

## 2009 Annual Report

### **American Contractors Insurance Group Ltd.**

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*"Our mission is to save lives, prevent injuries and reduce the overall cost of insurance for our shareholders by*  
*(1) effectively reducing losses,*  
*(2) providing a stable market with quality services,*  
*(3) utilizing our group purchasing power*  
*and (4) creating equity."*



# The Company

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American Contractors Insurance Group Ltd. (together with its subsidiaries, referred to as the “Company” or “ACIG”) writes insurance policies and provides related services to the construction industry. The policies cover workers compensation, general liability, automobile liability and financial guaranty exposures. The services include underwriting, supervision of claims, policy filings and issuance, loss control and engineering services. The Company provides a long term stable market to the contractor who desires a reasonably priced insurance program providing very broad coverages and specialized services. The members are companies who are willing to share the risks of other good contractors and desire to pay premiums reflecting their own exposures and loss experience over a long period of time.

The Company provides the following benefits to its members:

1. World class safety culture promoting zero loss mentality.
2. Competitive premiums.
3. Investment income on retained loss reserve funds.
4. Premiums based on an insured's own loss experience.
5. Broad coverages tailored for the construction industry.
6. More control over claim payments by the insured.
7. Group purchasing power.
8. Capture of profits normally earned by the insurance industry.
9. Networking with other quality organizations.
10. Access to specialized risk management services.
11. Identification and implementation of best practices.
12. A stable market during a tight insurance market.

The Company issues all of its general liability and automobile liability primary policies with limits of \$2 million per loss occurrence. ACIG Insurance Company (“ACIGIC”) is currently licensed in 49 states as well as the District of Columbia and writes substantially all of the workers compensation coverages that the Company issues. The Company has arranged for Discover Property and Casualty Insurance Company, one of the Travelers Companies (“Discover”), to issue workers compensation policies in the state where ACIGIC is not licensed or when the Company’s A. M. Best Company rating is not accepted, and ACIGIC assumes these policies from Discover. Discover provides excess reinsurance for ACIGIC’s workers compensation coverages.

All the Company’s policies are written for, and all services are provided to, the Company’s shareholders (and related parties). The shareholders are provided financial incentives to place profitable insurance business with the Company through a unique method of computing each shareholder’s equity.

The Company’s insurance companies (American Contractors Insurance Group Ltd., ACIGIC and American Contractors Insurance Company Risk Retention Group) carry a rating of “A (Excellent),” Financial Size Category “VIII” (\$100-\$250 million of policyholders’ surplus) from A.M. Best Company.

# Message to Shareholders

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Dear Shareholders:

We begin 2010 with 40 active contractor members and \$111,965,000 of shareholders' equity. Our members reported approximately \$16.3 billion of construction revenues during 2009. Since inception, ACIG has earned \$195,297,000 of profits and returned \$123,270,000 in dividends and distributions to our members. In addition, ACIG has returned net retro premiums to our members of approximately \$663,174,000 since inception, for a total economic benefit to our members of \$858,471,000.

In 1988, our members had the vision to initiate "Project Independence" to gain control over our insurance pricing and coverage. This project is complete. ACIG Insurance Company ("ACIGIC") is licensed in 50 jurisdictions and writes 99.9% of our members' total workers compensation premiums. Our first \$2 million liability coverage is written by American Contractors Insurance Company Risk Retention Group, which is allowed to operate in all 50 states. Our insurance companies carry a rating of "A (Excellent)," Financial Size Category "VIII" (\$100-\$250 million of policyholders' surplus) from A.M. Best Company.

Our primary mission as an organization is to save lives, prevent injuries and reduce the overall cost of insurance for our members. In this regard, our members, as a group, have reported sharp reductions in the frequency of liability claims and workers compensation indemnity claims per 200,000 manhours. Financial incentives aside, our members have saved countless lives and avoided thousands of injuries through their focus on providing a safe workplace.

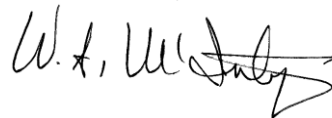
We began Project Lifesaver, an aggressive loss reduction initiative, in late 2003 to assist our members in developing strategic plans to reduce their losses. Action plans were developed and implemented to achieve the strategic goals. Our members have posted outstanding results. Our members reduced their loss rates 53% for workers compensation exposures, 84% for general liability exposures and 49% for automobile liability exposures as compared to the base policy year 2002.

