

MERCURY GENERAL CORP  
Form 10-Q  
November 07, 2007

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## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

### FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

For the Quarter Ended September 30, 2007

Commission File No. 001-12257

## MERCURY GENERAL CORPORATION

(Exact name of registrant as specified in its charter)

<b>California</b> (State or other jurisdiction of incorporation or organization)	<b>95-2211612</b> (I.R.S. Employer Identification No.)
<b>4484 Wilshire Boulevard, Los Angeles, California</b> (Address of principal executive offices)	<b>90010</b> (Zip Code)
<b>Registrant's telephone number, including area code:</b> <b>(323) 937-1060</b>	

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  NO

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

At October 31, 2007, the Registrant had issued and outstanding an aggregate of 54,721,501 shares of its Common Stock.

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## PART 1 FINANCIAL INFORMATION

## Item 1. Financial Statements

## MERCURY GENERAL CORPORATION

## AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(Unaudited)

Amounts expressed in thousands, except share data

	September 30, 2007	December 31, 2006
<b>ASSETS</b>		
Investments:		
Fixed maturities available for sale, at fair value (amortized cost \$2,834,897 in 2007 and \$2,851,715 in 2006)	\$ 2,855,325	\$ 2,898,987
Equity securities available for sale, at fair value (cost \$312,392 in 2007 and \$258,310 in 2006)	417,132	318,449
Equity securities trading, at fair value (cost \$8,068 in 2007)	8,483	
Short-term investments, at cost, which approximates fair value	332,000	282,302
<b>Total investments</b>	<b>3,612,940</b>	<b>3,499,738</b>
Cash	47,920	47,606
Receivables:		
Premiums receivable	313,278	298,772
Premium notes	31,350	29,613
Accrued investment income	37,818	34,307
Other	11,497	10,085
<b>Total receivables</b>	<b>393,943</b>	<b>372,777</b>
Deferred policy acquisition costs	215,650	209,783
Fixed assets, net	165,946	152,260
Other assets	41,431	18,898
<b>Total assets</b>	<b>\$ 4,477,830</b>	<b>\$ 4,301,062</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Losses and loss adjustment expenses	\$ 1,097,678	\$ 1,088,822
Unearned premiums	973,799	950,344
Notes payable	130,980	141,554
Accounts payable and accrued expenses	142,756	137,194
Current income taxes	15,685	18,241
Deferred income taxes	32,756	33,608
Other liabilities	238,504	207,169
<b>Total liabilities</b>	<b>2,632,158</b>	<b>2,576,932</b>
Commitments and contingencies		
Shareholders' equity:		
Common stock without par value or stated value: (Authorized 70,000,000 shares; issued and outstanding 54,721,501 shares in 2007 and 54,669,606 shares in 2006)	69,006	66,436
Accumulated other comprehensive income	80,726	69,652

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Retained earnings	1,695,940	1,588,042
Total shareholders' equity	1,845,672	1,724,130
Total liabilities and shareholders' equity	\$ 4,477,830	\$ 4,301,062

See accompanying notes to the consolidated financial statements.

**MERCURY GENERAL CORPORATION**  
**AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

(Unaudited)

Amounts expressed in thousands, except share and per share data

	<b>Three Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Revenues:</b>		
Earned premiums	\$ 748,798	\$ 753,122
Net investment income	39,216	36,857
Net realized investment gains	2,049	2,690
Other	1,324	1,263
<b>Total revenues</b>	<b>791,387</b>	<b>793,932</b>
<b>Expenses:</b>		
Losses and loss adjustment expenses	497,791	491,129
Policy acquisition costs	166,496	163,362
Other operating expenses	41,289	45,813
Interest	2,136	2,209
<b>Total expenses</b>	<b>707,712</b>	<b>702,513</b>
<b>Income before income taxes</b>	<b>83,675</b>	<b>91,419</b>
Provision for income taxes	20,397	23,192
<b>Net income</b>	<b>\$ 63,278</b>	<b>\$ 68,227</b>
<b>BASIC EARNINGS PER SHARE</b> (weighted average shares outstanding 54,720,110 in 2007 and 54,662,245 in 2006)	<b>\$ 1.16</b>	<b>\$ 1.25</b>
<b>DILUTED EARNINGS PER SHARE</b> (weighted average shares 54,850,536 as adjusted by 130,426 for the dilutive effect of options in 2007 and 54,750,002 as adjusted by 87,757 for the dilutive effect of options in 2006)	<b>\$ 1.15</b>	<b>\$ 1.25</b>
<b>Dividends declared per share</b>	<b>\$ 0.52</b>	<b>\$ 0.48</b>

See accompanying notes to the consolidated financial statements.

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**MERCURY GENERAL CORPORATION**
**AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)****Amounts expressed in thousands, except share and per share data**

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Revenues:</b>		
Earned premiums	\$ 2,258,626	\$ 2,243,152
Net investment income	122,156	112,502
Net realized investment gains	10,996	13,376
Other	3,896	3,729
<b>Total revenues</b>	<b>2,395,674</b>	<b>2,372,759</b>
<b>Expenses:</b>		
Losses and loss adjustment expenses	1,511,928	1,500,625
Policy acquisition costs	497,392	484,298
Other operating expenses	119,292	134,729
Interest	6,771	6,916
<b>Total expenses</b>	<b>2,135,383</b>	<b>2,126,568</b>
<b>Income before income taxes</b>	<b>260,291</b>	<b>246,191</b>
Provision for income taxes	67,051	81,506
<b>Net income</b>	<b>\$ 193,240</b>	<b>\$ 164,685</b>
<b>BASIC EARNINGS PER SHARE</b> (weighted average shares outstanding 54,697,145 in 2007 and 54,644,559 in 2006)	<b>\$ 3.53</b>	<b>\$ 3.01</b>
<b>DILUTED EARNINGS PER SHARE</b> (weighted average shares 54,829,878 as adjusted by 132,733 for the dilutive effect of options in 2007 and 54,759,549 as adjusted by 114,990 for the dilutive effect of options in 2006)	<b>\$ 3.52</b>	<b>\$ 3.01</b>
<b>Dividends declared per share</b>	<b>\$ 1.56</b>	<b>\$ 1.44</b>

See accompanying notes to the consolidated financial statements.

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**MERCURY GENERAL CORPORATION**
**AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited)****Amounts expressed in thousands**

	<b>Three Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Net income	\$ 63,278	\$ 68,227
Other comprehensive income (loss) before tax:		
Unrealized gains (losses) on securities:		
Unrealized holding gains arising during period	29,821	28,427
Reclassification adjustment for net losses (gains) included in net income	2,419	(299)
Other comprehensive income before tax	32,240	28,128
Income tax expense related to unrealized holding gains arising during period	10,437	9,933
Income tax expense (benefit) related to reclassification adjustment for net losses (gains) included in net income	847	(104)
Comprehensive income, net of tax	\$ 84,234	\$ 86,526

See accompanying notes to the consolidated financial statements.

**MERCURY GENERAL CORPORATION**

**AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(Unaudited)**

**Amounts expressed in thousands**

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Net income	\$ 193,240	\$ 164,685
Other comprehensive income (loss) before tax:		
Unrealized gains (losses) on securities:		
Unrealized holding gains arising during period	21,348	2,181
Reclassification adjustment for net gains included in net income	(4,311)	(6,601)
Other comprehensive income (loss) before tax	17,037	(4,420)
Income tax expense related to unrealized holding gains arising during period	7,472	757
Income tax benefit related to reclassification adjustment for net gains included in net income	(1,509)	(2,310)
Comprehensive income, net of tax	\$ 204,314	\$ 161,818

See accompanying notes to the consolidated financial statements.

