FIRST MERCURY FINANCIAL CORP
Form 10-Q
August 10, 2009

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

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 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 001-33077

FIRST MERCURY FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**38-3164336**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
29110 Inkster Road **Suite 100** **Southfield, Michigan**	**48034**
(Address of Principal Executive Offices)	(Zip Code)

Registrant s telephone number, including area code: (800) 762-6837

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

The number of shares of Common Stock, par value $0.01, outstanding on August 7, 2009 was 17,144,818.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
PART I. FINANCIAL INFORMATION
ITEM 1. Condensed Consolidated Financial Statements
Condensed Consolidated Balance Sheets

	June 30, 2009 (Unaudited)	December 31, 2008
	(Dollars in thousands, except share and per share data)	
ASSETS		
Investments		
Debt securities	$ 581,235	$ 495,799
Equity securities and other	27,008	15,089
Short-term	16,921	32,142
Total Investments	625,164	543,030
Cash and cash equivalents	23,574	31,833
Premiums and reinsurance balances receivable	58,504	56,398
Accrued investment income	6,327	5,400
Accrued profit sharing commissions	12,873	11,315
Reinsurance recoverable on paid and unpaid losses	150,819	135,617
Prepaid reinsurance premiums	54,207	48,921
Deferred acquisition costs	26,917	27,369
Intangible assets, net of accumulated amortization	38,201	39,351
Goodwill	25,483	25,483
Deferred federal income taxes		2,161
Other assets	23,625	16,775
Total Assets	$ 1,045,694	$ 943,653
LIABILITIES AND STOCKHOLDERS EQUITY		
Loss and loss adjustment expense reserves	$ 426,908	$ 372,721
Unearned premium reserves	151,283	147,849
Long-term debt	67,013	67,013
Funds held under reinsurance treaties	61,937	49,419
Premiums payable to insurance companies	31,519	27,831
Reinsurance payable on paid losses	1,196	1,167
Deferred federal income taxes	4,741	
Accounts payable, accrued expenses, and other liabilities	14,259	16,016
Total Liabilities	758,856	682,016
Stockholders Equity		
	175	178

Common stock, $0.01 par value; authorized 100,000,000 shares; issued and outstanding 17,558,483 and 17,836,337 shares		
Paid-in-capital	158,426	161,957
Accumulated other comprehensive income (loss)	5,642	(3,027)
Retained earnings	123,874	103,028
Treasury stock; 93,600 and 33,600 shares	(1,279)	(499)
Total Stockholders Equity	286,838	261,637
Total Liabilities and Stockholders Equity	$ 1,045,694	$ 943,653

See accompanying notes to condensed consolidated financial statements.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Income
(Unaudited)

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(Dollars in thousands, except share and per share data)			
Operating Revenue				
Net earned premiums	$ 51,432	$ 46,559	$ 104,027	$ 90,130
Commissions and fees	9,577	7,086	16,471	11,139
Net investment income	7,132	5,216	13,566	10,064
Net realized gains (losses) on investments	9,644	(1,587)	11,437	(1,586)
Other-than-temporary impairment losses on investments (1)	(97)	(225)	(134)	(225)
Total Operating Revenues	77,688	57,049	145,367	109,522
Operating Expenses				
Losses and loss adjustment expenses, net	35,463	25,732	65,956	49,177
Amortization of deferred acquisition expenses	13,600	9,096	26,930	17,310
Underwriting, agency and other expenses	9,526	11,615	18,750	17,598
Amortization of intangible assets	575	515	1,149	913
Total Operating Expenses	59,164	46,958	112,785	84,998
Operating Income	18,524	10,091	32,582	24,524
Interest Expense	1,417	1,476	2,833	2,940
Change in Fair Value of Derivative Instruments	(123)	(262)	(230)	174
Income From Continuing Operations Before Income Taxes	17,230	8,877	29,979	21,410
Income Taxes	5,621	2,641	9,689	6,540
Income From Continuing Operations	11,609	6,236	20,290	14,870
Income From Discontinued Operations, Net of Income Taxes		22,467		23,553
Net Income	$ 11,609	$ 28,703	$ 20,290	$ 38,423
Basic Net Income Per Share:				
Income From Continuing Operations	$ 0.65	$ 0.34	$ 1.14	$ 0.82
Income From Discontinued Operations		1.23		1.29
Total	$ 0.65	$ 1.57	$ 1.14	$ 2.11

Diluted Net Income Per Share:				
Income From Continuing Operations	$ 0.64	$ 0.33	$ 1.11	$ 0.79
Income From Discontinued Operations		1.18		1.25
Total	$ 0.64	$ 1.51	$ 1.11	$ 2.04
Weighted Average Shares Outstanding:				
Basic	17,700,272	18,259,602	17,737,708	18,182,832
Diluted	18,042,484	18,943,262	18,075,668	18,803,719

(1) 2008 amounts were reclassified to conform to current period s presentation.

See accompanying notes to condensed consolidated financial statements.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Stockholders Equity
(Unaudited)

	Common Stock	Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total
	(Dollars in thousands, except share data)					
Balance, January 1, 2008	$ 180	$ 165,836	$ 1,177	$ 62,187	$	$ 229,380
Exercise of stock options	3	597				600
Stock-based compensation expense		1,026				1,026
Stock-based compensation excess tax benefits		1,135				1,135
Common stock repurchased and held in treasury					(499)	(499)
Comprehensive income:						
Net income				38,423		38,423
Other comprehensive loss, net of tax						
Unrealized holding losses on securities arising during the period, net of tax of $1,609			(2,989)			(2,989)
Change in fair value of interest rate swap, net of tax of ($16)			29			29
Less reclassification adjustment for gains included in net income, net of tax of $3			(5)			(5)
Total other comprehensive loss						(2,965)
Total comprehensive income						35,458
Balance, June 30, 2008	$ 183	$ 168,594	$ (1,788)	$ 100,610	$ (499)	$ 267,100
Balance, January 1, 2009	$ 178	$ 161,957	$ (3,027)	$ 103,028	$ (499)	$ 261,637
Issuance of restricted stock	1	(1)				
Stock-based compensation expense		1,571				1,571

Stock-based compensation excess tax benefits		(21)				(21)
Common stock repurchased and held in treasury					(780)	(780)
Common stock repurchased and retired	(4)	(5,080)				(5,084)
Payment of shareholder dividend				(443)		(443)
Comprehensive income:						
Net income				20,290		20,290
Cumulative effect of adoption of FSP FAS 115-2 at April 1, 2009			(999)	999		
Other comprehensive income, net of tax						
Unrealized holding losses on securities arising during the period having credit losses recognized in the condensed consolidated statements of income, net of tax $257			(478)			(478)
Unrealized holding gains on securities arising during the period having no credit losses recognized in the condensed consolidated statements of income, net of tax ($5,822)			10,813			10,813
Change in fair value of interest rate swaps, net of tax of $84			(156)			(156)
Less reclassification adjustment for gains included in net income, net of tax of $275			(511)			(511)
Total other comprehensive income						9,668
Total comprehensive income						29,958
Balance, June 30, 2009	$ 175	$ 158,426	$ 5,642	$ 123,874	$ (1,279)	$ 286,838

See accompanying notes to condensed consolidated financial statements.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(Dollars in thousands)	
Cash Flows from Operating Activities		
Net Income	$ 20,290	$ 38,423
Less: Income from discontinued operations		23,553
Income from continuing operations	20,290	14,870
Adjustments to reconcile income from continuing operations to net cash provided by operating activities		
Depreciation and amortization	1,969	1,656
Realized (gains) losses on investments	(11,437)	1,586
Other-than-temporary impairment losses on investments	134	225
Deferrals of acquisition costs, net	452	(7,595)
Deferred income taxes	6,902	(906)
Stock-based compensation expense	1,571	1,026
Increase (decrease) in cash resulting from changes in assets and liabilities		
Premiums and reinsurance balances receivable	(2,106)	(3,717)
Accrued investment income	(927)	(251)
Accrued profit sharing commissions	(1,558)	4,409
Reinsurance recoverable on paid and unpaid losses	(15,202)	(21,985)
Prepaid reinsurance premiums	(5,287)	5,122
Loss and loss adjustment expense reserves	54,187	47,647
Unearned premium reserves	3,434	14,914
Funds held under reinsurance treaties	12,518	6,723
Reinsurance payable on paid losses	28	(1,156)
Premiums payable to insurance companies	3,689	(2,437)
Other	(9,582)	(1,509)
Net Cash Provided By Operating Activities Continuing Operations	59,075	58,622
Net Cash Provided By Operating Activities Discontinued Operations		2,376
Net Cash Provided By Operating Activities Total	59,075	60,998
Cash Flows From Investing Activities		
Cost of short-term investments acquired	(156,301)	(291,974)
Proceeds from disposals of short-term investments	171,522	262,194
Cost of debt and equity securities acquired	(154,762)	(121,635)
Proceeds from debt and equity securities	78,535	69,863
Acquisition, net of cash acquired		(18,476)
Cost of fixed asset purchases		(543)
Net Cash Used In Investing Activities Continuing Operations	(61,006)	(100,571)
Net Cash Provided By Investing Activities Discontinued Operations		41,830

Net Cash Used In Investing Activities Total	(61,006)	(58,741)
Cash Flows From Financing Activities		
Stock issued on stock options exercised		600
Purchase of common stock	(5,084)	
Payment of shareholder dividend	(443)	
Cash retained from excess tax benefits	(21)	
Purchase of treasury stock	(780)	(499)
Net Cash Provided By (Used In) Financing Activities	(6,328)	101
Net Increase (Decrease) In Cash and Cash Equivalents	(8,259)	2,358
Cash and Cash Equivalents, beginning of period	31,833	18,432
Cash and Cash Equivalents, end of period	$ 23,574	$ 20,790
Supplemental Disclosure of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ 2,734	$ 3,199
Income taxes	$ 4,750	$ 8,000

See accompanying notes to condensed consolidated financial statements.

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying condensed consolidated financial statements and notes of First Mercury Financial Corporation and Subsidiaries (FMFC or the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and do not contain all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Readers are urged to review the Company s 2008 audited consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2008 for a more complete description of the Company s business and accounting policies. In the opinion of management, all adjustments necessary for a fair presentation of the consolidated financial statements have been included. Such adjustments consist only of normal recurring items. Interim results are not necessarily indicative of results of operations for the full year. The consolidated balance sheet as of December 31, 2008 was derived from the Company s audited annual consolidated financial statements.

Significant intercompany transactions and balances have been eliminated.

Use of Estimates

In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the consolidated financial statements, and revenues and expenses reported for the periods then ended. Actual results may differ from those estimates. Material estimates that are susceptible to significant change in the near term relate primarily to the determination of the reserves for losses and loss adjustment expenses and valuation of intangible assets and goodwill.

Recently Issued Accounting Standards

On July 1, 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles A Replacement of FASB Statement No.162 (SFAS 168).* SFAS 168 replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* and establishes the *Accounting Standards Codification* (Codification) as the single official source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Once effective, all other nongrandfathered, non-SEC accounting literature not included in the Codification becomes nonauthoritative. SFAS 168 supersedes all existing, non-SEC accounting and reporting standards applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). SFAS 168 is effective for interim and annual reporting periods ending after September 15, 2009. As the Codification does not change GAAP, the Company does not expect SFAS 168 to have a material impact on its financial statements. Previous references to applicable literature via our disclosures will be updated with references to the new Codification sections after the effective date of this standard.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events (SFAS 165).* SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. SFAS 165 provides guidance on the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. We adopted SFAS 165 during the second quarter of 2009, and its application had no impact on our condensed consolidated financial statements. We evaluate subsequent events through the date the accompanying financial statements were issued, which was August 10, 2009.

In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2). FSP FAS 115-2 modifies the existing other-than-temporary impairment guidance to require the recognition of an other-than-temporary impairment when an entity has the intent to sell a debt security or when it is more likely than not an entity will be required to sell the debt security before its anticipated recovery. Additionally, FSP FAS 115-2 changes the presentation and amount of other-than-temporary losses recognized in the income statement for instances when the Company determines that there is a credit loss on a debt security but it is more likely than not that the entity will not be required to sell the security prior to the anticipated recovery of its remaining cost basis. For these debt securities, the amount representing the credit loss will be reported as an impairment loss in the Condensed Consolidated Statements of Income and the amount related to all other factors will be reported in accumulated other comprehensive income. FSP FAS 115-2 also requires the presentation of other-than-temporary impairments separately from realized gains and losses on the face of the income statement. In addition to the changes in measurement and presentation, FSP FAS 115-2 is intended to enhance the existing disclosure requirements for other-than-temporary impairments

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Concluded)

and requires all disclosures related to other-than-temporary impairments in both interim and annual periods. The provisions of FSP FAS 115-2/124-2 are effective for interim periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The adoption of FSP FAS 115-2/124-2 in the second quarter of 2009 resulted in a $1.0 million increase in retained earnings, which was offset by a corresponding decrease in accumulated other comprehensive income (loss) of the same amount.

In April 2009, the FASB issued FSP FAS 157-4, *Determining Fair Value When Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* (*FSP FAS 157-4*). Under FSP FAS 157-4, if an entity determines that there has been a significant decrease in the volume and level of activity for the asset or the liability in relation to the normal market activity for the asset or liability (or similar assets or liabilities), then transactions or quoted prices may not accurately reflect fair value. In addition, if there is evidence that the transaction for the asset or liability is not orderly; the entity shall place little, if any weight on that transaction price as an indicator of fair value. FSP FAS 157-4 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The adoption of FSP FAS 157-4 in the second quarter of 2009 did not have a material effect on the Company s results of operations, financial position, or liquidity.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (*FSP FAS 107-1 and APB 28-1*). FSP FAS 107-1 and APB 28-1 require disclosures about fair value of financial instruments in interim and annual financial statements. FSP FAS 107-1 and APB 28-1 are effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The adoption of FSP FAS 107-1 and APB 28-1 in the second quarter of 2009 is included in Note 11, Fair Value Measurements to the condensed consolidated financial statements.

We adopted the following accounting standards in the first quarter 2009, none of which had a material effect on the Company s results of operations, financial position, or liquidity:

SFAS No. 141(R), *Business Combinations;*

SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51;*

SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities;*

FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities;* and

FSP FAS No. 157-2, *Effective Date of FASB Statement No. 157.*

2. MERGERS AND ACQUISITIONS

American Management Corporation

On February 1, 2008, we completed the acquisition of all of the issued and outstanding shares of common stock of American Management Corporation (AMC). AMC is a managing general agency (MGA) that has focused primarily on the niche fuel-related marketplace for over 20 years. In addition, AMC owns and operates American Underwriters Insurance Company (AUIC), a single state, non-standard auto insurance company domiciled in the state of Arkansas, and AMC Re, Inc. (AMC Re), a captive reinsurer incorporated under the laws of Arkansas. AMC underwrites premiums for third party carriers and for AUIC. The acquisition gave the Company access to an established and experienced specialty admitted underwriting franchise with a definable niche market.