Six of our members sponsor contractor controlled insurance programs ("CCIPs"). We believe CCIPs provide an innovative approach to mitigate insurance risk arising from subcontractor activities. ACIG has bound 406 projects to date with construction values totaling \$6.5 billion.

We reported net premiums earned of \$36,169,000 for 2009 after accruing net retrospective rating and other premium refunds of \$92,127,000.

Investments and cash total \$304,731,000 as of December 31, 2009, or 95.2% of total assets. Our bond portfolio is of very high quality, with 46% of the portfolio value rated Aaa; 17%, Aa; 26%, A; 4%, Baa; and 7%, less than investment grade. Our capital position was \$111,965,000 as of December 31, 2009, and our ratio of premiums written to capital and surplus was a conservative .3:1.

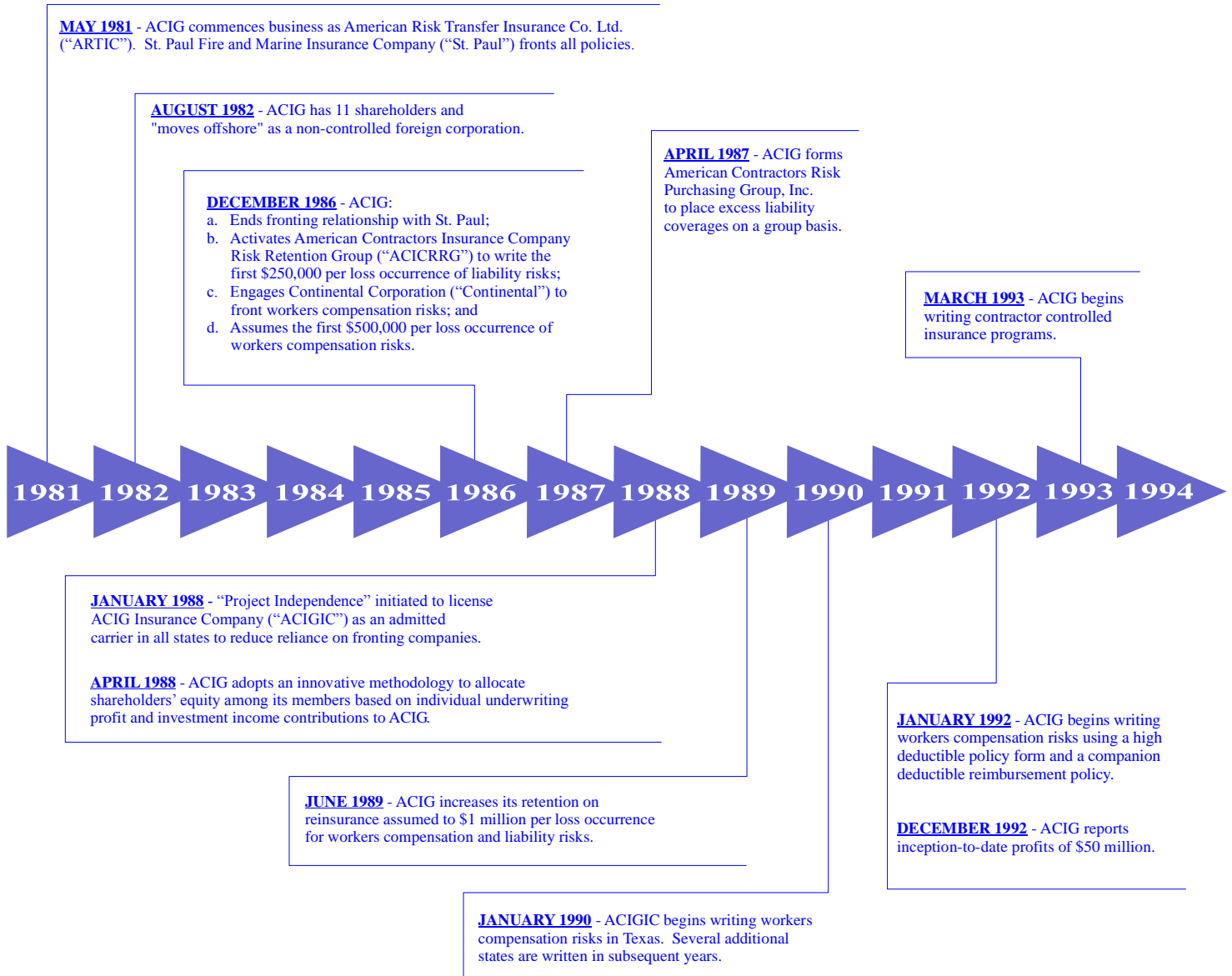
We welcome inquiries by contractors and their brokers for membership in our company. We enter 2010 with a strong financial position and look forward to the opportunities and challenges of the coming year.



