HEICO CORP
Form 10-K
December 23, 2009

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

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended October 31, 2009 or

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

For the transition period from ___________________to__________________

Commission file number 1-4604

HEICO CORPORATION
(Exact name of registrant as specified in its charter)

Florida (State or other jurisdiction of incorporation or organization)	65-0341002 (I.R.S. Employer Identification No.)
3000 Taft Street, Hollywood, Florida (Address of principal executive offices)	33021 (Zip Code)

Registrant's telephone number, including area code: (954) 987-4000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 par value per share Class A Common Stock, $.01 par value per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

Rights to Purchase Series B Junior Participating Preferred Stock
Rights to Purchase Series C Junior Participating Preferred Stock
(Title of class)

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

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 x

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 o

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 during the preceding 12 months. Yes o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the 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. x

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.

Large accelerated filer x   Accelerated filer o   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 x

The aggregate market value of the voting and non-voting common equity held by nonaffiliates of the registrant was $639,454,000 based on the closing price of HEICO Common Stock and Class A Common Stock as of April 30, 2009 as reported by the New York Stock Exchange.

The number of shares outstanding of each of the registrant's classes of common stock as of December 17, 2009:

Common Stock, $.01 par value	10,421,225 shares
Class A Common Stock, $.01 par value	15,732,299 shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant’s definitive proxy statement for the 2010 Annual Meeting of Shareholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

HEICO CORPORATION
INDEX TO ANNUAL REPORT ON FORM 10-K

			Page
PART I			
Item 1.	-	Business	1
Item 1A.	-	Risk Factors	11
Item 1B.	-	Unresolved Staff Comments	15
Item 2.	-	Properties	16
Item 3.	-	Legal Proceedings	16
Item 4.	-	Submission of Matters to a Vote of Security Holders	16
PART II			
Item 5.	-	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	17
Item 6.	-	Selected Financial Data	21
Item 7.	-	Management's Discussion and Analysis of Financial Condition and Results of Operations	22
Item 7A.	-	Quantitative and Qualitative Disclosures About Market Risk	38
Item 8.	-	Financial Statements and Supplementary Data	39
Item 9.	-	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	77
Item 9A.	-	Controls and Procedures	77
Item 9B.	-	Other Information	78
PART III			
Item 10.	-	Directors, Executive Officers and Corporate Governance	79
Item 11.	-	Executive Compensation	79
Item 12.	-	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	79
Item 13.	-	Certain Relationships and Related Transactions, and Director Independence	79
Item 14.	-	Principal Accounting Fees and Services	79
PART IV			
Item 15.	-	Exhibits, Financial Statement Schedules	80
SIGNATURES			85

Table of Contents

PART I

Item 1. BUSINESS

The Company

HEICO Corporation through its subsidiaries (collectively, "HEICO," "we," "us," "our" or the "Company") believes it is the world's largest manufacturer of Federal Aviation Administration ("FAA")-approved jet engine and aircraft component replacement parts, other than the original equipment manufacturers ("OEMs") and their subcontractors. HEICO also believes it is a leading manufacturer of various types of electronic equipment for the aviation, defense, space, medical, telecommunication and electronic industries.

The Company was organized in 1993 creating a new holding corporation known as HEICO Corporation and renaming the former holding company (formerly known as HEICO Corporation, organized in 1957) as HEICO Aerospace Corporation. The reorganization, which was completed in 1993, did not result in any change in the business of the Company, its consolidated assets or liabilities or the relative interests of its shareholders.

Our business is comprised of two operating segments:

The Flight Support Group. Our Flight Support Group ("FSG"), consisting of HEICO Aerospace Holdings Corp. ("HEICO Aerospace") and its subsidiaries, accounted for 73%, 75% and 76% of our net sales in fiscal 2009, 2008 and 2007, respectively. The Flight Support Group uses proprietary technology to design and manufacture jet engine and aircraft component replacement parts for sale at lower prices than those manufactured by OEMs. These parts are approved by the FAA and are the functional equivalent of parts sold by OEMs. In addition, the Flight Support Group repairs and distributes jet engine and aircraft components, avionics and instruments for domestic and foreign commercial air carriers and aircraft repair companies as well as military and business aircraft operators; and manufactures thermal insulation products and other component parts primarily for aerospace, defense and commercial applications.

The Flight Support Group competes with the leading industry OEMs and, to a lesser extent, with a number of smaller, independent parts distributors. Historically, the three principal jet engine OEMs, General Electric (including CFM International), Pratt & Whitney and Rolls Royce, have been the sole source of substantially all jet engine replacement parts for their jet engines. Other OEMs have been the sole source of replacement parts for their aircraft component parts. While we believe that we currently supply less than 2% of the market for jet engine and aircraft component replacement parts, we have in recent years been adding new products to our line at a rate of 400 to 500 per year of Parts Manufacturer Approvals ("PMA" or "PMAs"). We currently offer to our customers over 5,000 parts for which PMAs have been received from the FAA.

We believe that, based on our competitive pricing, reputation for high quality, short lead time requirements, strong relationships with domestic and foreign commercial air carriers and repair stations (companies that overhaul aircraft engines and/or components), strategic relationships with Lufthansa and other major airlines and successful track record of receiving PMAs from the FAA, we are uniquely positioned to continue to increase our product lines and gain market share.

The Electronic Technologies Group. Our Electronic Technologies Group ("ETG"), consisting of HEICO Electronic Technologies Corp. and its subsidiaries, accounted for 27%, 25% and 24% of our net

Table of Contents

sales in fiscal 2009, 2008 and 2007, respectively. Through our Electronic Technologies Group, which derived approximately 46% of its sales in fiscal 2009 from the sale of products and services to U.S. and foreign military agencies, we design, manufacture and sell various types of electronic, microwave and electro-optical products, including infrared simulation and test equipment, laser rangefinder receivers, electrical power supplies, back-up power supplies, power conversion products, underwater locator beacons, electromagnetic interference and radio frequency interference shielding, high power capacitor charging power supplies, amplifiers, photodetectors, amplifier modules, flash lamp drivers, laser diode drivers, arc lamp power supplies, custom power supply designs, cable assemblies, high voltage interconnection devices and wire, high voltage energy generators, high frequency power delivery systems and high-speed interface products that link devices such as telemetry receivers, digital cameras, high resolution scanners, simulation systems and test systems to almost any computer.

In October 1997, we entered into a strategic alliance with Lufthansa. Lufthansa is the world's largest independent provider of engineering and maintenance services for commercial aircraft components and jet engines and supports over 200 airlines, governments and other customers. As part of this strategic alliance, Lufthansa has invested over $60 million in our Company to acquire and maintain a 20% minority interest in HEICO Aerospace. This strategic alliance has enabled us to expand domestically and internationally by enhancing our ability to (i) identify key jet engine and aircraft component replacement parts with significant profit potential by utilizing Lufthansa's extensive operating data on engine and component parts; (ii) introduce those parts throughout the world in an efficient manner due to Lufthansa's testing and diagnostic resources; and (iii) broaden our customer base by capitalizing on Lufthansa's established relationships and alliances within the airline industry.

In March 2001, we entered into a joint venture with American Airlines, one of the world's largest airlines, to develop, design and sell FAA-approved jet engine and aircraft component replacement parts through HEICO Aerospace. The joint venture is partly owned by American Airlines. American Airlines and HEICO Aerospace have agreed to cooperate regarding technical services and marketing support on a worldwide basis. We have also entered into several strategic relationships with other leading airlines, such as United Airlines (May 2002), Delta Air Lines (February 2003), Japan Airlines (March 2004) and British Airways (May 2007). These relationships accelerate HEICO's efforts in developing a broad range of jet engine and aircraft component replacement parts for FAA approval. Each of the aforementioned airlines purchase these newly developed parts, and many of HEICO Aerospace's current FAA-approved parts product line, on an exclusive basis from HEICO Aerospace.

HEICO has continuously operated in the aerospace industry for more than 50 years. Since assuming control in 1990, our current management has achieved significant sales and profit growth through a broadened line of product offerings, an expanded customer base, increased research and development expenditures and the completion of a number of acquisitions. As a result of internal growth and acquisitions, our net sales from continuing operations have grown from $26.2 million in fiscal 1990 to $538.3 million in fiscal 2009, a compound annual growth rate of approximately 17%. During the same period, we improved our net income from $2.0 million to $44.6 million, representing a compound annual growth rate of approximately 18%.

Flight Support Group

The Flight Support Group, headquartered in Hollywood, Florida, serves a broad spectrum of the aviation industry, including (i) commercial airlines and air cargo carriers; (ii) repair and overhaul facilities; (iii) OEMs; and (iv) U.S. and foreign governments.

Jet engine and aircraft component replacement parts can be categorized by their ongoing ability to be repaired and returned to service. The general categories in which we participate are as follows: (i)

Table of Contents

rotable; (ii) repairable; and (iii) expendable. A rotable is a part which is removed periodically as dictated by an operator's maintenance procedures or on an as needed basis and is typically repaired or overhauled and re-used an indefinite number of times. An important subset of rotables is "life limited" parts. A life limited rotable has a designated number of allowable flight hours and/or cycles (one take-off and landing generally constitutes one cycle) after which it is rendered unusable. A repairable is similar to a rotable except that it can only be repaired a limited number of times before it must be discarded. An expendable is generally a part which is used and not thereafter repaired for further use.

Jet engine and aircraft component replacement parts are classified within the industry as (i) factory-new; (ii) new surplus; (iii) overhauled; (iv) repairable; and (v) as removed. A factory-new or new surplus part is one that has never been installed or used. Factory-new parts are purchased from FAA-approved manufacturers (such as HEICO or OEMs) or their authorized distributors. New surplus parts are purchased from excess stock of airlines, repair facilities or other redistributors. An overhauled part is one that has been completely repaired and inspected by a licensed repair facility such as ours. An aircraft spare part is classified as "repairable" if it can be repaired by a licensed repair facility under applicable regulations. A part may also be classified as "repairable" if it can be removed by the operator from an aircraft or jet engine while operating under an approved maintenance program and is airworthy and meets any manufacturer or time and cycle restrictions applicable to the part. A "factory-new," "new surplus" or "overhauled" part designation indicates that the part can be immediately utilized on an aircraft. A part in "as removed" or "repairable" condition requires inspection and possibly functional testing, repair or overhaul by a licensed facility prior to being returned to service in an aircraft.

Factory-New Jet Engine and Aircraft Component Replacement Parts. The Flight Support Group engages in the research and development, design, manufacture and sale of FAA-approved replacement parts that are sold to domestic and foreign commercial air carriers and aircraft repair and overhaul companies. Our principal competitors are Pratt & Whitney, a division of United Technologies Corporation, and General Electric Company, including its CFM International joint venture. The Flight Support Group's factory-new replacement parts include various jet engine and aircraft component replacement parts. A key element of our growth strategy is the continued design and development of an increasing number of PMA replacement parts in order to further penetrate our existing customer base and obtain new customers. We select the jet engine and aircraft component replacement parts to design and manufacture through a selection process which analyzes industry information to determine which replacement parts are suitable candidates. As part of Lufthansa's investment in the Flight Support Group, Lufthansa has the right to select 50% of the parts for which we will seek PMAs, provided that such parts are technologically and economically feasible and substantially comparable with the profitability of our other PMA parts.

Repair and Overhaul Services. The Flight Support Group provides repair and overhaul services on selected jet engine and aircraft component parts, as well as on avionics, instruments, composites and flight surfaces of commercial aircraft operated by domestic and foreign commercial airlines. The Flight Support Group also provides repair and overhaul services including avionics and navigation systems as well as subcomponents and other instruments utilized on military aircraft operated by the United States government and foreign military agencies and for aircraft repair and overhaul companies. Our repair and overhaul operations require a high level of expertise, advanced technology and sophisticated equipment. Services include the repair, refurbishment and overhaul of numerous accessories and parts mounted on gas turbine engines and airframes. Components overhauled include fuel pumps, generators, fuel controls, pneumatic valves, starters and actuators, turbo compressors and constant speed drives, hydraulic pumps, valves and actuators, composite flight controls, electro-mechanical equipment and auxiliary power unit accessories. The Flight Support Group also provides commercial airlines, regional operators, asset management companies and Maintenance, Repair and Overhaul ("MRO") providers with high quality and cost effective niche accessory component exchange services as an alternative to OEMs' spares services.

Table of Contents

Distribution. The Flight Support Group distributes FAA-approved parts including hydraulic, pneumatic, mechanical and electro-mechanical components for the commercial, regional and general aviation markets.

Manufacture of Specialty Aircraft/Defense Related Parts and Subcontracting for OEMs. The Flight Support Group manufactures thermal insulation blankets primarily for aerospace, defense and commercial applications. The Flight Support Group also manufactures specialty components for sale as a subcontractor for aerospace and industrial original equipment manufacturers and the United States government.

FAA Approvals and Product Design. Non-OEM manufacturers of jet engine replacement parts must receive a PMA from the FAA to sell the replacement part. The PMA approval process includes the submission of sample parts, drawings and testing data to one of the FAA's Aircraft Certification Offices where the submitted data are analyzed. We believe that an applicant's ability to successfully complete the PMA process is limited by several factors, including (i) the agency's confidence level in the applicant; (ii) the complexity of the part; (iii) the volume of PMAs being filed; and (iv) the resources available to the FAA. We also believe that companies such as HEICO that have demonstrated their manufacturing capabilities and established favorable track records with the FAA generally receive a faster turnaround time in the processing of PMA applications. Finally, we believe that the PMA process creates a significant barrier to entry in this market niche through both its technical demands and its limits on the rate at which competitors can bring products to market.

As part of our growth strategy, we have continued to increase our research and development activities. Research and development expenditures by the Flight Support Group, which were approximately $300,000 in fiscal 1991, increased to approximately $11.5 million in fiscal 2009, $11.1 million in fiscal 2008 and $10.7 million in 2007. We believe that our Flight Support Group's research and development capabilities are a significant component of our historical success and an integral part of our growth strategy. In recent years, the FAA granted us PMAs for approximately 400 to 500 new parts per year (excluding acquired PMAs); however, no assurance can be given that the FAA will continue to grant PMAs or that we will achieve acceptable levels of net sales and gross profits on such parts in the future.

We benefit from our proprietary rights relating to certain design, engineering and manufacturing processes and repair and overhaul procedures. Customers often rely on us to provide initial and additional components, as well as to redesign, re-engineer, replace or repair and provide overhaul services on such aircraft components at every stage of their useful lives. In addition, for some products, our unique manufacturing capabilities are required by the customer's specifications or designs, thereby necessitating reliance on us for production of such designed products.

We have no material patents for the proprietary techniques, including software and manufacturing expertise, we have developed to manufacture jet engine and aircraft component replacement parts and instead, we primarily rely on trade secret protection. Although our proprietary techniques and software and manufacturing expertise are subject to misappropriation or obsolescence, we believe that we take appropriate measures to prevent misappropriation or obsolescence from occurring by developing new techniques and improving existing methods and processes, which we will continue on an ongoing basis as dictated by the technological needs of our business.

Electronic Technologies Group

Our Electronic Technologies Group's strategy is to design and produce mission-critical subcomponents for smaller, niche markets, but which are utilized in larger systems – systems like

targeting, tracking, identification, simulation, testing, communications, lighting, surgical, x-ray, telecom and computer systems. These systems are, in turn, often located on another platform, such as aircraft, satellites, ships, vehicles, handheld devices and other platforms.

Electro-Optical Infrared Simulation and Test Equipment. The Electronic Technologies Group believes it is a leading international designer and manufacturer of niche state-of-the-art simulation, testing and calibration equipment used in the development of missile seeking technology, airborne targeting and reconnaissance systems, shipboard targeting and reconnaissance systems, space-based sensors as well as ground vehicle-based systems. These products include infrared scene projector equipment, such as our MIRAGE IR Scene Simulator, high precision blackbody sources, software and integrated calibration systems.

Simulation equipment allows the U.S. government and allied foreign military to save money on missile testing as it allows infrared-based missiles to be tested on a multi-axis, rotating table instead of requiring the launch of a complete missile. In addition, several large military prime contractors have elected to purchase such equipment from us instead of maintaining internal staff to do so because we can offer a more cost-effective solution. Our customers include major U.S. Department of Defense weapons laboratories and defense prime contractors, such as Lockheed Martin, Northrop Grumman and Boeing.

Electro-Optical Laser Products. The Electronic Technologies Group believes it is a leading designer and maker of Laser Rangefinder Receivers and other photodetectors used in airborne, vehicular and handheld targeting systems manufactured by major prime military contractors, such as Northrop Grumman and Lockheed Martin. Most of our Rangefinder Receiver product offering consists of complex and patented products which detect reflected light from laser targeting systems and allow the systems to confirm target accuracy and calculate target distances prior to discharging a weapon system. These products are also used in laser eye surgery systems for tracking ocular movement.

Electro-Optical, Microwave and Other Power Equipment. The Electronic Technologies Group produces power supplies, amplifiers and flash lamp drivers used in laser systems for military, medical and other applications that are sometimes utilized with our Rangefinder Receivers. We also produce emergency back-up power supplies and batteries used on commercial aircraft and business jets for services such as emergency exit lighting, emergency fuel shut-off, power door assists, cockpit voice recorders and flight computers. We offer custom or standard designs that solve challenging OEM requirements and meet stringent agency safety and emissions requirements. Our power electronics products include capacitor charger power supplies, laser diode drivers, arc lamp power supplies and custom power supply designs.

Our microwave products are used in satellites and electronic warfare systems. These products, which include isolators, bias tees, circulators, latching ferrite switches and waveguide adapters, are used in satellites to control or direct energy according to operator needs. As satellites are frequently used as sensors for stand-off warfare, we believe this product line further supports our goal of increasing our activity in the stand-off market. We believe we are a leading supplier of the niche products which we design and manufacture for this market, a market that includes commercial satellites. Our customers for these products include satellite manufacturers, such as Space Systems/Loral, Boeing and Raytheon.