The cash purchase price was $38.1 million, which was financed through cash on hand. We incurred $0.8 million in acquisition related costs, which are included in the initial cost of the investment of $38.9 million. In connection with the acquisition, the Company and the seller entered into an escrow agreement whereby $4.0 million of the cash purchase price was escrowed with a major financial institution to partially secure the majority selling shareholder s indemnity obligations of up to $12.0 million under the stock purchase agreement.

The results of operations of AMC and the estimated fair value of assets acquired and liabilities assumed are included in our consolidated financial statements beginning on the acquisition date. The estimated excess of the purchase price over the net tangible and intangible assets acquired of $13.4 million was recorded as goodwill in the amount of $25.5 million. We have completed the valuations of certain tangible and intangible assets acquired with the new business and have finalized the allocation of the excess of the purchase price over the net assets acquired. The acquired goodwill is not expected to be deductible for income tax purposes.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

2. MERGERS AND ACQUISITIONS (Concluded)

The following table represents the final allocation of the purchase price to assets acquired and liabilities assumed at the acquisition date:

		$ in thousands
Assets Acquired		
Investments	$	8,988
Cash and cash equivalents		20,012
Premiums receivable		19,570
Other assets		1,133
Goodwill		25,483
Intangible assets:		
Agent relationships		9,150
Tradename		2,130
Customer relationships		520
Total Assets Acquired	$	86,986
Liabilities Assumed		
Premiums payable to insurance companies	$	23,218
Loss and loss adjustment expense reserves		4,490
Unearned premium reserves		1,734
Deferred federal income taxes		3,917
Accounts payable, accrued expenses, and other liabilities		14,745
Total Liabilities Assumed		48,104
Net Assets Acquired	$	38,882

Agent relationships are being amortized as the economic benefits of these intangible assets are utilized over their estimated useful lives of approximately 18 years. The tradename is being amortized on a straight-line basis over its estimated useful life of 20 years. The customer relationships are being amortized on a straight-line basis, which approximates the utilization of the economic benefits of these assets, over their estimated useful lives of 15 years.

In connection with the AMC acquisition, we entered into an operating lease agreement for real property in Conway, Arkansas with an entity owned by the former majority shareholder and current president of AMC. The lease term is for ten years, with annual rent of approximately $0.5 million, payable in monthly installments.

3. DISCONTINUED OPERATIONS

On June 27, 2008, the Company sold all of the outstanding shares of capital stock of ARPCO Holdings, Inc. and its subsidiaries (ARPCO) for a purchase price of $43.0 million. The net assets disposed of in the transaction were $7.2 million and were principally intangible assets.

The operating results of discontinued operations included in the accompanying Condensed Consolidated Statements of Income are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(Dollars in thousands)			
Revenues	$	$2,908	$	$5,884
Income Before Income Taxes	$	$1,620	$	$3,533

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

4. NET INCOME PER SHARE

Basic net income per share is computed by dividing net income by the weighted-average number of shares of common stock outstanding for the period. Diluted net income per share reflects the potential dilution that could occur if common stock equivalents were issued and exercised.

The following is a reconciliation of basic number of common shares outstanding to diluted common and common equivalent shares outstanding:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
	(Dollars in thousands, except share and per share data)			
Income from Continuing Operations	$ 11,609	$ 6,236	$ 20,290	$ 14,870
Income from Discontinued Operations		22,467		23,553
Net income as reported	11,609	28,703	20,290	38,423
Net income allocated to unvested restricted stock shares	(87)	(86)	(152)	(115)
Net income available to common	$ 11,522	$ 28,617	$ 20,138	$ 38,308
Weighted-average number of common and common equivalent shares outstanding:				
Basic number of common shares outstanding	17,700,272	18,259,602	17,737,708	18,182,832
Dilutive effect of stock options	342,212	678,837	337,960	616,572
Dilutive effect of unvested restricted stock		4,823		4,315
Dilutive number of common and common equivalent shares outstanding	18,042,484	18,943,262	18,075,668	18,803,719
Basic Net Income Per Common Share:				
Income from Continuing Operations	$ 0.65	$ 0.34	$ 1.14	$ 0.82
Income from Discontinued Operations		1.23		1.29
Total	$ 0.65	$ 1.57	$ 1.14	$ 2.11
Diluted Net Income Per Common Share:				
Income from Continuing Operations	$ 0.64	$ 0.33	$ 1.11	$ 0.79
Income from Discontinued Operations		1.18		1.25
Total	$ 0.64	$ 1.51	$ 1.11	$ 2.04

Anti-dilutive shares excluded from diluted net income per common share	1,103,688	932,188	1,103,688	932,188

On January 1, 2009, we adopted FASB FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities* (*FSP EITF 03-6-1*), which requires that unvested restricted stock with a nonforfeitable right to receive dividends be included in the two-class method of computing earnings per share. FSP EITF 03-6-1 did not have a material impact on our reported earnings per share amounts.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

5. INVESTMENTS

The amortized cost, gross unrealized gains and losses, and market value of marketable investment securities classified as available-for-sale at June 30, 2009 by major security type were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
	(Dollars in thousands)			
Debt Securities				
U.S. government securities	$ 3,941	$ 161	$ (1)	$ 4,101
Government agency mortgage-backed securities	93,058	3,429	(81)	96,406
Government agency obligations	1,018	38		1,056
Collateralized mortgage obligations and other asset-backed securities	87,040	2,368	(5,147)	84,261
Obligations of states and political subdivisions	194,413	7,336	(380)	201,369
Corporate bonds	136,225	6,060	(1,821)	140,464
Total Debt Securities	515,695	19,392	(7,430)	527,657
Preferred stocks	1,416		(271)	1,145
Short-term investments	16,921			16,921
Total	$ 534,032	$ 19,392	$ (7,701)	$ 545,723

The amortized cost, gross unrealized gains and losses, and market value of marketable investment securities classified as available-for-sale at December 31, 2008 by major security type were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
	(Dollars in thousands)			
Debt Securities				
U.S. government securities	$ 5,256	$ 307	$	$ 5,563
Government agency mortgage-backed securities	82,548	2,422	(39)	84,931
Government agency obligations	3,163	76		3,239
Collateralized mortgage obligations and other asset-backed securities	71,378	337	(7,087)	64,628
Obligations of states and political subdivisions	205,425	5,634	(694)	210,365
Corporate bonds	89,383	1,499	(3,874)	87,008
Total Debt Securities	457,153	10,275	(11,694)	455,734
Preferred stocks	1,416		(367)	1,049
Short-term investments	32,142			32,142
Total	$ 490,711	$ 10,275	$ (12,061)	$ 488,925

Impairment of Investment Securities

Impairment of investment securities results when a market decline below cost is other-than-temporary. The other-than-temporary write down is separated into an amount representing the credit loss which is recognized in earnings and the amount related to all other factors which is recorded in other comprehensive income. Management regularly reviews our fixed maturity securities portfolio to evaluate the necessity of recording impairment losses for other-than-temporary declines in the fair value of investments. Factors considered in evaluating potential impairment include, but are not limited to, the current fair value as compared to cost or amortized cost of the security, as appropriate, the length of time the investment has been below cost or amortized cost and by how much, our intent to sell a security and whether it is more-likely-than-not we will be required to sell the security before the recovery of our amortized cost basis, and specific credit issues related to the issuer and current economic conditions. Other-than-temporary impairment losses result in a reduction of the cost basis of the underlying investment. Significant changes in these factors we consider when evaluating investments for impairment losses could result in a change in impairment losses reported in the consolidated financial statements.

As mentioned above, the Company considers its intent and ability to hold a security until the value recovers as part of the process of evaluating whether a security s unrealized loss represents an other-than-temporary decline. The Company s ability to hold such securities is supported by sufficient cash flow from its operations and from maturities within its investment portfolio in order to meet its claims payment and other disbursement obligations arising from its underwriting operations without selling such investments. With respect to securities where the decline in value is determined to be temporary and the security s value is not written down, a subsequent decision may be made to sell that security and realize a loss. Subsequent decisions on security sales are made within the

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

5. INVESTMENTS (Continued)

context of overall risk monitoring, changing information and market conditions. Management of the Company s investment portfolio is outsourced to third party investment managers, which is directed and monitored by the investment committee. While these investment managers may, at a given point in time, believe that the preferred course of action is to hold securities with unrealized losses that are considered temporary until such losses are recovered, the dynamic nature of the portfolio management may result in a subsequent decision to sell the security and realize the loss, based upon a change in market and other factors described above. The Company believes that subsequent decisions to sell such securities are consistent with the classification of the Company s portfolio as available-for-sale.

Investment managers are required to notify management of rating agency downgrades of securities in their portfolios as well as any potential investment valuation issues no later than the end of each quarter. Investment managers are also required to notify management, and receive prior approval, prior to the execution of a transaction or series of related transactions that may result in a realized loss above a certain threshold. Additionally, investment managers are required to notify management, and receive approval, prior to the execution of a transaction or series of related transactions that may result in any realized loss up until a certain period beyond the close of a quarterly accounting period.

Under current accounting standards, an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered in circumstances where (1) an entity has the intent to sell a security, (2) it is more-likely-than-not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more-likely-than-not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the difference between the security s amortized cost and its fair value. If an entity does not intend to sell the security or it is not more-likely-than-not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income.

The table below represents the gross and net presentation of other-than-temporary impairment losses on investments:

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
	(Dollars in thousands)			
Other-than-temporary impairment losses on investments:				
Total losses	$ (832)	$ (225)	$ (869)	$ (225)
Portion of losses recognized in accumulated other comprehensive income	735		735	
Other-than-temporary impairment losses on investments	(97)	(225)	(134)	(225)

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
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5. INVESTMENTS (Continued)

The following table presents a roll-forward of the credit component of other-than-temporary impairments (OTTI) on debt securities recognized in the consolidated statement of income for which a portion of the other-than-temporary impairment was recognized in other comprehensive income for the period April 1, 2009 through June 30, 2009:

	April 1, 2009 Cumulative OTTI Credit Losses Recognized for Securities Still Held	Additions for OTTI Securities Where No Credit Losses Were Recognized Prior to April 1, 2009	Additions for OTTI Securities Where Credit Losses Have Been Recognized Prior to April 1, 2009	Reductions Due to Sales or Intend/ Required to Sell of Credit-Impaired Securities	Adjustments to Book Value of Credit-Impaired Securities due to Changes in Cash Flows	June 30, 2009 Cumulative OTTI Credit Losses Recognized for Securities Still Held
	(Dollars in thousands)					
Debt securities:						
Mortgage-backed securities, collateralized mortgage obligations and passthrough securities	$164	$ 97	$	$	$	$ 261
All other corporate bonds	569					569
Total debt securities	$733	$ 97	$	$	$	$ 830

The fair value and amount of unrealized losses segregated by the time period the investment had been in an unrealized loss position is as follows at June 30, 2009:

	Less than 12 Months		**Greater than 12 Months**	
	Fair Value of Investments With Unrealized Losses	**Gross Unrealized Losses**	**Fair Value of Investments With Unrealized Losses**	**Gross Unrealized Losses**
	(Dollars in thousands)			
Debt Securities				
U.S. government securities	$ 108	$ (1)	$	$
Government agency mortgage-backed securities	17,200	(71)	281	(10)

Government agency obligations				
Collateralized mortgage obligations and other asset-backed securities	7,583	(316)	20,521	(4,831)
Obligations of states and political subdivisions	3,289	(71)	12,917	(309)
Corporate bonds	9,833	(78)	15,736	(1,743)
Total Debt Securities	38,013	(537)	49,455	(6,893)
Preferred Stocks	875	(35)	270	(236)
Total	$ 38,888	$ (572)	$ 49,725	$ (7,129)

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
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5. INVESTMENTS (Continued)

The fair value and amount of unrealized losses segregated by the time period the investment had been in an unrealized loss position is as follows at December 31, 2008:

	Less than 12 Months		Greater than 12 Months	
	Fair Value of Investments With Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments With Unrealized Losses	Gross Unrealized Losses
	(Dollars in thousands)			
Debt Securities				
U.S. government securities	$	$	$	$
Government agency mortgage-backed securities	3,902	(37)	326	(2)
Government agency obligations				
Collateralized mortgage obligations and other asset-backed securities	48,125	(5,143)	5,963	(1,944)
Obligations of states and political subdivisions	14,063	(427)	8,809	(267)
Corporate bonds	42,402	(2,549)	12,824	(1,325)
Total Debt Securities	108,492	(8,156)	27,922	(3,538)
Preferred Stocks	832	(78)	216	(289)
Total	$ 109,324	$ (8,234)	$ 28,138	$ (3,827)

Below is a table that illustrates the unrecognized impairment loss by sector. The increase in spread relative to U.S. Treasury Bonds was the primary factor leading to impairment for the periods ended June 30, 2009. All asset sectors were affected by the overall increase in spreads as can be seen from the table below. In addition to the general level of rates, we also look at a variety of other factors such as direction of credit spreads for an individual issue as well as the magnitude of specific securities that have declined below amortized cost.

Sector	Amount of Unrealized Loss at June 30, 2009 (Dollars in thousands)
Debt Securities	
U.S. Treasuries	(1)
U.S. Agencies	
U.S. government securities	(1)
Government agency mortgage-backed securities	(81)

Government agency obligations		
MBS Passthroughs		(42)
CMOs		(1,462)
Asset Backed Securities		(577)
Commercial MBS		(3,066)
Collateralized mortgage obligations and other asset-backed securities		(5,147)
Obligations of states and political subdivisions		(380)
Corporate Bonds		(1,807)
High Yield Bonds		(14)
Corporate Bonds		(1,821)
Total Debt Securities		**(7,430)**
Preferred Stocks		(271)
Short-term investments		
Total	**$**	**(7,701)**

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
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5. INVESTMENTS (Continued)

At June 30, 2009, there were 169 unrealized loss positions with a total unrealized loss of $7.7 million. This represents approximately 1.2% of quarter end invested assets of $625.2 million. This unrealized loss position is a function of the purchase of specific securities in a lower interest rate or spread environment than what prevails as of June 30, 2009. Some of these losses are due to the increase in spreads of select corporate bonds or structured securities. We have viewed these market value declines as being temporary in nature. Our portfolio is relatively short as the duration of the core fixed income portfolio excluding cash, convertible securities, limited partnerships and equity is approximately 3.7 years. We do not intend to sell and it is not expected we will need to sell these temporarily impaired securities before maturity in the event that interest rates do not decline from current levels. In light of our significant growth over the past 24 months, liquidity needs from the portfolio are minimal. As a result, we would not expect to have to liquidate temporarily impaired securities to pay claims or for any other purposes. There have been certain instances over the past year, where due to market based opportunities; we have elected to sell a small portion of the portfolio. These situations were unique and infrequent occurrences and in our opinion, do not reflect an indication that we intend to sell or will be required to sell these securities before they mature or recover in value.