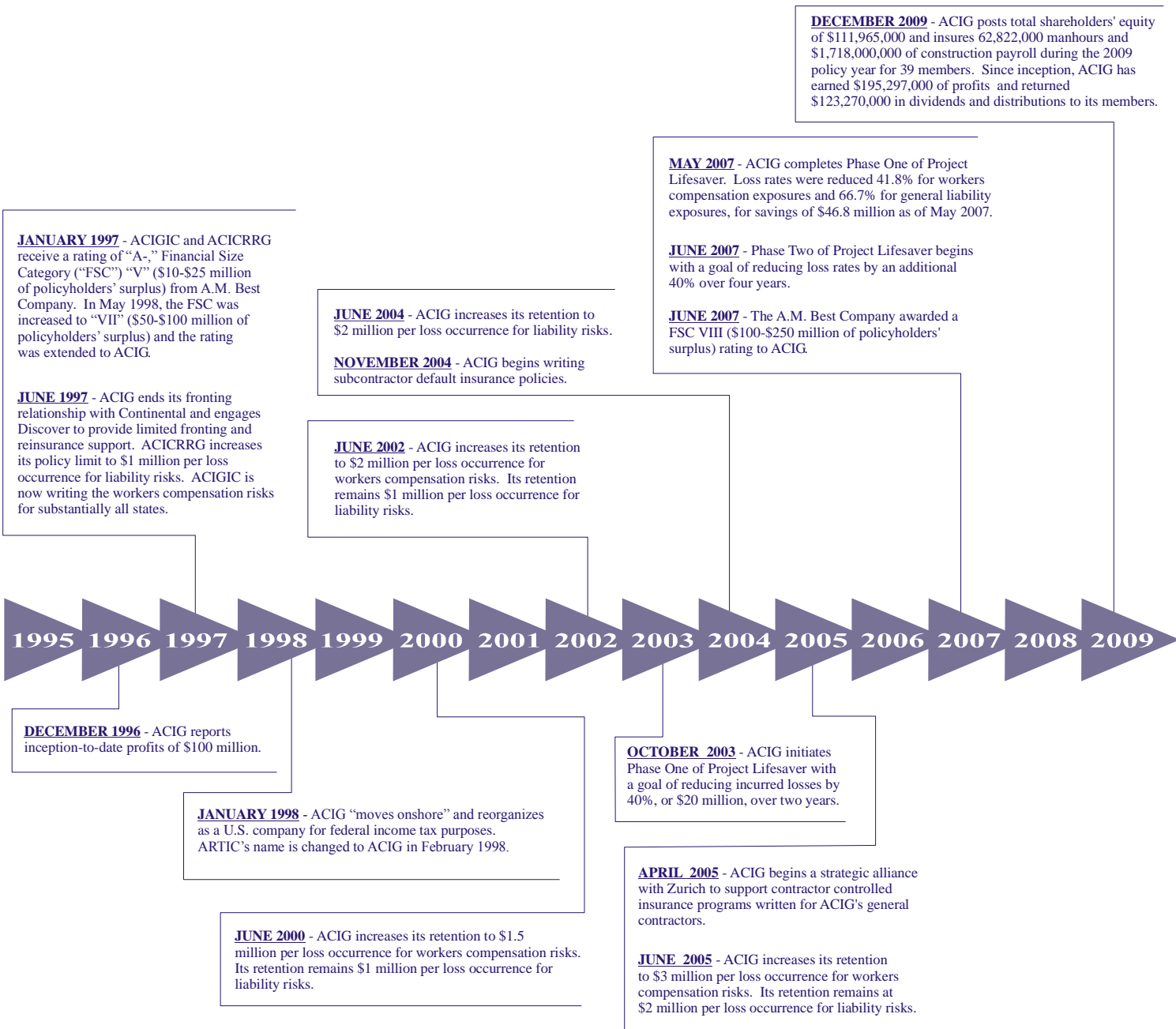
William S. McIntyre IV, CEO

# American Contractors Insurance Group Ltd.

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# Chronology of Progress



**Summary of Operations and Other Information**

(Dollar Amounts Expressed in Thousands of U.S. Dollars)