Electromagnetic and Radio Interference Shielding. The Electronic Technologies Group designs and manufactures shielding used to prevent electromagnetic energy and radio frequencies from interfering with computers, telecommunication devices, avionics, weapons systems and other electronic equipment. Our products include a patented line of shielding applied directly to circuit boards and a line of gasket-type shielding applied to computers and other electronic equipment. Our customers consist essentially of medical, electronic, telecommunication and defense equipment producers.

Table of Contents

High-Speed Interface Products. The Electronic Technologies Group designs and manufactures advanced high-technology, high-speed interface products utilized in homeland security, defense, medical research, astronomical and other applications across numerous industries.

High Voltage Interconnection Devices. The Electronic Technologies Group designs and manufactures high and very high voltage interconnection devices, cable assemblies and wire for the medical equipment, defense and other industrial markets. Among others, our products are utilized in aircraft missile defense, fighter pilot helmet displays, avionic systems, medical applications, wireless communications, and industrial applications including high voltage test equipment and underwater monitoring systems.

High Voltage Advanced Power Electronics. The Electronic Technologies Group designs and manufactures a patented line of high voltage energy generators for medical, baggage inspection and industrial imaging systems, and also offers a patented line of high frequency power delivery systems for the commercial sign industry.

Power Conversion Products. The Electronic Technologies Group designs and provides innovative power conversion products principally serving the high-reliability military, space and commercial avionics end-markets. These high density, low profile and lightweight DC-to-DC converters and electromagnetic interference filters, which include thick film hermetically sealed hybrids, military commercial-off-the-shelf and custom designed and assembled products, have become the primary specified components of their kind on a generation of complex military, space and avionics equipment.

Underwater Locator Beacons. The Electronic Technologies Group designs and manufactures Underwater Locator Beacons (“ULBs”) used to locate aircraft Cockpit Voice Recorders and Flight Data Recorders, marine ship Voyage Recorders and various other devices which have been submerged under water. ULBs are required equipment on all U.S. FAA and European Aviation Safety Agency (“EASA”) approved Flight Data and Cockpit Voice Recorders used in aircraft and on similar systems utilized on large marine shipping vessels.

As part of our growth strategy, we have continued to increase our research and development activities. Research and development expenditures by the Electronic Technologies Group were $8.2 million in fiscal 2009, $7.3 million in fiscal 2008 and $5.8 million in fiscal 2007. We believe that our Electronic Technologies Group’s research and development capabilities are a significant component of our historical success and an integral part of our growth strategy.

Financial Information About Operating Segments and Geographic Areas

See Note 14, Operating Segments, of the Notes to Consolidated Financial Statements for financial information by operating segment and by geographic areas.

Distribution, Sales, Marketing and Customers

Each of our operating segments independently conducts distribution, sales and marketing efforts directed at their respective customers and industries and, in some cases, collaborates with other operating divisions and subsidiaries within its group for cross-marketing efforts. Sales and marketing efforts are conducted primarily by in-house personnel and, to a lesser extent, by independent manufacturers’ representatives. Generally, the in-house sales personnel receive a base salary plus commission and manufacturers’ representatives receive a commission on sales.

Table of Contents

We believe that direct relationships are crucial to establishing and maintaining a strong customer base and, accordingly, our senior management is actively involved in our marketing activities, particularly with established customers. We are also a member of various trade and business organizations related to the commercial aviation industry, such as the Aerospace Industries Association, which we refer to as AIA, the leading trade association representing the nation's manufacturers of commercial, military and business aircraft, aircraft engines and related components and equipment. Due in large part to our established industry presence, we enjoy strong customer relations, name recognition and repeat business.

We sell our products to a broad customer base consisting of domestic and foreign commercial and cargo airlines, repair and overhaul facilities, other aftermarket suppliers of aircraft engine and airframe materials, OEMs, domestic and foreign military units, electronic manufacturing services companies, manufacturers for the defense industry as well as medical, telecommunication, scientific, and industrial companies. No one customer accounted for sales of 10% or more of total consolidated sales from continuing operations during any of the last three fiscal years. Net sales to our five largest customers accounted for approximately 20% of total net sales during the year ended October 31, 2009.

Competition

The aerospace product and service industry is characterized by intense competition and some of our competitors have substantially greater name recognition, inventories, complementary product and service offerings, financial, marketing and other resources than we do. As a result, such competitors may be able to respond more quickly to customer requirements than we can. Moreover, smaller competitors may be in a position to offer more attractive pricing as a result of lower labor costs and other factors.

Our jet engine and aircraft component replacement parts business competes primarily with Pratt & Whitney, General Electric, and other OEMs. The competition is principally based on price and service to the extent that our parts are interchangeable. With respect to other aerospace products and services sold by the Flight Support Group, we compete with both the leading jet engine OEMs and a large number of machining, fabrication and repair companies, some of which have greater financial and other resources than we do. Competition is based mainly on price, product performance, service and technical capability.

Competition for the repair and overhaul of jet engine and aircraft components comes from three principal sources: OEMs, major commercial airlines and other independent service companies. Some of these competitors have greater financial and other resources than we do. Some major commercial airlines own and operate their own service centers and sell repair and overhaul services to other aircraft operators. Foreign airlines that provide repair and overhaul services typically provide these services for their own aircraft components and for third parties. OEMs also maintain service centers that provide repair and overhaul services for the components they manufacture. Other independent service organizations also compete for the repair and overhaul business of other users of aircraft components. We believe that the principal competitive factors in the repair and overhaul market are quality, turnaround time, overall customer service and price.

Our Electronic Technologies Group competes with several large and small domestic and foreign competitors, some of which have greater financial and other resources than we do. The markets for our electronic products are niche markets with several competitors with competition based mainly on design, technology, quality, price, and customer satisfaction.

Raw Materials

We purchase a variety of raw materials, primarily consisting of high temperature alloy sheet metal and castings, forgings, pre-plated metals and electrical components from various vendors. The

Table of Contents

materials used by our operations are generally available from a number of sources and in sufficient quantities to meet current requirements subject to normal lead times.

Backlog

Our total backlog of unshipped orders was $104.5 million as of October 31, 2009 compared to $107.1 million as of October 31, 2008. The Flight Support Group's backlog of unshipped orders was $32.9 million as of October 31, 2009 as compared to $49.0 million as of October 31, 2008. This backlog excludes forecasted shipments for certain contracts of the Flight Support Group pursuant to which customers provide only estimated annual usage and not firm purchase orders. Our backlogs within the Flight Support Group are typically short-lead in nature with many product orders being received within the month of shipment. The decrease in the Flight Support Group's backlog reflects a reduction in demand for our aftermarket replacement parts and repair and overhaul services resulting from worldwide airline capacity cuts and efforts to reduce spending and conserve cash by the airline industry. The Electronic Technologies Group's backlog of unshipped orders was $71.6 million as of October 31, 2009 as compared to $58.1 million as of October 31, 2008. The increase in the Electronic Technologies Group's backlog is primarily related to backlogs of businesses acquired during fiscal 2009 and some increased orders associated with our defense related businesses, including homeland security products. Substantially the entire backlog of orders as of October 31, 2009 is expected to be delivered during fiscal 2010.

Government Regulation

The FAA regulates the manufacture, repair and operation of all aircraft and aircraft parts operated in the United States. Its regulations are designed to ensure that all aircraft and aviation equipment are continuously maintained in proper condition to ensure safe operation of the aircraft. Similar rules apply in other countries. All aircraft must be maintained under a continuous condition monitoring program and must periodically undergo thorough inspection and maintenance. The inspection, maintenance and repair procedures for the various types of aircraft and equipment are prescribed by regulatory authorities and can be performed only by certified repair facilities utilizing certified technicians. Certification and conformance is required prior to installation of a part on an aircraft. Aircraft operators must maintain logs concerning the utilization and condition of aircraft engines, life-limited engine parts and airframes. In addition, the FAA requires that various maintenance routines be performed on aircraft engines, some engine parts, and airframes at regular intervals based on cycles or flight time. Engine maintenance must also be performed upon the occurrence of certain events, such as foreign object damage in an aircraft engine or the replacement of life-limited engine parts. Such maintenance usually requires that an aircraft engine be taken out of service. Our operations may in the future be subject to new and more stringent regulatory requirements. In that regard, we closely monitor the FAA and industry trade groups in an attempt to understand how possible future regulations might impact us.

There has been no material adverse effect to our consolidated financial statements as a result of these government regulations.

Environmental Regulation

Our operations are subject to extensive, and frequently changing, federal, state and local environmental laws and substantial related regulation by government agencies, including the Environmental Protection Agency. Among other matters, these regulatory authorities impose requirements that regulate the operation, handling, transportation and disposal of hazardous materials; protect the health and safety of workers; and require us to obtain and maintain licenses and permits in connection with our operations. This extensive regulatory framework imposes significant compliance

Table of Contents

burdens and risks on us. Notwithstanding these burdens, we believe that we are in material compliance with all federal, state and local laws and regulations governing our operations.

Other Regulation

We are also subject to a variety of other regulations including work-related and community safety laws. The Occupational Safety and Health Act of 1970 mandates general requirements for safe workplaces for all employees and established the Occupational Safety and Health Administration ("OSHA") in the Department of Labor. In particular, OSHA provides special procedures and measures for the handling of some hazardous and toxic substances. In addition, specific safety standards have been promulgated for workplaces engaged in the treatment, disposal or storage of hazardous waste. Requirements under state law, in some circumstances, may mandate additional measures for facilities handling materials specified as extremely dangerous. We believe that our operations are in material compliance with OSHA's health and safety requirements.

Insurance

We are a named insured under policies which include the following coverage: (i) product liability, including grounding; (ii) personal property, inventory and business income at our facilities; (iii) general liability coverage; (iv) employee benefit liability; (v) international liability and automobile liability; (vi) umbrella liability coverage; and (vii) various other activities or items subject to certain limits and deductibles. We believe that our insurance coverage is adequate to insure against the various liability risks of our business.

Employees

As of October 31, 2009, we had approximately 2,100 full-time and part-time employees including approximately 1,400 in the Flight Support Group and approximately 700 in the Electronic Technologies Group. None of our employees are represented by a union. Our management believes that we have good relations with our employees.

Available Information

Our Internet web site address is http://www.heico.com. We make available free of charge through our web site our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission ("SEC"). These materials are also available free of charge on the SEC's website at http://www.sec.gov. The information on or obtainable through our web site is not incorporated into this annual report on Form 10-K.

We have adopted a code of ethics that applies to our principal executive officer, principal financial officer, principal accounting officer or controller and other persons performing similar functions. Our Code of Ethics for Senior Financial Officers and Other Officers is part of our Code of Business Conduct, which is located on our web site at http://www.heico.com. Any amendments to or waivers from a provision of this code of ethics will be posted on the web site. Also located on the web site are our Corporate Governance Guidelines, Finance/Audit Committee Charter, Nominating & Corporate Governance Committee Charter, and Compensation Committee Charter.

Copies of the above referenced materials will be made available, free of charge, upon written request to the Corporate Secretary at the Company's headquarters.

Table of Contents

Executive Officers of the Registrant

Our executive officers are elected by the Board of Directors at the first meeting following the annual meeting of shareholders and serve at the discretion of the Board. The following table sets forth the names, ages of, and positions and offices held by our executive officers as of December 17, 2009:

Name	Age	Position(s)	Director Since
Laurans A. Mendelson	71	Chairman of the Board and Chief Executive Officer	1989
Eric A. Mendelson	44	Co-President and Director; President and Chief Executive Officer of HEICO Aerospace Holdings Corp.	1992
Victor H. Mendelson	42	Co-President and Director; President and Chief Executive Officer of HEICO Electronic Technologies Corp.	1996
Thomas S. Irwin	63	Executive Vice President and Chief Financial Officer	
William S. Harlow	61	Vice President of Corporate Development	

Laurans A. Mendelson has served as our Chairman of the Board since December 1990. He has also served as our Chief Executive Officer since February 1990 and served as our President from September 1991 through September 2009. HEICO Corporation is a member of the Aerospace Industries Association (“AIA”) in Washington D.C., and Mr. Mendelson serves on the Board of Governors of AIA. He is also former Chairman of the Board of Trustees, former Chairman of the Executive Committee and a current member of the Society of Mt. Sinai Founders of Mt. Sinai Medical Center in Miami Beach, Florida. In addition, Mr. Mendelson served as a Trustee of Columbia University in The City of New York from 1995 to 2001, as well as Chairman of the Trustees’ Audit Committee. Mr. Mendelson currently serves as Trustee Emeritus of Columbia University. Mr. Mendelson is a Certified Public Accountant. Laurans Mendelson is the father of Eric Mendelson and Victor Mendelson.

Eric A. Mendelson has served as our Co-President since October 2009 and served as our Executive Vice President from 2001 through September 2009. He also serves as President and Chief Executive Officer of HEICO Aerospace Holdings Corp., a subsidiary of ours, since its formation in 1997; and President of HEICO Aerospace Corporation since 1993. He also served as our Vice President from 1992 to 2001; President of HEICO’s Jet Avion Corporation, a wholly owned subsidiary of HEICO Aerospace, from 1993 to 1996; and Jet Avion’s Executive Vice President and Chief Operating Officer from 1991 to 1993. From 1990 to 1991, Mr. Mendelson was our Director of Planning and Operations. Mr. Mendelson is a co-founder, and, since 1987, has been Managing Director of Mendelson International Corporation, a private investment company and a shareholder of HEICO. In addition, Mr. Mendelson is a member of the Advisory Board of Trustees of Mt. Sinai Medical Center in Miami Beach, Florida and a member of the Board of Trustees of Ransom – Everglades School in Coconut Grove, Florida, as well as a member of the Executive Committee of the Columbia College Alumni Association. Eric Mendelson is the son of Laurans Mendelson and the brother of Victor Mendelson.

Victor H. Mendelson has served as our Co-President since October 2009 and served as our Executive Vice President from 2001 through September 2009. He also serves as President and Chief

Table of Contents

Executive Officer of HEICO Electronic Technologies Corp., a subsidiary of ours, since September 1996. He served as our General Counsel from 1993 to September 2008 and our Vice President from 1996 to 2001. In addition, Mr. Mendelson was the Executive Vice President of our former MediTek Health Corporation subsidiary from 1994 and MediTek Health's Chief Operating Officer from 1995 until its sale in July 1996. He was our Associate General Counsel from 1992 until 1993. From 1990 until 1992, he worked on a consulting basis with us, developing and analyzing various strategic opportunities. Mr. Mendelson is a co-founder, and, since 1987, has been President of Mendelson International Corporation, a private investment company and a shareholder of HEICO. He is a member of the Board of Visitors of Columbia College in New York City, a Trustee of St. Thomas University in Miami Gardens, Florida and President and a Director of the Florida Grand Opera. Victor Mendelson is the son of Laurans Mendelson and the brother of Eric Mendelson.

Thomas S. Irwin has served as our Executive Vice President and Chief Financial Officer since September 1991; our Senior Vice President from 1986 to 1991; and our Vice President and Treasurer from 1982 to 1986. Mr. Irwin is a Certified Public Accountant. He is a Trustee of the Greater Hollywood Chamber of Commerce and a Director of the Broward Alliance.

William S. Harlow has served as our Vice President of Corporate Development since 2001 and served as Director of Corporate Development from 1995 to 2001.

Item 1A. RISK FACTORS

Our business, financial condition, operating results and cash flows can be impacted by a number of factors, many of which are beyond our control, including those set forth below and elsewhere in this Annual Report on Form 10-K, any one of which may cause our actual results to differ materially from anticipated results:

Our success is highly dependent on the performance of the aviation industry, which could be impacted by lower demand for commercial air travel or airline fleet changes causing lower demand for our goods and services.

Economic factors and passenger security concerns that affect the aviation industry also affect our business. The aviation industry has historically been subject to downward cycles from time to time which reduce the overall demand for jet engine and aircraft component replacement parts and repair and overhaul services, and such downward cycles result in lower prices and greater credit risk. These economic factors and passenger security concerns may have a material adverse effect on our business, financial condition and results of operations.

We are subject to governmental regulation and our failure to comply with these regulations could cause the government to withdraw or revoke our authorizations and approvals to do business and could subject us to penalties and sanctions that could harm our business.

Governmental agencies throughout the world, including the FAA, highly regulate the manufacture, repair and overhaul of aircraft parts and accessories. We include, with the replacement parts that we sell to our customers, documentation certifying that each part complies with applicable regulatory requirements and meets applicable standards of airworthiness established by the FAA or the equivalent regulatory agencies in other countries. In addition, our repair and overhaul operations are subject to certification pursuant to regulations established by the FAA. Specific regulations vary from country to country, although compliance with FAA requirements generally satisfies regulatory requirements in other countries. The revocation or suspension of any of our material authorizations or approvals would have an

Table of Contents

adverse effect on our business, financial condition and results of operations. New and more stringent government regulations, if adopted and enacted, could have an adverse effect on our business, financial condition and results of operations. In addition, some sales to foreign countries of the equipment manufactured by our Electronic Technologies Group require approval or licensing from the U.S. government. Denial of export licenses could reduce our sales to those countries and could have a material adverse effect on our business.

The retirement of commercial aircraft could reduce our revenues.

Our Flight Support Group designs, engineers, manufactures and distributes jet engine and aircraft component replacement parts and also repairs, refurbishes and overhauls jet engine and aircraft components. If aircraft or engines for which we have replacement parts or supply repair and overhaul services are retired and there are fewer aircraft that require these parts or services, our revenues may decline.

Reductions in defense, space or homeland security spending by U.S. and/or foreign customers could reduce our revenues.