The most significant risk or uncertainty inherent in our assessment methodology is that the current credit rating of a particular issue changes over time. If the rating agencies should change their rating on a particular security in our portfolio, it could lead to a reclassification of that specific issue. The vast majority of our unrecognized impairment losses are investment grade and AAA or AA rated securities. Should the credit quality of individual issues decline for whatever reason then it would lead us to reconsider the classification of that particular security. Within the non-investment grade sector, we continue to monitor the particular status of each issue. Should prospects for any one issue deteriorate, we would potentially alter our classification of that particular issue.

The table below illustrates the breakdown of impaired securities by investment grade and non investment grade as well as the duration that these sectors have been trading below amortized cost. The average duration of the impairment has been greater than 12 months. The unrealized loss of impaired securities as a percent of the amortized cost of those securities is 8.0% as of June 30, 2009.

	% of Total Amortized Cost	Total Amortized Cost	Total Unrealized Losses	Average Unrealized Loss as % of Amortized Cost	% of Loss > 12 Months
			(Dollars in thousands)		
Non Investment Grade	4.2%	$ 4,046	$ 1,102	27.2%	99.1%
Investment Grade	95.8	92,268	6,599	7.2	91.5
Total	100.0%	$ 96,314	$ 7,701	8.0%	92.6%

The majority of these securities are AAA or AA rated. These issues are continually monitored and may be classified in the future as being other than temporarily impaired.

The largest concentration of temporarily impaired securities is Commercial MBS at approximately 39.8% of the total unrealized loss. These securities are all AAA rated and have been affected primarily by the widening of spreads within this sector and/or the general level of interest rates. The next largest concentration of temporarily impaired securities is Corporate Bonds at approximately 23.6% of the total unrealized loss. Within Corporate Bonds 88.0% are rated investment grade BBB or better, and their temporary impairment results primarily from the widening of credit spreads. The next highest concentration of temporarily impaired securities is CMOs at 19.0% of the total unrealized loss. Within CMOs 96.8% are rated AAA including the 79.8% of the CMO exposure that is agency issued, and have primarily been affected by the general level of interest rates as well.

For the six months ended June 30, 2009, we sold approximately $3.3 million of market value of fixed income securities, excluding convertibles, which were trading below amortized cost while recording a realized loss of $0.1 million. This realized loss represented 3.8% of the amortized cost of the positions. These sales were unique opportunities to sell specific positions due to changing market conditions. These situations were exceptions to our general assertion regarding our ability and intent to hold securities with unrealized losses until they mature or recover in value. This position is further supported by the insignificant losses as a percentage of amortized cost for the respective periods.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
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5. INVESTMENTS (Concluded)

Hybrid Instruments

As of June 30, 2009 and December 31, 2008, the market value of convertible securities accounted for as hybrid instruments was $58.9 million and $43.5 million, respectively. Convertible bonds and bond units had a market value of $52.4 million and $39.0 million and were included in Debt securities in the Condensed Consolidated Balance Sheets at June 30, 2009 and December 31, 2008, respectively. Convertible preferred stocks had a market value of $6.5 million and $4.5 million and were included in Equity securities and other in the Condensed Consolidated Balance Sheets at June 30, 2009 and December 31, 2008, respectively. The Company recorded an increase in the fair value of the hybrid instruments of $4.3 million and $6.9 million in Net realized gains on investments for the three and six months ended June 30, 2009. As of June 30, 2009 and December 31, 2008, there were no convertible securities that were not accounted for as hybrid instruments in accordance with SFAS 155.

Alternative Investments

The Company has $10.0 million invested in a limited partnership, which invests in high yield convertible securities. An additional $2.0 million was invested during January 2009 for a total cost of $12.0 million. The market value of this investment was $10.0 million at June 30, 2009. In addition, the Company invested $5.0 million in another limited partnership, which invests in distressed structured finance products. An additional $5.0 million was invested during March 2009 for a total cost of $10.0 million. The market value of this investment was $10.5 million at June 30, 2009. The Company elected the fair value option for these investments in accordance with SFAS 159. The change in fair value of these investments is recorded in Net investment income and Net realized gains (losses) on investments in the Condensed Consolidated Statements of Income. These investments are recorded in Equity securities and other in the Condensed Consolidated Balance Sheets.

6. INCOME TAXES

At June 30, 2009 and December 31, 2008, FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes, an Interpretation of SFAS No. 109* (FIN 48), which clarifies the accounting for uncertainty in income taxes recognized in an entity s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes* , did not have an impact on our financial position or results of operations, and we have taken no tax positions which would require disclosure under FIN 48. Although the IRS is not currently examining any of our income tax returns, tax years 2005, 2006 and 2007 remain open and are subject to examination.

The Company files a consolidated federal income tax return with its subsidiaries. Taxes are allocated among the Company s subsidiaries based on the Tax Allocation Agreement employed by these entities, which provides that taxes of the entities are calculated on a separate-return basis at the highest marginal tax rate.

Income taxes in the accompanying unaudited Condensed Consolidated Statements of Income differ from the statutory tax rate of 35.0% primarily due to state income taxes, non-deductible expenses, and the nontaxable portion of dividends received and tax-exempt interest.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
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7. LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

The Company establishes a reserve for both reported and unreported covered losses, which includes estimates of both future payments of losses and related loss adjustment expenses. The following represents changes in those aggregate reserves for the Company during the periods presented below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
	(Dollars in thousands)			
Balance, beginning of period	$ 400,152	$ 301,314	$ 372,721	$ 272,365
Less reinsurance recoverables	138,943	103,068	128,552	91,444
Net Balance, beginning of period	261,209	198,246	244,169	180,921
AUIC net reserves, date of acquisition				4,490
Incurred Related To				
Current year	39,084	25,732	70,327	49,177
Prior years	(3,621)		(4,371)	
Total Incurred	35,463	25,732	65,956	49,177
Paid Related To				
Current year	3,533	2,004	4,439	2,338
Prior years	12,388	11,381	24,935	21,657
Total Paid	15,921	13,385	29,374	23,995
Net Balance	280,751	210,593	280,751	210,593
Plus reinsurance recoverables	146,157	113,909	146,157	113,909
Balance, end of period	$ 426,908	$ 324,502	$ 426,908	$ 324,502

8. REINSURANCE

Net written and earned premiums, including reinsurance activity, were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	**2008**	**2009**	**2008**
	(Dollars in thousands)			
Written Premiums				

Direct	$ 77,892	$ 75,761	$ 151,012	$ 151,974
Assumed	4,629	4,153	9,387	9,146
Ceded	(29,079)	(27,673)	(57,132)	(50,376)
Net Written Premiums	$ 53,442	$ 52,241	$ 103,267	$ 110,744
Earned Premiums				
Direct	$ 74,913	$ 69,571	$ 148,218	$ 138,224
Assumed	4,460	4,231	8,747	7,983
Ceded	(26,773)	(27,818)	(51,845)	(55,497)
Earned but unbilled premiums	(1,168)	575	(1,093)	(580)
Net Earned Premiums	$ 51,432	$ 46,559	$ 104,027	$ 90,130

The Company manages its credit risk on reinsurance recoverables by reviewing the financial stability, A.M. Best rating, capitalization, and credit worthiness of prospective and existing risk-sharing partners. The Company customarily collateralizes reinsurance balances due from unauthorized reinsurers through funds withheld, grantor trusts, or stand-by letters of credit issued by highly rated banks.

The Company s 2009 and 2008 ceded reinsurance program includes quota share reinsurance agreements with authorized reinsurers that were entered into and are accounted for on a funds withheld basis. Under the funds withheld basis, the Company records the

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
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8. REINSURANCE (Concluded)

ceded premiums payable to the reinsurer, less ceded paid losses and loss adjustment expenses receivable from the reinsurer, less any amounts due to the reinsurer for the reinsurer s margin, or cost of the reinsurance contract, as a liability, and reported $61.9 million and $49.4 million as Funds held under reinsurance treaties in the accompanying Condensed Consolidated Balance Sheets at June 30, 2009 and December 31, 2008, respectively. As specified under the terms of the agreements, the Company credits the funds withheld balance at stated interest crediting rates applied to the funds withheld balance. If the funds withheld liability is exhausted, interest crediting would cease and additional claim payments would be recoverable from the reinsurer.

Interest cost on reinsurance contracts accounted for on a funds withheld basis is incurred during all periods in which a funds withheld liability exists or as otherwise specified under the terms of the contract and is included in Underwriting, agency and other expenses. The amount subject to interest crediting rates was $22.6 million and $19.3 million at June 30, 2009 and 2008, respectively.

9. SHARE REPURCHASE PROGRAM

The Board of Directors of the Company authorized a share repurchase plan to purchase up to 1.5 million shares of common stock through open market or privately negotiated transactions. The repurchase program expires on August 18, 2009. During the three and six months ended June 30, 2009, the Company repurchased 387,758 shares of common stock for $5.1 million at an average cost of $13.11 per share. As of June 30, 2009, the Company had 413,665 shares of remaining capacity under the share repurchase program. Shares purchased under the program are retired and returned to the status of authorized but unissued shares. Subsequent to June 30, 2009, the Company repurchased the remaining 413,665 shares of common stock for $5.4 million at an average cost of $13.06 per share. These purchases fulfilled the remaining capacity of the Company s 1.5 million share repurchase plan.

10. STOCK COMPENSATION PLANS

The 1998 Stock Compensation Plan (the 1998 Plan) was established September 3, 1998. Under the terms of the plan, directors, officers, employees and key individuals may be granted options to purchase the Company s common stock. Option and vesting periods and option exercise prices are determined by the Compensation Committee of the Board of Directors, provided no stock options shall be exercisable more than ten years after the grant date. All outstanding stock options under the plan became fully vested on August 17, 2005 under the change in control provision in the plan. Of the 4,625,000 shares of the Company s common stock initially reserved for future grant under the 1998 Plan, shares available for future grant totaled 2,443,387 at June 30, 2009, however, on May 13, 2009, the Company adopted an amendment to the 1998 Plan prohibiting the issuance of any additional awards under the 1998 Plan.

The First Mercury Financial Corporation Omnibus Incentive Plan of 2006 (the Omnibus Plan) was established October 16, 2006. The Company has reserved 1,500,000 shares of its common stock for future granting of stock options, stock appreciation rights (SAR), restricted stock, restricted stock units (RSU), deferred stock units (DSU), performance shares, performance cash awards, and other stock or cash awards to employees and non-employee directors at any time prior to October 15, 2016. On May 13, 2009, the Company s stockholders approved an amendment to the Omnibus Plan to increase the number of shares authorized for issuance thereunder by 1,650,000 shares, which brings the total number of shares reserved under the Omnibus Plant to 3,150,000. All of the terms of the vesting or other restrictions will be determined by the Company s Compensation Committee of the Board of Directors. The exercise price will not be less than the fair market value of the shares on the date of grant. During the three months ended June 30, 2009, the Company did not make any stock option grants under the Omnibus Plan. During the six months ended June 30, 2009, the Company granted 197,500 stock options and 93,500 shares of restricted stock to employees under the Omnibus Plan. The stock options and shares of restricted stock vest in three equal installments over a period of three years commencing on March 5, 2010. Stock-based compensation will be recognized over the expected vesting period of the stock options and shares of restricted stock. During the three and six months ended June 30, 2009, the Company granted 19,704 shares of restricted stock to non-employee directors under the Omnibus

Plan. These shares of restricted stock vested immediately, but are not transferable for one year after the grant date, and stock-based compensation was recognized immediately. During the three and six months ended June 30, 2008, the Company granted 226,000 and 374,500 stock options, respectively, to employees and 30,500 and 45,500 shares of restricted stock, respectively, to employees under the Omnibus Plan. The stock options and shares of restricted stock vest in three equal installments over a period of three years. Stock-based compensation will be recognized over the expected vesting period of the stock options and shares of restricted stock. During the three months ended June 30, 2008, the Company granted 12,124 shares of restricted stock to non-employee directors under the Omnibus Plan. These shares of restricted stock vested immediately, but are not transferable for one year after the grant date, and stock-based compensation expense was recognized immediately. Shares available for future grants under the Omnibus Plan totaled 1,836,036 at June 30, 2009.

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10. STOCK COMPENSATION PLANS (Continued)

The following table summarizes stock option activity for the six months ended June 30, 2009 and 2008.

	1998 Plan		Omnibus Plan	
	Number of Options	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
Oustanding at January 1, 2008	927,775	$ 2.24	573,688	$ 19.10
Granted during the period			374,500	16.38
Forfeited during the period			(12,700)	18.77
Exercised during the period	(302,575)	1.80	(3,300)	17.00
Cancelled during the period				
Outstanding at June 30, 2008	625,200	$ 2.50	932,188	$ 18.02
Oustanding at January 1, 2009	431,050	$ 2.82	932,188	$ 17.93
Granted during the period			197,500	13.01
Forfeited during the period			(15,000)	18.78
Exercised during the period				
Cancelled during the period				
Outstanding at June 30, 2009	431,050	$ 2.82	1,114,688	$ 17.05
Exercisable at:				
June 30, 2008	625,200	$ 2.50	152,566	$ 18.80
June 30, 2009	431,050	2.82	453,125	18.26

The aggregate intrinsic value of fully vested options outstanding and exercisable under the 1998 Plan was $4.7 million at June 30, 2009. There was $0.2 million of aggregate intrinsic value of options expected to vest under the Omnibus Plan at June 30, 2009.

There were no stock options exercised during the three and six months ended June 30, 2009.

The number of stock option awards outstanding and exercisable at June 30, 2009 by range of exercise prices was as follows:

	Options Outstanding			Options Exercisable	
Range of Exercisable Price	Outstanding as of June 30, 2009	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price Per Share	Exercisable as of June 30, 2009	Weighted-Average Exercise Price Per Share
1998 Plan					
$1.51 - $1.95	319,125	3.60 Years	$ 1.71	319,125	$ 1.71
$4.86 - $6.49	111,925	1.30	5.97	111,925	5.97
Total	431,050	3.00	2.82	431,050	2.82

Omnibus Plan					
$10.98 - $14.93	347,000	9.28 Years	$ 13.70	45,829	$ 14.93
$17.00 - $20.75	767,688	7.06	18.56	407,296	18.64
Total	1,114,688	7.75	17.05	453,125	18.26

As of June 30, 2009, there was approximately $4.4 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Omnibus Plan. That cost is expected to be recognized over a weighted-average period of 2.1 years.