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
<b>Revenues:</b>				
Standard premiums	\$ 40,784	\$ 52,582	\$ 70,765	\$ 92,875
Net retrospective rating and other adjustments	<u>(15,006)</u>	<u>(24,869)</u>	<u>(10,218)</u>	<u>(33,725)</u>
Net premiums earned	25,778	27,713	60,547	59,150
Net investment income	5,575	5,782	5,078	4,739
Realized investment gains (losses), net	<u>174</u>	<u>1,258</u>	<u>440</u>	<u>3,473</u>
Total revenues	31,527	34,753	66,065	67,362
<b>Expenses:</b>				
Losses and loss adjustment expenses incurred	15,933	20,126	47,144	51,520
Other operating expenses	<u>7,093</u>	<u>8,629</u>	<u>8,270</u>	<u>10,634</u>
Total expenses	<u>23,026</u>	<u>28,755</u>	<u>55,414</u>	<u>62,154</u>
<b>Income (loss) before income taxes</b>	8,501	5,998	10,651	5,208
<b>Provision (benefit) for U. S. federal income taxes</b>	<u>2,017</u>	<u>1,548</u>	<u>3,163</u>	<u>1,235</u>
<b>Net income (loss)</b>	<u>\$ 6,484</u>	<u>\$ 4,450</u>	<u>\$ 7,488</u>	<u>\$ 3,973</u>
<b>Year-end financial position:</b>				
Investments	\$ 127,969	\$ 130,604	\$ 141,711	\$ 162,918
Cash and cash equivalents	\$ 11,439	\$ 8,264	\$ 12,178	\$ 27,807
Total assets	\$ 141,525	\$ 146,359	\$ 175,353	\$ 208,107
Shareholders' equity	\$ 57,424	\$ 59,272	\$ 61,910	\$ 75,556
<b>Insured exposures (unaudited):</b>				
Manhours (000's) (June 1 policy year)*	38,891	43,312	46,960	47,080

\*Manhours include projects insured under contractor controlled programs.

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<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>
\$ 90,325	\$ 114,915	\$ 153,621	\$ 168,559	\$ 161,610	\$ 128,296
<u>(39,025)</u>	<u>(53,876)</u>	<u>(73,213)</u>	<u>(94,014)</u>	<u>(87,788)</u>	<u>(92,127)</u>
51,300	61,039	80,408	74,545	73,822	36,169
5,188	6,275	8,817	9,520	8,780	8,841
<u>2,001</u>	<u>(697)</u>	<u>4,191</u>	<u>4,903</u>	<u>(15,624)</u>	<u>8,420</u>
58,489	66,617	93,416	88,968	66,978	53,430
42,522	48,843	64,121	62,674	49,281	28,031
<u>11,502</u>	<u>13,133</u>	<u>15,531</u>	<u>20,092</u>	<u>19,735</u>	<u>19,480</u>
<u>54,024</u>	<u>61,976</u>	<u>79,652</u>	<u>82,766</u>	<u>69,016</u>	<u>47,511</u>
4,465	4,641	13,764	6,202	(2,038)	5,919
<u>629</u>	<u>618</u>	<u>3,433</u>	<u>743</u>	<u>(331)</u>	<u>(925)</u>
<u>\$ 3,836</u>	<u>\$ 4,023</u>	<u>\$ 10,331</u>	<u>\$ 5,459</u>	<u>\$ (1,707)</u>	<u>\$ 6,844</u>
\$ 192,123	\$ 205,116	\$ 250,849	\$ 304,326	\$ 249,996	\$ 284,710
\$ 18,169	\$ 34,517	\$ 39,090	\$ 13,354	\$ 34,358	\$ 20,021
\$ 228,804	\$ 253,259	\$ 298,834	\$ 326,713	\$ 300,552	\$ 319,959
\$ 84,948	\$ 89,993	\$ 97,198	\$ 103,483	\$ 88,333	\$ 111,965
50,870	62,783	75,276	71,422	70,055	62,822