**MERCURY GENERAL CORPORATION**  
**AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

Amounts expressed in thousands

	Nine Months Ended September 30,	
	2007	2006
Cash flows from operating activities:		
Net income	\$ 193,240	\$ 164,685
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	19,486	17,803
Net realized investment gains	(10,996)	(13,376)
Bond amortization, net	4,264	3,371
Excess tax benefit from exercise of stock options	(203)	(489)
Increase in premiums receivable	(14,506)	(10,694)
Increase in premium notes	(1,737)	(3,966)
Increase in deferred policy acquisition costs	(5,867)	(15,777)
Increase in unpaid losses and loss adjustment expenses	8,856	42,461
Increase in unearned premiums	23,455	60,798
Increase in accounts payable and accrued expenses	5,562	18,872
(Decrease) Increase in accrued income taxes, excluding deferred tax on change in unrealized gain	(8,879)	20,872
Net increase in trading securities	(6,064)	
Share-based compensation	388	894
Other, net	(558)	7,719
 Net cash provided by operating activities	 206,441	 293,173
Cash flows from investing activities:		
Fixed maturities available for sale:		
Purchases	(1,419,283)	(1,817,114)
Sales	1,163,314	1,056,826
Calls or maturities	261,920	517,520
Equity securities available for sale:		
Purchases	(413,946)	(331,370)
Sales	376,903	308,309
Increase in payable for securities, net	4,085	21,638
Net (increase) decrease in short-term investments	(49,698)	32,025
Purchase of fixed assets	(32,437)	(22,533)
Sale of fixed assets	924	935
Other, net	(3,499)	9,273
 Net cash used in investing activities	 \$ (111,717)	 \$ (224,491)

(Continued)



**MERCURY GENERAL CORPORATION**  
**AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Continued)

	<b>Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Cash flows from financing activities:</b>		
Dividends paid to shareholders	\$ (85,342)	\$ (78,719)
Proceeds from stock options exercised	1,979	1,866
Mortgage loan pay-off	(11,250)	
Excess tax benefit from exercise of stock options	203	489
<b>Net cash used in financing activities</b>	<b>(94,410)</b>	<b>(76,364)</b>
<b>Net increase (decrease) in cash</b>	<b>314</b>	<b>(7,682)</b>
<b>Cash:</b>		
Beginning of the period	47,606	69,784
End of the period	\$ 47,920	\$ 62,102
<b>Supplemental disclosures of cash flow information:</b>		
Interest paid during the period	\$ 8,618	\$ 8,490
Income taxes paid during the period	\$ 76,311	\$ 60,162
See accompanying notes to the consolidated financial statements.		

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**MERCURY GENERAL CORPORATION & SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles ( GAAP ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant assumptions in the preparation of these consolidated financial statements relate to losses and loss adjustment expenses. Actual results could differ materially from those estimates (See Note 1 Significant Accounting Policies of Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2006).

The financial data of Mercury General Corporation and its subsidiaries (collectively, the Company ) included herein have been prepared without audit. In the opinion of management, all material adjustments of a normal recurring nature necessary to present fairly the Company s financial position at September 30, 2007 and the results of operations, comprehensive income and cash flows for the periods presented have been made. Operating results and cash flows for the nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

Certain reclassifications have been made to the prior-period balances to conform to the current-period presentation.

**2. Recently Adopted Accounting Standards**

Effective January 1, 2007, the Company adopted the Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN No. 48 ). FIN No. 48 provides guidance on financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return related to uncertainties in income taxes. FIN No. 48 prescribes a more-likely-than-not recognition threshold that must be met before a tax benefit can be recognized in the financial statements. For a tax position that meets the recognition threshold, the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement is recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company s adoption of FIN No. 48 did not have a material impact on its consolidated financial statements.

Effective January 1, 2007, the Company adopted the American Institute of Certified Public Accountants ( AICPA ) Statement of Position 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts ( SOP 05-1 ). SOP 05-1 provides accounting guidance for deferred policy acquisition costs associated with internal replacements of insurance and investment contracts other than those already described in Statement of Financial Accounting Standards ( SFAS ) No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments. SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverages that occurs by the exchange of a contract for a new contract, or by amendment, endorsement or rider to a contract, or by the election of a feature or coverage within a contract. The provisions of SOP 05-1 are effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The Company s adoption of SOP 05-1 did not have a material impact on its consolidated financial statements.

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**MERCURY GENERAL CORPORATION & SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Effective January 1, 2007, the Company adopted SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140 ( SFAS No. 155 ). The provisions of SFAS No. 155 are effective for all financial instruments acquired or issued after the beginning of the first fiscal year after September 15, 2006. SFAS No. 155 amends the accounting for hybrid financial instruments and eliminates the exclusion of beneficial interests in securitized financial assets from the guidance under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. It also eliminates the prohibition on the type of derivative instruments that qualified special purpose entities may hold under SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. Furthermore, SFAS No. 155 clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. The Company's adoption of SFAS No. 155 did not have a material impact on its consolidated financial statements.

**3. Investments**

The Company monitors investments that have declined in fair value below net book value and if the decline is judged to be other-than-temporary, the asset is written down to its fair value in accordance with Statement of Financial Accounting Standards No. 115 ( SFAS No. 115 ), as amended, Accounting for Certain Investments in Debt and Equity Securities. The Company wrote down approximately \$8.6 million (\$5.6 million after tax) and \$2.0 million (\$1.3 million after tax) of its investments as other-than-temporary declines during the first nine months of 2007 and 2006, respectively.

**4. Stock-Based Compensation**

Effective January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123R ), using the modified prospective transition method. Under this transition method, share-based compensation expense includes compensation expense for all share-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation. Share-based compensation expense for all share-based payment awards granted or modified on or after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. The Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, which is the option vesting term of generally five years, for only those shares expected to vest. The fair value of stock option awards is estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair values.

**5. Accounting for Uncertainty in Income Taxes**

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various states. Tax years that remain subject to examination by major taxing jurisdictions are 2004 through 2006 for federal taxes and 2001 through 2006 for California state taxes.

The total amount of unrecognized tax benefits at implementation of FIN No. 48 as of January 1, 2007, excluding consideration of expected offsetting federal tax benefits and accrued interest expense, was \$7,382,000. Of this total, \$2,266,000, net of federal tax benefit and including interest expense, represents exposures which, if recognized, would affect the Company's effective tax rate.

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**MERCURY GENERAL CORPORATION & SUBSIDIARIES**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company does not expect any changes in unrecognized tax benefits within the next 12 months to have any significant impact on its consolidated financial statements. The Company recognizes interest and assessed penalties related to unrecognized tax benefits as part of income taxes. As of January 1, 2007, the Company had accrued \$260,000 of interest related to unrecognized tax benefits. During the three and nine months ended September 30, 2007, the changes in the liability for uncertain tax positions had no material impact on the Company's consolidated financial statements.

The Company is under examination by the state of California taxing authority for tax years 2001, 2002 and 2004. The taxing authority has proposed significant adjustments to the Company's California tax liabilities. Management does not believe that the ultimate outcome of this examination will have a material impact on the Company's financial position. However, an unfavorable outcome may have a material impact on the Company's results of operations in the period of such resolution.

**6. Recently Issued Accounting Standards**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently assessing the impact of adopting SFAS No. 157 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 (SFAS No. 159). SFAS No. 159 permits an entity to measure certain financial assets and financial liabilities at fair value. The main objective of SFAS No. 159 is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. Entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. SFAS No. 159 establishes presentation and disclosure requirements to help financial statement users understand the effect of the entity's election on its earnings, but does not eliminate disclosure requirements of other accounting standards. SFAS No. 159 is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. SFAS No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. The Company is currently assessing the impact of adopting SFAS No. 159 on its consolidated financial statements.