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

10. STOCK COMPENSATION PLANS (Concluded)

The fair value of stock options granted during the six months ended June 30, 2009 and 2008 were determined on the dates of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008
Omnibus Plan		
Expected term	6.0	6.0
Expected stock price volatility	41.11%	29.78%
Risk-free interest rate	2.16%	3.12%
Expected dividend yield		
Estimated fair value per option	$ 5.53	$ 5.79

The expected term of options was determined based on the simplified method from SEC Staff Accounting Bulletin 107 (SAB 107), as amended by Staff Accounting Bulletin 110 *(SAB 110)*. Expected stock price volatility was based on an average of the volatility factors utilized by companies within the Company s peer group with consideration given to the Company s historical volatility. The risk-free interest rate is based on the yield of U.S. Treasury securities with an equivalent remaining term. Prior to the second quarter of 2009, the Company had not paid dividends and therefore no expected dividend yield was included in the Black-Scholes option pricing model. In the future, expected dividend yield will be an assumption utilized in the Black-Scholes option pricing model.

The assumptions used to calculate the fair value of options granted are evaluated and revised, as necessary, to reflect market conditions and the Company s historical experience and future expectations. The calculated fair value is recognized as compensation cost in the Company s financial statements over the requisite service period of the entire award. Compensation cost is recognized only for those options expected to vest, with forfeitures estimated at the date of grant and evaluated and adjusted periodically to reflect the Company s historical experience and future expectations. Any change in the forfeiture assumption is accounted for as a change in estimate, with the cumulative effect of the change on periods previously reported being reflected in the financial statements of the period in which the change is made. The Company recognized stock-based compensation expense of $1.0 million and $1.6 million for the three and six months ended June 30, 2009, respectively. The Company recognized stock-based compensation expense of $0.7 million and $1.0 million for the three and six months ended June 30, 2008, respectively.

11. FAIR VALUE MEASUREMENTS

Our available-for-sale investment portfolio consists of fixed maturity and equity securities and short-term investments, and is recorded at fair value in the accompanying Condensed Consolidated Balance Sheets in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115). The change in the fair value of these investments is recorded as a component of Other comprehensive income (loss).

We adopted FASB Statement No. 159, *The Fair Value Option of Financial Assets and Financial Liabilities* (SFAS 159) effective January 1, 2008. Under this standard, we are permitted to elect to measure financial instruments and certain other items at fair value, with the change in fair value recorded in earnings. On January 1, 2008, we elected not to measure any eligible items using the fair value option in accordance with SFAS 159. We believe the current accounting is appropriate for our available-for-sale investments as we have the intent and ability to hold our investments, therefore, SFAS 159 did not have any impact on our consolidated financial condition or results of operations on the adoption date.

We also adopted FASB Statement No. 157, *Fair Value Measurements* (SFAS 157) effective January 1, 2008. SFAS 157 defines fair value as the price that would be received to sell an asset or would be paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the measurement date, and establishes a framework to make the measurement of fair value more consistent and comparable. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets, or market approach as defined by SFAS 157. The implementation of SFAS 157 did not have any impact on our consolidated financial condition or results of operations. The implementation of SFAS 157 resulted in expanded disclosures about securities measured at fair value, as discussed below.

SFAS 157 established a three-level hierarchy for fair value measurements that distinguishes between market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and the

FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

11. FAIR VALUE MEASUREMENTS (Continued)

reporting entity s own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The hierarchy level assigned to each security in our available-for-sale, hybrid securities, and alternative investments portfolios is based on our assessment of the transparency and reliability of the inputs used in the valuation of such instrument at the measurement date. The three hierarchy levels are defined as follows:

Level 1 Valuations based on unadjusted quoted market prices in active markets for identical securities. The fair values of fixed maturity and equity securities and short-term investments included in the Level 1 category were based on quoted prices that are readily and regularly available in an active market. The Level 1 category includes publicly traded equity securities; highly liquid U.S. Government notes, treasury bills and mortgage-backed securities issued by the Government National Mortgage Association; highly liquid cash management funds; and short-term certificates of deposit.

Level 2 Valuations based on observable inputs (other than Level 1 prices), such as quoted prices for similar assets at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, either directly or indirectly. The fair value of fixed maturity and equity securities and short-term investments included in the Level 2 category were based on the market values obtained from an independent pricing service that were evaluated using pricing models that vary by asset class and incorporate available trade, bid and other market information and price quotes from well established independent broker-dealers. The independent pricing service monitors market indicators, industry and economic events, and for broker-quoted only securities, obtains quotes from market makers or broker-dealers that it recognizes to be market participants. The Level 2 category includes corporate bonds, municipal bonds, redeemable preferred stocks and certain publicly traded common stocks with no trades on the measurement date.

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement, and involve management judgment.

If the inputs used to measure fair value fall in different levels of the fair value hierarchy, a financial security s hierarchy level is based upon the lowest level of input that is significant to the fair value measurement. A number of our investment grade corporate bonds are frequently traded in active markets and traded market prices for these securities existed at June 30, 2009. These securities were classified as Level 2 at June 30, 2009 because our third party pricing service uses valuation models which use observable market inputs in addition to traded prices.

The following table presents our investments measured at fair value on a recurring basis as of June 30, 2009 classified by the SFAS No. 157 valuation hierarchy (as discussed above):

		Fair Value Measurements Using		
	Total	**Level 1**	**Level 2**	**Level 3**
		(Dollars in thousands)		
Available for sale investments:				
Fixed maturity securities	$ 528,802	$ 4,101	$ 524,041	$ 660
Short-term investments	16,921	16,921		
Hybrid securities	58,948		58,948	
Alternative investments	20,493		10,520	9,973
Total	$ 625,164	$ 21,022	$ 593,509	$ 10,633

Level 3 assets above include one asset-backed security collateralized by home equity loans with a market value of $0.6 million within fixed maturity securities. Liquidity remains extremely low in markets for non-agency residential mortgage-backed securities, especially those with ratings below AAA. This security s market value was adjusted to a model price that assumed stressed default assumptions, which generated a 25.3% principal loss, and included a 8.0% discount rate. Also included within Level 3 assets is a $10.0 million investment in a limited partnership. At times, this limited partnership will invest in highly illiquid high yield convertible securities for which observable inputs are not available. The manager of this limited partnership valued this investment through an internally developed model.

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FIRST MERCURY FINANCIAL CORPORATION AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
(Unaudited)

11. FAIR VALUE MEASUREMENTS (Concluded)

	Three Months Ended June 30, 2009	Six Months Ended June 30, 2009
Level 3 investments, beginning of period	$ 8,512	$ 6,282
Purchases		2,000
Increase in market value	2,121	2,351
Level 3 investments as of June 30, 2009	$ 10,633	$ 10,633

The Company uses derivatives to hedge its exposure to interest rate fluctuations. For these derivatives, the Company uses quoted market prices to estimate fair value and includes the estimate as a Level 2 measurement.

The Company s financial instruments include investments, cash and cash equivalents, premiums and reinsurance balances receivable, reinsurance recoverable on paid losses and long-term debt. At June 30, 2009, the carrying amounts of the Company s financial instruments, including its derivative financial instruments, approximated fair value, except for the $67.0 million of the Company s junior subordinated debentures. The fair value of these junior subordinated debentures is estimated to be $21.9 million at June 30, 2009. The estimate of fair value for the Company s junior subordinated debentures is a Level 3 measurement. We use a discounted cash flow model based on the contractual terms of the junior subordinated debentures and a discount rate of 15%, which was based on yields of comparable securities. The fair values of the Company s investments, as determined by quoted market prices, are disclosed in Note 5.

12. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The Company s accumulated other comprehensive income (loss) included the following:

	June 30, 2009	June 30, 2008
	(Dollars in thousands)	
Unrealized holding losses on securities having credit losses recognized in the condensed consolidated statements of income, net of tax	$ (478)	$
Unrealized holding gains (losses) on securities having no credit losses recognized in the condensed consolidated statements of income, net of tax	7,852	(1,193)
Fair value of interest rate swaps, net of tax	(1,732)	(595)
Total accumulated other comprehensive income (loss)	$ 5,642	$ (1,788)

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

This Quarterly Report on Form 10-Q contains forward-looking statements that relate to future periods and includes statements regarding our anticipated performance. Generally, the words anticipates, believes, expects, intends, estimates, projects, plans and similar expressions identify forward-looking statements. These forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results, performance or achievements or industry results to differ materially from any future results, performance or achievements expressed or implied by these forward-looking statements. These risks, uncertainties and other important factors include, among others: recent and future events and circumstances impacting financial, stock, and capital markets, and the responses to such events by governments and financial communities; the impact of catastrophic events and the occurrence of significant severe weather conditions on our operating results; our ability to maintain or the lowering or loss of one of our financial or claims-paying ratings; our actual incurred losses exceeding our loss and loss adjustment expense reserves; the failure of reinsurers to meet their obligations; our estimates for accrued profit sharing commissions are based on loss ratio performance and could be reduced if the underlying loss ratios deteriorate; our inability to obtain reinsurance coverage at reasonable prices; the failure of any loss limitations or exclusions or changes in claims or coverage; our ability to successfully integrate acquisitions that we make such as our acquisition of AMC; our lack of long-term operating history in certain specialty classes of insurance; our ability to acquire and retain additional underwriting expertise and capacity; the concentration of our insurance business in relatively few specialty classes; the increasingly competitive property and casualty marketplace; fluctuations and uncertainty within the excess and surplus lines insurance industry; the extensive regulations to which our business is subject and our failure to comply with those regulations; our ability to maintain our risk-based capital at levels required by regulatory authorities; our inability to realize our investment objectives; and the risks identified in our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K. Given these uncertainties, you are cautioned not to place undue reliance on these forward-looking statements. We assume no obligation to update or revise them or provide reasons why actual results may differ.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the related notes included elsewhere in this Form 10-Q.

Overview

We are a provider of insurance products and services to the specialty commercial insurance markets, primarily focusing on niche and underserved segments where we believe that we have underwriting expertise and other competitive advantages. During our 36 years of underwriting security risks, we have established CoverX® as a recognized brand among insurance agents and brokers and developed significant underwriting expertise and a cost-efficient infrastructure. Over the last nine years, we have leveraged our brand, expertise and infrastructure to expand into other specialty classes of business, particularly focusing on smaller accounts that receive less attention from competitors.

First Mercury Financial Corporation (FMFC) is a holding company for our operating subsidiaries. Our operations are conducted with the goal of producing overall profits by strategically balancing underwriting profits from our insurance subsidiaries with the commissions and fee income generated by our non-insurance subsidiaries. FMFC s principal operating subsidiaries are CoverX Corporation (CoverX), First Mercury Insurance Company (FMIC), First Mercury Casualty Company (FMCC), First Mercury Emerald Insurance Services, Inc. (FM Emerald), and American Management Corporation (AMC).

CoverX produces and underwrites insurance policies for which we retain risk and receive premiums. As a wholesale insurance broker, CoverX markets our insurance policies through a nationwide network of wholesale and retail insurance brokers who then distribute these policies through retail insurance brokers. CoverX also provides underwriting services with respect to the insurance policies it markets in that it reviews the applications submitted for insurance coverage, decides whether to accept all or part of the coverage requested and determines applicable premiums. CoverX receives commissions from affiliated insurance companies, reinsurers, and non-affiliated insurers as well as policy fees from wholesale and retail insurance brokers.

FM Emerald is a wholesale insurance agency producing commercial lines business on primarily an excess and surplus lines basis for CoverX via a producer agreement. As a wholesale insurance agency, FM Emerald markets insurance products for CoverX through a nationwide network of wholesale and retail insurance brokers who then distribute these products through retail insurance brokers.

FMIC and FMCC are two of our insurance subsidiaries. FMIC writes substantially all the policies produced by CoverX. FMCC provides reinsurance to FMIC. FMIC and FMCC have entered into an intercompany pooling reinsurance agreement wherein all premiums, losses and expenses of FMIC and FMCC, including all past liabilities, are combined and apportioned between FMIC and FMCC in accordance with fixed percentages. FMIC also provides claims handling and adjustment services for policies produced by CoverX and directly written by third parties.

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On June 27, 2008, the Company sold all of the outstanding capital stock of American Risk Pooling Consultants, Inc. (ARPCO). The results of ARPCO s operations are presented as Discontinued Operations in the Condensed Consolidated Statements of Income. ARPCO provided third party administrative services for risk sharing pools of governmental entity risks, including underwriting, claims, loss control and reinsurance services. ARPCO was solely a fee-based business and received fees for these services and commissions on excess per occurrence insurance placed in the commercial market with third party companies on behalf of the pools.

On February 1, 2008, we acquired 100% of the issued and outstanding common stock of American Management Corporation. AMC is a managing general agency writing primarily commercial lines package policies focused primarily on the niche fuel-related marketplace. AMC distributes these insurance policies through a nationwide distribution system of independent general agencies. AMC underwrites these policies for third party insurance carriers and receives commission income for its services. AMC also provides claims handling and adjustment services for policies produced by AMC and directly written for third parties. In addition, AMC owns and operates American Underwriters Insurance Company (AUIC), a single state, non-standard auto insurance company domiciled in the state of Arkansas, and AMC Re, Inc. (AMC Re), a captive reinsurer incorporated under the provisions of the laws of Arkansas. Effective July 1, 2008, FMIC and AUIC entered into an intercompany reinsurance agreement wherein all premiums and losses of AUIC, including all past liabilities, are 100% assumed by FMIC.

GAAP and Non-GAAP Financial Performance Metrics

Throughout this report, we present our operations in the way we believe will be most meaningful, useful, and transparent to anyone using this financial information to evaluate our performance. In addition to the GAAP (generally accepted accounting principles in the United States of America) presentation of net income and certain statutory reporting information, we show certain non-GAAP financial measures that we believe are valuable in managing our business and drawing comparisons to our peers. These measures are gross written premiums, net written premiums, and combined ratio.

Following is a list of non-GAAP measures found throughout this report with their definitions, relationships to GAAP measures, and explanations of their importance to our operations:

Gross written premiums. While net premiums earned is the related GAAP measure used in the statements of earnings, gross written premiums is the component of net premiums earned that measures insurance business produced before the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an overall gauge of gross business volume in our insurance underwriting operations with some indication of profit potential subject to the levels of our retentions, expenses, and loss costs.

Net written premiums. While net premiums earned is the related GAAP measure used in the statements of earnings, net written premiums is the component of net premiums earned that measures the difference between gross written premiums and the impact of ceding reinsurance premiums, but without respect to when those premiums will be recognized as actual revenue. We use this measure as an indication of retained or net business volume in our insurance underwriting operations. It is an indicator of future earnings potential subject to our expenses and loss costs.

Combined ratio. This ratio is a common industry measure of profitability for any underwriting operation, and is calculated in two components. First, the loss ratio is losses and settlement expenses divided by net premiums earned. The second component, the expense ratio, reflects the sum of policy acquisition costs and insurance operating expenses, net of insurance underwriting commissions and fees, divided by net premiums earned. The sum of the loss and expense ratios is the combined ratio. The difference between the combined ratio and 100 reflects the per-dollar rate of underwriting income or loss. For example, a combined ratio of 85 implies that for every $100 of premium we earn, we record $15 of pre-tax underwriting income.