In fiscal 2009, approximately 46% of the sales of our Electronic Technologies Group were derived from the sale of defense products and services to U.S. and foreign military agencies and their suppliers. A decline in defense, space or homeland security budgets or additional restrictions imposed by the U.S. government on sales of products or services to foreign military agencies could lower sales of our products and services.

Intense competition from existing and new competitors may harm our business.

We face significant competition in each of our businesses.

Flight Support Group

- For jet engine replacement parts, we compete with the industry's leading jet engine OEMs, particularly Pratt & Whitney and General Electric.

- For the overhaul and repair of jet engine and airframe components as well as avionics and navigation systems, we compete with:

  - major commercial airlines, many of which operate their own maintenance and overhaul units;
  - OEMs, which manufacture, repair and overhaul their own parts; and
  - other independent service companies.

Electronic Technologies Group

- For the design and manufacture of various types of electronic and electro-optical equipment as well as high voltage interconnection devices and high speed interface products, we compete in a fragmented marketplace with a number of companies, some of which are well capitalized.

The aviation aftermarket supply industry is highly fragmented, has several highly visible leading companies, and is characterized by intense competition. Some of our OEM competitors have greater name recognition than HEICO, as well as complementary lines of business and financial, marketing and other

12

Table of Contents

resources that HEICO does not have. In addition, OEMs, aircraft maintenance providers, leasing companies and FAA-certificated repair facilities may attempt to bundle their services and product offerings in the supply industry, thereby significantly increasing industry competition. Moreover, our smaller competitors may be able to offer more attractive pricing of parts as a result of lower labor costs or other factors. A variety of potential actions by any of our competitors, including a reduction of product prices or the establishment by competitors of long-term relationships with new or existing customers, could have a material adverse effect on our business, financial condition and results of operations. Competition typically intensifies during cyclical downturns in the aviation industry, when supply may exceed demand. We may not be able to continue to compete effectively against present or future competitors, and competitive pressures may have a material and adverse effect on our business, financial condition and results of operations.

Our success is dependent on the development and manufacture of new products, equipment and services. Our inability to develop, manufacture and introduce new products and services at profitable pricing levels could reduce our sales or sales growth.

The aviation, defense, space, medical, telecommunication and electronic industries are constantly undergoing development and change and, accordingly, new products, equipment and methods of repair and overhaul service are likely to be introduced in the future. In addition to manufacturing electronic and electro-optical equipment and selected aerospace and defense components for OEMs and the U.S. government and repairing jet engine and aircraft components, we re-design sophisticated aircraft replacement parts originally developed by OEMs so that we can offer the replacement parts for sale at substantially lower prices than those manufactured by the OEMs. Consequently, we devote substantial resources to research and product development. Technological development poses a number of challenges and risks, including the following:

- We may not be able to successfully protect the proprietary interests we have in various aircraft parts, electronic and electro-optical equipment and our repair processes;

- As OEMs continue to develop and improve jet engines and aircraft components, we may not be able to re-design and manufacture replacement parts that perform as well as those offered by OEMs or we may not be able to profitably sell our replacement parts at lower prices than the OEMs;

- We may need to expend significant capital to:
  - purchase new equipment and machines,
  - train employees in new methods of production and service, and
  - fund the research and development of new products; and

- Development by our competitors of patents or methodologies that preclude us from the design and manufacture of aircraft replacement parts or electrical and electro-optical equipment could adversely affect our business, financial condition and results of operations.

In addition, we may not be able to successfully develop new products, equipment or methods of repair and overhaul service, and the failure to do so could have a material adverse effect on our business, financial condition and results of operations.

Table of Contents

Product specification costs and requirements could cause an increase to our costs to complete contracts.

The costs to meet customer specifications and requirements could result in us having to spend more to design or manufacture products and this could reduce our profit margins on current contracts or those we obtain in the future.

We may incur product liability claims that are not fully insured.

Our jet engine and aircraft component replacement parts and repair and overhaul services expose our business to potential liabilities for personal injury or death as a result of the failure of an aircraft component that we have designed, manufactured or serviced. The commercial aviation industry occasionally has catastrophic losses that may exceed policy limits. An uninsured or partially insured claim, or a claim for which third-party indemnification is not available, could have a material adverse effect on our business, financial condition and results of operations. Additionally, insurance coverage costs may become even more expensive in the future. Our customers typically require us to maintain substantial insurance coverage and our inability to obtain insurance coverage at commercially reasonable rates could have a material adverse effect on our business.

We may not have the administrative, operational or financial resources to continue to grow the company.

We have experienced rapid growth in recent periods and intend to continue to pursue an aggressive growth strategy, both through acquisitions and internal expansion of products and services. Our growth to date has placed, and could continue to place, significant demands on our administrative, operational and financial resources. We may not be able to grow effectively or manage our growth successfully, and the failure to do so could have a material adverse effect on our business, financial condition and results of operations.

We may not be able to execute our acquisition strategy, which could slow our growth.

A key element of our strategy is growth through the acquisition of additional companies. Our acquisition strategy is affected by and poses a number of challenges and risks, including the following:

- Availability of suitable acquisition candidates;
- Availability of capital;
- Diversion of management’s attention;
- Integration of the operations and personnel of acquired companies;
- Potential write downs of acquired intangible assets;
- Potential loss of key employees of acquired companies;
- Use of a significant portion of our available cash;
- Significant dilution to our shareholders for acquisitions made utilizing our securities; and
- Consummation of acquisitions on satisfactory terms.

Table of Contents

We may not be able to successfully execute our acquisition strategy, and the failure to do so could have a material adverse effect on our business, financial condition and results of operations.

We may incur environmental liabilities and these liabilities may not be covered by insurance.

Our operations and facilities are subject to a number of federal, state and local environmental laws and regulations, which govern, among other things, the discharge of hazardous materials into the air and water as well as the handling, storage and disposal of hazardous materials. Pursuant to various environmental laws, a current or previous owner or operator of real property may be liable for the costs of removal or remediation of hazardous materials. Environmental laws typically impose liability whether or not the owner or operator knew of, or was responsible for, the presence of hazardous materials. Although management believes that our operations and facilities are in material compliance with environmental laws and regulations, future changes in them or interpretations thereof or the nature of our operations may require us to make significant additional capital expenditures to ensure compliance in the future.

We do not maintain specific environmental liability insurance and the expenses related to these environmental liabilities, if we are required to pay them, could have a material adverse effect on our business, financial condition and results of operations.

We are dependent on key personnel and the loss of these key personnel could have a material adverse effect on our success.

Our success substantially depends on the performance, contributions and expertise of our senior management team led by Laurans A. Mendelson, our Chairman and Chief Executive Officer, Eric A. Mendelson, our Co-President, and Victor H. Mendelson, our Co-President. Technical employees are also critical to our research and product development, as well as our ability to continue to re-design sophisticated products of OEMs in order to sell competing replacement parts at substantially lower prices than those manufactured by the OEMs. The loss of the services of any of our executive officers or other key employees or our inability to continue to attract or retain the necessary personnel could have a material adverse effect on our business, financial condition and results of operations.

Our executive officers and directors have significant influence over our management and direction.

As of December 17, 2009, collectively our executive officers and entities controlled by them, our 401(k) Plan and members of the Board of Directors beneficially owned approximately 26% of our outstanding Common Stock and approximately 7% of our outstanding Class A Common Stock. Accordingly, they will be able to substantially influence the election of the Board of Directors and control our business, policies and affairs, including our position with respect to proposed business combinations and attempted takeovers.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Table of Contents

Item 2. PROPERTIES

We own or lease a number of facilities, which are utilized by our Flight Support Group ("FSG"), Electronic Technologies Group ("ETG") and Corporate office. All of the facilities listed below are in good operating condition, well maintained and in regular use. We believe that our existing facilities are sufficient to meet our operational needs for the foreseeable future. Summary information on the facilities utilized within the FSG and the ETG to support their principal operating activities is as follows:

Flight Support Group

	Square Footage		
Location	Leased	Owned	Description
United States facilities (8 states)	294,000	173,000	Manufacturing, engineering and distribution facilities, and corporate headquarters
United States facilities (6 states)	134,000	127,000	Repair and overhaul facilities
International facilities (3 countries) - India, Singapore and United Kingdom	10,000	—	Manufacturing, engineering and distribution facilities

Electronic Technologies Group

	Square Footage		
Location	Leased	Owned	Description
United States facilities (9 states)	185,000	76,000	Manufacturing and engineering facilities
International facilities (2 countries) - Canada and United Kingdom	52,000	12,000	Manufacturing and engineering facilities

Corporate

	Square Footage		
Location	Leased	Owned (1)	Description
United States facilities (1 state)	—	4,000	Administrative offices

(1) Represents the square footage of corporate offices in Miami, Florida. The square footage of our corporate headquarters in Hollywood, FL is included within the square footage under the caption "United States facilities (8 states)" under Flight Support Group.

Item 3. LEGAL PROCEEDINGS

We are involved in various legal actions arising in the normal course of business. Based upon the company's and our legal counsel's evaluations of any claims or assessments, management is of the opinion that the outcome of these matters will not have a material adverse effect on our results of operations, financial position or cash flows.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of fiscal 2009.

Table of Contents

PART II

Item 5. MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our Class A Common Stock and Common Stock are listed and traded on the New York Stock Exchange (“NYSE”) under the symbols “HEI.A” and “HEI”, respectively. The following tables set forth, for the periods indicated, the high and low share prices for our Class A Common Stock and our Common Stock as reported on the NYSE, as well as the amount of cash dividends paid per share during such periods.

Class A Common Stock

	High	Low		Cash Dividends Per Share			
Fiscal 2008:							
First Quarter	$ 44.63	$ 32.05		$ .05			
Second Quarter	42.24	32.80					
Third Quarter	41.68	24.87	1,729		1,039	919	2,736
Net income	$ 821	$ 2,538		$ 4,365	$ 3,762	$ 6,699	
Earnings per share							
Basic	$ .35	$ 1.19		$ 2.07	$ 1.78	$ 3.17	
Diluted	$ .35	$ 1.19		$ 2.07	$ 1.78	$ 3.17	
Weighted average number of shares outstanding:							
Basic	2,343	2,125		2,110	2,114	2,115	
Diluted	2,343	2,129		2,111	2,118	2,118	
Balance Sheet Data: (at year end)							
Total investments	$ 213,132	$ 209,397		$ 202,887	$ 197,709	$ 182,289	
Total assets	285,078	265,900		268,678	255,704	233,978	
Reserve for losses and loss adjustment	151,355	147,136		146,474	128,415	115,191	

expenses					
Unearned premiums	50,179	35,119	36,176	33,685	29,662
Stockholders equity	68,551	67,924	70,259	71,974	75,894
Dividend Data:					
Cash dividend per common share	$ .40	$ .40	$ .40	$ .40	$ .55

Table of Contents

Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Proposal by Mutual

On March 20, 2006, the Chairman of the Board of the Company received a letter from the Chairman of Mutual that indicated that Mutual was interested in acquiring the Company and was prepared to negotiate an all cash acquisition (by way of a tender offer and/or merger) for all the outstanding common stock of the Company at $29.00 per share. The letter noted that the per share price of the proposed offer is less than both the GAAP and STAT book values per share of the Company s stock as well as recent closing prices of the Company s common stock on the American Stock Exchange, but it stated that the proposed offer would be within the range of values that Mutual believed the Company s shareholders would find acceptable for an all cash offer for all shares under the circumstances. The letter indicated that the only conditions that Mutual could foresee to a closing would be any approvals required from the State Insurance Departments (which Mutual stated that it was highly confident could be obtained in a relatively short time) and assurances from A.M. Best Company and Fitch Ratings that the respective ratings of Mutual and the Company would not be reduced as a result of the acquisition. The letter indicated that Mutual s offer to negotiate the proposed offer would remain outstanding until the close of business on April 4, 2006, provided, however, that Mutual would consider extending the period of the offer to negotiate through April 21, 2006 if the Company advises Mutual by April 4, 2006 that its Board of Directors requires additional time to evaluate the proposal.

For a discussion of the relationship between the Company and Mutual, see Relationship with Mutual, below, and Item 1. BUSINESS Administration, above.

2005 Compared to 2004

The following discussion should be considered in light of the statements under the heading Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995, at the end of this Item. All capitalized terms used in this Item that are not defined in this Item have the meanings given to them in the Notes to Consolidated Statements contained in Item 15 (a) (1) of this Form 10-K.

Results of operations for 2005 and 2004 reflect the effects of the Services Agreement and the Reinsurance Pooling Agreement among the Company, its wholly-owned insurance subsidiary, MNH, and Mutual, effective January 1, 2003. The Services Agreement calls for Mutual to provide underwriting, administrative, claims and investment services to the Company and MNH. The Reinsurance Pooling Agreement provides for the pooling, or sharing, of insurance business traditionally written by Mutual and MNH on or after the effective date. MNH s share of pooled (combined Mutual and MNH) premiums earned and losses and loss adjustment expenses (LAE) for 2005 and 2004 in accordance with the Reinsurance Pooling Agreement was 30% and 35%, respectively. The Reinsurance Pooling Agreement pertains to premiums earned and incurred losses and LAE. Direct premiums written by MNH or Mutual are not pooled. MNH s share of pooled premiums will be reduced to 25% in 2006 and 2007, though not to exceed $42,500,000 and $37,500,000 in net written premiums, respectively. MNH s limit on net written premiums in 2005 in accordance with the pooling Agreement was $50,000,000.

Total combined Mutual and MNH or group-wide direct premiums written (DWP) for the year ended December 31, 2005 were $195,228,000, an increase of $4,090,000, or 2%, from $191,138,000 in 2004. The Company s pro-forma share of combined direct premiums written in 2005, in accordance with the Reinsurance Pooling Agreement, was $58,569,000 compared to $66,900,000 in 2004. The table below shows a comparison of direct premiums written by major category in 2005 and 2004:

	Group-wide DWP Year ended December 31,			MNH Pro Forma Share Year ended December 31,		
	2005	2004	Variance	2005	2004	Variance
	(000 s omitted)			(000 s omitted)		
Voluntary Personal	$ 40,842	$ 50,879	(20%)	$ 12,253	$ 17,808	(31%)

Voluntary Commercial	131,789	119,113	11%	39,537	41,690	(5%)
Umbrella Program	19,688	17,536	12%	5,906	6,138	(4%)
Involuntary	2,909	3,610	(19%)	873	1,264	(31%)
Total Direct Written Premiums	$ 195,228	$ 191,138	2%	$ 58,569	$ 66,900	(12%)

The 20% (or $10,037,000) decrease in group-wide voluntary personal direct premiums written resulted from a 30% decrease in private passenger automobile (PPA) direct premiums written and a 1% decrease in homeowners direct premiums written. The decrease in PPA direct premiums written is the result of the companies decision, implemented in 2001, not to write new policies in certain jurisdictions and from the approval of the companies plan to withdraw from the New Jersey PPA market by the New Jersey Department of Banking and Insurance, which was effective in June 2003 and was completed in May 2005. As a result, voluntary PPA policies in force at December 31, 2005 were 14,640, a decrease of 5,291 or 27%, from 19,931 at December 31, 2004.

Table of Contents

Mutual s monoline commercial umbrella program (the Umbrella Program) is marketed exclusively through one independent agent and approximately 95% of the premiums related to Umbrella Program policies are reinsured with an A rated national reinsurer through a quota share reinsurance treaty.

Group-wide voluntary commercial direct premiums written were $131,789,000, an increase of $12,676,000, or 11%, from $119,113,000 in 2004. This increase resulted from period to period increases in every significant group-wide commercial product. The average premium per group-wide, non-Umbrella Program commercial policy increased 2% from the year earlier period. Total non-Umbrella Program commercial policies in force at December 31, 2005 were 36,050, an increase of 8% from 33,415 at December 31, 2004.

The 19% decrease in group-wide involuntary direct premiums written resulted primarily from a decrease in assignments from the New York Automobile Insurance Plan (NYAIP). Direct premiums written related to policies assigned from the NYAIP decreased 16% to $2,329,000 from $2,783,000 for 2004. The NYAIP provides coverage for individuals who are unable to obtain auto insurance in the voluntary market. Assignments from the NYAIP vary depending upon a company s PPA market share and the size of the NYAIP. The Company is unable to predict the volume of future assignments from the NYAIP.

In order to minimize the adverse impact of assignments from the NYAIP, the Company purchased territorial credits from an unaffiliated company pursuant to Section 6.A.7. of the NYAIP Manual. The credits against NYAIP assignments were generated by the other insurance company for writing PPA business in certain localities in New York with PPA market availability problems. The other insurance company, by nature of its concentration in PPA business in credit territories, generated more credits than it required to offset its NYAIP assignments. The purchased credits reduced the Company s share of the NYAIP. The purchased credits decreased direct premiums written related to NYAIP assignments during 2005 and 2004 by approximately $1,200,000 and $2,351,000, respectively.

Group-wide pooled net premiums written for 2005 were $164,302,000, an increase of $756,000, or less than 1%, from $163,546,000 for 2004. This increase resulted from the 2% increase in group-wide direct premiums written, somewhat offset by an increase in 2005 as compared to 2004 of reinsurance premiums ceded to third parties. The Company s share of pooled net premiums written in 2005 in accordance with the Reinsurance Pooling Agreement was $45,135,000, a decrease of $7,967,000, or 15%, from $53,102,000 in 2004. This decrease resulted primarily from the 5 percentage point decrease in the Company s participation in the Reinsurance Pooling Agreement.

Total revenues for 2005 were $57,425,000, a decrease of $8,080,000 or 12%, from $65,505,000 in 2004.

The Company s share of pooled net premiums earned in accordance with the Reinsurance Pooling Agreement for 2005 was $49,121,000. The Company s share of net premiums earned in 2004 was $57,123,000. This $8,002,000, or 14%, decrease in net premiums earned primarily resulted from the 5 percentage point decrease in the Company s participation in the Reinsurance Pooling Agreement.