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

### General

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

The Company utilizes standard industry measures to report operating results that may not be presented in accordance with GAAP. Included within Management's Discussion and Analysis of Financial Condition and Results of Operations is net premiums written, a non-GAAP financial measure, which represents the premiums charged on policies issued during a fiscal period less any reinsurance. This measure is not intended to replace, and should be read in conjunction with, the Company's GAAP financial results and is reconciled to the most directly comparable GAAP measure, earned premiums, below in Results of Operations.

The Company is headquartered in Los Angeles, California and operates primarily as a personal automobile insurer, selling policies through a network of independent producers. The Company also offers homeowners insurance, mechanical breakdown insurance, commercial and dwelling fire insurance, umbrella insurance, commercial automobile insurance and commercial property insurance. Private passenger automobile lines of insurance accounted for approximately 84% of the Company's \$2,282 million of net written premiums in the first nine months of 2007.

The Company operates primarily in California, the only state in which it operated prior to 1990. The Company has since expanded its operations into the following states: Georgia and Illinois (1990), Oklahoma and Texas (1996), Florida (1998), Virginia and New York (2001), New Jersey (2003), and Arizona, Pennsylvania, Michigan and Nevada (2004). California accounted for approximately 77% and 73% of the Company's net written premiums during the nine months ended September 30, 2007 and 2006, respectively.

### Regulatory and Litigation Matters

The Department of Insurance (DOI) in each state in which the Company operates conducts periodic financial and market conduct examinations of the Company's insurance subsidiaries domiciled within the respective state. The Georgia DOI conducted a financial examination of the Company's Georgia insurance subsidiaries for the period January 1, 2001 through December 31, 2003. No material matters were noted in the final report of this examination issued in July 2007. The Virginia DOI conducted a market conduct examination of Mercury Casualty Company in 2007 for the period of January 1, 2006 through June 30, 2006. No material matters were noted in the final report of this examination issued in August 2007. The California DOI is conducting a rating and underwriting examination of the business written in California in the 2004, 2005, and 2006 underwriting years. The examination is in its early stages. The California DOI has notified the Company that it will begin its financial examination of the Company during the 4<sup>th</sup> quarter of 2007.

On July 14, 2006, the California Office of Administrative Law approved proposed regulations by the California DOI that effectively reduce the weight that insurers can place on a person's residence when establishing automobile insurance rates. Insurance companies in California are now required to file rating plans with the California DOI that comply with the new regulations. There is a two year phase-in period for insurers to fully implement those plans. As such, the Company made a rate filing in August 2006 that reduced the territorial impact of its rates and requested a small overall rate increase. Additional rate filings will be required during the two year phase-in period. The DOI has not yet approved the August 2006 filing, nor is there any assurance that it will. In general, the Company expects that the regulations will cause rates for urban drivers to decrease and those for non-urban drivers to increase. These rate changes are likely to increase consumer shopping for insurance which could affect the volume and the retention rates of the Company's business. It is the Company's intention to maintain its competitive position in the marketplace while complying with the new regulations.

In April 2007, new regulations governing the approval of property and casualty insurance rates became effective in California. These regulations generally tighten the existing Proposition 103 prior approval ratemaking regime primarily by establishing a maximum allowable rate of return of currently just below 11 percent (the average of short, intermediate and long-term T-bill rates, plus 6 percent) and a minimum allowable rate of return of negative 6 percent of surplus. However, the practical impact of these limitations is unclear because the new regulations allow for the California DOI to grant a number of variances based on loss prevention, business mix, service to underserved communities, and other factors.

On January 31, 2006, the Florida Financial Services Commission approved new regulations requiring insurers to submit information to the Florida Office of Insurance Regulation ( OIR ) regarding the use of credit reports and credit scores in establishing rules, rates or underwriting guidelines. Under the regulations, any insurer that uses credit scores or credit reports in filing a new rule, rate or underwriting guideline will be required to provide information sufficient to demonstrate that its credit scoring methodology does not disproportionately affect persons of any particular race, color, religion, marital status, age, gender, income level or place of residence. The regulations were challenged by several insurance industry trade associations and were recently struck down by a Florida Administrative Law Judge. However, the OIR has subsequently proposed the regulations again.

In the January 2007 special session of the Florida legislature, a bill designed to improve the availability and affordability of property insurance in Florida was passed and subsequently signed by the Governor. Among the significant provisions in the new law is a requirement that all companies that write private passenger automobile policies in Florida also write homeowners policies in the state if they write homeowners policies in any other state. The law also expands the availability of reinsurance through the Florida Hurricane Catastrophe Fund, requires rate filings to reflect savings from the availability of such reinsurance, includes homeowners insurance under Florida's existing excess profits regulations, and requires insurers to offer discounts for various deductible options and hurricane mitigation measures. The Company has made the rate filings required by the new law, and is prepared to comply with all provisions as they become effective. The initial rate impact of the new law has not met the expectations of some Florida governmental leaders, and the law may therefore be subject to further enhancements in the next legislative session. The Company is closely monitoring these developments.

In October 2007, Florida's personal injury protection ( PIP ) expired as a required coverage. The Florida legislature failed to renew the requirement that automobile insurers offer PIP coverage during its regular session. Subsequently, the Governor has signed a new bill that will reinstate PIP as a required coverage effective January 1, 2008. The Company will continue to offer PIP for new and renewal businesses as an optional coverage through December 31, 2007.

The Company is not able to determine the impact of any of the legal and regulatory changes described above. However, it is possible that the impact of some of the changes could adversely affect the Company and its operating results.

The Company is, from time to time, named as a defendant in various lawsuits incidental to its insurance business. In most of these actions, plaintiffs assert claims for punitive damages which are not insurable under judicial decisions. The Company has established reserves for lawsuits in which the Company is able to estimate its potential exposure and the likelihood that the court will rule against the Company is probable. The Company vigorously defends these actions, unless a reasonable settlement appears appropriate. An unfavorable ruling against the Company in the actions currently pending may, but is not likely to, have a material impact on the Company's quarterly results of operations; however, it is not expected to be material to the Company's financial position. For a further discussion of the Company's pending material litigation, see Item 1. Legal Proceedings in Part II Other Information of this Quarterly Report on Form 10-Q and the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

### **Critical Accounting Policies**

#### *Reserves*

The preparation of the Company's consolidated financial statements requires judgment and estimates. The most significant is the estimate of loss reserves as required by Statement of Financial Accounting Standards No. 60, Accounting and Reporting by Insurance Enterprises ( SFAS No. 60 ), and Statement of Financial Accounting

Standards No. 5, Accounting for Contingencies ( SFAS No. 5 ). Estimating loss reserves is a difficult process as many factors can ultimately affect the final settlement of a claim, and therefore, the reserve that is required. Changes in the regulatory and legal environment, results of litigation, medical costs, the cost of repair materials and labor rates, among other factors, can each impact ultimate claim costs. In addition, time can be a critical part of reserving determinations since the longer the span between the incidence of a loss and the payment or settlement of the claim, the more variable the ultimate settlement amount can be. Accordingly, short-tail claims, such as property damage claims, tend to be more reasonably predictable than long-tail liability claims, such as bodily injury claims. Inflation is reflected in the reserving process through analysis of cost trends and reviews of historical reserving results.