Critical Accounting Policies

The critical accounting policies discussed below are important to the portrayal of our financial condition and results of operations and require us to exercise significant judgment. We use significant judgments concerning future results and developments in making these critical accounting estimates and in preparing our consolidated financial statements. These judgments and estimates affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of material contingent assets and liabilities. We evaluate our estimates on a continual basis using information that we believe to be relevant. Actual results may differ materially from the estimates and assumptions used in preparing the consolidated financial statements.

Readers are also urged to review Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies and Note 1 to the audited consolidated financial statements thereto included in the Annual Report on

Form 10-K for the year ended December 31, 2008 on file with the Securities and Exchange Commission for a more complete description of our critical accounting policies and estimates.

Use of Estimates

In preparing our consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosures of contingent assets and liabilities as of the date of the consolidated financial statements, and revenues and expenses reported for the periods then ended. Actual results may differ from those estimates. Material estimates that are susceptible to significant change in the near term relate primarily to the determination of the reserves for losses and loss adjustment expenses and valuation of intangible assets and goodwill.

Loss and Loss Adjustment Expense Reserves

The reserves for losses and loss adjustment expenses represent our estimated ultimate costs of all reported and unreported losses and loss adjustment expenses incurred and unpaid at the balance sheet date. Our reserves reflect our estimates at a given time of amounts that we expect to pay for losses that have been reported, which are referred to as Case reserves, and losses that have been incurred but not reported and the expected development of losses and allocated loss adjustment expenses on reported cases, which are referred to as IBNR reserves. We do not discount the reserves for losses and loss adjustment expenses.

We allocate the applicable portion of our estimated loss and loss adjustment expense reserves to amounts recoverable from reinsurers under ceded reinsurance contracts and report those amounts separately from our loss and loss adjustment expense reserves as an asset on our balance sheet.

The estimation of ultimate liability for losses and loss adjustment expenses is an inherently uncertain process, requiring the use of informed estimates and judgments. Our loss and loss adjustment expense reserves do not represent an exact measurement of liability, but are our estimates based upon various factors, including:

- actuarial projections of what we, at a given time, expect to be the cost of the ultimate settlement and administration of claims reflecting facts and circumstances then known;
- estimates of future trends in claims severity and frequency;
- assessment of asserted theories of liability; and
- analysis of other factors, such as variables in claims handling procedures, economic factors, and judicial and legislative trends and actions.

Most or all of these factors are not directly or precisely quantifiable, particularly on a prospective basis, and are subject to a significant degree of variability over time. In addition, the establishment of loss and loss adjustment expense reserves makes no provision for the broadening of coverage by legislative action or judicial interpretation or for the extraordinary future emergence of new types of losses not sufficiently represented in our historical experience or which cannot yet be quantified. Accordingly, the ultimate liability may be more or less than the current estimate. The effects of changes in the estimated reserves are included in the results of operations in the period in which the estimate is revised.

Our reserves consist of reserves for property and liability losses, consistent with the coverages provided for in the insurance policies directly written or assumed by the Company under reinsurance contracts. In many cases, several years may elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of the loss. Although we believe that our reserve estimates are reasonable, it is possible that our actual loss experience may not conform to our assumptions and may, in fact, vary significantly from our assumptions. Accordingly, the ultimate settlement of losses and the related loss adjustment expenses may vary significantly from the estimates included in our financial statements. We continually review our estimates and adjust them as we believe appropriate as our experience develops or new information becomes known to us.

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Our reserves for losses and loss adjustment expenses at June 30, 2009 and December 31, 2008, gross and net of ceded reinsurance were as follows:

	June 30, 2009	December 31, 2008
	(Dollars in thousands)	
Gross		
Case reserves	$ 102,448	$ 91,057
IBNR and ULAE reserves	324,460	281,664
Total reserves	$ 426,908	$ 372,721
Net of reinsurance		
Case reserves	$ 71,038	$ 62,497
IBNR and ULAE reserves	209,714	181,672
Total	$ 280,752	$ 244,169

Revenue Recognition

Premiums. Premiums are recognized as earned using the daily pro rata method over the terms of the policies. When premium rates change, the effect of those changes will not immediately affect earned premium. Rather, those changes will be recognized ratably over the period of coverage. Unearned premiums represent the portion of premiums written that relate to the unexpired terms of policies-in-force. As policies expire, we audit those policies comparing the estimated premium rating units that were used to set the initial premium to the actual premiums rating units for the period and adjust the premiums accordingly. Premium adjustments identified as a result of these audits are recognized as earned when identified.

Commissions and Fees. Wholesale agency commissions and fee income from unaffiliated companies are earned at the effective date of the related insurance policies produced or as services are provided under the terms of the administrative and service provider contracts. Related commissions to retail agencies are concurrently expensed at the effective date of the related insurance policies produced. Profit sharing commissions due from certain insurance and reinsurance companies, based on losses and loss adjustment expense experience, are earned when determined in accordance with the applicable contract.

Investments

Our marketable investment securities, including money market accounts held in our investment portfolio, are classified as available-for-sale and, as a result, are reported at market value. Effective January 1, 2008, we adopted SFAS No. 157, *Fair Value Measurements,* which resulted in no material changes in valuation techniques we previously used to measure fair values. See Note 11 to the Condensed Consolidated Financial Statements for a more complete description. .Convertible securities were accounted for under FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments* (SFAS 155) for the three and six months ended June 30, 2009 and 2008. Alternative investments consist of our investments in limited partnerships, which invest in high yield convertible securities and distressed structured finance products. These alternative investments are accounted for under FASB Statement No. 159, *The Fair Value Option of Financial Assets and Financial Liabilities* (SFAS 159), for the three and six months ended June 30, 2009 and 2008.

Premiums and discounts are amortized or accreted over the life of the related debt security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned. Realized gains and losses are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Impairment of Investment Securities

Impairment of investment securities results when a market decline below cost is other-than-temporary. The other-than-temporary write down is separated into an amount representing the credit loss which is recognized in earnings and the amount related to all other factors which is recorded in other comprehensive income. Management regularly reviews our fixed maturity securities portfolio to evaluate the necessity of recording impairment losses for other-than-temporary declines in the fair value of investments. Factors considered in evaluating potential impairment include, but are not limited to, the current fair value as compared to cost or amortized cost of the security, as appropriate, the length of time the investment has been below cost or amortized cost and by how much, our intent to sell a security and whether it is more-likely-than-not we will be required to sell the security before the recovery of our amortized cost basis, and specific credit issues related to the issuer and current economic conditions.

Other-than-temporary

impairment losses result in a reduction of the cost basis of the underlying investment. Significant changes in these factors we consider when evaluating investments for impairment losses could result in a change in impairment losses reported in the consolidated financial statements.

As mentioned above, the Company considers its intent and ability to hold a security until the value recovers as part of the process of evaluating whether a security s unrealized loss represents an other-than-temporary decline. The Company s ability to hold such securities is supported by sufficient cash flow from its operations and from maturities within its investment portfolio in order to meet its claims payment and other disbursement obligations arising from its underwriting operations without selling such investments. With respect to securities where the decline in value is determined to be temporary and the security s value is not written down, a subsequent decision may be made to sell that security and realize a loss. Subsequent decisions on security sales are made within the context of overall risk monitoring, changing information and market conditions. Management of the Company s investment portfolio is outsourced to third party investment managers, which is directed and monitored by the investment committee. While these investment managers may, at a given point in time, believe that the preferred course of action is to hold securities with unrealized losses that are considered temporary until such losses are recovered, the dynamic nature of the portfolio management may result in a subsequent decision to sell the security and realize the loss, based upon a change in market and other factors described above. The Company believes that subsequent decisions to sell such securities are consistent with the classification of the Company s portfolio as available-for-sale.

Investment managers are required to notify management of rating agency downgrades of securities in their portfolios as well as any potential investment valuation issues no later than the end of each quarter. Investment managers are also required to notify management, and receive prior approval, prior to the execution of a transaction or series of related transactions that may result in a realized loss above a certain threshold. Additionally, investment managers are required to notify management, and receive approval, prior to the execution of a transaction or series of related transactions that may result in any realized loss up until a certain period beyond the close of a quarterly accounting period.

Under current accounting standards, an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered in circumstances where (1) an entity has the intent to sell a security, (2) it is more-likely-than-not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more-likely-than-not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the difference between the security s amortized cost and its fair value. If an entity does not intend to sell the security or it is not more-likely-than-not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income.

Deferred Policy Acquisition Costs

Policy acquisition costs related to direct and assumed premiums consist of commissions, underwriting, policy issuance, and other costs that vary with and are primarily related to the production of new and renewal business, and are deferred, subject to ultimate recoverability, and expensed over the period in which the related premiums are earned. Investment income is included in the calculation of ultimate recoverability.

Goodwill and Intangible Assets

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets,* goodwill and intangible assets that are not subject to amortization shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test for goodwill shall consist of a comparison of the fair value of the goodwill with the carrying amount of the reporting unit to which it is assigned. The impairment test for intangible assets shall consist of a comparison of the fair value of the intangible assets with their carrying amounts. If the carrying amount of the goodwill or intangible assets exceed their fair value, an impairment loss shall be recognized in an amount equal to that excess.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, the carrying value of long-lived assets, including amortizable intangibles and property and equipment, are evaluated whenever events or changes in circumstances indicate that a potential impairment has occurred relative to a given asset or assets.

Impairment is deemed to have occurred if projected undiscounted cash flows associated with an asset are less than the carrying value of the asset. The estimated cash flows include management s assumptions of cash inflows and outflows directly resulting from the use of that asset in operations. The amount of the impairment loss recognized is equal to the excess of the carrying value of the asset over its then estimated fair value.

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Results of Operations

Three Months Ended June 30, 2009 Compared to Three Months Ended June 30, 2008

The following table summarizes our results for the three months ended June 30, 2009 and 2008:

	Three Months Ended June 30, 2009	2008	Change
	(Dollars in thousands)		
Operating Revenue			
Net earned premiums	$ 51,432	$ 46,559	10%
Commissions and fees	9,577	7,086	35
Net investment income	7,132	5,216	37
Net realized gains (losses) on investments	9,644	(1,587)	708
Other-than-temporary impairment losses on investments	(97)	(225)	57
Total Operating Revenues	77,688	57,049	36
Operating Expenses			
Losses and loss adjustment expenses, net	35,463	25,732	38
Amortization of intangible assets	575	515	12
Other operating expenses	23,126	20,711	12
Total Operating Expenses	59,164	46,958	26
Operating Income	18,524	10,091	84
Interest Expense	1,294	1,214	7
Income From Continuing Operations Before Income Taxes	17,230	8,877	94
Income Taxes	5,621	2,641	113
Income From Continuing Operations	11,609	6,236	86
Income From Discontinued Operations, Net of Income Taxes		22,467	(100)
Net Income	$ 11,609	$ 28,703	(60)%
Loss Ratio	69.0%	55.3%	13.7 points
Underwriting Expense Ratio	30.9%	28.7%	2.2 points
Combined Ratio	99.9%	84.0%	15.9 points

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Operating Revenue
Net Earned Premiums

	Three Months Ended June 30, 2009	Three Months Ended June 30, 2008	Change
	(Dollars in thousands)		
Written premiums			
Direct	$ 77,892	$ 75,761	3%
Assumed	4,629	4,153	11
Ceded	(29,079)	(27,673)	5
Net written premiums	$ 53,442	$ 52,241	2%
Earned premiums			
Direct	$ 74,913	$ 69,571	8%
Assumed	4,460	4,231	5
Ceded	(26,773)	(27,818)	(4)
Earned but unbilled premiums	(1,168)	575	(303)
Net earned premiums	$ 51,432	$ 46,559	10%

Direct written premiums increased $2.1 million, or 3%, primarily due to increases in premium production from the Company s Contract Underwriting and FM Emerald underwriting platforms offset somewhat by decreases in production from the Company s Security and Specialty underwriting platforms during the three months ended June 30, 2009. Direct earned premiums increased $5.3 million in the three months ended June 30, 2009, or 8%, compared to the three months ended June 30, 2008.

Assumed written premiums increased $0.5 million, or 11%, and assumed earned premiums increased $0.2 million, or 5%. The increase in assumed written premiums is primarily due to an increase in production for the admitted legal liability business.

Ceded written premiums increased $1.4 million, or 5%, and ceded earned premiums decreased $1.0 million, or 4%, for the three months ended June 30, 2009 compared to the three months ended June 30, 2008. Ceded written premiums increased to 35.2% of direct and assumed written premiums during the second quarter of 2009 compared to 34.6% of direct and assumed written premiums during the second quarter of 2008 principally due to purchasing more quota share reinsurance during the second quarter of 2009 for the Company s primary casualty business compared to the second quarter of 2008. The increase in quota share cessions was offset somewhat by lower cessions under our excess of loss treaties during the second quarter of 2009 and the elimination of a 50% quota share on a contract underwriting class of business during the fourth quarter of 2008, which impacted the second quarter of 2009. Ceded earned premiums decreased primarily due to ceded written premiums continuing to be earned on the Company s 2008 quota share reinsurance treaties.

Earned but unbilled premiums decreased $1.7 million, or 303%, primarily due to the net earned premiums subject to audit during the three months ended June 30, 2009 decreasing compared to the net premiums earned subject to audit during the three months ended June 30, 2008.

Commissions and Fees

	Three Months Ended June 30, 2009	2008	Change
	(Dollars in thousands)		
Insurance underwriting commissions and fees	$ 1,360	$ 1,426	(5)%
Insurance services commissions and fees	8,217	5,660	45
Total commissions and fees	$ 9,577	$ 7,086	35%

Insurance underwriting commissions and fees decreased 5% from the three months ended June 30, 2008 to the three months ended June 30, 2009. Insurance services commissions and fees, which were principally AMC income and not related to gross written premiums, increased $2.6 million, as the result of increased AMC commission and fee income of $0.9 million during the second quarter of 2009 compared to the second quarter of 2008 and the favorable settlement of a contingent commission adjustment due to an unaffiliated carrier for $1.3 million. In addition, commission income related to our workers compensation service program increased $0.4 million.

Net Investment Income and Realized Gains (Losses) on Investments. During the three months ended June 30, 2009, net investment income was $7.1 million, a $1.9 million, or 37%, increase from $5.2 million reported for the three months ended June 30, 2008 primarily due to the increase in invested assets over the period. At June 30, 2009, invested assets were $625.2 million, a $100.9 million, or 19%, increase over $524.3 million of invested assets at June 30, 2008. This increase was due to cash flows from net written premiums, and from the cash retained on our quota share reinsurance contracts on a funds withheld basis. The annualized investment yield on total investments (net of investment expenses) was 4.7% and 4.0% at June 30, 2009 and 2008, respectively. The annualized taxable equivalent yield on total investments (net of investment expenses) was 5.3% and 4.7% at June 30, 2009 and 2008, respectively.