Net investment income was $7,733,000, a decrease of $148,000, or 2%, from $7,881,000 in 2004. The average pre-tax yield on the investment portfolio increased 6 basis points to 4.2% in 2005 compared to 2004. Average invested assets for 2005 decreased 5% from the year earlier period.

Table of Contents

There were no net investment gains or losses in 2005 compared to $221,000 ($.07 per fully diluted share after taxes) of net investment losses in 2004. The 2004 amount included an aggregate $700,000 of investment losses related to an other-than-temporary impairment in the value of two investment securities owned by the Company at December 31, 2004.

Other revenues were $571,000 in 2005, a decrease of $151,000, or 21%, from $722,000 in 2004, primarily due to the 5 percentage point decrease in the Company s participation in the Reinsurance Pooling Agreement.

Net losses and LAE were $26,408,000 for 2005, a decrease of $11,273,000, or 30%, from $37,681,000 for 2004. The decrease in net losses and LAE was due to the 14% decrease in net premiums earned and a 12.2 percentage point decrease in the loss and LAE ratio to 53.8% in 2005 from 66.0% in 2004. This 12.2 percentage point decrease in the loss and LAE ratio was due to a 6.9 percentage point decrease in the loss and LAE ratio for the current accident year to 60.5% in 2005 from 67.4% in 2004 and a $2,460,000 increase in the amount of favorable development of the Company s estimates of losses incurred related to prior accident years.

The 6.9 percentage point decrease in the loss and ALAE ratio for the current accident year primarily resulted from:

- An improvement in the accident year direct loss and ALAE ratio for each of the Company s primary products, the most significant of which was an improvement from 64.4% to 54.1% in the accident year direct loss and LAE ratio in the Company s PPA product. This improvement was due to increased fraud prevention, detection and prosecution efforts resulting from certain legislative changes in New York State. PPA liability is one of the Company s larger products and represents approximately 23% of the Company s net earned premiums. The decrease in the PPA loss and LAE ratio decreased the Company s overall loss and LAE ratio by approximately 1.6 percentage points.

- Mild weather in the Company s operating territory during 2005 contributed to significant decreases in claim frequency (reported claims per earned policy) in the Company s homeowners and commercial property products.

The Company recorded decreases to its estimate of losses and LAE related to prior accident years of $3,303,000 and $843,000 in 2005 and 2004, respectively, a difference of $2,460,000. These decreases in losses and LAE relating to prior accident years reduced the loss and LAE ratio in 2005 and 2004 by 6.7 and 1.5 percentage points, respectively. The reserve development for each product and for each accident year during 2005 was within the range of reasonably likely reserves by product as of December 31, 2004. It is not appropriate to predict future increases or decreases in the estimate of losses and LAE for prior accident years from past experience. See Critical Accounting Policies and Estimates for a further discussion of the Company s Reserves for Losses and LAE. The following table documents the changes in the estimate of losses and LAE related to prior accident years recorded in 2005 for the Company s primary products.

Accident Year	Home-owners	PPA Liability	Commercial Auto Liability	Workers Compen-sation	Commercial Package	General Liability	All Other	Total
			Increases (decreases) (in thousands)					
Prior to 2002	$ 126	$ (172)	$ (43)	$ (1,856)	$ 2,054	$ 1,540	$ 300	$ 1,949
2002	79	(568)	(132)	(501)	(1,216)	(99)	21	(2,416)
2003	211	(333)	(323)	(36)	91	117	(104)	(377)
2004	(361)	(926)	(731)	(166)	4	223	(502)	(2,459)
Total	$ 55	$ (1,999)	$ (1,229)	$ (2,559)	$ 933	$ 1,781	$ (285)	$ (3,303)

29

The Company experienced favorable development during 2005 in its PPA liability product of $1,999,000 of which $926,000 related to accident year 2004, primarily due to lower claims frequency and lower estimated severity on voluntary business. These changes are consistent with increased fraud prevention, detection and prosecution efforts stemming from certain legislative changes in New York State.

The Company experienced favorable development during 2005 in its workers compensation product of $1,856,000 relating to accident years prior to 2002. The development for accident years prior to 2002 primarily resulted from lower than expected emergence of paid losses and incurred losses during 2005, and a resulting reduction in the expected loss per claim.

The Company made no significant changes to its procedures for processing or reserving for workers compensation claims during 2005. In addition to the comments above related to accident years prior to 2002, the favorable loss development on the workers compensation product stems from inherent uncertainty in estimating ultimate costs in circumstances that involve the complex and changing medical condition of claimants.

During 2005, the Company experienced unfavorable development in its commercial package and general liability products amounting to $3,594,000 related to accident years prior to 2002, due to greater than anticipated incurred loss development.

The Company has made no changes to its procedures for processing or reserving for commercial package and general liability claims and is not aware of any changes to its business that might have caused a change in loss development patterns.

The Company s reduction in its estimate of losses and LAE related to prior accident years represented less than 3% of the recorded reserve for losses and LAE at December 31, 2004 and is within a reasonable range of loss reserve volatility for the products being underwritten.

The Company made no changes to the key assumptions used in evaluating the adequacy of its reserves for losses and LAE during 2005. A reasonable possibility exists in any year that relatively minor fluctuations in the estimate of reserves for losses and LAE may have a significant impact on the Company s net income. This is due primarily to the size of the Company s reserves for losses and LAE ($115,191,000 at December 31, 2005) relative to its net income.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned increased to 43.9% for 2005 from 40.5% for 2004. A $2,081,000 or 14% decrease in the amortization of deferred acquisition costs was partly offset by a $520,000 or 6% increase in other underwriting expenses. Other underwriting expenses included $3,320,000 (6.8 percentage points of the expense ratio) of retrospective commission expense related to the Reinsurance Pooling Agreement, which provides for retrospective commission income or expense based on actual experience compared to a targeted loss and LAE ratio. The commission is owed to Mutual based on a decrease during 2005 in the estimated cumulative loss and LAE ratio on the pooled business since the inception of the Reinsurance Pooling Agreement.

During 2004 the Company recorded $1,543,000 of retrospective commission expense related to the Reinsurance Pooling Agreement, which increased the 2004 ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned by 2.7 percentage points. Other underwriting

expenses in 2004 also included $266,000 related to the November 2004 resignation of the Company s President and $486,000 of consulting and due diligence expenses pertaining to the investigation of business opportunities. Other underwriting expenses also included $329,000 and $462,000 in 2005 and 2004, respectively, related to the purchase of territorial credits against NYAIP assignments discussed earlier in this item. Commissions (other than retrospective commissions under the Reinsurance Pooling Agreement), premium taxes and other state assessments that vary directly with the Company s premium volume represented 19.7% and 19.9% of net premiums earned in 2005 and in 2004, respectively.

Tax exempt income reduced the Company s effective income tax rate by 5 and 8 percentage points, respectively, for the years ended December 31, 2005 and 2004. In addition, the Company reversed excess tax reserves related to uncertain tax positions which reduced the Company s effective income tax rate by 4 percentage points for the year ended December 31, 2004.

2004 Compared to 2003

Results of operations for 2004 and 2003 reflect the effects of the Services Agreement and the Reinsurance Pooling Agreement among the Company, its wholly-owned insurance subsidiary, MNH, and Mutual, effective January 1, 2003. MNH s share of pooled premiums earned and losses and LAE for 2004 and 2003 in accordance with the Reinsurance Pooling Agreement was 35% and 40%, respectively. The Reinsurance Pooling Agreement pertains to premiums earned and incurred losses and LAE.

Total combined Mutual and MNH or group-wide DWP for the year ended December 31, 2004 were $191,138,000, an increase of $15,995,000 or 9%, from $175,143,000 in 2003. The Company s pro-forma share of combined DWP in 2004, in accordance with the Reinsurance Pooling Agreement, was $66,900,000 compared to $70,057,000 in 2003. The table below shows a comparison of direct premiums written by major category in 2004 and 2003:

	Group-wide DWP Year ended December 31,			MNH Pro Forma Share Year ended December 31,		
	2004	2003	Variance	2004	2003	Variance
	(000 s omitted)			(000 s omitted)		
Voluntary Personal	$ 50,879	$ 63,548	(20%)	$ 17,808	$ 25,419	(30%)
Voluntary Commercial	119,113	103,262	15%	41,690	41,305	1%
Umbrella Program	17,536	3,136	459%	6,138	1,254	389%
Involuntary	3,610	5,197	(31%)	1,264	2,079	(39%)
Total Direct Written Premiums	$ 191,138	$ 175,143	9%	$ 66,900	$ 70,057	(5%)

The 20% (or $12,669,000) decrease in group-wide voluntary personal DWP resulted from a 27% decrease in PPA DWP and a 1% decrease in homeowners DWP. The decrease in PPA DWP is the result of the companies decision, implemented in 2001, not to write new policies in certain jurisdictions and from the approval of the companies plan to withdraw from the New Jersey PPA market by the New Jersey Department of Banking and Insurance, which was effective in June 2003. As a result, voluntary PPA policies in force at December 31, 2004 were 19,931, a decrease of 8,492 or 30%, from 28,423 at December 31, 2003.

Mutual introduced a monoline commercial umbrella program in the fourth quarter of 2003 (the Umbrella Program). The Umbrella Program is marketed exclusively through one independent agent and

approximately 95% of the premiums related to Umbrella Program policies are reinsured with an A rated national reinsurer through a quota share reinsurance treaty.

Group-wide voluntary commercial DWP were $119,113,000, an increase of $15,851,000, or 15%, from $103,262,000 in 2003. This increase resulted from period to period increases in every significant group-wide commercial product. The average premium per group-wide, non-Umbrella Program commercial policy increased 7% from the year earlier period. Total non-Umbrella Program commercial policies in force at December 31, 2004 were 33,415, an increase of 6% from 31,485 at December 31, 2003.

The 31% decrease in group-wide involuntary DWP resulted primarily from a decrease in assignments from the NYAIP. DWP related to policies assigned from the NYAIP decreased to $2,783,000 for 2004 from $3,909,000 for 2003. NYAIP credits purchased reduced the Company s share of the NYAIP. The credits purchased decreased DWP related to NYAIP assignments during 2004 by approximately $2,351,000 and by approximately $2,256,000 for 2003.

Group-wide pooled net premiums written for 2004 were $163,546,000, an increase of $1,857,000, or 1%, from $161,689,000 for 2003. This increase resulted from the 9% increase in group-wide DWP, offset by an increase in 2004 as compared to 2003 of reinsurance premiums ceded to third parties, primarily for premiums written related to the Umbrella Program. The Company s share of pooled net premiums written in 2004 in accordance with the Reinsurance Pooling Agreement was $53,102,000, a decrease of $11,077,000 or 17% from $64,179,000 in 2003. This decrease resulted primarily from the 5 percentage point decrease in the Company s participation in the Reinsurance Pooling Agreement.

Total revenues for 2004 were $65,505,000, a decrease of $11,467,000 or 15%, from $76,972,000 in 2003.

The Company s share of pooled net premiums earned in accordance with the Reinsurance Pooling Agreement for 2004 was $57,123,000. The Company s share of net premiums earned in 2003 were $65,097,000. This $7,974,000, or 12%, decrease in net premiums earned primarily resulted from the 5 percentage point decrease in the Company s participation in the Reinsurance Pooling Agreement.

Net investment income was $7,881,000, a decrease of $934,000 or 11% from $8,815,000 in 2003. The average pre-tax yield on the investment portfolio decreased 40 basis points to 4.0% in 2004 compared to 2003. Average invested assets for 2004 decreased 2% from the year earlier period.

Net investment losses were $221,000 ($.07 per fully diluted share after taxes) in 2004 compared to $2,500,000 of net investment gains ($.78 per fully diluted share after taxes) in 2003. The 2004 amount included an aggregate $700,000 of investment losses related to an other-than-temporary impairment in the value of two investment securities owned by the Company at December 31, 2004. The 2003 amount related primarily to the sale of an otherwise illiquid security to its issuer through a share repurchase program.

Other revenues were $722,000 in 2004, an increase of $162,000 or 29% from $560,000 in 2003, primarily due to a $180,000 decrease in premium receivable charge-offs.

Net losses and LAE were $37,681,000 for 2004, a decrease of $11,931,000 or 24% from $49,612,000 for 2003. The decrease in net losses and LAE was due to the 12% decrease in net premiums earned and a 10.2 percentage point decrease in the loss and LAE ratio to 66.0% in 2004 from 76.2% in 2003. This 10.2 percentage point decrease in the loss and LAE ratio was due to an 9.0 percentage point decrease in

Table of Contents

the loss and LAE ratio for the current accident year to 67.4% in 2004 from 76.4% in 2003 and a $753,000 decrease in the change in the Company s estimates of losses incurred related to prior accident years.

The 9.0 percentage point decrease in the loss and LAE ratio for the current accident year primarily resulted from:

- A reduction in PPA liability net earned premium as a percentage of total Company net earned premium to 16.7% in 2004 from 20.2% in 2003. PPA liability was the Company s highest loss and LAE ratio product and accounted for 1.5 percentage points of the decrease.
- An improvement in the PPA liability loss and LAE ratio to 86.6% in 2004 from 111.6% in 2003, which accounted for 4.2 percentage points of the decrease. This improvement was due to improved involuntary loss experience, primarily from the NYAIP.
- An improvement in the commercial package loss and LAE ratio to 69.0% in 2004 from 81.8% in 2003 which accounted for 3.5 percentage points of the decrease. This improvement was the result of a reduction in loss frequency.

The Company recorded decreases to its estimate of losses and LAE related to prior accident years of $843,000 and $90,000 in 2004 and 2003, respectively, a change of $753,000. These decreases in losses and LAE relating to prior accident years reduced the loss and LAE ratio in 2004 and 2003 by 1.5 and .1 percentage points, respectively. The reserve development for each product and for each accident year during 2004 was within the range of reasonably likely reserves by product as of December 31, 2003. It is not appropriate to predict future increases or decreases in the estimate of losses and LAE for prior accident years from past experience. See Critical Accounting Policies and Estimates for a further discussion of the Company s Reserves for Losses and LAE. The following table documents the changes in the estimate of losses and LAE related to prior accident years recorded in 2004 for the Company s primary products.

Accident Year	Home-owners	PPA Liability	Commercial Auto Liability	Workers Compen-sation	Commercial Package	General Liability	All Other	Total
	Increases (decreases) (in thousands)							
Prior to 2001	$ (109)	$ 455	$ 764	$ 533	$ 2,183	$ 1,119	$ (176)	$ 4,769
2001	152	(17)	121	(1,221)	(450)	(123)	(41)	(1,579)
2002	60	(269)	(1,072)	(921)	915	59	94	(1,134)
2003	(7)	(1,529)	268	(433)	(909)	(299)	10	(2,899)
Total	$ 96	$ (1,360)	$ 81	$ (2,042)	$ 1,739	$ 756	$ (113)	$ (843)

The Company experienced favorable development during 2004 in its PPA liability product of $1,529,000 relating to accident year 2003, primarily due to lower claims frequency and lower estimated severity on involuntary business assigned from the NYAIP. These changes are consistent with increased fraud prevention, detection and prosecution efforts stemming from certain legislative changes in New York State. Furthermore, the Company believes that due to increased market availability in the voluntary market, many of the worst drivers previously insured in the NYAIP no longer obtain insurance from the NYAIP. The impact of the legislative activity and the shift in the market was not evident until 2004 and as such are reflected in current reserve estimates.

The Company experienced favorable development during 2004 in its workers compensation product of $1,221,000 relating to accident year 2001 and $921,000 relating to accident year 2002. The accident year 2001 development resulted from lower than expected emergence of paid losses and incurred losses in 2004, and a reduction in the expected loss per claim to $11,500 as of 2004 from $12,200 as of 2003.

Table of Contents

The Company made no significant changes to its procedures for processing or reserving for workers compensation claims during 2004. In addition to the comments above related to the 2001 accident year, the $2,042,000 of favorable loss development on the workers compensation product stems from inherent uncertainty in estimating ultimate costs in circumstances that involve the complex and changing medical condition of claimants. However, the Company believes that the decrease in loss estimates for workers compensation business is consistent with changes initiated by the Company in 2002 to reduce the concentration in its workers compensation policy portfolio of classes of risk that are subject to high severity losses, which became evident in the loss development activity in 2004. The underwriting changes have continued through 2004. The Company believes that it took several years for the absence of severe losses to become apparent, as the severity of such losses, if it were to develop, typically does not become apparent for several years.

During 2004, the Company experienced unfavorable development in its commercial package and general liability products amounting to $3,302,000 related to accident years prior to 2001, due to greater than anticipated incurred loss development. For instance, the Company experienced adverse jury verdicts in 2004 that it believed had no merit and were therefore not reflected in case reserves. These claims, when considered in the loss development factors used during 2004, impacted severity for several accident years.

The Company has made no changes to its procedures for processing or reserving for commercial package and general liability claims and is not aware of any changes to its business that might have caused a change in loss development patterns, except for the two large claims noted above.

The Company s reduction in its estimate of losses and LAE related to prior accident years represented less than 1% of the recorded reserve for losses and LAE at December 31, 2003 and is within a reasonable range of loss reserve volatility for the products being underwritten.

The Company made no changes to the key assumptions used in evaluating the adequacy of its reserves for losses and LAE during 2004. A reasonable possibility exists in any year that relatively minor fluctuations in the estimate of reserves for losses and LAE may have a significant impact on the Company s net income. This is due primarily to the size of the Company s reserves for losses and LAE ($128,415,000 at December 31, 2004) relative to its net income.

Involuntary automobile insurance business increased the Company s calendar year loss and LAE ratio by approximately .2 and 1.8 percentage points for the years ended December 31, 2004 and 2003, respectively.

The ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned increased to 40.5% for 2004 from 33.7% for 2003. A $2,073,000 or 12% decrease in the amortization of deferred acquisition costs was more than offset by a $3,260,000 or 65% increase in other underwriting expenses. Other underwriting expenses included $1,543,000 (2.7 percentage points of the expense ratio) of retrospective commission expense related to the Reinsurance Pooling Agreement, which is owed to Mutual based on a decrease during 2004 in the estimated cumulative loss and LAE ratio on the pooled business since the inception of the Reinsurance Pooling Agreement. During 2003 the Company recorded $305,000 of retrospective commission income related to the Reinsurance Pooling Agreement. This amount reduced the 2003 ratio of amortized deferred policy acquisition costs and other underwriting expenses to net premiums earned by .5 percentage points.

Other underwriting expenses also included $266,000 related to the November 2004 resignation of the Company s President and $486,000 of consulting and due diligence expenses pertaining to the investigation of business opportunities. Other underwriting expenses also included $462,000 and $228,000 in 2004 and 2003, respectively, related to the purchase of territorial credits against NYAIP assignments discussed earlier in this item. Commissions (other than retrospective commissions under the Reinsurance Pooling Agreement), premium taxes and other state assessments that vary directly with the Company s premium volume represented 19.9% and 19.7% of net premiums earned in 2004 and 2003, respectively.

Tax exempt income reduced the Company s effective income tax rate by 8 and 4 percentage points, respectively, for the years ended December 31, 2004 and 2003. In addition, the Company recorded adjustments to prior years taxes and reversed excess tax reserves related to uncertain tax positions which reduced the Company s effective income tax rate by 4 and 3 percentage points, respectively, for the years ended December 31, 2004 and 2003. The provision for income taxes for 2003 also included the effect of a May 2003 change in New York State law with respect to the taxation of non-life insurance companies. This change eliminated state income taxes for all non-life insurance companies and increased the premium tax rate from 1.3% to 2.0%. This change in New York State law lowered the Company s effective income tax rate by approximately 4 percentage points in 2003. Further, as a result of this change, the Company reduced its deferred tax liability with respect to New York State income taxes to $0 during 2003. This one time benefit reduced the Company s effective income tax rate for 2003 by 9 percentage points.

Critical Accounting Policies

Reserve for Losses and LAE

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

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

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

Table of Contents

Paid Loss Development

The paid loss development method is based on the assumption that past rates of claims payments are indicative of future rates of claims payments. An advantage of this method is that paid losses contain no case reserve estimates. Additionally, paid losses are not as greatly influenced by changes in claims reserving practices as are incurred losses. Estimates can be distorted if changes in claims handling practices or procedures cause an acceleration or deceleration in claims payments. Furthermore, paid loss development may produce biased estimates for long-tailed products where paid loss development factors are large at early evaluation points.

Incurred Loss Development

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

Bornhuetter-Ferguson with Premium and Paid Loss

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

Bornhuetter-Ferguson with Premium and Incurred Loss

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

Ultimate Claims and Average Loss

This method multiplies the estimated number of ultimate claims by a selected ultimate average loss for each accident year to produce ultimate loss estimates. If loss development methods produce erratic or unreliable estimates, this method can provide more stable estimates, consistent with recent loss history. This method may produce erratic results if there has been a change in the way claims

Table of Contents

are counted or in the mix of types of loss. The occurrence or absence of large losses can also distort the average loss estimate.

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

Paid ALAE Development

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

Bornhuetter-Ferguson with Ultimate Loss and Paid ALAE

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

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

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

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

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

- closed claim to reported claim ratios
- average case reserves per open claim
- paid loss per closed claim
- paid loss to incurred loss ratios
- the reasonableness of ultimate loss & ALAE ratios and ultimate severities
- management s consideration of other factors such as premium and loss trends, large loss experience, legislative and judicial changes and changes in underwriting guidelines and practices.

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

As stated previously, the above methods assume that past experience adjusted for the effects of current developments and trends is an appropriate basis for predicting future events. A range of reasonably likely reserves by product as of December 31, 2005, net of reinsurance, developed by the Company s actuaries are shown in the table below. Generally the low and the high values in the range represent

Table of Contents

reasonable minimum and maximum amounts of these actuarial indications using the methods described above.

	Range of Net Loss & LAE Reserves ($000 s)		
Products*	Low	Recorded	High
Personal Auto	$10,872	$ 12,491	$ 14,121
Homeowners	$ 2,086	$ 2,731	$ 3,382
Commercial Auto	$ 9,654	$ 13,449	$ 17,388
Workers Compensation	$21,066	$ 24,709	$ 29,072
Commercial General Liability	$34,968	$ 43,637	$ 54,402
Commercial Property	$ 2,797	$ 4,317	$ 6,051
Other	$ 40	$ 50	$ 60
All Products	$90,741	$101,384	$112,394

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

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

Despite the many factors considered in the reserving process, it is reasonably probable that actual payments for losses and LAE will differ from those contemplated in the Company s reserves. Such fluctuations could have a significant impact on the Company s net income. This is primarily due to the size of the Company s reserves for losses and LAE ($115,191,000 at December 31, 2005) relative to its net income.

The following table presents the liability for the reserve for unpaid losses and loss adjustment expenses separated into case reserves, reserves for IBNR losses and reserves for LAE by major product:

Table of Contents

	December 31,	
	2005	2004
	(000 s)	
Case reserves:		
PPA liability	$ 6,072	$ 10,099
Homeowners	1,899	2,097
Commercial auto liability	5,384	7,677
Workers compensation	14,531	15,698
Commercial package	12,739	13,795
General liability	505	750
Other	308	243
Total case reserves	41,438	50,359
IBNR:		
PPA liability	4,372	6,197
Homeowners	228	257
Commercial auto liability	6,396	6,154
Workers compensation	8,074	9,884
Commercial package	16,965	14,467
General liability	2,581	1,107
Other	(407)	(223)
Total IBNR	38,209	37,843
Reserve for LAE:		
PPA liability	2,004	2,973
Homeowners	604	640
Commercial auto liability	1,622	1,852
Workers compensation	2,104	2,125
Commercial package	11,493	13,712
General liability	3,668	3,145
Other	242	136
Total reserve for LAE	21,737	24,583
Subtotal	101,384	112,785
Reinsurance recoverables	13,807	15,630
Reserve for losses and LAE	$ 115,191	$ 128,415

Deferred Policy Acquisition Costs

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

income. Premium deficiencies, if any, are recorded as amortization of deferred policy acquisition costs. Actual amounts may vary from the Company s estimates.

Investments

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

The Company s investment committee, comprised of the Chief Operating Officer, the Chief Investment Officer and the Chief Financial Officer, meets monthly and monitors the Company s investment

portfolio for declines in value that are other-than-temporary. This assessment requires significant judgment. The investment committee considers the nature of the investment, the severity and length of the decline in fair value, events specific to the issuer including valuation modeling, overall market conditions, and the Company s intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in market value. When a decline in the fair value of a security is determined to be other-than-temporary, the Company adjusts the cost basis of that security to fair value and records a charge to earnings. Future increases in fair value and future decreases in fair value if not other-than-temporary are included in other comprehensive income.

Liquidity and Capital Resources

In developing its investment strategy the Company determines a level of cash and short-term investments which, when combined with expected cash flow, is estimated to be adequate to meet expected cash obligations. Due to declining written premiums however, the Company s operating activities have resulted in a use of cash each year since 2001. The Company s decreasing participation percentage in the pooled business over the remaining years of the Reinsurance Pooling Agreement will likely result in continued negative cash flows from operations. Net cash used in operations was $1,653,000 in 2005. The Company believes that careful management of the relationship between assets and liabilities will minimize the likelihood that investment portfolio sales will be necessary to fund insurance operations, and that the effect of such sales, if any, on the Company s stockholders equity will not be material.

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

At December 31, 2005, the Company owned 127 investment securities, of which 108 were in an unrealized loss position. As of December 31, 2005 all of the Company s fixed maturity investments were exchange traded or are readily marketable and are supported by the broker/dealer community. The total potential impact on the Company s future earnings if the unrealized losses associated with its investment portfolio at December 31, 2005 were to become other-than-temporary would be $3,128,000, or $2,064,000 after taxes.

Included in net investment losses for the year ended December 31, 2004 are write-downs on two investment securities held in the Company s investment portfolio at December 31, 2004 determined to have had an other-than-temporary impairment in market value. The total amount of other-than-temporary impairments recorded as losses amounted to $700,000 in 2004. No other-than-temporary impairments were recorded in 2005 or 2003.

At December 31, 2005, $6,123,000 or 3% of the Company s investment portfolio was invested in non-investment grade securities, compared to $2,150,000 or 1% at December 31, 2004.

The Company designates newly acquired fixed maturity investments as available for sale and carries these investments at fair value. Unrealized gains and losses related to these investments are recorded as accumulated other comprehensive income within stockholders equity. At December 31, 2005, the Company recorded as accumulated other comprehensive loss in its Consolidated Balance Sheet $2,540,000 of net unrealized losses, net of taxes, associated with investments classified as available for sale.

Table of Contents

At December 31, 2005 the Company s portfolio of fixed maturity investments represented 91.4% of invested assets. Management believes that this level of fixed maturity investments is consistent with the Company s liquidity needs because it anticipates that cash receipts from net premiums written, investment income and maturing securities will enable the Company to satisfy its cash obligations. Furthermore, a portion of the Company s fixed maturity investments are invested in mortgage-backed and other asset-backed securities which, in addition to interest income, provide monthly paydowns of bond principal.

At December 31, 2005, $97,044,000, or 58.3%, of the Company s fixed maturity portfolio was invested in mortgage-backed and other asset-backed securities. The Company invests in a variety of collateralized mortgage obligation (CMO) products but has not invested in the derivative type of CMO products such as interest only, principal only or inverse floating rate securities. All of the Company s CMO investments have a secondary market and their effect on the Company s liquidity does not differ significantly from that of other fixed maturity investments.

At December 31, 2005, the Company owed $2,590,000 of retrospective commissions to Mutual in accordance with the Reinsurance Pooling Agreement (see the 2005 compared to 2004 section of this Item for a discussion of retrospective commissions). The Reinsurance Pooling Agreement requires the amount of retrospective commissions to be calculated and paid annually, six months after the end of each calendar year.

The Company did not repurchase any shares of its common stock during 2005. At December 31, 2005 the Company was holding 1,139,700 shares in treasury.

During 2005 stock options for 18,500 shares of the Company s stock were exercised. Proceeds to the Company from the exercise of these options amounted to $389,000.

The Company has arranged for a $2,000,000 unsecured credit facility from a bank. Any borrowings under this facility are payable on demand and carry an interest rate which can be fixed or variable and is negotiated at the time of each advance. This facility is available for general working capital purposes and for repurchases of the Company s common stock. No amounts were outstanding related to this facility at December 31, 2005.

As a holding company, the Company is dependent upon cash dividends from MNH to meet its obligations and to pay any cash dividends. MNH is subject to New Hampshire insurance laws which place certain restrictions on its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of the insurer s policyholders surplus as of the preceding December 31st. The maximum amount of dividends that MNH could pay during any twelve month period ending in 2006 without the prior approval of the New Hampshire Insurance Commissioner is $6,639,000. MNH paid $800,000, $1,200,000, $800,000 and $600,000 of dividends to the Company in February 2005, October 2005, November 2005 and December 2005, respectively. The Company paid aggregate quarterly cash dividends to its common stockholders of $.55 per share in 2005, which amounted to $1,164,000.

Regulatory guidelines suggest that the ratio of a property and casualty insurer s annual net premiums written to its statutory surplus should not exceed 3 to 1. The Company has consistently followed a business strategy that would allow MNH to meet this 3 to 1 regulatory guideline. MNH s ratio of net premiums written to statutory surplus for 2005 was .7 to 1.

Table of Contents

Off-Balance Sheet Arrangements

The Company does not have any off-balance sheet arrangements.

Contractual Obligations

At December 31, 2005, the Company had no contractual obligations related to long-term debt, capital leases, operating leases, purchase obligations or other long-term liabilities reflected on its balance sheet.

A summary of the Company s non-cancelable contractual obligations follows:

	Total	Less than 1 Year	1 3 Years	3 5 Years	More than 5 Years
Reserve for losses and loss adjustment expenses	$ 115,191	$ 30,048	$ 34,876	$ 19,307	$ 30,960

Unlike most other contractual obligations, reserves for losses and LAE do not have specified due dates. The amounts shown in the preceding table are the Company s estimates of these amounts.

Recently Issued Accounting Standards

The following accounting pronouncements were issued by the Financial Accounting Standards Board during 2005 and 2006 and are effective for fiscal years ending subsequent to December 31, 2005:

Statement of Financial Accounting Standards (SFAS) No. 154 Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 .

SFAS No. 155 Accounting for Certain Hybrid Instruments .

SFAS No. 156 Accounting for Servicing Assets and Liabilities .

The Company does not expect these pronouncements to have any impact on its financial statements.

In September 2005, the Accounting Standards Executive Committee (AcSEC) issued Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications of Exchanges of Insurance Contracts (SOP 05-1). SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in SFAS No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments. SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. The Company has not yet determined the impact of adopting SOP 05-1 on its consolidated financial statements, if any.

Federal Legislation

The Terrorism Risk Insurance Act of 2002 (TRIA), signed into law on November 26, 2002, provides a federal backstop for losses related to the writing of the terrorism peril in property and casualty insurance policies. In December 2005, TRIA was extended through December 31, 2007. The Company has complied with TRIA requirements to notify commercial policyholders about requirements of the law, that the Company was required to offer terrorism coverage and how the coverage would be priced. Currently, the Company is issuing terrorism exclusions on its commercial lines policies in states other than New York, where terrorism exclusions have not been approved by the New York Insurance Department. These exclusions will be effective if TRIA expires at December 31, 2007.

Environmental Claims

MNH, like many other property and casualty insurance companies, is subject to environmental damage claims asserted by or against its insureds. Management of the Company is of the opinion that based on various court decisions throughout the country, certain of these claims should not be recoverable under

the terms of MNH s insurance policies because of either specific or general coverage exclusions contained in the policies. However, there is no assurance that the courts will agree with MNH s position in every case, nor can there be assurance that material claims will not be asserted under policies which a court will find do not explicitly or implicitly exclude claims for environmental damages. Management, however, is not aware of any pending claim or group of claims which would result in a liability that would have a material adverse effect on the financial condition of the Company or MNH.

Inflation

Inflation affects the Company, like other companies in the property and casualty insurance industry, by contributing to higher losses, LAE and operating costs, as well as greater investment income resulting from the higher interest rates which can prevail in an inflationary period. Premium rates, however, may not keep pace with inflation since competitive forces may limit the Company s ability to increase premium rates. The Company considers inflationary trends in estimating its reserves for reported and IBNR claims.

Relationship with Mutual

The Company s and MNH s business and day-to-day operations are closely aligned with those of Mutual. This is the result of a combination of factors. Mutual has had a historical ownership interest in the Company and MNH. Prior to November 1986 MNH was a wholly-owned subsidiary of Mutual. Following the Company s initial public offering in November 1986 and until a secondary stock offering in July 1993 the Company was a majority-owned subsidiary of Mutual. At December 31, 2005 Mutual owned 12.0% of the Company s common stock. Under the Services Agreement, Mutual provides the Company and MNH with all facilities and personnel to operate their business. The officers of the Company or MNH are employees of Mutual whose services are provided to, and paid for by, the Company and MNH through the Services Agreement. Also, the operation of MNH s insurance business, which offers substantially the same products as Mutual through the same independent insurance agents, creates a very close relationship among the companies.

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

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

Table of Contents

filed by the Company with the Securities and Exchange Commission. Forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors that may cause the Company s actual results, performance, achievements or financial condition to be materially different from any future results, performance, achievements, or financial condition expressed or implied by the forward-looking statements. The Company expressly disclaims any obligation to update any forward-looking statements as a result of developments occurring after the filing of this report.

Table of Contents

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market Risk

Market risk represents the potential for loss due to changes in the fair value of financial instruments. The market risk related to the Company s financial instruments primarily relates to its investment portfolio. The value of the Company s investment portfolio of $182,289,000 at December 31, 2005 is subject to changes in interest rates and to a lesser extent on credit quality. Further, certain mortgage-backed and asset-backed securities are exposed to prepayment or extension risk generally caused by interest rate movements. If interest rates decline, mortgage holders would be more likely to refinance existing mortgages at lower rates. Acceleration of future repayments could adversely affect future investment income, if the accelerated receipts were invested in lower yielding securities.

The table below provides information related to the Company s fixed maturity investments at December 31, 2005. The table presents cash flows of principal amounts and related weighted average interest rates by expected maturity dates. The cash flows are based upon the maturity date or, in the case of mortgage-backed and asset-backed securities, expected payment patterns. Actual cash flows could differ from those shown in the table.

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

							TOTAL	
	2006	2007	2008	2009	2010	There-after	Amor-tized Cost	Esti-mated Market Value
Available for Sale								
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$ 0	$ 0	$ 3,004	$ 0	$ 4,244	$ 0	$ 7,248	$ 7,145
Average interest rate	0.0%	0.0%	3.2%	0.0%	4.8%	0.0%		
Obligations of states and political subdivisions	11,367	3,908	15,597	3,906	7,419	3,730	45,927	45,257
Average interest rate	3.6%	4.3%	3.9%	4.1%	5.0%	4.8%		
Corporate securities	999	0	3,243	5,975	1,991	5,432	17,640	17,147
Average interest rate	3.2%	0.0%	3.7%	4.9%	4.6%	6.8%		
Mortgage & asset backed securities	23,461	21,396	15,473	13,537	8,422	16,562	98,851	97,044
Average interest rate	4.8%	4.8%	4.8%	4.9%	5.0%	5.1%		

Total	$ 35,827	$ 25,304	$ 37,317	$ 23,418	$ 22,076	$ 25,724	$ 169,666	$ 166,593

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

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The consolidated financial statements required in response to this Item are submitted as part of Item 14 (a) of this report, and are incorporated in this item by reference.