The Company engages independent actuarial consultants to review the Company's reserves and to provide the annual actuarial opinions required under state statutory accounting requirements. The Company does not rely on actuarial consultants for GAAP reporting or periodic report disclosure purposes. The Company analyzes loss reserves internally on a quarterly basis using primarily the incurred loss development, average severity and claim count development methods described below. The Company also uses the paid loss development method to analyze loss adjustment expense reserves and at times uses industry claims data as part of its reserve analysis. When deciding which methodologies to use in estimating its reserves, the Company evaluates the credibility of each methodology based on the maturity of the data available and the claims settlement practices for each particular line of business or coverage within a line of business. When establishing the reserve, the Company will generally analyze the results from all of the methods used rather than relying on one method over the others. While these methodologies are designed to determine the ultimate losses on claims under the Company's policies, there is inherent uncertainty in all actuarial models since they generally use historical data to project outcomes. The Company believes that the techniques it uses provide a reasonable basis in estimating loss reserves.

The incurred loss development method analyzes historical incurred case loss (case reserves plus paid losses) development to estimate ultimate losses. The Company applies development factors against current incurred case losses by accident period to calculate ultimate expected losses. The Company believes that the incurred loss development method provides a reasonable basis for evaluating ultimate losses, particularly in the Company's larger, more established lines of business which have a long operating history. The average severity method analyzes historical loss payments and/or incurred losses divided by closed claims and/or total claims to calculate an estimated average cost per claim. From this, the expected ultimate average cost per claim can be estimated. The claim count development method analyzes historical claim count development to estimate future incurred claim count development for current claims. The Company applies these development factors against current claim counts by accident period to calculate ultimate expected claim counts. The average severity method coupled with the claim count development method provides meaningful information regarding inflation and frequency trends that the Company believes is useful in establishing reserves. The paid loss development method analyzes historical payment patterns to estimate the amount of losses yet to be paid. The Company primarily uses this method for loss adjustment expenses because specific case reserves are not established for loss adjustment expenses.

The Company uses varying methods and assumptions in states with little operating history where there is insufficient claims data to prepare a reserve analysis relying solely on the Company's historical data. In these cases, the Company may project ultimate losses using industry average loss data or based on expected loss ratios. As the Company develops an operating history in these states, the Company will rely increasingly on the incurred loss development and average severity and claim count development methods. The Company analyzes catastrophe losses separately from non-catastrophe losses. For these losses, the Company determines claim counts based on claims reported and development expectations from previous catastrophes and applies an average expected loss per claim based on reserves established by adjusters and average losses on previous catastrophes.

At September 30, 2007, the Company recorded its point estimate of approximately \$1,098 million in loss and loss adjustment expense reserves which includes approximately \$321 million of incurred but not reported ( IBNR ) loss reserves. IBNR includes estimates, based upon past experience, of ultimate developed costs which may differ from case estimates, unreported claims which occurred on or prior to September 30, 2007 and estimated future payments for reopened claims. Management believes that the liability for losses and loss adjustment expenses is adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date; however, since the provisions are necessarily based upon estimates, the ultimate liability may be more or less than such provision.

The Company reevaluates its reserves quarterly. When management determines that the estimated ultimate claim cost requires reduction for previously reported accident years, positive development occurs and a reduction in

losses and loss adjustment expenses is reported in the current period. If the estimated ultimate claim cost requires an increase for previously reported accident years, negative development occurs and an increase in losses and loss adjustment expenses is reported in the current period. For the nine months ended September 30, 2007, the Company reported negative development of approximately \$15 million on the 2006 and prior accident years' loss and loss adjustment expense reserves which at December 31, 2006 totaled approximately \$1,089 million. The loss development included approximately \$18 million of negative development from the California operations and approximately \$3 million of positive development from the operations outside of California. The negative development in California resulted from several factors, including a greater number of reported California automobile claims than was anticipated at December 31, 2006 and adverse development on prior accident years' loss reserves for California homeowners business.

For a further discussion of the Company's reserving methods, see the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

#### *Premiums*

The Company complies with SFAS No. 60 in recognizing revenue on insurance policies written. The Company's insurance premiums are recognized as income ratably over the term of the policies, that is, in proportion to the amount of insurance protection provided. Unearned premiums are carried as a liability on the balance sheet and are computed on a monthly pro-rata basis. The Company evaluates its unearned premiums periodically for premium deficiencies by comparing the sum of expected claim costs, unamortized acquisition costs and maintenance costs to related unearned premiums, net of investment income. To the extent that any of the Company's lines of business become substantially unprofitable, a premium deficiency reserve may be required. The Company does not expect this to occur on any of its significant lines of business.

#### *Investments*

The Company carries its fixed maturity and equity investments at market value as required for securities classified as "Available for Sale" and "Trading" by SFAS No. 115, as amended. In most cases, market valuations were drawn from trade data sources. No valuations were made by the Company's management. Equity holdings, including non-sinking fund preferred stocks, are, with minor exceptions, actively traded on national exchanges or trading markets, and were valued at the last transaction price on the balance sheet date. The Company regularly evaluates its investments for other-than-temporary declines and writes them off as realized losses through the consolidated statements of income, as required by SFAS No. 115, as amended, when declines are deemed to be other-than-temporary. SFAS No. 155 allows the Company to include changes in fair value in earnings on an instrument-by-instrument basis for certain hybrid financial instruments that contain an embedded derivative that would otherwise be required to be bifurcated and accounted for separately under SFAS No. 133. Temporary unrealized gains and losses for investments available for sale, except for those accounted for under SFAS No. 133 and SFAS No. 155, are credited or charged directly to shareholders' equity as part of accumulated other comprehensive income (loss), net of applicable taxes. It is possible that in the future, information will become available about the Company's current investments that would require accounting for them as realized losses due to other-than-temporary declines in value. The financial statement effect would be to reclassify the unrealized loss from accumulated other comprehensive income (loss) on the consolidated balance sheet to realized investment losses on the consolidated statements of income. Changes in fair value for those investments accounted for under SFAS No. 133 and SFAS No. 155, as well as for trading securities accounted for under SFAS No. 115, are reflected in net realized gains or losses in the consolidated statements of income.

#### *Contingent Liabilities*

The Company may have certain known and unknown potential liabilities that are evaluated using the criteria established by SFAS No. 5. These include claims, assessments or lawsuits relating to its business. The Company continually evaluates these potential liabilities and accrues for them and/or discloses them in the notes to the consolidated financial statements if they meet the requirements stated in SFAS No. 5. While it is not possible to know with certainty the ultimate outcome of contingent liabilities, an unfavorable result may have a material impact on the Company's quarterly results of operations; however, it is not expected to be material to the Company's financial position.



## Forward-Looking Statements

Certain statements in this report on Form 10-Q that are not historical facts constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements may address, among other things, the Company's strategy for growth, business development, regulatory approvals, market position, expenditures, financial results and reserves. Forward-looking statements are not guarantees of performance and are subject to important factors and events that could cause the Company's actual business, prospects and results of operations to differ materially from the historical information contained in this Form 10-Q and from those that may be expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, among others: the competition currently existing in the California automobile insurance markets, the Company's success in expanding its business in states outside of California, the Company's ability to successfully complete its initiative to standardize its policies and procedures nationwide in all of its functional areas, the impact of potential third party bad-faith legislation, changes in laws or regulations, the ultimate outcome of tax position challenges by the California Franchise Tax Board, and decisions of courts, regulators and governmental bodies, particularly in California, the Company's ability to obtain and the timing of the approval of premium rate changes for private passenger automobile policies issued in states where the Company does business, the investment yields the Company is able to obtain with its investments in comparison to recent yields and the market risk associated with the Company's investment portfolio, the cyclical and general competitive nature of the property and casualty insurance industry and general uncertainties regarding loss reserve or other estimates, the accuracy and adequacy of the Company's pricing methodologies, uncertainties related to assumptions and projections generally, inflation and changes in economic conditions, changes in driving patterns and loss trends, acts of war and terrorist activities, court decisions and trends in litigation and health care and auto repair costs, adverse weather conditions or natural disasters in the markets served by the Company, the stability of the Company's information technology systems and the ability of the Company to execute on its information technology initiatives, and other uncertainties, all of which are difficult to predict and many of which are beyond the Company's control. GAAP prescribes when a Company may reserve for particular risks including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain periods. The Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information or future events or otherwise. Investors are cautioned not to place undue reliance on any forward-looking statements, which speak only as of the date of this Form 10-Q or, in the case of any document the Company incorporates by reference, the date of that document. Investors also should understand that it is not possible to predict or identify all factors and should not consider the risks set forth above to be a complete statement of all potential risks and uncertainties. If the expectations or assumptions underlying the Company's forward-looking statements prove inaccurate or if risks or uncertainties arise, actual results could differ materially from those predicted in any forward-looking statements. The factors identified above are believed to be some, but not all, of the important factors that could cause actual events and results to be significantly different from those that may be expressed or implied in any forward-looking statements. Any forward-looking statements should also be considered in light of the information provided in Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 and in Item 1A. Risk Factors in Part II Other Information of this Quarterly Report on Form 10-Q.

