and excess capacity. These cycles can have a large impact on the Company s ability to grow and retain business.

This section discusses some of the relevant factors that management considers in evaluating the Company s performance, prospects, and risks. It is not all-inclusive and is meant to be read in conjunction with the entirety of management s discussion and analysis, the Company s condensed consolidated financial statements and notes thereto, and all other items contained within this Quarterly Report on Form 10-Q.

B. Business

The Company is primarily engaged in writing automobile insurance through 13 insurance subsidiaries (Insurance Companies). The Company also writes homeowners, mechanical breakdown, fire, umbrella, and commercial automobile and property insurance. These policies are mostly sold through independent agents and brokers who receive a commission for selling policies. The Company believes that it has a thorough underwriting process that gives the Company an advantage over its competitors. The Company views its agent relationships and underwriting process as one of its primary competitive advantages because it allows the Company to charge lower premiums yet realize better margins than many competitors.

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The Company operates primarily in the state of California, the only state in which it operated prior to 1990. The Company has since expanded its operations into the following states: Georgia and Illinois (1990), Oklahoma and Texas (1996), Florida (1998), Virginia and New York (2001), New Jersey (2003), and Arizona, Pennsylvania, Michigan, and Nevada (2004). The direct premiums written during the three months ended March 31, 2011 and 2010 by state and line of business were:

Three Months Ended March 31, 2011

(Amounts in thousands)

	Private Passenger Auto	Homeowners	Commercial Auto	Other Lines	Total	
California	$ 414,237	$ 52,506	$ 19,368	$ 13,404	$ 499,515	75.8%
Florida	44,469	2,069	3,622	2,396	52,556	8.0%
Texas	16,499	269	1,263	4,490	22,521	3.4%
New Jersey	22,497	385		87	22,969	3.5%
Other states	47,310	7,631	1,628	4,984	61,553	9.3%
Total	$ 545,012	$ 62,860	$ 25,881	$ 25,361	$ 659,114	100.0%
	82.7%	9.5%	3.9%	3.9%	100.0%	

Three Months Ended March 31, 2010

(Amounts in thousands)

	Private Passenger Auto	Homeowners	Commercial Auto	Other Lines	Total	
California	$ 423,456	$ 48,733	$ 20,028	$ 13,889	$ 506,106	77.5%
Florida	38,622	2,528	3,248	1,453	45,851	7.0%
Texas	17,517	301	1,518	3,809	23,145	3.5%
New Jersey	21,493	92		81	21,666	3.3%
Other states	45,375	5,150	1,717	4,405	56,647	8.7%
Total	$ 546,463	$ 56,804	$ 26,511	$ 23,637	$ 653,415	100%
	83.6%	8.7%	4.1%	3.6%	100%	

C. Regulatory and Litigation Matters

The Department of Insurance (DOI) in each state in which the Company operates is responsible for conducting periodic financial and market conduct examinations of the Insurance Companies in their states. Market conduct examinations typically review compliance with insurance statutes and regulations with respect to rating, underwriting, claims handling, billing, and other practices. The following table presents a summary of current financial and market conduct examinations:

State	Exam Type	Period Under Review	Status
OK	Financial	2008 to 2010	Fieldwork will begin in the second quarter of 2011.
OK	Market Conduct	2008 to 2010	Fieldwork began on March 15, 2011.
TX	Financial	2005 to 2009	Received final report on February 16, 2011.
FL	Financial	2005 to 2009	Received final report on February 4, 2011.
CA	Financial	2008 to 2010	Fieldwork began on January 31, 2011.
IL	Market Conduct	Jul 2009 to Jun 2010	Fieldwork completed. Awaiting final report.