Quarterly data for the two most recent fiscal years is set forth below:

	Three months ended			
	3/31	6/30	9/30	12/31
	(in thousands, except per share amounts)			
2005				
Net premiums earned	$ 11,977	$ 12,767	$ 12,155	$ 12,222
Net investment income	1,936	1,908	1,890	1,999
Net investment gains				
Other revenues	136	114	163	158
Total revenues	$ 14,049	$ 14,789	$ 14,208	$ 14,379
Income before income taxes	$ 1,599	$ 4,532	$ 2,484	$ 820
Net income	$ 1,188	$ 3,178	$ 1,721	$ 612
Net income per diluted share	$ .56	$ 1.50	$ .81	$ .29
2004				
Net premiums earned	$ 14,069	$ 14,364	$ 14,161	$ 14,529
Net investment income	2,054	1,965	1,935	1,927
Net investment gains (losses)	377	93		(691)
Other revenues	166	97	185	274
Total revenues	$ 16,666	$ 16,519	$ 16,281	$ 16,039
Income before income taxes	$ 1,130	$ 1,958	$ 1,309	$ 284
Net income	$ 811	$ 1,550	$ 1,163	$ 238
Net income per diluted share	$ .38	$ .73	$ .55	$ .11

Table of Contents

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

Item 9A. CONTROLS AND PROCEDURES.

After evaluating the effectiveness of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) as of the end of the period covered by this Annual Report on Form 10-K, the Company s Chief Operating Officer and Chief Financial Officer, who are, respectively, its principal executive officer and principal financial officer, concluded that the Company s disclosure controls and procedures were effective in reaching a reasonable level of assurance that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the SEC s rules and forms.

The Company s Chief Operating Officer and Chief Financial Officer also evaluated the Company s internal controls over financial reporting (as defined in Exchange Act Rule 13a-15(f)) and determined that no changes in internal control over financial reporting occurred during the quarter ended December 31, 2005 that have materially affected, or which are reasonably likely to material affect, the Company s internal controls over financial reporting.

Item 9.B. OTHER INFORMATION.

None.

Table of Contents

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

The information in response to this item regarding Directors of the Company who are standing for reelection is incorporated by reference herein to the information under the caption Election of Directors presented in the Company s definitive proxy statement filed or to be filed pursuant to Regulation 14A and used in connection with the Company s 2006 Annual Meeting of Shareholders to be held on or about June 7, 2006, provided, however, that information appearing under the heading Report of the Audit Committee is not incorporated herein and should not be deemed included in this document for any purpose.

The Board of Directors of the Company has determined that Thomas E. Kahn is an audit committee financial expert as defined by Item 401(h) of Regulation S-K of the Securities Exchange Act of 1934, as amended (the Exchange Act) and is independent within the meaning of Item 7(d) (3) (iv) of Schedule 14A of the Exchange Act.

The Company has a separately designated Audit Committee established in accordance with Section 3(a) (58) (A) of the Exchange Act. The members of the Audit Committee are: Frank J. Colantuono, Thomas E. Kahn and Henry P. Semmelhack (Chair).

The Company s Board of Directors has adopted a Code of Conduct and Ethics and a Code of Business Conduct, which governs business decisions made and actions taken by the Company s directors, officers and employees. A copy of this code is available in print to any shareholder upon written request to:

Investor Relations
Merchants Group, Inc.
250 Main Street
Buffalo, NY 14202

Item 11. EXECUTIVE COMPENSATION.

The information in response to this item is incorporated by reference herein to the information under the captions Executive Compensation and Compensation of Directors presented in the Company s definitive proxy statement filed or to be filed pursuant to Regulation 14A and used in connection with the Company s 2006 Annual Meeting of Shareholders to be held on or about June 7, 2006, provided, however that information appearing under the captions Compensation Committee Report on Executive Compensation and Performance Comparison is not incorporated herein and should not be deemed to be included in this document for any purpose.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

The information in response to this item is incorporated by reference herein to the information under the caption Security Ownership of Certain Beneficial Owners and Security Ownership of Management presented in the Company s definitive proxy statement filed or to be filed pursuant to Regulation 14A and used in connection with the Company s 2006 Annual Meeting of Stockholders to be held on or about June 7, 2006.

Table of Contents

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

The information in response to this item is incorporated herein by reference to the information under the caption Services Agreement and Reinsurance Pooling Agreement and Certain Transactions presented in the Company s definitive Proxy Statement filed or to be filed pursuant to Regulation 14A and used in connection with the Company s 2006 Annual Meeting of Shareholders to be held on or about June 7, 2006.

Item 14. PRINCIPAL ACCOUNTANTS FEES AND SERVICES

The information in response to this item is incorporated by reference to the information under the caption Audit Fees presented in the Registrant s definitive Proxy Statement filed pursuant to Regulation 14A and used in connection with the Company s 2006 Annual Meeting of Shareholders to be held on or about June 7, 2006.

PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENTS SCHEDULES.

(a) (1) The following financial statements of Merchants Group, Inc. are included on pages F-1 to F-25:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheet December 31, 2005 and 2004.

Consolidated Statement of Operations Years ended December 31, 2005, 2004 and 2003.

Consolidated Statement of Changes in Stockholders Equity Years ended December 31, 2005, 2004 and 2003.

Consolidated Statement of Cash Flows Years ended December 31, 2005, 2004 and 2003.

Notes to Consolidated Financial Statements.

(a) (2) The following financial statement schedules of Merchants Group, Inc. are filed herewith pursuant to Item 8:

Schedule I -

Summary of Investments Other Than Investments in Related Parties.

Schedule II -

Amounts Receivable From/Payable to Related Parties, and Underwriters, Promoters and Employees Other Than Related Parties.

Schedule III -

Condensed Financial Information of Registrant.

Schedule IV Reinsurance

Schedule V -

Supplemental Insurance Information (see Schedule VI).

Schedule VI -

Supplemental Insurance Information Concerning Property Casualty Subsidiaries

(a) (3) Exhibits required by Item 601 of Regulation S-K:

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

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

(10) (a) Management Agreement dated as of September 29, 1986 by and among Merchants Mutual Insurance Company, Registrant and Merchants Insurance Company of New Hampshire, Inc. (incorporated by reference to Exhibit No. 10A to the Company s Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).

(b) Services Agreement Among Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and Merchants Group, Inc. dated January 1, 2003 (incorporated by reference to Exhibit No. 10b to the Company s 2003 Quarterly Report on Form 10-Q filed on May 14, 2003).

(c) Reinsurance Pooling Agreement between Merchants Insurance Company of New Hampshire, Inc. and Merchants Mutual Insurance Company effective January 1, 2003 (incorporated by reference to Exhibit No. 10c to the Company s 2003 Quarterly Report on Form 10-Q filed on May 14, 2003).

(d) Endorsement to the Casualty Excess of Loss Reinsurance agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company dated February 23, 2004 (incorporated by reference to Exhibit 10(e) to the Company s 2004 Quarterly Report on Form 10-Q filed on November 10, 2004).

(e) Property Per Risk Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and American Reinsurance Company dated April 16, 2004 (incorporated by reference to Exhibit 10(f) to the Company s 2004 Quarterly Report on Form 10-Q filed on November 10, 2004).

(f) Property Catastrophe Excess of Loss Reinsurance Agreement between Merchants Mutual Insurance Company, Merchants Insurance Company of New Hampshire, Inc. and the various reinsurers as identified by the Interest and Liabilities Agreements attaching to and forming part of this Agreement (filed herewith).

(g) Quota Share Reinsurance Treaty Agreement between Merchants Insurance Company of New Hampshire, Inc. and The Subscribing Underwriting Members of Lloyd s, London specifically identified on the schedules attached to this agreement dated January 1, 2000 (incorporated by reference to Exhibit 10(h) to the Company s 2000 Annual Report on Form 10-K filed on March 28, 2001).

* (h) Form of Amended Indemnification Agreement entered into by Registrant with each director and executive officer of Registrant (incorporated by reference to Exhibit No. 10N to Amendment No. 1 to the Company s Registration Statement on (No. 33-9188) Form S-1 filed on November 7, 1986).

* (i) Merchants Mutual Insurance Company Adjusted Return on Equity Incentive Compensation Plan January 1, 2000 (incorporated by reference to Exhibit 10p to the Company s 2000 Annual Report on Form 10-K filed on March 28, 2001).

*	(j)	Amendment No. 1 to Employee Retention Agreement between Robert M. Zak and Merchants Mutual Insurance Company originally dated as of May 31, 1999, dated February 6, 2002 (incorporated by reference to Exhibit 10(s) to the Company s 2002 Annual Report on Form 10-K filed on March 31, 2003).
*	(k)	Amendment No. 1 to Employee Retention Agreement between Edward M. Murphy and Merchants Mutual Insurance Company originally dated as of March 1, 1999 dated February 6, 2002 (incorporated by reference to Exhibit 10(t) to the Company s 10-K filed on March 31, 2003).
*	(l)	Amendment No. 1 to Employee Retention Agreement between Kenneth J. Wilson and Merchants Mutual Insurance Company originally dated as of March 1, 1999 dated February 6, 2002 (incorporated by reference to Exhibit 10(u) to the Company s Annual Report on Form 10-K filed on March 31, 2003).
(11)	(a)	Statement re computation of per share earnings (incorporated herein by reference to Note 9 to the Consolidated Financial Statements included in Item 8).
(14.1)		Merchants Group, Inc. Code of Conduct and Ethics (incorporated by reference to Exhibit 14.1 to the Company s Annual Report on Form 10-K filed on March 31, 2005).
(14.2)		Merchants Insurance Group Code of Business Conduct, amended 12/2004 (incorporated by reference to Exhibit 14.2 to the Company s Annual Report on Form 10-K filed on March 31, 2005).
(21)		List of Subsidiaries of Registrant (incorporated by reference to Exhibit No. 22 to the Company s Registration Statement (No. 33-9188) on Form S-1 filed on September 30, 1986).
(23)		Report and Consent of Independent Registered Public Accounting Firm (filed herewith).
(31)		Rule 13a-14(a)/15d-14(a) Certifications (filed herewith).
(32)		Certification Pursuant to Section 906 of Sarbanes-Oxley Act of 2002 (subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code (filed herewith).

* Indicates a management contract or compensation plan or arrangement.

The Company will forward upon request any exhibit not contained herein upon payment of a fee equal to the Company s reasonable expenses in furnishing the exhibits. Requests should be directed to:

Investor Relations
Merchants Group, Inc.
250 Main Street
Buffalo, New York 14202

Table of Contents

MERCHANTS GROUP, INC.
SCHEDULE I SUMMARY OF INVESTMENTS -
OTHER THAN INVESTMENTS IN RELATED PARTIES
December 31, 2005
(in thousands)

Type of Investment	Amortized Cost/ Cost	Market Value	Amount at which shown in the balance sheet
Fixed maturities:			
United States Government and government agencies and authorities	$ 7,248	$ 7,145	$ 7,145
Corporate securities	17,641	17,147	17,147
Mortgage and asset backed securities	98,850	97,044	97,044
Obligations of states and political subdivisions	45,927	45,257	45,257
Total fixed maturities	169,666	166,593	166,593
Preferred stocks	4,248	4,312	4,312
Short-term investments	10,650	10,650	10,650
Other	676	734	734
	$ 185,240	$ 182,289	$ 182,289

MERCHANTS GROUP, INC.
SCHEDULE II AMOUNTS RECEIVABLE FROM/PAYABLE TO RELATED PARTIES, AND UNDERWRITERS, PROMOTERS AND EMPLOYEES OTHER THAN RELATED PARTIES
Years ended December 31, 2005, 2004 and 2003
(in thousands)

	2005	2004	2003
Receivable from (payable to) related parties, primarily Merchants Mutual Insurance Company (1):			
Balance at beginning of period	$ (5,571)	$ (2,090)	$ (3,237)
Change during the period	5,458	(3,481)	1,147
Balance at end of period	$ (113)	$ (5,571)	$ (2,090)
Retrospective commission receivable from (payable to) Merchants Mutual Insurance Company (2):			
Balance at beginning of period	$ (1,141)	$ 305	$
Change during the period	(1,449)	(1,446)	305
Balance at end of period	$ (2,590)	$ (1,141)	$ 305

(1) Under a Services Agreement, Merchants Mutual Insurance Company (Mutual) provides employees, services and facilities for Merchants Insurance Company of New Hampshire, Inc. (MNH) to carry on its traditional insurance business on a fee basis. Under a Reinsurance Pooling Agreement, Mutual and MNH pool or share

premiums and losses on their traditional insurance business. The balance in the intercompany receivable (payable) account indicates the amount due from (to) Mutual for the excess (deficiency) of premiums collected over (from) payments for losses, services and facilities provided to MNH.

(2) A Pooling Agreement between the Company and Mutual provides for retrospective commission income or expense based upon the actual cumulative experience of the pooled business since the agreement s inception, compared to a targeted loss and LAE ratio of 74%. Commissions are settled annually, six months after the end of the calendar year.

Table of Contents

MERCHANTS GROUP, INC.
SCHEDULE III CONDENSED FINANCIAL INFORMATION OF REGISTRANT
(in thousands except per share and share amounts)

BALANCE SHEET

	December 31,	
	2005	2004
Assets		
Investment in subsidiary	$ 73,033	$ 71,433
Other assets	2,974	601
Total assets	$ 76,007	$ 72,034
Liabilities and Stockholders Equity		
Other liabilities	$ 113	$ 60
Total liabilities	113	60
Stockholders equity:		
Preferred stock, $.01 par value, authorized and unissued 3,000,000 shares		
Preferred stock, no par value, $424.30 stated value, no shares issued or outstanding at December 31, 2005 or 2004		
Common stock, $.01 par value, authorized 10,000,000 shares; 2,132,652 shares issued and outstanding at December 31, 2005 and 2,114,152 shares issued and outstanding at December 31, 2004	33	33
Additional paid in capital	36,267	35,878
Treasury stock, 1,139,700 shares at December 31, 2005 and 2004	(22,766)	(22,766)
Accumulated other comprehensive loss	(2,540)	(536)
Accumulated earnings	64,900	59,365
Total stockholders equity	75,894	71,974
Total liabilities and stockholders equity	$ 76,007	$ 72,034

55

Table of Contents

MERCHANTS GROUP, INC.
SCHEDULE III CONDENSED FINANCIAL INFORMATION OF REGISTRANT
Continued
(in thousands)

INCOME STATEMENT

	Year ended December 31,		
	2005	2004	2003
Revenues:			
Equity in net income of subsidiary	$ 7,004	$ 4,209	$ 4,516
Investment income	27	8	4
Total revenues	7,031	4,217	4,520
Expenses:			
General and administrative expenses	489	685	177
Operating income before income taxes	6,542	3,532	4,343
Income tax benefit	(157)	(230)	(22)
Net income	$ 6,699	$ 3,762	$ 4,365

Table of Contents

MERCHANTS GROUP, INC.
SCHEDULE III CONDENSED FINANCIAL INFORMATION OF REGISTRANT
Continued
(in thousands)

STATEMENT OF CASH FLOWS
Increase (Decrease) in Cash and Cash Equivalents:

	Year ended December 31,		
	2005	2004	2003
		(in thousands)	
Cash flows from operating activities:	$ (179)	$ (655)	$ (161)
Cash flows from investing activities:			
Receipt of subsidiary common stock dividend	3,400	1,200	1,200
Purchase of other investments, net	(2,412)	210	(188)
Cash flows from investing activities	988	1,410	1,012
Cash flows from financing activities:			
Cash dividends	(1,164)	(845)	(843)
Exercise of common stock options	389	84	
Cash flows from financing activities	(775)	(761)	(843)
Net increase (decrease) in cash and cash equivalents	34	(6)	8
Cash and cash equivalents, beginning of year	6	12	4
Cash and cash equivalents, end of year	$ 40	$ 6	$ 12
Reconciliation of net income to net cash provided by operations:			
Net income	$ 6,699	$ 3,762	$ 4,365
Adjustments to reconcile net income to net cash provided by operations:			
Equity in income of subsidiary	(7,004)	(4,209)	(4,516)
Increase (decrease) in other liabilities	53	2	(4)
(Increase) decrease in other (non-investment) assets	39	(204)	(14)
Other, net	34	(6)	8
Net cash used in operating activities	$ (179)	$ (655)	$ (161)

57

Table of Contents

MERCHANTS GROUP, INC.
SCHEDULE III CONDENSED FINANCIAL INFORMATION
Continued

NOTES TO CONDENSED FINANCIAL STATEMENTS

Cash dividends of $3,400,000, $1,200,000 and $1,200,000 were paid to the Registrant by its consolidated subsidiary in the years ended December 31, 2005, 2004 and 2003, respectively.

The Company may be a defendant from time to time in legal proceedings in the ordinary course of its business. The Company is of the opinion that the ultimate aggregate liability, if any, resulting from such proceedings will not materially affect the financial condition of the Company.

Table of Contents

MERCHANTS GROUP, INC.
SCHEDULE IV REINSURANCE
YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003
(in thousands except percentages)

	Gross amount	Ceded to third parties	Ceded to affiliates (1)	Assumed from third parties	Assumed from affiliates (1)	Net amount	Percentage of amount assumed to net
Year ended December 31, 2005 Property and Casualty Premiums	$53,532	$3,747	$50,957	$1,172	$45,135	$45,135	102.6%
Year ended December 31, 2004 Property and Casualty Premiums	$53,900	$2,967	$52,452	$1,519	$53,102	$53,102	102.9%
Year Ended December 31, 2003 Property and Casualty Premiums	$58,233	$3,077	$90,596	$1,412	$98,207	$64,179	155.2%

(1) Amounts are comprised of premiums assumed or ceded in accordance with the Reinsurance Pooling Agreement with Mutual.