## Results of Operations

### *Three Months Ended September 30, 2007 compared to Three Months Ended September 30, 2006*

Premiums earned in the third quarter of 2007 decreased approximately 0.6% from the corresponding period in 2006. Net premiums written in the third quarter of 2007 decreased approximately 2.2% from the corresponding period in 2006. Net premiums written on the California automobile lines of business were \$521.5 million in the third quarter of 2007, a 2.1% increase over the corresponding period in 2006. Net premiums written by the Company's non-California operations were \$171.1 million in the third quarter of 2007, a 15.7% decrease over the corresponding period in 2006. The decrease in net premiums written is primarily due to a decrease in the number of policies written by the Company's non-California operations, mostly in New Jersey and Florida which are experiencing a significant amount of competition.

Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed

to determine production levels. Net premiums earned, the most directly comparable GAAP measure, represents the portion of net premiums written that is recognized as income in the financial statements for the period presented. The following is a reconciliation of total Company net premiums written to net premiums earned for the quarters ended September 30, 2007 and 2006, respectively:

	Quarter Ended September 30,	
	2007	2006
	(Amounts in thousands)	
Net premiums written	\$ 758,849	\$ 776,186
Increase in unearned premiums	(10,051)	(23,064)
<b>Earned premiums</b>	<b>\$ 748,798</b>	<b>\$ 753,122</b>

The loss ratio (GAAP basis) in the third quarter (loss and loss adjustment expenses related to premiums earned) was 66.5% in 2007 and 65.2% in 2006. There was negative development of approximately \$2 million and approximately \$3 million on prior accident years' loss reserves for the quarters ended September 30, 2007 and 2006, respectively. Excluding the effect of prior accident years' loss development, the loss ratio in the third quarter was 66.2% in 2007 and 64.8% in 2006. The increase in the loss ratio excluding the effect of prior accident years' loss development is primarily due to higher average loss severities in the 2007 accident year resulting from inflation.

The expense ratio (GAAP basis) in the third quarter of 2007 (policy acquisition costs and other expenses related to premiums earned) of 27.7% is not significantly different from 27.8% in the corresponding period of 2006. The majority of expenses vary directly with premiums.

The combined ratio of losses and expenses (GAAP basis) is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results; a combined ratio over 100% generally reflects unprofitable underwriting results. The combined ratio of losses and expenses (GAAP basis) was 94.2% in the third quarter of 2007 compared with 93.0% in the corresponding period of 2006, which indicates that the Company's underwriting performance contributed \$43.2 million to the Company's income before income taxes of \$83.7 million during the 2007 period versus contributing \$52.8 million to the Company's income before income taxes of \$91.4 million in the 2006 period.

Investment income in the third quarter of 2007 was \$39.2 million, compared with \$36.9 million in the third quarter of 2006. The after-tax yield on average investments (fixed maturities and equities valued at cost) was 3.9% in the third quarter of 2007 compared to 3.7% in the corresponding period of 2006 on average invested assets of \$3,498 million and \$3,358 million, respectively. The increase in after-tax yield is largely due to overall higher yields earned on new purchases in the investment portfolio, which reflects higher market interest rates in 2006 and 2007 when compared to earlier periods.

The income tax provision in the third quarter of 2007 of \$20.4 million represented an effective tax rate of 24% compared with an effective rate of 25% in the corresponding period of 2006. The lower rate in 2007 compared to 2006 is primarily attributable to an increased proportion of tax exempt investment income including tax sheltered dividend income, in contrast to taxable investment income and underwriting income.

Net income for the third quarter 2007 of \$63.3 million, or \$1.15 per share (diluted), compares with \$68.2 million, or \$1.25 per share (diluted), in the corresponding period of 2006. Basic net income per share was \$1.16 in the third quarter of 2007 and \$1.25 in the third quarter of 2006.

*Nine Months Ended September 30, 2007 compared to Nine Months Ended September 30, 2006*

Premiums earned in the nine months ended September 30, 2007 increased approximately 0.7% from the corresponding period in 2006. Net premiums written in the nine months ended September 30, 2007 decreased approximately 1.0% from the corresponding period in 2006. Net premiums written on the California automobile lines of business were \$1,564.7 million in the first nine months of 2007, an increase of 3.5% over the same period in 2006. Net premiums written by the Company's non-California operations were \$525.5 million in the nine months ended September 30, 2007, a decrease of approximately 14.2% over the same period in 2006. The decrease in net

premiums written is primarily due to a decrease in the number of policies written by the Company's non-California operations, mostly in New Jersey and Florida, which are experiencing a significant amount of competition. The decrease is partially offset by a slight increase in the number of policies written by the Company's California operations and an increase in the average premium collected per policy. In addition, the Company accrued a liability for coupons at June 30, 2007 that are expected to be issued and redeemed as part of the Donabedian litigation (see *Sam Donabedian, individually and on behalf of those similarly situated v. Mercury Insurance Company, et al.* in Item 1. Legal Proceedings in Part II-Other Information). These coupons will be redeemable for \$25 or \$45 towards new or renewal premiums. The impact of the accrual is a \$5 million reduction in premiums written and earned for the nine months ended September 30, 2007.

Net premiums written is a non-GAAP financial measure which represents the premiums charged on policies issued during a fiscal period less any applicable reinsurance. Net premiums written is a statutory measure designed to determine production levels. Net premiums earned, the most directly comparable GAAP measure, represents the portion of net premiums written that is recognized as income in the financial statements for the period presented and earned on a pro-rata basis over the term of the policies. The following is a reconciliation of total Company net premiums written to net premiums earned for the nine months ended September 30, 2007 and 2006, respectively:

	Nine Months Ended September 30,	
	2007	2006
	(Amounts in thousands)	
Net premiums written	\$ 2,282,126	\$ 2,304,032
Increase in unearned premiums	(23,500)	(60,880)
<b>Earned premiums</b>	<b>\$ 2,258,626</b>	<b>\$ 2,243,152</b>

The loss ratio (GAAP basis) in the first nine months (loss and loss adjustment expenses related to premiums earned) was 66.9% in 2007 and 66.9% in 2006. There was negative development of approximately \$15 million and approximately \$18 million on prior accident years' loss reserves for the nine months ended September 30, 2007 and 2006, respectively. Excluding the effect of prior accident years' loss development, the loss ratio in the first nine months was 66.3% in 2007 and 66.1% in 2006. The slight increase in the loss ratio excluding the effect of prior accident years' loss development is primarily due to higher average loss severities in the 2007 accident year resulting from inflation, partially offset by an increase in the average premium collected per policy.