During the three months ended June 30, 2009, net realized gains were $9.6 million compared to net realized losses of $1.6 million during the three months ended June 30, 2008. The second quarter 2009 net realized gains were due to the mark to market increase in securities carried at market in accordance with SFAS 155 and SFAS 159 during the three months ended June 30, 2009 of approximately $6.6 million and gains on the sale of certain securities of $3.0 million.

Other-than-temporary Impairment Losses on Investments. During the three months ended June 30, 2009 other-than-temporary impairment losses on investments were $0.1 million compared to other-than-temporary impairment losses on investments of $0.2 million during the three months ended June 30, 2008.

Operating Expenses

Losses and Loss Adjustment Expenses. Losses and loss adjustment expenses incurred increased $9.7 million, or 38%, in the three months ended June 30, 2009 compared to the three months ended June 30, 2008. This increase was primarily due to the increase in net earned exposures reflected in the 10% increase in net earned premiums, an increase in the accident year loss and loss adjustment expense ratio from decreased premium rates, $2.4 million of storm-related losses experienced during the second quarter of 2009, and $5.2 million of higher than anticipated 2009 commercial property fire and other losses and loss adjustment expenses. Losses and loss adjustment expenses for the three months ended June 30, 2009 included approximately $3.6 million of favorable development of December 31, 2008 prior years loss and loss adjustment expense reserves. Favorable development of $1.9 million in our security general liability classes in the 2006-2007 accident years and $1.5 million in our specialty general liability classes in the 2007 accident year was due to lower than expected claim frequency along with lower than expected severity. Net favorable development of $0.2 million in unallocated loss and loss adjustment expenses was recorded for the 2006-2007 accident years. There was no development of December 31, 2007 prior years loss and loss adjustment expense reserves for the three months ended June 30, 2008.

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Other Operating Expenses

	Three Months Ended June 30		
	2009	2008	Change
	(Dollars in thousands)		
Amortization of deferred acquisition expenses	$ 13,600	$ 9,096	50%
Ceded reinsurance commissions	(8,550)	(8,313)	3
Other underwriting and operating expenses	18,076	19,928	(9)
Other operating expenses	$ 23,126	$ 20,711	12%

During the three months ended June 30, 2009, other operating expenses increased $2.4 million, or 12%, from the three months ended June 30, 2008. Amortization of deferred acquisition expenses increased by $4.5 million, or 50% due to the impact of purchasing less quota share reinsurance and increased acquisition expenses on new underwriting initiatives. Ceded reinsurance commissions increased $0.2 million, or 3%, principally due to the effect of purchasing approximately the same amount of quota share reinsurance during the second quarter of 2009 compared to the second quarter of 2008. Other underwriting and operating expenses, which consist of commissions, other acquisition costs, and general and underwriting expenses, net of acquisition cost deferrals decreased by $1.9 million, or 9%. The decrease was principally due to lower corporate expenses of $1.8 million, and a decrease of $0.1 million in general and underwriting expenses related to our insurance services operations.

Interest Expense. Interest expense increased 7% from the three months ended June 30, 2008 compared to the three months ended June 30, 2009. This increase was primarily due to a $0.1 million increase in the change in fair value of the interest rate swaps on junior subordinated debentures as discussed in Liquidity and Capital Resources below.

Income Taxes. Our effective tax rates were approximately 32.6% for the three months ended June 30, 2009 and 29.8% for the three months ended June 30, 2008 and differed from the federal statutory rate primarily due to state income taxes, non-deductible expenses, and the nontaxable portion of dividends received and tax-exempt interest.

Discontinued Operations. On June 27, 2008, the Company sold all of the outstanding capital stock of American Risk Pooling Consultants, Inc. (ARPCO). The results of ARPCO s operations are presented as Discontinued Operations in the Condensed Consolidated Statements of Income. For the three months ended June 30, 2008, income from discontinued operations consisted principally of ARPCO s operating income, net of taxes, and a gain on the sale of $21.4 million.

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Six Months Ended June 30, 2009 Compared to Six Months Ended June 30, 2008

The following table summarizes our results for the six months ended June 30, 2009 and 2008:

	Six Months Ended June 30,		
	2009	2008	Change
	(Dollars in thousands)		
Operating Revenue			
Net earned premiums	$ 104,027	$ 90,130	15%
Commissions and fees	16,471	11,139	48
Net investment income	13,566	10,064	35
Net realized gains (losses) on investments	11,437	(1,586)	(821)
Other-than-temporary impairment losses on investments	(134)	(225)	(40)
Total Operating Revenues	145,367	109,522	33
Operating Expenses			
Losses and loss adjustment expenses, net	65,956	49,177	34
Amortization of intangible assets	1,149	913	26
Other operating expenses	45,680	34,908	31
Total Operating Expenses	112,785	84,998	33
Operating Income	32,582	24,524	33
Interest Expense	2,603	3,114	(16)
Income From Continuing Operations Before Income Taxes	29,979	21,410	40
Income Taxes	9,689	6,540	48
Income From Continuing Operations	20,290	14,870	36
Income From Discontinued Operations, Net of Income Taxes		23,553	(100)
Net Income	$ 20,290	$ 38,423	(47)%
Loss Ratio	63.4%	54.6%	8.8 points
Underwriting Expense Ratio	30.6%	25.1%	5.5 points
Combined Ratio	94.0%	79.7%	14.3 points

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Operating Revenue
Net Earned Premiums

	Six Months Ended June 30, 2009	2008	Change
	(Dollars in thousands)		
Written premiums			

Direct written premiums decreased $1.0 million, or 1%, primarily due to decreases in premium production from the Company s Security and Specialty underwriting platforms offset somewhat by increases in production from the Company s FM Emerald and Contract Underwriting platforms during the six months ended June 30, 2009. Direct earned premiums increased $10.0 million in the six months ended June 30, 2009, or 7%, compared to the six months ended June 30, 2008.

Assumed written premiums increased $0.2 million, or 3%, and assumed earned premiums increased $0.8 million, or 10%. The increase in assumed written premiums is primarily due to an increase in production for the admitted legal liability business.

Ceded written premiums increased $6.8 million, or 13%, and ceded earned premiums decreased $3.7 million, or 7%, for the six months ended June 30, 2009 compared to the six months ended June 30, 2008. Ceded written premiums increased to 36% of direct and assumed written premiums during the second quarter of 2009 compared to 31% of direct and assumed written premiums during the second quarter of 2008 principally due to purchasing more quota share reinsurance during the second quarter of 2009 for the Company s primary casualty business compared to the second quarter of 2008. The increase in quota share cessions was offset somewhat by lower cessions under our excess of loss treaties during the second quarter of 2009 and the elimination of a 50% quota share on a contract underwriting class of business during the fourth quarter of 2008. Ceded earned premiums decreased primarily due to ceded written premiums continuing to be earned on the Company s 2008 quota share reinsurance treaties.

Earned but unbilled premiums decreased $0.5 million, or 88%, primarily due to the net earned premiums subject to audit during the six months ended June 30, 2009 decreasing compared to the net premiums earned subject to audit during the six months ended June 30, 2008.

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Commissions and Fees

	Six Months Ended June 30, 2009	Six Months Ended June 30, 2008	Change
	(Dollars in thousands)		
Insurance underwriting commissions and fees	$ 2,717	$ 2,755	(1)%
Insurance services commissions and fees	13,754	8,384	64
Total commissions and fees	$ 16,471	$ 11,139	48%

Insurance underwriting commissions and fees were flat from the six months ended June 30, 2008 to the six months ended June 30, 2009. Insurance services commissions and fees, which were principally AMC income and not related to gross written premiums, increased $5.4 million, as the result of six months of commission and fee income during the second half of 2009 compared to five months during the second half of 2008, the favorable settlement of a contingent adjustment due to an unaffiliated carrier for $1.3 million, and $0.9 million increase in commission income related to our workers compensation service program.

Net Investment Income and Realized Gains (Losses) on Investments. During the six months ended June 30, 2009, net investment income was $13.6 million, a $3.5 million, or 35%, increase from $10.1 million reported for the six months ended June 30, 2008 primarily due to the increase in invested assets over the period. At June 30, 2009, invested assets were $625.2 million, a $100.9 million, or 19%, increase over $524.3 million of invested assets at June 30, 2008. This increase was due to cash flows from net written premiums and from the cash retained on our quota share reinsurance contracts on a funds withheld basis. The annualized investment yield on total investments (net of investment expenses) was 4.7% and 4.0% at June 30, 2009 and 2008, respectively. The annualized taxable equivalent yield on total investments (net of investment expenses) was 5.3% and 4.7% at June 30, 2009 and 2008, respectively.

During the six months ended June 30, 2009, net realized gains were $11.4 million compared to net realized losses of $1.6 million during the six months ended June 30, 2008. The second quarter 2009 net realized gains were principally due to the mark to market increase in securities carried at market in accordance with SFAS 155 and SFAS 159 during the six months ended June 30, 2009 of approximately $8.8 million and gains on the sale of certain securities of $2.6 million.

Other-than-temporary Impairment Losses on Investments. During the six months ended June 30, 2009 other-than-temporary impairment losses on investments were $0.1 million compared to other-than-temporary impairment losses on investments of $0.2 million during the six months ended June 30, 2008.

Operating Expenses

Losses and Loss Adjustment Expenses. Losses and loss adjustment expenses incurred increased $16.8 million, or 34%, in the six months ended June 30, 2009 compared to the six months ended June 30, 2008. This increase was primarily due to the increase in net earned exposures reflected in the 15% increase in net earned premiums, an increase in the accident year loss and loss adjustment expense ratio from decreased premium rates, $2.4 million of storm-related losses experienced during the second quarter of 2009, and $5.2 million of higher than anticipated 2009 commercial property fire and other losses and loss adjustment expenses. Losses and loss adjustment expenses for the six months ended June 30, 2009 included approximately $4.4 million of favorable development of December 31, 2008 prior years loss and loss adjustment expense reserves. Favorable development of $1.9 million in our Security general liability classes in 2006-2007 accident years and $2.3 million in our Specialty general liability classes in the 2006-2007 accident years was due to lower than expected claim frequency and lower than expected severity. Net favorable development of $0.2 million in unallocated loss and loss adjustment expenses was recorded for the 2006-2007 accident years. There was no development of December 31, 2007 prior years loss and loss adjustment expense reserves for the six months ended June 30, 2008.

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Other Operating Expenses

	Six Months Ended June 30		
	2009	**2008**	**Change**
	(Dollars in thousands)		
Amortization of deferred acquisition expenses	$ 26,930	$ 17,310	56%
Ceded reinsurance commissions	(16,427)	(16,795)	(2)
Other underwriting and operating expenses	35,177	34,393	2
Other operating expenses	$ 45,680	$ 34,908	31%

During the six months ended June 30, 2009, other operating expenses increased $10.8 million, or 31%, from the six months ended June 30, 2008. Amortization of deferred acquisition expenses increased by $9.6 million, or 56% due to the impact of purchasing less quota share reinsurance and increased acquisition expenses on new underwriting initiatives. Ceded reinsurance commissions decreased $0.4 million, or 2%, principally due to the effect of purchasing more quota share reinsurance during the six months ended June 30, 2009 compared to the six months ended June 30, 2008, and lower ceding commissions related to profit sharing on ceded written premiums. Other underwriting and operating expenses, which consist of commissions, other acquisition costs, and general and underwriting expenses, net of acquisition cost deferrals, increased by $0.8 million, or 2%. The increase was principally due to an increase of $2.0 million in general and underwriting expenses related to our insurance services operations principally due to having six months of AMC results compared to five months during the six months ended June 30, 2008 due to the closing of the AMC acquisition on February 1, 2008, and a decrease in corporate expenses of $2.8 million during the six months ended June 30, 2009.

Interest Expense. Interest expense decreased 16% from the six months ended June 30, 2008 compared to the six months ended June 30, 2009. This decrease was primarily due to a $0.5 million decrease in the change in fair value of the interest rate swaps on junior subordinated debentures as discussed in Liquidity and Capital Resources below.

Income Taxes. Our effective tax rates were approximately 32.3% for the six months ended June 30, 2009 and 30.5% for the six months ended June 30, 2008 and differed from the federal statutory rate primarily due to state income taxes, non-deductible expenses, and the nontaxable portion of dividends received and tax-exempt interest.

Discontinued Operations. On June 27, 2008, the Company sold all of the outstanding capital stock of American Risk Pooling Consultants, Inc. (ARPCO). The results of ARPCO s operations are presented as Discontinued Operations in the Condensed Consolidated Statements of Income. For the six months ended June 30, 2008, income from discontinued operations consisted principally of ARPCO s operating income, net of taxes, and the gain on the sale of ARPCO of $21.4 million.

Liquidity and Capital Resources

Sources and Uses of Funds

FMFC. FMFC is a holding company with all of its operations being conducted by its subsidiaries. Accordingly, FMFC has continuing cash needs for primarily administrative expenses, debt service and taxes. Funds to meet these obligations come primarily from management and administrative fees from all of our subsidiaries, and dividends from our non-insurance subsidiaries.

Insurance Subsidiaries. The primary sources of our insurance subsidiaries cash are net written premiums, claims handling fees, amounts earned from investments and the sale or maturity of invested assets. Additionally, FMFC has in the past and may in the future contribute capital to its insurance subsidiaries.

The primary uses of our insurance subsidiaries cash include the payment of claims and related adjustment expenses, underwriting fees and commissions and taxes and making investments. Because the payment of individual claims cannot be predicted with certainty, our insurance subsidiaries rely on our paid claims history and industry data in determining the expected payout of claims and estimated loss reserves. To the extent that FMIC, FMCC, and AUIC have an unanticipated shortfall in cash, they may either liquidate securities held in their investment portfolios or obtain capital from FMFC. However, given the cash generated by our insurance subsidiaries operations and the relatively short duration of their investment portfolios, we do not currently foresee any such shortfall.

Non-insurance Subsidiaries. The primary sources of our non-insurance subsidiaries cash are commissions and fees, policy fees, administrative fees and claims handling and loss control fees. The primary uses of our non-insurance subsidiaries cash are commissions paid to brokers, operating expenses, taxes and dividends paid to FMFC. There are generally no restrictions on the payment of dividends by our non-insurance subsidiaries, except as may be set forth in our borrowing arrangements.

Cash Flows

Our sources of funds have consisted primarily of net written premiums, commissions and fees, investment income and proceeds from the issuance of equity securities and debt. We use operating cash primarily to pay operating expenses and losses and loss adjustment expenses and for purchasing investments. A summary of our cash flows is as follows:

	Six Months Ended June 30,	
	2009	**2008**
	(Dollars in thousands)	
Cash and cash equivalents provided by (used in):		
Operating activities continuing operations	$ 59,075	$ 58,622
Operating activities discontinued operations		2,376
Investing activities continuing operations	(61,006)	(100,571)
Investing activities discontinued operations		41,830
Financing activities	(6,328)	101
Change in cash and cash equivalents	$ (8,259)	$ 2,358

Net cash provided by operating activities from continuing operations for the six months ended June 30, 2009 and 2008 was primarily from cash received on net written premiums and less cash disbursed for operating expenses and losses and loss adjustment expenses. Cash received from net written premiums for the six months ended June 30, 2009 and 2008 were retained on a funds withheld basis in accordance with the quota share reinsurance contracts.