Table of Contents

MERCHANTS GROUP, INC.
SCHEDULE VI SUPPLEMENTAL INSURANCE INFORMATION CONCERNING
PROPERTY CASUALTY SUBSIDIARIES
Years ended December 31, 2005, 2004 and 2003
(in thousands)

	Deferred policy acquis-ition costs	Reserves for losses and loss adjustment expenses	Discount if any, deducted from reserves	Unearned premiums	Net earned premiums	Net investment income	Losses & loss adjustment expenses incurred related to (1) Current years	(2) Prior years	Amortiza-tion of deferred acquisition costs	Paid losses & loss ad-justment expenses	Direct premium written
Year ended:											
December 31, 2005	$6,527	$115,191	$3,651	$29,662	$49,121	$7,733	$29,711	$(3,303)	$12,771	$37,810	$53,532
December 31, 2004	$7,570	$128,415	$4,531	$33,685	$57,123	$7,881	$38,524	$ (843)	$14,852	$48,655	$53,900
December 31, 2003	$8,623	$146,474	$4,920	$36,176	$65,097	$8,815	$49,702	$ (90)	$16,925	$53,609	$58,233

60

Report of Independent Registered Public Accounting Firm

To the Board of Directors and
Stockholders of Merchants Group, Inc.

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Merchants Group, Inc. and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules appearing under Item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of the Company s management; our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with Standards of the Public Company Accounting Oversight Board (United States). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP
Buffalo, New York
March 30, 2006

Table of Contents

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

	December 31, 2005	December 31, 2004
Assets		
Investments:		
Fixed maturities available for sale at fair value	$ 166,593	$ 184,092
Preferred stock at fair value	4,312	3,509
Other long-term investments at fair value	734	2,696
Short-term investments	10,650	7,412
Total investments	182,289	197,709
Cash	82	145
Interest due and accrued	998	1,079
Premiums receivable from affiliate, net of allowance for doubtful accounts of $158 in 2005 and $215 in 2004	13,540	15,136
Deferred policy acquisition costs from affiliate	6,527	7,570
Reinsurance recoverable on unpaid losses	13,807	15,630
Prepaid reinsurance premiums from affiliate	4,559	4,595
Income taxes receivable	109	
Deferred income taxes	5,367	5,028
Other assets	6,700	8,812
Total assets	$ 233,978	$ 255,704

The accompanying notes are an integral part of these consolidated financial statements.

F-2

Table of Contents

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

	December 31,	
	2005	2004
Liabilities and Stockholders Equity		
Liabilities:		
Reserve for losses and loss adjustment expenses (from affiliate $50,239 and $44,094)	$ 115,191	$ 128,415
Unearned premiums from affiliate	29,662	33,685
Payable for securities		4,751
Payable to affiliate	113	5,571
Retrospective commission payable to affiliate	2,590	1,141
Other liabilities (from affiliate $5,044 and $4,262)	10,528	10,167
Total liabilities	158,084	183,730
Stockholders equity:		
Common stock, $.01 par value, 10,000,000 shares authorized, 2,132,652 shares issued and outstanding at December 31, 2005 and 2,114,152 shares issued and outstanding at December 31, 2004	33	33
Additional paid in capital	36,267	35,878
Treasury stock, 1,139,700 shares at December 31, 2005 and 2004	(22,766)	(22,766)
Accumulated other comprehensive loss	(2,540)	(536)
Accumulated earnings	64,900	59,365
Total stockholders equity	75,894	71,974
Commitments and contingencies		
Total liabilities and stockholders equity	$ 233,978	$ 255,704

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

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

	Year ended December 31,		
	2005	2004	2003
Revenues:			
Net premiums earned from affiliate	$ 49,121	$ 57,123	$ 65,097
Net investment income	7,733	7,881	8,815
Net investment gains (losses)		(221)	2,500
Other revenues from affiliate	571	722	560
Total revenues	57,425	65,505	76,972
Expenses:			
Net losses and loss adjustment expenses (from affiliate $26,558, $35,137 and $49,336)	26,408	37,681	49,612
Amortization of deferred policy acquisition costs from affiliate	12,771	14,852	16,925
Other underwriting expenses (from affiliate $7,888, $6,433 and $4,044)	8,811	8,291	5,031
Total expenses	47,990	60,824	71,568
Income before income taxes	9,435	4,681	5,404
Income tax provision	2,736	919	1,039
Net income	$ 6,699	$ 3,762	$ 4,365
Earnings per share:			
Basic	$ 3.17	$ 1.78	$ 2.07
Diluted	$ 3.16	$ 1.78	$ 2.07
Weighted average number of shares outstanding:			
Basic	2,115	2,114	2,110
Diluted	2,118	2,118	2,111

The accompanying notes are an integral part of these consolidated financial statements.

F-4

Table of Contents

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

	Year ended December 31,		
	2005	2004	2003
Net income	$ 6,699	$ 3,762	$ 4,365
Other comprehensive income (loss) before tax:			
Unrealized gains (losses) on securities	(3,039)	(1,926)	688
Reclassification adjustment for gains or losses included in net income		221	(2,488)
Other comprehensive loss before tax	(3,039)	(1,705)	(1,800)
Income tax benefit related to items of other comprehensive loss	(1,035)	(419)	(613)
Other comprehensive loss	(2,004)	(1,286)	(1,187)
Comprehensive income	$ 4,695	$ 2,476	$ 3,178

The accompanying notes are an integral part of these consolidated financial statements.

F-5

Table of Contents

MERCHANTS GROUP, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
(in thousands except per share amounts)

	Year ended December 31,		
	2005	2004	2003
Common stock:			
Beginning of year	$ 33	$ 32	$ 32
Exercise of common stock options		1	
End of year	33	33	32
Additional paid in capital:			
Beginning of year	35,878	35,795	35,795
Exercise of common stock options	389	83	
End of year	36,267	35,878	35,795
Treasury stock:			
Beginning and end of year	(22,766)	(22,766)	(22,766)
Accumulated other comprehensive income (loss):			
Beginning of year	(536)	750	1,937
Other comprehensive loss	(2,004)	(1,286)	(1,187)
End of year	(2,540)	(536)	750
Accumulated earnings:			
Beginning of year	59,365	56,448	52,926
Net income	6,699	3,762	4,365
Cash dividends ($.55/share in 2005, and $.40/share in 2004 and in 2003), (to affiliate, $140, $102 and $102)	(1,164)	(845)	(843)
End of year	64,900	59,365	56,448
Total stockholders equity	$ 75,894	$ 71,974	$ 70,259

The accompanying notes are an integral part of these consolidated financial statements.

F-6

Table of Contents

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

	Year ended December 31,		
	2005	2004	2003
Cash flows from operations:			
Collection of premiums from affiliate	$ 47,175	$ 53,924	$ 62,789
Payment of losses and loss adjustment expenses (from affiliate $20,413, $22,299 and $18,081)	(36,088)	(50,276)	(54,043)
Payment of underwriting expenses (from affiliate $(17,437), $(21,946) and $(19,527))	(18,781)	(23,550)	(20,594)
Investment income received	8,002	8,259	9,170
Investment expenses paid	(380)	(280)	(289)
Income taxes paid	(2,152)	(376)	(1,152)
Other cash receipts from affiliate	571	722	560
Net cash used in operations	(1,653)	(11,577)	(3,559)
Cash flows from investing activities:			
Proceeds from fixed maturities sold or matured	56,653	46,124	139,217
Purchase of fixed maturities	(41,962)	(37,547)	(140,467)
Net (increase) decrease in preferred stock	(850)	2,000	1,500
Net (increase) decrease in other long-term investments	1,970	(948)	1,926
Net (increase) decrease in short-term investments	(3,238)	(6,294)	5,302
Settlement of securities transactions, net	(4,751)	5,644	(1,915)
Net cash provided by investing activities	7,822	8,979	5,563
Cash flows from financing activities:			
Settlement of affiliate balances, net	(5,457)	3,481	(1,147)
Proceeds from exercise of common stock options	389	84	
Cash dividends (to affiliate $140, $102 and $102)	(1,164)	(845)	(843)
Net cash provided by (used in) financing activities	(6,232)	2,720	(1,990)
Increase (decrease) in cash	(63)	122	14
Cash, beginning of year	145	23	9
Cash, end of year	$ 82	$ 145	$ 23

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

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

	Year ended December 31,		
	2005	2004	2003
Net income	$ 6,699	$ 3,762	$ 4,365
Adjustments:			
Net discount accretion on investments	(193)	(83)	(268)
Net investment (gains) losses		221	(2,500)
(Increase) decrease in assets:			
Interest due and accrued	81	181	334
Premiums receivable from affiliate	1,596	1,541	(2,181)
Deferred policy acquisition costs from affiliate	1,043	1,053	194
Reinsurance recoverable on paid and unpaid losses	1,823	7,085	(3,629)
Prepaid reinsurance premiums from affiliate	36	(1,529)	(1,975)
Income taxes receivable	(109)	881	(424)
Deferred income taxes	696	(113)	311
Retrospective commission receivable from affiliate		305	(305)
Other assets	1,941	(1,919)	(865)
Increase (decrease) in liabilities:			
Reserve for losses and loss adjustment expenses (from affiliate $6,145, $12,838 and $31,256)	(13,224)	(18,059)	(662)
Unearned premiums from affiliate	(4,023)	(2,491)	1,057
Retrospective commission payable to affiliate	1,449	1,141	
Other liabilities (from affiliate $953, $(3,807) and $3,068)	532	(3,553)	2,989
Net cash used in operations	$ (1,653)	$ (11,577)	$ (3,559)

The accompanying notes are an integral part of these consolidated financial statements.

F-8

MERCHANTS GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Significant Accounting Policies

Principles of consolidation and basis of presentation

The consolidated financial statements of Merchants Group, Inc. (the Company) include the accounts of the Company, its wholly-owned subsidiary, Merchants Insurance Company of New Hampshire, Inc. (MNH), and M.F.C. of New York, Inc., an inactive premium finance company which is a wholly-owned subsidiary of MNH. MNH is a stock property and casualty insurance company domiciled in the state of New Hampshire. MNH offers property and casualty insurance to preferred risk individuals and small to medium sized businesses in the northeast United States, primarily in New York, New Hampshire and New Jersey where a majority of its policies are written. As a holding company, the Company has no operations.

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which differ in some respects from those followed in reports to insurance regulatory authorities. In its Annual Statement filed with regulatory authorities, MNH reported policyholders surplus of $66,390,000 and $61,708,000 at December 31, 2005 and 2004, respectively. MNH s net income as reported in its Annual Statement was $8,708,000 in 2005, $5,191,000 in 2004 and $4,915,000 in 2003. All significant intercompany balances and transactions have been eliminated.

The preparation of consolidated financial statements in conformity with GAAP 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. Actual results may differ from those estimates.

Investments

Fixed maturities are classified as available for sale and are presented at fair value. Fixed maturities consist of debt securities that management may not hold until maturity. All preferred stocks are classified as available for sale and are presented at fair value. The net aggregate unrealized gain or loss, net of applicable income taxes, related to fixed maturities and preferred stock classified as available for sale is included as a component of accumulated other comprehensive income (loss) in stockholders equity.

Other long-term investments include collateralized mortgage obligation residuals, carried at unpaid principal balances which do not vary significantly from fair value. Short-term investments, consisting primarily of money market mutual funds, have original maturities of three months or less and are carried at cost, which approximates fair value. Realized gains and losses on the sale of investments are based on the cost of the specific investment sold.

Net unrealized holding gains or losses, net of taxes, are shown as other comprehensive income. Management monitors the Company s investment portfolio for declines in value that are other-than-temporary. When a decline in the fair value of a security has been determined to be other-than-temporary, the investment s cost is written down to fair value and a realized loss is recorded in the Consolidated Statement of Operations.

Net premiums earned

Premiums are recorded as revenue ratably over the terms of the policies written (principally one year). Unearned premiums are calculated using a monthly pro rata method.

Deferred policy acquisition costs

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

	Year Ended December 31,		
	2005	2004	2003
		(in thousands)	
Beginning balance	$ 7,570	$ 8,623	$ 8,817
Acquisition cost deferred	11,728	13,799	16,731
Amortized to expense	(12,771)	(14,852)	(16,925)
Ending balance	$ 6,527	$ 7,570	$ 8,623

Reinsurance

Reinsurance assumed from business written through state reinsurance facilities or through a reinsurance pooling agreement with an affiliate (see note 2) has been reflected in unearned premiums, loss reserves, premiums earned and losses incurred based on reports received from such entities. Ceded reinsurance premiums, losses and ceding commissions are netted against earned premiums, losses and commission expense, respectively.

Table of Contents

Reserve for losses and loss adjustment expenses

Liabilities for unpaid losses and loss adjustment expenses (LAE) are estimates of future payments to be made to settle all insurance claims for reported losses and estimates of incurred but not reported losses based upon past experience modified for current trends. With the exception of workers compensation losses, loss reserves are not discounted. Estimated amounts of salvage and subrogation on paid and unpaid losses are deducted from the liability for unpaid claims. The estimated liabilities may be more or less than the amount ultimately paid when the claims are settled. Management and the Company s independent consulting actuary regularly review the estimates of reserves needed and any changes are reflected in current operating results.

The Company discounts its liability for workers compensation case reserves on a tabular basis, using the National Council on Compensation Insurance Workers Compensation Statistical Plan Table III A at a rate of 3.5%. The amount of discount at December 31, 2005 and 2004 is $3,651,000 and $4,531,000, respectively. Reserves for losses incurred but not reported and for LAE are not discounted.

Structured settlements have been negotiated for claims on certain insurance policies. Structured settlements are agreements to provide periodic payments to claimants, and are funded by annuities purchased from various life insurance companies. Historically the Company recorded the net present value of the aggregate amount of its contingent liability related to claims settled by the purchase of structured settlements in its Consolidated Balance Sheet within Other Liabilities. A corresponding asset was recorded in Other Assets for the same amount. The Company believed that in all instances in which a structured settlement was purchased, it remained contingently liable to its claimant if the life insurance company were to default on payment of the structured settlement. Many of the Company s structured settlements include Uniform Qualified Assignments. In 2006, the Company received guidance from its legal counsel that such Uniform Qualified Assignments relieve the Company of any contingent liability for which the Assignment is properly executed. The Company included a liability in its Consolidated Balance Sheets as of December 31, 2004 for all instances where structured settlements were purchased, including those where the Company received a Uniform Qualified Assignment. Other Liabilities and Other Assets included structured settlements with Uniform Qualified Assignments of $4,745,000 at December 31, 2004. The Company s Consolidated Balance Sheet at December 31, 2004 has been adjusted to remove this overstatement. This adjustment had no effect on the Company s net income, stockholders equity or cash flows. The Company remains primarily liable for those claims which have been funded with a structured settlement but which do not include Uniform Qualified Assignments. Accordingly, a liability and a corresponding asset in the amount of $5,349,000 and $5,520,000 at December 31, 2005 and 2004, respectively, are recorded in the Company s Consolidated Balance Sheet in Other Liabilities and Other Assets, respectively.

Income taxes

The Company and its wholly-owned subsidiaries file a consolidated federal income tax return. The Company follows the asset and liability approach to account for income taxes, which requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of temporary differences between the financial statement carrying amounts and the tax basis of assets and liabilities.

Other financial instruments

The fair value of the Company s other financial instruments, principally premiums receivable and certain non-insurance related liabilities, does not vary significantly from the amounts assigned in these financial statements.

Certain prior year balances were reclassified to conform to current year classification.

2. Related Party Transactions

The Company and MNH operate and manage their business with Merchants Mutual Insurance Company (Mutual) under a services agreement (the Services Agreement) that became effective January 1, 2003. At December 31, 2005, Mutual owned 12.0% of the Company s outstanding common stock. The Company and MNH do not have any operating assets or employees. In accordance with the Services Agreement, Mutual provides the Company with facilities, management and personnel required to operate its day-to-day business, including the following services: administrative services, underwriting services, claims services, and investment and cash management services. The Services Agreement contains termination provisions that vary based on the service rendered. Underwriting services may be terminated on one year s notice, but the termination may not be effective before January 1, 2008. Claims services and administrative services may be terminated on 6 months notice. In June 2005 the Company notified Mutual that it will terminate the investment and cash management services annex to the Services Agreement as of June 30, 2006.

Effective January 1, 2003, Mutual and MNH agreed to pool, or share, underwriting results on their traditional insurance business (the Traditional Business) by means of a reinsurance pooling agreement (the Pooling Agreement). It does not apply to any new endeavor of either Mutual or MNH outside of their Traditional Business, unless the companies agree otherwise. The Pooling Agreement applies to premiums earned and losses incurred after the effective date. Due to the possibility of development of losses and LAE for accident years prior to the inception of the Pooling Agreement, the amount of net losses and LAE from affiliate for any given year may be more or less than the amount of net losses and LAE as shown on the Company s Consolidated Statement of Operations.

Table of Contents

The Pooling Agreement provides for MNH to cede, or transfer, to Mutual all premiums and risks on its Traditional Business during the term of the agreement, and then to assume from Mutual a percentage of all of Mutual s and MNH s Traditional Business (the Pooled Business). MNH assumed 30% and 35% of the Pooled Business in 2005 and 2004, respectively. MNH s share of the Pooled Business will be 25% in 2006 and 2007, though not to exceed $42.5 million and $37.5 million in assumed net written premiums in 2006 and 2007, respectively.

The Pooling Agreement provides for retrospective commission income or expense based on the actual cumulative experience of the Pooled Business since its inception compared to a targeted loss and LAE ratio of 74%. Commissions are settled annually, 6 months after the end of the calendar year. Until settlement, retrospective commissions owed to or due from Mutual are recorded in the consolidated balance sheet as Retrospective commission payable to, or receivable from, affiliate.