The expense ratio (GAAP basis) in the first nine months of 2007 (policy acquisition costs and other operating expenses related to premiums earned) was 27.3% compared to 27.6% in the corresponding period of 2006. Other operating expenses for the first nine months of 2006 included a goodwill impairment charge of \$3 million. Excluding this charge, the expense ratio in the first nine months of 2006 was 27.5%, which is not significantly different from that in the same period of 2007. The majority of expenses vary directly with premiums.

The combined ratio of losses and expenses (GAAP basis) is the key measure of underwriting performance traditionally used in the property and casualty insurance industry. A combined ratio under 100% generally reflects profitable underwriting results; a combined ratio over 100% generally reflects unprofitable underwriting results. The combined ratio of losses and expenses (GAAP basis) was 94.2% in the first nine months of 2007 compared with 94.5% in the corresponding period of 2006, which indicates that the Company's underwriting performance contributed \$130.0 million to the Company's income before income taxes of \$260.3 million during the 2007 period versus contributing \$123.5 million to the Company's income before income taxes of \$246.2 million in the 2006 period.

Investment income for the first nine months of 2007 was \$122.2 million, compared with \$112.5 million in the first nine months of 2006. The after-tax yield on average investments (fixed maturities and equities valued at cost) was 4.0% in the first nine months of 2007 compared to 3.8% in the corresponding period of 2006 on average invested assets of \$3,452 million and \$3,291 million, respectively. The increase in after-tax yield is largely due to overall higher yields earned on new purchases in the investment portfolio, which is reflective of higher market interest rates in 2006 and 2007 when compared to earlier periods.

The income tax provision in the first nine months of 2006 of \$81.5 million was impacted significantly by a \$15 million income tax charge relating to the Notices of Proposed Assessments for the tax years 1993 through 1996 (the NPAs) that were upheld by the California State Board of Equalization. Excluding the effect of this income tax charge results in an effective tax rate of 27% in 2006 compared with an effective rate of 26% in the corresponding period of 2007. The lower rate in 2007 is primarily attributable to an increased proportion of tax exempt investment income including tax sheltered dividend income, in contrast to taxable investment income and underwriting income.

Net income for the first nine months of 2007 of \$193.2 million, or \$3.52 per share (diluted), compares with \$164.7 million, or \$3.01 per share (diluted), in the corresponding period of 2006. Basic net income per share was \$3.53 in the first nine months of 2007 and \$3.01 in the first nine months of 2006.

### Liquidity and Capital Resources

Net cash provided by operating activities in the first nine months of 2007 was \$206.4 million, a decrease of \$86.7 million over the same period in 2006. This decrease was primarily due to higher losses and loss adjustment expenses paid in relation to premiums collected during the first nine months of 2007 when compared with the same period in 2006. The Company has utilized the cash provided from operating activities primarily for its investment in fixed maturity and equity securities, the purchase and development of information technology and the payment of dividends to its shareholders. Funds derived from the sale, redemption or maturity of fixed maturity investments of \$1,425.2 million were reinvested by the Company generally in highly-rated fixed maturity securities.

The Company's cash and short-term investment portfolio totaled \$379.9 million at September 30, 2007. Together with cash flows from operations, the Company believes that such liquid assets are adequate to satisfy its liquidity requirements without the forced sale of investments. However, the Company operates in a rapidly evolving and often unpredictable business environment that may change the timing or amount of expected future cash receipts and expenditures. Accordingly, there can be no assurance that the Company's sources of funds will be sufficient to meet its liquidity needs or that the Company will not be required to raise additional funds to meet those needs, including future business expansion, through the sale of equity or debt securities or from credit facilities with lending institutions.

The following table sets forth the composition of the total investment portfolio of the Company as of September 30, 2007:

	Cost or amortized cost	Market value
	(Amounts in thousands)	
<b>Fixed maturity securities:</b>		
U.S. government bonds and agencies	\$ 38,453	\$ 38,156
States, municipalities and political subdivisions	2,413,833	2,438,568
Mortgage-backed securities	241,527	241,926
Corporate securities	139,005	134,596
Redeemable preferred stock	2,079	2,079
	2,834,897	2,855,325
<b>Equity securities:</b>		
<b>Common Stock:</b>		
Public utilities	41,783	85,282
Banks, trusts and insurance companies	18,702	20,283
Industrial and other	235,062	294,473
Non-redeemable preferred stock	24,913	25,577
	320,460	425,615
<b>Short-term cash investments</b>	<b>332,000</b>	<b>332,000</b>
<b>Total investments</b>	<b>\$ 3,487,357</b>	<b>\$ 3,612,940</b>

The market value of total investments held at market exceeded amortized cost at September 30, 2007 by \$125.6 million (\$81.6 million, net of applicable tax effects) compared to \$107.4 million (\$69.8 million, net of applicable tax effects) at December 31, 2006. During the first nine months of 2007, the Company recognized approximately \$11.0 million in net realized gains which included approximately \$8.6 million (\$5.6 million after taxes) in write-downs of investments as other-than-temporary declines, approximately \$1.0 million gain (\$0.7 million



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after taxes) related to the change in the fair value of hybrid financial instruments, and approximately \$0.4 million gain (\$0.3 million after taxes) related to the change in the fair value of trading securities.

At September 30, 2007, the average rating of the \$2,853.2 million bond portfolio at market (amortized cost \$2,832.8 million) was AA, unchanged from December 31, 2006. Bond holdings are broadly diversified geographically, within the tax-exempt sector. Holdings in the taxable sector consist principally of investment grade issues. At September 30, 2007, bond holdings rated below investment grade totaled \$46.3 million at market (amortized cost \$43.0 million) representing approximately 1.3% of total investments. This compares to approximately \$48.6 million at market (amortized cost \$43.8 million) representing approximately 1.4% of total investments at December 31, 2006.

The entire mortgage-backed securities ( CMO ) portfolio consists of loans to prime borrowers except for approximately \$20 million (amortized cost and market value) of Alt-A CMO s. Alt-A mortgages are generally home loans made to individuals that have credit scores as high as prime borrowers, but provide less documentation of their finances on their credit applications. All of the Company s Alt-A CMO s are currently rated AAA and the overall rating of the entire CMO portfolio is AAA.

Equity holdings consist of perpetual preferred stocks and dividend-bearing common stocks on which dividend income is partially tax-sheltered by the 70% corporate dividend exclusion. At September 30, 2007, short-term cash investments consisted of highly rated short duration securities redeemable on a daily or weekly basis. The Company does not have any material direct equity investment in subprime lenders.

The Company monitors its investments closely. If an unrealized loss is determined to be other-than-temporary, it is written off as a realized loss through the consolidated statements of income in the period of such determination. The Company s assessment of other-than-temporary impairments is based on security-specific analysis as of the balance sheet date and considers various factors including the length of time and the extent to which the fair value has been lower than the cost, the financial condition and the near-term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, and the Company s ability and intent to hold the investment for a period of time sufficient to allow the security to recover its value.

The following table illustrates the gross unrealized losses on securities available for sale and the fair value of those securities, aggregated by investment category as of September 30, 2007. The table also illustrates the length of time that they have been in a continuous unrealized loss position.