Net cash provided by operating activities from discontinued operations for the six months ended June 30, 2008 was primarily from cash received on commissions and service fees less cash disbursed for operating expenses.

Net cash used in investing activities from continuing operations for the six months ended June 30, 2009 primarily resulted from our net investment in short-term, debt and equity securities. Net cash used in investing activities from continuing operations for the six months ended June 30, 2008 primarily resulted from our net investment in short-term, debt and equity securities, and for the acquisition of AMC.

Net cash provided by investing activities from discontinued operations for the six months ended June 30, 2008 was from cash received on the sale of ARPCO less cash disbursed for transaction costs.

Net cash used in financing activities for the six months ended June 30, 2009 was primarily from the purchase of common stock under the Company s Share Repurchase Plan (Note 9), the payment of the shareholders dividend, and the purchase of common stock by the Company to be held in a rabbi trust for the benefit of the Company s Supplemental Executive Retirement Plan.

Net cash provided by financing activities for the six months ended June 30, 2008 resulted from the issuance of common stock as a result of the exercise of stock options offset by the purchase of common stock by the Company to be held in a rabbi trust for the benefit of the Company s Supplemental Executive Retirement Plan.

Based on historical trends, market conditions, and our business plans, we believe that our existing resources and sources of funds will be sufficient to meet our liquidity needs in the next twelve months. Because economic, market and regulatory conditions may change, however, there can be no assurances that our funds will be sufficient to meet our liquidity needs. In addition, competition, pricing, the frequency and severity of losses, and interest rates could significantly affect our short-term and long-term liquidity needs.

Stockholders Equity

Our total stockholders equity was $286.8 million, or $16.34 per outstanding share, as of June 30, 2009 compared to $261.6 million, or $14.67 per outstanding share, as of December 31, 2008. Our tangible stockholders equity attributable to common shareholders was $236.2 million, or $13.45 per outstanding share, as of June 30, 2009 compared to $210.2 million, or $11.79 per outstanding share as of December 31, 2008. Below is a reconciliation of our total stockholders equity to our tangible stockholders equity attributable to common shareholders:

	June 30, 2009	December 31, 2008
	(Dollars in thousands, except share and per share data)	
Total stockholders equity	$ 286,838	$ 261,637
Intangible assets, net	(38,201)	(39,351)
Deferred tax liability intangible assets, net	12,997	13,399
Goodwill	(25,483)	(25,483)
Tangible stockholders equity attributable to common shareholders	$ 236,151	$ 210,202
Common shares outstanding	17,558,483	17,836,337
Book value per share	$ 16.34	$ 14.67
Tangible book value per share	$ 13.45	$ 11.79

Book value per share is total common stockholders equity divided by the number of common shares outstanding. Tangible book value per share is book value per share excluding the value of intangible assets, goodwill, and the deferred tax liability related to intangible assets divided by the number of common shares outstanding.

Long-term debt

Junior Subordinated Debentures. We have $67.0 million cumulative principal amount of floating rate junior subordinated debentures outstanding. The debentures were issued in connection with the issuance of trust preferred stock by our wholly-owned, non-consolidated trusts. Cumulative interest on $46.4 million cumulative principal amount of the debentures is payable quarterly in arrears at a variable annual rate, reset quarterly, equal to the three month LIBOR plus 3.75% for $8.2 million, the three month LIBOR plus 4.00% for $12.4 million, and the three month LIBOR plus 3.0% for $25.8 million principal amount of the debentures. Cumulative interest on $20.6 million of the cumulative principal amount of the debentures is payable quarterly in arrears at a fixed annual rate of 8.25% through December 15, 2012, and a variable annual rate, reset quarterly, equal to the three month LIBOR plus 3.30% thereafter. For our floating rate junior subordinated debentures, we have entered into interest rate swap agreements to pay a fixed rate of interest. See Derivative Financial Instruments for further discussion. At June 30, 2009, the three month LIBOR rate was 0.60%. We may defer the payment of interest for up to 20 consecutive quarterly periods; however, no such deferral has been made.

Credit Facility. In October 2006, we entered into a credit facility which provided for borrowings of up to $30.0 million. Borrowings under the credit facility bear interest at our election as follows: (i) at a rate per annum equal to the greater of the lender s prime rate and the federal funds rate less 0.5%, each minus 0.75%; or, (ii) a rate per annum equal to LIBOR plus an applicable margin which is currently 0.75% or 1.0% based on our leverage ratio. The obligations under the credit facility are guaranteed by our material non-insurance subsidiaries. The maturity date of borrowings made under the credit facility is September 2011. The credit facility contains covenants which, among other things, restrict our ability to incur indebtedness, grant liens, make investments and sell assets. The credit facility also has certain financial covenants. At June 30, 2009, there were no borrowings under the agreement. We are not required to comply with the financial-related covenants until we borrow under the credit facility. However, at June 30, 2009, the Company was in compliance with all of the covenants related to the credit facility.

Derivative Financial Instruments. Financial derivatives are used as part of the overall asset and liability risk management process. We use interest rate swap agreements with a combined notional amount of $65.0 million in order to reduce our exposure to interest rate fluctuations with respect to our junior subordinated debentures. In June 2009, the Company entered into two new interest rate swap agreements to replace the swaps expiring in August of 2009. Both of these new swap agreements expire in August 2014; under one of the swap agreements we pay interest at a fixed rate of 3.695% and under the other swap agreement we pay interest at a fixed rate of 3.710%. Under the two swap agreements which expire in August 2009, we pay interest at a fixed rate of 4.12%; under our other swap agreement, which expires in December 2011, we pay interest at a fixed rate of 5.013%. Under all five swap agreements, we receive interest at the three month LIBOR, which is equal to the contractual rate under the junior subordinated debentures. At June 30, 2009, we had no exposure to credit loss on the interest rate swap agreements.

Cash and Invested Assets

Our cash and invested assets consist of fixed maturity securities, convertible securities, equity securities, and cash and cash equivalents. At June 30, 2009, our investments had a market value of $625.2 million and consisted of the following investments:

	June 30, 2009	
	Market Value	**% of Portfolio**
	(Dollars in thousands)	
Short Term Investments	$ 16,921	2.7%
U.S. Treasuries	4,101	0.7%
U.S. Agencies	1,056	0.2%
Municipal Bonds	201,369	32.3%
Corporate Bonds	122,759	19.6%
High Yield Bonds	17,705	2.8%
MBS Passthroughs	60,315	9.6%
CMOs	46,215	7.4%
Asset Backed Securities	23,258	3.7%
Commercial MBS	50,879	8.1%
Convertible Securities	58,948	9.4%
High Yield Convertible Fund	9,973	1.6%
Structured Finance Fund	10,520	1.7%
Preferred Stocks	1,145	0.2%
Common Stocks		0.0%
Total	$ 625,164	100.0%

The following table shows the composition of the investment portfolio by remaining time to maturity at June 30, 2009. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Additionally, the expected maturities of our investments in putable bonds fluctuate inversely with interest rates and therefore may also differ from contractual maturities.

Average Life	**% of Total Investment**
Less than one year	13.8%
One to two years	14.3%
Two to three years	16.4%
Three to four years	14.2%
Four to five years	14.4%

Five to seven years	9.5%
More than seven years	17.4%
Total	90.5%

The effective duration of the portfolio as of June 30, 2009 is approximately 3.4 years and the taxable equivalent duration is 3.1 years. Excluding cash and cash equivalents, equity and convertible securities, the portfolio duration and taxable equivalent duration are 3.7 years and 3.3 years, respectively. The shorter taxable equivalent duration reflects the significant portion of the portfolio in municipal securities. The annualized investment yield on total investments (net of investment expenses) was 4.7% at June 30, 2009 and 4.0% at June 30, 2008. The annualized taxable equivalent yield on total investments (net of investment expenses) was 5.3% at June 30, 2009 and 4.7% at June 30, 2008.

The majority of our portfolio consists of AAA or AA rated securities with a Standard and Poor s weighted average credit quality of AA- at June 30, 2009. The fixed income portfolio had a weighted average credit quality of AA at June 30, 2009. The majority of the investments rated BBB and below are convertible securities. Consistent with our investment policy, we review any security if it falls below BBB- and assess whether it should be held or sold. The following table shows the ratings distribution of our investment portfolio as of June 30, 2009 as a percentage of total market value.

S&P Rating	% of Total Investments
AAA	47.6%
AA	17.2%
A	15.5%
BBB	10.6%
BB	4.9%
B	0.8%
C	0.1%
CCC	1.6%
NR	1.7%
Total	100.0%

Within Mortgages, the Company invests in residential collateralized mortgage obligations (CMO) that typically have high credit quality and are expected to provide an advantage in yield compared to U.S. Treasury securities. The Company s investment strategy is to purchase CMO tranches which offer the most favorable return given the risks involved. One significant risk evaluated is prepayment sensitivity. While prepayment risk (either shortening or lengthening of duration) and its effect on total return cannot be fully controlled, particularly when interest rates move dramatically, the investment process generally favors securities that control this risk within expected interest rate ranges. The Company does not purchase residual interests in CMO s.

At June 30, 2009, the Company held CMO s classified as available-for-sale with a fair value of $46.2 million. Approximately 80.0% of those CMO holdings were guaranteed by or fully collateralized by securities issued by a full faith and credit agency such as GNMA, or government sponsored enterprises (GSE) such as FNMA or FHLMC. In addition, at June 30, 2009, the Company held $59.5 million of mortgage-backed pass-through securities issued by one of the GSE s and classified as available-for-sale.

The Company held commercial mortgage-backed securities (CMBS) of $50.9 million, of which 88.9% are pre-2006 vintage, at June 30, 2009. The weighted average credit support (adjusted for defeasance) of our CMBS portfolio was 42.7% and comprised mainly of super senior structures. The average loan to value at origination was 67.7%. The average credit rating of these securities was AAA. The CMBS portfolio was supported by loans that were diversified across economic sectors and geographical areas. It is not believed that this portfolio exposes the Company to a material adverse impact on its results of operations, financial position or liquidity, due to the underlying credit strength of these securities.

The Company s fixed maturity investment portfolio included asset-backed securities and collateralized mortgage obligations collateralized by sub-prime mortgages and alternative documentation mortgages (Alt-A) with market values of $0.1 million and $1.3 million at June 30, 2009, respectively. The Company defines sub-prime mortgage-backed securities as investments with weighted average FICO scores below 650. Alt-A securities are defined by above-prime interest rates, high loan-to-value ratios, high debt-to-income ratios, low loan documentation (e.g., limited or no verification of income and assets), or other characteristics that are inconsistent with conventional underwriting standards employed by government-sponsored mortgage entities. The average credit rating on these securities and obligations held by the Company at June 30, 2009 was BB.

The Company s fixed maturity investment portfolio at June 30, 2009 included securities issued by numerous municipalities with a total carrying value of $201.4 million. Approximately $21.4 million, or 10.6%, were pre-refunded (escrowed with Treasuries). Approximately $101.5 million, or 50.4%, of the securities were enhanced by third-party insurance for the payment of principal and interest in the event of an issuer default. Such insurance, prior to the downgrades of many of the monolines, results in a rating of AAA being assigned by independent rating agencies to those securities. The downgrade of credit ratings of insurers of these securities could result in a corresponding downgrade in the ratings of the securities from AAA to the underlying rating of the respective security without giving effect to the benefit of insurance. Of the total $101.5 million of insured municipal securities in the Company s investment portfolio at June 30, 2009, 99.0% were rated at A- or above, and approximately 78.5% were rated AA- or above, without the benefit of insurance. The average underlying credit rating of the entire municipal bond portfolio was AA+ at June 30, 2009. The

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Company believes that a loss of the benefit of insurance would not result in a material adverse impact on the Company s results of operations, financial position or liquidity, due to the underlying credit strength of the issuers of the securities, as well as the Company s ability and intent to hold the securities.

The Company s investment portfolio does not contain any exposure to Collateralized Debt Obligations (CDO) or investments collateralized by CDOs. In addition, the Company s investment portfolio does not contain any exposure to auction-rate securities.

Cash and cash equivalents consisted of cash on hand of $23.6 million at June 30, 2009.

The amortized cost, gross unrealized gains and losses, and market value of marketable investment securities classified as available-for-sale at June 30, 2009 by major security type were as follows:

	Amortized	Gross Unrealized		Market
	Cost	Gains	Losses	Value
		(Dollars in thousands)		
Debt Securities				
U.S. government securities	$ 3,941	$ 161	$ (1)	$ 4,101
Government agency mortgage-backed securities	93,058	3,429	(81)	96,406
Government agency obligations	1,018	38		1,056
Collateralized mortgage obligations and other asset-backed securities	87,040	2,368	(5,147)	84,261
Obligations of states and political subdivisions	194,413	7,336	(380)	201,369
Corporate bonds	136,225	6,060	(1,821)	140,464
Total Debt Securities	515,695	19,392	(7,430)	527,657
Preferred stocks	1,416		(271)	1,145
Short-term investments	16,921			16,921
Total	$ 534,032	$ 19,392	$ (7,701)	$ 545,723

At June 30, 2009, there were 169 unrealized loss positions with a total unrealized loss of $7.7 million. This represents approximately 1.2% of quarter end invested assets of $625.2 million. This unrealized loss position is a function of the purchase of specific securities in a lower interest rate or spread environment than what prevails as of June 30, 2009. Some of these losses are due to the increase in spreads of select corporate bonds or structured securities. We have viewed these market value declines as being temporary in nature. Our portfolio is relatively short as the duration of the core fixed income portfolio excluding cash, convertible securities, limited partnerships and equity is approximately 3.7 years. We do not intend to sell and it is not expected we will need to sell these temporarily impaired securities before maturity in the event that interest rates do not decline from current levels. In light of our significant growth over the past 24 months, liquidity needs from the portfolio are minimal. As a result, we would not expect to have to liquidate temporarily impaired securities to pay claims or for any other purposes. There have been certain instances over the past year, where due to market based opportunities; we have elected to sell a small portion of the portfolio. These situations were unique and infrequent occurrences and in our opinion, do not reflect an indication that we intend to sell or will be required to sell these securities before they mature or recover in value.