The Pooling Agreement may be terminated by either party at the beginning of any calendar year on or after January 1, 2008 upon not less than 6 months notice. However, the Pooling Agreement may be terminated effective January 1, 2007 upon 6 months notice, but only by MNH and only if the ratio of net losses and LAE to net earned premiums on a cumulative basis from the inception of the Pooling Agreement exceeds 76% as of the date notice is given. As of December 31, 2005, the ratio of net losses and LAE to net premiums earned on a cumulative basis since the inception of the Pooling Agreement was 65.8%.

The payable to or receivable from affiliate (Mutual) is non-interest bearing and represents the net of premiums collected and loss and operating expense payments made by Mutual on behalf of MNH. This balance is settled in cash on a monthly basis.

Table of Contents

3. Investments

Investments in fixed maturities, preferred stock and other long-term investments

The amortized cost and estimated fair value of investments in fixed maturities available for sale and the cost and estimated fair value of preferred stock and other long term investments are as follows:

	Amortized Cost/Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(in thousands)		
December 31, 2005				
Fixed maturities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 7,248	$ 6	$ 109	$ 7,145
Obligations of states and political subdivisions	45,927		670	45,257
Corporate securities	17,641	2	496	17,147
Mortgage and asset backed securities	98,850	47	1,853	97,044
Total	$ 169,666	$ 55	$ 3,128	$ 166,593
Preferred stock	$ 4,248	$ 118	$ 54	$ 4,312
Other long-term investments	$ 676	$ 58	$	$ 734

F-14

Table of Contents

	Amortized Cost/Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
December 31, 2004				
Fixed maturities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 5,028	$ 29	$ 29	$ 5,028
Obligations of states and political subdivisions	41,010	100	131	40,979
Corporate securities	27,929	136	62	28,003
Mortgage and asset backed securities	110,204	557	679	110,082
Total	$ 184,171	$ 822	$ 901	$ 184,092
Preferred stock	$ 3,392	$ 117	$	$ 3,509
Other long-term investments	$ 2,646	$ 50	$	$ 2,696

A summary of investment securities that as of December 31, 2005 and 2004 have been in a continuous unrealized loss position for less than twelve months and those that have been in a continuous unrealized loss position for twelve months or more follows:

Table of Contents

	Less than 12 months		12 months or more	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)			
December 31, 2005				
Fixed maturities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 2,980	$ 20	$ 2,915	$ 89
Obligations of states and political subdivisions	20,877	201	20,224	469
Corporate securities	8,278	235	8,766	261
Mortgage and asset backed securities	64,509	938	29,071	915
Total	$ 96,644	$ 1,394	$ 60,976	$ 1,734
Preferred stock	$ 1,296	$ 54	$	$
Other long-term investments	$	$	$	$
December 31, 2004				
Fixed maturities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 2,977	$ 29	$	$
Obligations of states and political subdivisions	11,943	65	3,502	66
Corporate securities	6,996	40	972	22
Mortgage and asset backed securities	55,173	525	5,011	154
Total	$ 77,089	$ 659	$ 9,485	$ 242
Preferred stock	$	$	$	$
Other long-term investments	$	$	$	$

Table of Contents

None of the securities in the table above were determined to have any fundamental issues that would cause the Company to believe that they were other-than-temporarily impaired. All of the Company s securities in an unrealized loss position at December 31, 2005 were rated as investment grade. Therefore, the Company believes that any impairment relates to the movement of interest rates and the Company has the intent and ability to retain its investments for a period of time sufficient to allow for an anticipated recovery in market value including until maturity if necessary.

Included in net investment losses for 2004 are $700,000 of write downs on securities which the Company determined had experienced an other-than-temporary decline in market value. There were no such write downs in 2005 or 2003.

The amortized cost and fair value of fixed maturities by expected maturity at December 31, 2005 are shown below. Mortgage and asset backed securities are distributed in the table based upon management s estimate of repayment periods. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
	(in thousands)	
Due in one year or less	$ 35,705	$ 35,259
Due after one year through five years	106,991	104,957
Due after five years through ten years	19,444	18,978
Due after ten years	7,526	7,399
Total	$ 169,666	$ 166,593

Discount and premium pertaining to collateralized mortgage obligations are amortized over the securities estimated redemption periods using the effective interest method. Yields used to calculate premium or discount are adjusted for prepayments quarterly.

Fixed maturities with a par value of $850,000 were on deposit at December 31, 2005 with various state insurance departments in compliance with applicable insurance laws.

Proceeds from sales of fixed maturity securities, preferred stock and common stock and gross realized gains and losses related to such sales are as follows:

Table of Contents

	Year ended December 31,		
	2005	2004	2003
		(in thousands)	
Proceeds from sales	$	$10,641	$11,089
Gross realized gains		479	2,500
Gross realized losses			

Net investment income

Net investment income consists of:

	Year ended December 31,		
	2005	2004	2003
		(in thousands)	
Fixed maturities	$ 7,573	$ 7,873	$ 8,534
Short-term investments	206	64	45
Other	334	297	525
Total investment income	8,113	8,234	9,104
Investment expenses	380	353	289
Net investment income	$ 7,733	$ 7,881	$ 8,815

4. Reinsurance

MNH follows the customary practice of reinsuring a portion of the exposure under its policies. Insurance is ceded principally to reduce net liability on individual risks and to protect against catastrophic losses. Although reinsurance does not legally discharge an insurer from its primary liability for the full amount of coverage provided by its policies, it does make the assuming reinsurer liable to the insurer to the extent of the reinsurance ceded.

The effect of reinsurance transactions on premiums written and earned for the years ended December 31, 2005, 2004 and 2003 is as follows:

	2005		2004		2003	
	Premiums Written	Premiums Earned	Premiums Written	Premiums Earned	Premiums Written	Premiums Earned
			(in thousands)			
Direct	$ 53,532	$ 53,603	$ 53,900	$ 55,528	$ 58,233	$ 63,517
Assumed						
With third parties	1,172	1,258	1,519	1,814	1,412	1,694
Pooling Agreement	45,135	49,122	53,102	57,123	98,207	65,098
Subtotal	46,307	50,380	54,621	58,937	99,619	66,792
Ceded						
With third parties	(3,747)	(3,398)	(2,967)	(2,891)	(3,077)	(3,337)
Pooling Agreement	(50,957)	(51,464)	(52,452)	(54,451)	(90,596)	(61,875)
Subtotal	(54,704)	(54,862)	(55,419)	(57,342)	(93,673)	(65,212)
Net Premiums	$ 45,135	$ 49,121	$ 53,102	$ 57,123	$ 64,179	$ 65,097

Reinsurance transactions had the following effect on net losses and LAE incurred for the years ended December 31, 2005, 2004 and 2003.

	2005	2004	2003
		(in thousands)	
Direct	$ 30,986	$ 38,392	$ 59,326
Assumed			
With third parties	1,414	1,453	1,631
Pooling Agreement	26,558	35,137	49,336
Subtotal	27,972	36,590	50,967
Ceded			
With third parties	(4,209)	(3,754)	(8,779)
Pooling Agreement	(28,341)	(33,547)	(51,902)
Subtotal	(32,550)	(37,301)	(60,681)
Net losses and LAE	$ 26,408	$ 37,681	$ 49,612

As a result of the reinsurance agreements maintained by MNH, MNH is exposed to certain credit risk if one or more of its primary reinsurers were to become financially unstable. As of December 31, 2005, MNH has recognized amounts to be recovered from its primary reinsurers related to ceded losses and ceded unearned premiums totaling $18,366,000. MNH generally does not require collateral for reinsurance recoverable.

Table of Contents

5. Reserve for Losses and Loss Adjustment Expenses

Activity in the reserve for losses and LAE is summarized as follows:

	2005	2004
	(in thousands)	
Reserve for losses and LAE at beginning of year	$ 128,415	$ 146,474
Less reinsurance recoverables	(15,630)	(22,715)
Net balance at beginning of year	112,785	123,759
Provision for losses and LAE for claims occurring in:		
Current year	29,711	38,524
Prior years	(3,303)	(843)
	26,408	37,681
Loss and LAE payments for claims occurring in:		
Current year	(10,359)	(13,647)
Prior years	(27,450)	(35,008)
	(37,809)	(48,655)
Reserve for losses and LAE at end of year, net	101,384	112,785
Plus reinsurance recoverables	13,807	15,630
Balance at end of year	$ 115,191	$ 128,415

In 2005 and 2004, the Company decreased reserves for prior years by $3,303,000 and $843,000, respectively, primarily due to favorable loss development related to private passenger auto liability and workers compensation policies, somewhat offset by unfavorable development on its commercial package policies.

6. Demand Loan

The Company has arranged for a $2,000,000 unsecured credit facility from a bank. Any borrowings under this facility are payable on demand and carry an interest rate which can be fixed or variable and is negotiated at the time of each advance. This facility is available for general working capital purposes and for repurchases of the Company s common stock. No amount related to this facility was outstanding at December 31, 2005.

7. Income Taxes

The provision (benefit) for income taxes consists of:

	Year ended December 31,		
	2005	2004	2003
		(in thousands)	
Current	$ 2,040	$ 1,032	$ 728
Deferred	696	(113)	311
Total income tax provision	$ 2,736	$ 919	$ 1,039

A reconciliation of the difference between the Company s total income tax provision and that calculated using statutory income tax rates is as follows:

	Year ended December 31,		
	2005	2004	2003
		(in thousands)	
Computed provision at statutory rate	$ 3,208	$ 1,592	$ 1,837
Adjustments:			
State income taxes, net of federal effect			(479)
Tax-exempt investment income	(368)	(315)	(217)
Dividend received deduction	(61)	(47)	(79)
Adjustments to prior years taxes		(196)	
Reversal of excess tax reserves related to uncertain tax positions	(50)	(120)	
Other	7	5	(23)
Total income tax provision	$ 2,736	$ 919	$ 1,039

The provision for income taxes for 2003 includes the effect of a 2003 change in New York State law with respect to the taxation of non-life insurance companies. This change eliminated state income taxes for all non-life insurance companies and increased the premium tax rate from 1.3% to 2.0%. As a result, the Company reduced its deferred tax liability with respect to New York State income taxes to $0, and recorded a one-time benefit, net of federal income taxes, to its income tax provision of $505,000 during 2003.

Table of Contents

Deferred tax (liabilities) assets are comprised of the following:

	December 31,	
	2005	2004
	(in thousands)	
Deferred policy acquisition costs	$ (2,219)	$ (2,574)
Other	(150)	(182)
Total deferred tax liabilities	(2,369)	(2,756)
Discounting of reserve for losses and loss adjustment expenses	4,552	5,354
Unearned premiums	1,726	1,997
Unrealized net investment losses	1,295	251
Other	163	182
Total deferred tax assets	7,736	7,784
Net deferred income taxes	$ 5,367	$ 5,028

Although realization is not assured, based upon the evidence available the Company believes that it is more likely than not that the net deferred income tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income are not achieved.

8. Stockholders Equity

Dividends

The Company depends on dividends from its subsidiary, MNH, to pay cash dividends to its stockholders and to meet its expenses. MNH is subject to New Hampshire state insurance laws which restrict its ability to pay dividends without the prior approval of state regulatory authorities. These restrictions limit dividends to those that, when added to all other dividends paid within the preceding twelve months, would not exceed 10% of an insurer s policyholders surplus as of the preceding December 31. The maximum amount of dividends that MNH could pay during any twelve-month period ending in 2006 without the prior approval of the New Hampshire Insurance Commissioner is $6,639,000.

Stock option plan

The Company s stock option plan (the Plan), which reserved 200,000 shares of common stock for issuance to the Company s and MNH s officers and key employees of Mutual, expired in 1996. Under the Plan, qualified and non-qualified stock options were granted at amounts not less than the fair market value of the Company s stock on the date of grant. Options granted under the Plan have a 10 year life and vested in cumulative annual increments of 25% commencing one year from the date of grant.

Table of Contents

In accounting for the Plan, the Company remains under the expense recognition provisions of Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees but follows the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123 Accounting for Stock Based Compensation . No options were granted in 2005, 2004 or 2003 and, therefore, no compensation expense was recognized in those years.
A summary of the status of the Company s outstanding options as of December 31, 2005, 2004 and 2003, and changes during the years ending on those dates is presented below:

	2005		2004		2003	
	Options Outstanding	Weighted Average Exercise Price	Options Outstanding	Weighted Average Exercise Price	Options Outstanding	Weighted Average Exercise Price
Beginning of year	31,500	$ 21.00	35,500	$ 21.00	35,500	21.00
Granted						
Exercised	(18,500)	21.00	(4,000)	21.00		
Forfeited						
End of year	13,000	21.00	31,500	21.00	35,500	21.00
Options exercisable at year-end	13,000	21.00	31,500	21.00	35,500	21.00

The following table summarizes information about the Company s outstanding stock options at December 31, 2005:

Number Outstanding at 12/31/05	Remaining Contractual Life in Years	Average Exercise Price	Number Exercisable at 12/31/05
13,000	.1	$ 21.00	13,000

Treasury stock

The Company did not repurchase any shares of its common stock in 2005, 2004 or 2003. The Company was holding 1,139,700 shares in treasury at December 31, 2005.

Table of Contents

Preferred stock

The Company s Preferred stock, no par value, $424.30 stated value, consists of 10,000 shares authorized; no shares were issued or outstanding at December 31, 2005 or December 31, 2004. The Company also has 3,000,000 shares of $.01 par value preferred stock which is authorized and unissued.

9. Earnings Per Share

The computations for basic and diluted earnings per share are as follows:

	Year Ended December 31,		
	2005	2004	2003
	(in thousands except per share amounts)		
Basic:			
Net income	$ 6,699	$ 3,762	$ 4,365
Weighted average shares outstanding	2,115	2,114	2,110
Basic earnings per share	$ 3.17	$ 1.78	$ 2.07
Diluted:			
Net income	$ 6,699	$ 3,762	$ 4,365
Weighted average shares outstanding	2,115	2,114	2,110
Plus incremental shares from assumed conversion of stock options	3	4	1
Weighted average shares outstanding-adjusted	2,118	2,118	$ 2,111
Diluted earnings per share	$ 3.16	$ 1.78	$ 2.07

10. Underwriting Results by Product

The following table shows, for each of the years in the three year period ended December 31, 2005, the amount of the Company s net premiums earned for each of its major products and the calendar year loss and allocated loss adjustment expense (ALAE) ratio for each product. The loss and ALAE ratio is one measure of product profitability and shows the relationship of incurred losses and allocated loss adjustment expenses to net premiums earned for a given period.

	For The Year Ended December 31, (000 s)					
	2005		2004		2003	
	Net Premiums Earned	Loss & ALAE Ratio	Net Premiums Earned	Loss & ALAE Ratio	Net Premiums Earned	Loss & ALAE Ratio
Private passenger auto liability	$ 5,870	21.0%	$ 9,543	59.0%	$ 13,131	75.6%
Homeowners	4,732	50.3%	5,541	63.6%	6,352	52.3%
Commercial auto liability	11,616	32.0%	12,532	53.5%	12,561	23.9%
Workers compensation	4,532	9.1%	4,535	31.4%	4,619	188.8%
Commercial package	15,343	63.9%	15,764	76.7%	16,449	79.1%
General liability	1,147	244.5%	700	165.5%	638	406.9%
Other	5,881	37.3%	8,508	43.5%	11,347	45.5%
Total	$ 49,121	45.9%	$ 57,123	59.9%	$ 65,097	70.3%

11. Benefit Programs

Mutual maintains a capital accumulation plan which is a profit sharing plan under Section 401(a) of the Internal Revenue Code that covers all employees who have completed six months of service. Mutual matches at least 15% and up to 100% of employee contributions, based on the combined net operating profits of Mutual and MNH. Additional contributions may be made at the discretion of the Board of Directors of Mutual. The portion of the 2005, 2004 and 2003 service fees charged to the Company by Mutual relating to Mutual s contribution to its capital accumulation plan were $301,000, $213,000 and $414,000, respectively.

Mutual has established a supplemental executive retirement plan covering certain employees. The portion of the 2005, 2004 and 2003 service fees charged to the Company by Mutual relating to Mutual s contribution to its supplemental executive retirement plan were $52,000, $36,000 and $59,000, respectively.

12. Commitments and Contingencies

MNH, like many other property and casualty insurance companies, is subject to environmental damage claims asserted by or against its insureds. Management is of the opinion that based on various court decisions throughout the country, such claims should not be recoverable under the terms of MNH s insurance policies because of either specific or general coverage exclusions contained in the policies. However, there is no assurance that

the courts will agree with MNH s position in every case, nor can there be assurance that material claims will not be asserted under policies which a court will find do not explicitly or implicitly exclude claims for environmental damages. Management, however, is not aware of any pending claim or group of claims which would result in a liability that would have a material adverse effect on the financial condition of MNH.

In addition to the foregoing, MNH may be a defendant from time to time in a number of other legal proceedings in the ordinary course of its business. Management of the Company is of the opinion that the ultimate aggregate liability, if any, resulting from such proceedings will not materially affect the financial condition of MNH or the Company.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

		Merchants Group, Inc.
Date: March 31, 2006	BY:	/s/ Robert M. Zak
		Robert M. Zak, Senior Vice President and Chief Operating Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

SIGNATURE	TITLE	DATE
/s/ Robert M. Zak Robert M. Zak	Director, Sr. VP & Chief Operating Officer (principal executive officer)	March 31, 2006
/s/ Kenneth J. Wilson Kenneth J. Wilson	Vice President & CFO (principal financial and accounting officer)	March 31, 2006
/s/ Thomas E. Kahn Thomas E. Kahn	Director, Chairman of the Board	March 31, 2006
/s/ Brent D. Baird Brent D. Baird	Director	March 31, 2006
/s/ Andrew A. Alberti Andrew A. Alberti	Director	March 31, 2006
/s/ Frank J. Colantuono Frank J. Colantuono	Director	March 31, 2006
/s/ Henry P. Semmelhack Henry P. Semmelhack	Director	March 31, 2006