	Less than 12 months		12 months or more		Total	
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
	(Amounts in thousands)					
U.S. government bonds and agencies	\$ 396	\$ 17,561	\$ 7	\$ 7,692	\$ 403	\$ 25,253
States, municipalities and political subdivisions	18,120	996,361	3,552	182,428	21,672	1,178,789
Corporate securities	1,742	31,567	4,643	69,932	6,385	101,499
Mortgage-backed securities	212	20,814	1,674	80,366	1,886	101,180
Redeemable preferred stock			9	1,185	9	1,185
Subtotal, debt securities	\$ 20,470	\$ 1,066,303	\$ 9,885	\$ 341,603	\$ 30,355	\$ 1,407,906
Equity securities	5,126	58,411	734	6,748	5,860	65,159
Total temporarily impaired securities	\$ 25,596	\$ 1,124,714	\$ 10,619	\$ 348,351	\$ 36,215	\$ 1,473,065

The \$36.2 million gross unrealized losses on securities available for sale represents 1.04% of total investments at amortized cost. These unrealized losses consist mostly of individual securities with unrealized losses of less than 20% of each security s amortized cost. Of these, the most significant unrealized loss relates to one corporate bond with an unrealized loss of approximately \$1.3 million and with a market value decline of 10% of amortized cost. Approximately \$1.8 million of the total gross unrealized losses relate to 20 individual equity securities and two fixed maturity securities with unrealized losses that exceed 20% of each security s amortized cost. Of these, the most significant unrealized losses relate to four equity securities totaling \$1.2 million, with an individual unrealized loss between \$0.1 million and \$0.5 million and with a market value decline between 29% and 40% of amortized cost.

Based upon the Company's analysis of the securities, which includes the status of debt servicing for fixed maturities and third party analyst estimates for the equity securities, and the Company's intent and ability to hold the securities until they mature or recover their costs, the Company has concluded that the gross unrealized losses of \$36.2 million on securities available for sale were temporary in nature at September 30, 2007. However, facts and circumstances in future periods may change, which could result in a decline in market value considered to be other-than-temporary.

The following table illustrates the gross unrealized losses on securities available for sale and the fair value of those securities, aggregated by investment category as of December 31, 2006. The table also illustrates the length of time that they had been in a continuous unrealized loss position.

	Less than 12 months		12 months or more		Total	
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
	(Amounts in thousands)					
U.S. government bonds and agencies	\$ 127	\$ 34,167	\$ 1,165	\$ 84,517	\$ 1,292	\$ 118,684
States, municipalities and political subdivisions	3,140	436,060	3,555	181,190	6,695	617,250
Corporate securities	927	39,263	4,626	61,136	5,553	100,399
Mortgage-backed securities	1,043	83,784	1,823	70,457	2,866	154,241
Redeemable preferred stock	27	2,772			27	2,772
Subtotal, debt securities	\$ 5,264	\$ 596,046	\$ 11,169	\$ 397,300	\$ 16,433	\$ 993,346
Equity securities	5,153	48,653	684	15,323	5,837	63,976
Total temporarily impaired securities	\$ 10,417	\$ 644,699	\$ 11,853	\$ 412,623	\$ 22,270	\$ 1,057,322

Unrealized losses that have been in a continuous unrealized loss position over 12 months are mostly accounted for by unrealized losses of fixed maturity securities, and amounted to 0.29% of the total investment market value at September 30, 2007 compared to 0.34% at December 31, 2006. The increase from December 31, 2006 to September 30, 2007 in the total unrealized losses is primarily in the less than 12 months category and relates primarily to the general credit market disruption experienced during the quarter ended September 30, 2007.

Industry and regulatory guidelines suggest that the ratio of a property and casualty insurer's annual net premiums written to statutory policyholders' surplus should not exceed 3 to 1. Based on the combined surplus of all of the licensed insurance subsidiaries of \$1.7 billion at September 30, 2007 and net written premiums for the twelve months ended on that date of \$3.0 billion, the ratio of writings to surplus was approximately 1.8 to 1.

The Company's book value per share at September 30, 2007 was \$33.73 per share.

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

There have been no material changes in the Company's investment strategies, types of financial instruments held or the risks associated with such instruments which would materially alter the market risk disclosures made in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

### Item 4. Controls and Procedures

#### *Evaluation of Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.





As required by Securities and Exchange Commission Rule 13a-15(b), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

*Changes in Internal Control over Financial Reporting*

There has been no change in the Company's internal control over financial reporting during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect the Company's internal control over financial reporting. The Company's process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies which may be identified during this process.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is, from time to time, named as a defendant in various lawsuits incidental to its insurance business. In most of these actions, plaintiffs assert claims for punitive damages which are not insurable under judicial decisions. The Company has established reserves for lawsuits in which the Company is able to estimate its potential exposure and the likelihood that the court will rule against the Company is probable. The Company vigorously defends these actions, unless a reasonable settlement appears appropriate. An unfavorable ruling against the Company in the actions currently pending may have a material impact on the Company's quarterly results of operations; however, it is not expected to be material to the Company's financial position. Also, see the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

*Sam Donabedian, individually and on behalf of those similarly situated v. Mercury Insurance Company, et al.*, was originally filed on April 20, 2001 in the Los Angeles Superior Court, asserting, among other things, a claim that the Company's calculation of persistency discounts to determine premiums is an unfair business practice, a violation of the California Consumer Legal Remedies Act ( CLRA ) and a breach of the covenant of good faith and fair dealing. The Company originally prevailed on a Demurrer to the Complaint and the case was dismissed; however, the California Court of Appeal reversed the trial court's ruling, deciding that the California Insurance Commissioner does not have the exclusive right to review the calculation of insurance rates/premiums. After filing two additional pleadings, on June 28, 2005, the Plaintiff filed a Fourth Amended Complaint asserting claims for violation of California Business & Professions Code Section 17200 and breach of the covenant of good faith and fair dealing (the CLRA claim previously had been dismissed with prejudice). Plaintiff again sought injunctive relief, unspecified restitution and monetary damages as well as punitive damages and attorneys' fees and costs. Without leave of court, the Plaintiff also attempted to state claims for breach of contract and fraud. The Company filed a Demurrer and Motion to Strike certain portions of the Plaintiff's Fourth Amended Complaint. Following a hearing on September 19, 2005, the Court took the matter under submission. While the motions were under submission, counsel for the Plaintiff asked Mercury to engage in settlement discussions. The Court agreed to stay the matter and counsel for the Plaintiff and the Company met on several occasions to seek resolution, but none was reached.

Additionally, over the Company's objection, on May 9, 2005, the trial court permitted The Foundation for Taxpayer and Consumer Rights ( FTCR ) to file a Complaint in Intervention to allege that the Company's calculation of persistency discounts constitutes a violation of insurance Code Section 1861.02(a) and (c). Following a ruling by the Court of Appeal in another case which found that there is no private right of action to allege violations of Section 1861.02, the Company brought a motion for judgment on the pleadings to have FTCR's Complaint in Intervention dismissed. That motion was heard on April 28, 2006. Subsequent to the hearing, FTCR filed an amended complaint in intervention, and Mercury again filed a motion for judgment on the pleadings, which the Court denied at a hearing on July 31, 2006. In view of the then on-going settlement discussions with the Plaintiff, the Company did not seek further appellate review of the Court's ruling.