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The fair value and amount of unrealized losses segregated by the time period the investment had been in an unrealized loss position is as follows at June 30, 2009:

	Less than 12 Months		Greater than 12 Months	
	Fair Value of Investments With Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments With Unrealized Losses	Gross Unrealized Losses
	(Dollars in thousands)			
Debt Securities				
U.S. government securities	$ 108	$ (1)	$	$
Government agency mortgage-backed securities	17,200	(71)	281	(10)
Government agency obligations				
Collateralized mortgage obligations and other asset-backed securities	7,583	(316)	20,521	(4,831)
Obligations of states and political subdivisions	3,289	(71)	12,917	(309)
Corporate bonds	9,833	(78)	15,736	(1,743)
Total Debt Securities	38,013	(537)	49,455	(6,893)
Preferred Stocks	875	(35)	270	(236)
Total	$ 38,888	$ (572)	$ 49,725	$ (7,129)

The fair value and amount of unrealized losses segregated by the time period the investment had been in an unrealized loss position is as follows at December 31, 2008:

	Less than 12 Months		Greater than 12 Months	
	Fair Value of Investments With Unrealized Losses	Gross Unrealized Losses	Fair Value of Investments With Unrealized Losses	Gross Unrealized Losses
	(Dollars in thousands)			
Debt Securities				
U.S. government securities	$	$	$	$
Government agency mortgage-backed securities	3,902	(37)	326	(2)
Government agency obligations				
Collateralized mortgage obligations and other asset-backed securities	48,125	(5,143)	5,963	(1,944)
Obligations of states and political subdivisions	14,063	(427)	8,809	(267)
Corporate bonds	42,402	(2,549)	12,824	(1,325)
Total Debt Securities	108,492	(8,156)	27,922	(3,538)
Preferred Stocks	832	(78)	216	(289)

Total	$ 109,324	$ (8,234)	$ 28,138	$ (3,827)

Below is a table that illustrates the unrecognized impairment loss by sector. The increase in spread relative to U.S. Treasury Bonds was the primary factor leading to impairment for the year ended June 30, 2009. All asset sectors were affected by the overall increase in spreads as can be seen from the table below. In addition to the general level of rates, we also look at a variety of other factors such as direction of credit spreads for an individual issue as well as the magnitude of specific securities that have declined below amortized cost.

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Sector	Amount of Unrealized Loss at June 30, 2009 (Dollars in thousands)
Short Term Investments	$
U.S. Treasuries	(1)
U.S. Agencies	
Municipal Bonds	(380)
Corporate Bonds	(1,807)
High Yield Bonds	(14)
MBS Passthroughs	(105)
CMOs	(1,480)
Asset Backed Securities	(577)
Commercial MBS	(3,066)
Convertible Securities	
High Yield Convertible Fund	
Structured Finance Fund	
Preferred Stocks	(271)
Common Stocks	
	$ (7.701)

The most significant risk or uncertainty inherent in our assessment methodology is that the current credit rating of a particular issue changes over time. If the rating agencies should change their rating on a particular security in our portfolio, it could lead to a reclassification of that specific issue. The vast majority of our unrecognized impairment losses are investment grade and AAA or AA rated securities. Should the credit quality of individual issues decline for whatever reason then it would lead us to reconsider the classification of that particular security. Within the non-investment grade sector, we continue to monitor the particular status of each issue. Should prospects for any one issue deteriorate, we would potentially alter our classification of that particular issue.

The table below illustrates the breakdown of impaired securities by investment grade and non investment grade as well as the duration that these sectors have been trading below amortized cost. The average duration of the impairment has been greater than 12 months. The unrealized loss of impaired securities as a percent of the amortized cost of those securities is 8.0% as of June 30, 2009.

	% of Total Amortized Cost	Total Amortized Cost	Total Unrealized Losses	Average Unrealized Loss as % of Amortized Cost	% of Loss > 12 Months
		(Dollars in thousands)			
Non Investment Grade	4.2%	$ 4,046	$ 1,102	27.2%	99.1%
Investment Grade	95.8	92,268	6,599	7.2	91.5
Total	100.0%	$ 96,314	$ 7,701	8.0%	92.6%

The majority of these securities are AAA or AA rated. These issues are continually monitored and may be classified in the future as being other than temporarily impaired.

The largest concentration of temporarily impaired securities is Commercial MBS at approximately 39.8% of the total loss. These securities are all AAA rated and have been affected primarily by the widening of spreads within this sector and/or the general level of interest rates. The next largest concentration of temporarily impaired securities is Corporate Bonds at approximately 23.6% of the total loss. Within Corporate Bonds 88.0% are rated investment grade BBB or better, and their temporary impairment results primarily from the widening of credit spreads. The next highest concentration of temporarily impaired securities is CMOs at 19.2% of the total loss. Within CMOs 96.8% are rated AAA including the 79.8% of the CMO exposure that is agency issued, and have primarily been affected by the general level of interest rates as well.

For the six months ended June 30, 2009, we sold approximately $3.3 million of market value of fixed income securities excluding convertibles, which were trading below amortized cost while recording a realized loss of $0.1 million. This loss represented 3.8% of the amortized cost of the positions. These sales were unique opportunities to sell specific positions due to changing market conditions. These situations were exceptions to our general assertion regarding our ability and intent to hold securities with unrealized losses until they mature or recover in value. This position is further supported by the insignificant losses as a percentage of amortized cost for the respective periods.

During the six months ended June 30, 2009 net realized gains on investments were $11.4 million compared to net realized losses of $1.6 million during the six months ended June 30, 2008. Net realized gains for the six months ended June 30, 2009 were principally due to mark to market increases in securities carried at market in accordance with SFAS 155 and SFAS 159 of approximately $8.8 million, offset somewhat by losses on the sale of certain securities.

Deferred Policy Acquisition Costs

We defer a portion of the costs of acquiring insurance business, primarily commissions and certain policy underwriting and issuance costs, which vary with and are primarily related to the production of insurance business. For the six months ended June 30, 2009, $27.1 million of the costs were deferred. Deferred policy acquisition costs totaled $26.9 million, or 27.7% of unearned premiums (net of reinsurance), at June 30, 2009.

Reinsurance

The following table illustrates our direct written premiums and premiums ceded for the three months ended June 30, 2009 and 2008:

	Six Months Ended June 30,	
	2009	**2008**
	(Dollars in thousands)	
Direct written premiums	$ 151,012	$ 151,974
Ceded written premiums	57,132	50,376
Net written premiums	$ 93,880	$ 101,598
Ceded written premiums as percentage of direct written premiums	37.8%	33.1%

The following table illustrates the effect of our reinsurance ceded strategies on our results of operations:

	Six Months Ended June 30,	
	2009	**2008**
	(Dollars in thousands)	
Ceded written premiums	$57,132	$50,376
Ceded premiums earned	51,845	55,497
Losses and loss adjustment expenses ceded	37,507	29,347
Ceding commissions	14,183	19,716

Our net cash flows relating to ceded reinsurance activities (premiums paid less losses recovered and ceding commissions received) were approximately $12.8 million net cash paid for the six months ended June 30, 2009 compared to net cash paid of $22.3 million for the six months ended June 30, 2008.

The assuming reinsurer is obligated to indemnify the ceding company to the extent of the coverage ceded. The inability to recover amounts due from reinsurers could result in significant losses to us. To protect us from reinsurance recoverable losses, FMIC seeks to enter into reinsurance agreements with financially strong reinsurers. Our senior executives evaluate the credit risk of each reinsurer before entering into a contract and monitor the financial strength of the reinsurer. On June 30, 2009, substantially all reinsurance contracts to which we were a party were with companies with A.M. Best ratings of A or better. One reinsurance contract to which we were a party was with a reinsurer that does not carry an A.M. Best rating. For this contract, we required full collateralization of our recoverable via a grantor trust and an irrevocable letter of credit. In addition, ceded reinsurance contracts contain trigger clauses through which FMIC can initiate cancellation including immediate return of all ceded unearned premiums at its option, or which result in immediate collateralization of ceded reserves by the assuming company in the event of a financial strength rating downgrade, thus limiting credit exposure. On June 30, 2009, there was no allowance for uncollectible reinsurance, as all reinsurance balances were current and there were no disputes with reinsurers.

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On June 30, 2009 and December 31, 2008, FMFC had a net amount of recoverables from reinsurers of $201.6 million and $181.2 million, respectively, on a consolidated basis.

Recent Accounting Pronouncements

On July 1, 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles A Replacement of FASB Statement No.162 (SFAS 168).* SFAS 168 replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* and establishes the *Accounting Standards Codification* (Codification) as the single official source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Once effective, all other nongrandfathered, non-SEC accounting literature not included in the Codification becomes nonauthoritative. SFAS 168 supersedes all existing, non-SEC accounting and reporting standards applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP). SFAS 168 is effective for interim and annual reporting periods ending after September 15, 2009. As the Codification does not change GAAP, the Company does not expect SFAS 168 to have a material impact on its financial statements. Previous references to applicable literature via our disclosures will be updated with references to the new Codification sections.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events (SFAS 165).* SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. SFAS 165 provides guidance on the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. We adopted SFAS 165 during the second quarter of 2009, and its application had no impact on our condensed consolidated financial statements. We evaluate subsequent events through the date the accompanying financial statements were issued, which was August 10, 2009.

In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2). FSP FAS 115-2 modifies the existing other-than-temporary impairment guidance to require the recognition of an other-than-temporary impairment when an entity has the intent to sell a debt security or when it is more likely than not an entity will be required to sell the debt security before its anticipated recovery. Additionally, FSP FAS 115-2 changes the presentation and amount of other-than-temporary losses recognized in the income statement for instances when the Company determines that there is a credit loss on a debt security but it is more likely than not that the entity will not be required to sell the security prior to the anticipated recovery of its remaining cost basis. For these debt securities, the amount representing the credit loss will be reported as an impairment loss in the Condensed Consolidated Statement of Income and the amount related to all other factors will be reported in accumulated other comprehensive income. FSP FAS 115-2 also requires the presentation of other-than-temporary impairments separately from realized gains and losses on the face of the income statement. In addition to the changes in measurement and presentation, FSP FAS 115-2 is intended to enhance the existing disclosure requirements for other-than-temporary impairments and requires all disclosures related to other-than-temporary impairments in both interim and annual periods. The provisions of FSP FAS 115-2 are effective for interim periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The adoption of FSP FAS 115-2/124-2 in the second quarter of 2009 resulted in a $1.0 million increase in retained earnings which was offset by a corresponding decrease in accumulated other comprehensive income (loss) of the same amount.

In April 2009, the FASB issued FSP FAS 157-4*, Determining Fair Value When Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly (FSP FAS 157-4).* Under FSP FAS 157-4, if an entity determines that there has been a significant decrease in the volume and level of activity for the asset or the liability in relation to the normal market activity for the asset or liability (or similar assets or liabilities), then transactions or quoted prices may not accurately reflect fair value. In addition, if there is evidence that the transaction for the asset or liability is not orderly; the entity shall place little, if any weight on that transaction price as an indicator of fair value. FSP FAS 157-4 is effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The adoption of FSP FAS 157-4 in the second quarter of 2009 did not have a material effect on the Company s results of operations, financial position, or liquidity.

In April 2009, the FASB issued FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (*FSP FAS 107-1 and APB 28-1*). FSP FAS 107-1 and APB 28-1 require disclosures about fair value of financial instruments in interim and annual financial statements. FSP FAS 107-1 and APB 28-1 are effective for periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. The adoption of FSP FAS 107-1 and APB 28-1 in the second quarter of 2009 is included in Note 11, Fair Value Measurements to the condensed consolidated financial statements.

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We adopted the following accounting standards in the first quarter 2009, none of which had a material effect on the Company s results of operations, financial position, or liquidity:

- SFAS No. 141(R), *Business Combinations;*
- SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51;*
- SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities;*
- FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities;* and
- FSP FAS No. 157-2, *Effective Date of FASB Statement No. 157.*

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2008 for a complete discussion of the Company s market risk. There have been no material changes to the market risk information included in the Company s Annual Report on Form 10-K.

Item 4. Controls and Procedures

The Company s chief executive officer and chief financial officer have concluded, based on their evaluation as of the end of the period covered by this report, that the Company s disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) are effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding financial disclosures. There was no change in the Company s internal control over financial reporting that occurred during the quarter ended June 30, 2009 that has materially affected or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II. OTHER INFORMATION

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

During the three months ended September 30, 2008, the Board of Directors of the Company authorized a share repurchase plan to purchase up to 1.5 million shares of common stock through open market or privately negotiated transactions. The repurchase program expires on August 18, 2009.

During the three months ended June 30, 2009, the Company repurchased 387,758 shares of common stock for $5.1 million at an average cost of $13.11 per share. Shares purchased under the program are retired and returned to the status of authorized but unissued shares.

Month	Total Number of Shares (or Units) Purchased	Average Price as Paid per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plan or Programs
April		$		801,423
May	186,405	12.99	186,405	615,018
June	201,353	13.23	201,353	413,665
Total	387,758	$ 13.11	387,758	413,665

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

On May 13, 2009, the Company held its annual meeting of stockholders at which stockholders:

(i) elected to the Board of Directors of First Mercury Financial Corporation two class II directors; and

(ii) approved the amendment and restatement of the First Mercury Financial Corporation Omnibus Incentive Plan of 2006 (the Omnibus Plan) to increase the number of shares authorized for issuance thereunder by 1,650,000 shares (which will bring the total number of shares reserved under the Omnibus Plan to 3,150,000) and to made certain other changes to the Omnibus Plan; and

(iii) approved the Omnibus Plan for purposes of complying with the requirements of Section 162(m) of the Internal Revenue Code, as amended; and

(iv) ratified the appointment of BDO Seidman, LLP as independent registered public accounting firm of the Company for the year ending December 31, 2009.

Voting results were as follows:

(i)

Director Nominee	Votes For	Votes Withheld

Thomas B. Kearney	8,102,001	9,456,387
William C. Tyler	16,749,127	809,261

(ii)

	For	Against	Abstain	Non Votes
Approve amendment and restatement of Omnibus Plan:	13,389,414	3,659,992	2,961	506,021

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(iii)

	For	Against	Abstain
Approve Omnibus Plan for purposes of complying with Section 162(m):	17,148,241	405,741	4,406

(iv)

	For	Against	Abstain
Ratification of appointment of BDO Seidman, LLP	17,480,335	62,142	15,911

Item 6. Exhibits

See Index of Exhibits following the signature page, which is incorporated herein by reference.

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SIGNATURES

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

FIRST MERCURY FINANCIAL CORPORATION

By: /s/ RICHARD H. SMITH
Richard H. Smith
Chairman, President and Chief Executive Officer

By: /s/ JOHN A. MARAZZA
John A. Marazza
Executive Vice President and Chief Financial Officer

Date: August 10, 2009

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INDEX OF EXHIBITS

Exhibit Number	Note	Description
31 (a)	(1)	Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
31 (b)	(1)	Certification of Chief Financial Officer, pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934
32 (a)	(1)	Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(b) of the Securities Exchange Act of 1934
32 (b)	(1)	Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(b) of the Securities Exchange Act of 1934

(1) Filed herewith