During the fall of 2005, counsel for the Plaintiff and the Company met on several occasions in an effort to resolve the case. FTCR was not invited to participate in these discussions. When Plaintiff and the Company were not able to reach a resolution, the Court ordered the parties to a settlement conference before another judge. On August 1, 2006, following three settlement conferences, the Company and the Plaintiff reached a preliminary settlement which was subject to completion of the class approval process and was also subject to objections and review by the Court. Prior to the hearing scheduled for October 30, 2006, the FTCR filed objections to the proposed settlement. Also, shortly before the hearing, the California DOI filed a letter with the Court contending that the terms of the settlement, which provided for a coupon to class members to be used toward the purchase of new, not renewal business, constituted a discount of insurance rates and thus would be subject to the California DOI's approval. Following several delays and further briefing by the parties, at a hearing on February 5, 2007, the Court declined to give preliminary approval to the proposed settlement. Accordingly, upon the Company's request, the tentative ruling on the Company's demurrer and motion to strike was unsealed. The Court sustained the Company's demurrer to all but the Section 17200 claim, as well as a claim for alleged violation of Insurance Code Section 1861.02 which the parties subsequently stipulated to dismiss. The Court also granted the Company's request to strike the punitive damage claim. On February 27, 2007, the Court determined, at the Company's request, that the Court would initially evaluate the Company's defenses that its conduct was protected by the administrative estoppel and filed rate plan doctrines and thus the Company has no liability in the case and established a schedule for discovery and briefing on these issues. Thereafter, the Company and Plaintiff continued settlement discussions and ultimately were able to reach an agreement which has preliminarily been approved by the Court. The settlement provides for the Company to issue coupons to class members (who do not opt out of the class) that can be used towards new or renewal business in a minimum aggregate amount of \$5 million, and if coupons up to that amount are not redeemed, the difference will go to charities to be designated by the Court. The Company submitted the filing to the DOI for approval and the terms of the settlement were approved by the DOI in September 2007. Accordingly, the Company has mailed notice of the settlement to all class members who will then have a period of time to object or opt out of the settlement if they choose not to participate. A final settlement hearing has been set for December 14, 2007. At that time, in addition to considering any objections to the proposed settlement, the Court also will consider an award of attorneys' fees to Plaintiffs (for which the settlement provides a cap on fees of \$1.575 million with the exact amount to be determined by the Court). FTCR also has indicated its intent to seek attorneys' fees which the Company intends to oppose.

Although the Company continues to believe that it has strong defenses to the action, given the DOI's actions in connection with the Company's application of the persistency discount, the proposed settlement is believed to be a favorable outcome of the case considering the cost, inconvenience and uncertainty of litigation. The Company accrued \$5 million as a reduction in premiums in the second quarter of 2007 as a result of the proposed settlement.

In *Marissa Goodman, on her own behalf and on behalf of all others similarly situated v. Mercury Insurance Company* (Los Angeles Superior Court), filed June 16, 2002, the Plaintiff is challenging the Company's use of certain automated database vendors to assist in valuing claims for medical payments. The Plaintiff filed a motion seeking class action certification to include all of the Company's insureds from 1998 to the present who presented a medical payments claim, had the claim reduced using the computer program and whose claim did not reach the policy limits for medical payments. On January 11, 2007, the Court certified the requested class and class notice has been sent to approximately 14,000 class members. The Company has appealed the class certification ruling, and the Court of Appeal has stayed the case pending their review. The Plaintiff alleges that these automated databases systematically undervalue medical payment claims to the detriment of insureds. The Plaintiff is seeking unspecified actual and punitive damages. Similar lawsuits have been filed against other insurance carriers in the industry. The case has been coordinated with two other similar cases, and also with ten other cases relating to total loss claims. The Court denied the Company's Motion for Summary Judgment holding that there is an issue of fact as to whether Ms. Goodman sustained any damages as a result of the Company's handling of her medical payments claim. The trial against Mercury has been scheduled for March 28, 2008. The Company is not able to evaluate the likelihood of an unfavorable outcome or to estimate a range of potential loss in the event of an unfavorable outcome at the present time. The Company intends to vigorously defend this lawsuit jointly with the other defendants in the coordinated proceedings.

On March 28, 2006, the California State Board of Equalization (SBE) upheld Notices of Proposed Assessments issued against the Company for tax years 1993 through 1996 in which the California Franchise Tax Board disallowed a portion of the Company's expenses related to management services provided to its insurance

company subsidiaries. As a result of this ruling, the Company recorded an income tax charge (including penalties and interest) of approximately \$15 million, after federal tax benefit, in the first quarter of 2006. On April 24, 2007, the Company filed a complaint in the Superior Court for the City and County of San Francisco challenging the SBE decision and seeking recovery of the taxes, penalties and interest paid by the Company as a result of the SBE decision. The trial has been scheduled for March 17, 2008. The Company believes that the deduction of the expenses related to management services provided to its insurance company subsidiaries is appropriate and intends to vigorously prosecute the case.

In *Robert Krumme, On Behalf Of The General Public v. Mercury Insurance Company, Mercury Casualty Company, and California Automobile Insurance Company* (Superior Court for the City and County of San Francisco), the Court issued a modified injunction on July 11, 2005 that, among other things, required the Company to accept applications for insurance from any California licensed broker with limited exceptions, restricted the use of broker manuals and communications with brokers by the Company's field personnel, and required the Company to compensate brokers at the same rate based on volume of sales. The Company has implemented changes to its operations and believes that it is in compliance with the modified injunction. At the time the injunction was issued, the Court stated that it would consider vacating the modified injunction following a one year period of review of the changes in the Company's operations. On March 2, 2007, the Company filed a motion seeking to vacate the modified injunction. At the hearing, the Court ordered that counsel be permitted to conduct a further limited investigation and to file a report for further consideration by the Court. The Company is unable to determine whether the modified injunction will be vacated or estimate the impact of the Court's decision regarding the modified injunction on future trends in earnings or loss ratios.

#### **Item 1A. Risk Factors**

There have been no material changes to the risk factors as previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

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

None

#### **Item 3. Defaults Upon Senior Securities**

None

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

None

#### **Item 5. Other Information**

##### *Amendment of Bylaws*

On November 2, 2007, the Board of Directors of the Company approved Amended and Restated Bylaws of the Company to permit the Company to issue uncertificated shares as required by the New York Stock Exchange to enable the Company to participate in the Direct Registration System for publicly traded securities operated by The Depository Trust Company. The full text of the Amended and Restated Bylaws is filed as Exhibit 3.1.

##### *Real Estate Transaction*

In October 2007, the Company completed the acquisition of a 4.25 acre parcel of land in Brea, California. The purchase price of \$7.5 million includes issuing a \$4.5 million promissory note that is due in April 2009. In addition, in October 2007, the Company executed a definitive Purchase and Sale Agreement to acquire an 88,300 square foot office building in Folsom, California for approximately \$18.4 million in cash. The transaction is expected to be closed near the end of 2007. The land in Brea is adjacent to the property currently owned by the Company and will be used for future expansion. The building in Folsom will be used to house the Company's northern California employees when the existing lease expires on the building that they currently occupy.

*California Fire Storm*

In October 2007, the Southern California region was devastated by sweeping fire storms. As of November 1, 2007, approximately 2,200 homes have been reported as destroyed. The Company estimates its California homeowners market share to be approximately 3%. As of November 1, 2007, the Company has received 13 total property loss claims and 153 partial property loss claims related to the fires and over 700 claims related to wind damage. The Company anticipates that the number of reported claims will increase but is uncertain as to the total number of claims that will ultimately be reported. These claims are expected to negatively impact the Company's operating results for the fourth quarter of 2007.

**Item 6. Exhibits**

- 3.1 Amended and Restated Bylaws of Mercury General Corporation to permit the Company to issue uncertificated shares
- 15.1 Letter Regarding Unaudited Interim Financial Information
- 15.2 Awareness Letter of Independent Registered Public Accounting Firm
- 31.1 Certification of Registrant's Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Registrant's Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Registrant's Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.
- 32.2 Certification of Registrant's Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002. This certification is being furnished solely to accompany this Quarterly Report on Form 10-Q and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company.

**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.

**MERCURY GENERAL CORPORATION**

Date: November 6, 2007

By: /s/ Gabriel Tirador  
Gabriel Tirador

President and Chief Executive Officer

Date: November 6, 2007

By: /s/ Theodore Stalick  
Theodore Stalick

Vice President and Chief Financial Officer