# Our Mission

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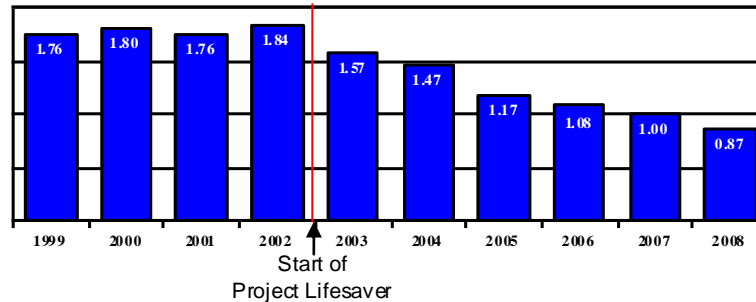
Our mission is to save lives, prevent injuries and reduce the overall cost of insurance for our shareholders by (1) effectively reducing losses, (2) providing a stable market with quality services, (3) utilizing our group purchasing power and (4) creating equity. The key components of our mission follow:

- 1. Effectively reducing losses**
  - Top management commitment
  - Middle management and field support
  - Contract administration/risk allocation
  - Safety/quality management
  - Claims management, including cost containment efforts
  - Claims information systems and benchmarks
  - Training and networking
  - Selected risk avoidance
  - Performance measurements and assessments
  - Promotion of best practices and continuous improvement (e.g., Project Lifesaver, risk mitigation through contractor controlled insurance programs)
  - Identify and proactively address emerging issues
  
- 2. Providing a stable market with quality services**
  - Long-term buying attitudes
  - Strong financial position
  - Building a strong relationship with Discover Property and Casualty Insurance Company, a part of the Travelers Companies, Zurich, NovaPro and other Third Party Administrators
  - Maintenance of licenses of ACIG Insurance Company
  - Reinsurance market support
  - Specialized risk management services
  - Prudent risk retention
  - Risk-based pricing
  - Market, regulatory and industry relations
  - Proactive communication
  - Motivated, qualified staff
  
- 3. Utilizing our group purchasing power**
  - Controlled addition of quality shareholders
  - Adequate pool of premiums
  - Above average risks
  - Long-term commitment by participants
  - Selected transfer of risk
  - Market and customer relations
  - Homogeneous and insurable risks
  - Reduced overhead
  - Broad coverages designed for the construction industry
  - Equitable treatment of participants
  
- 4. Creating equity**
  - Achievement of underwriting profit targets by individual participants
  - Profits from pooled activities
  - Prudent tax management
  - Careful underwriting of new shareholders
  - Use of retrospective rating plans with three year terms
  - Prudent investment management

Losses represent 80% or more of earned premiums, and loss reduction is our key focus. Our shareholders, as a group, have reported a significant reduction in the frequency of workers compensation indemnity claims per 200,000 manhours over the last several years, as seen in the chart on the next page.

## Our Mission (Continued)

**Frequency of Workers Compensation Indemnity Claims  
Per 200,000 Manhours (June 1 Policy Years)**

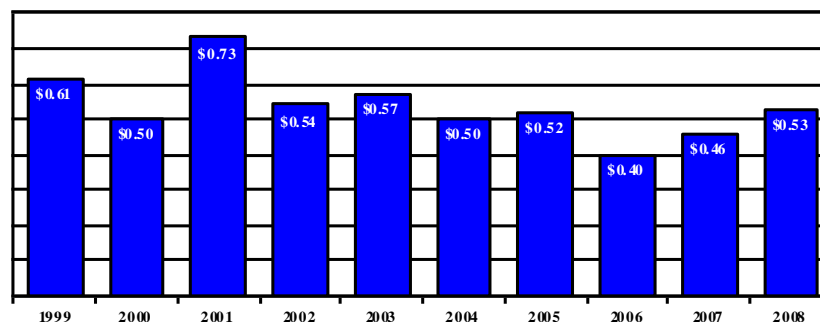


This improvement was recorded in spite of increasing manhours of work; 62,822,000 manhours of work were completed in the June 2008-09 policy year versus 36,095,000 manhours during the June 1999-00 policy year. Meaningful safety improvement and reductions in accident frequency require long-term effort. This reduced accident frequency produced substantial cost savings to the contractors. Our members, as a group, reported 317 claims in the June 1999-00 policy year on 36,095,000 of manhours worked. For the June 2008-09 policy year, our members reported 273 claims on 62,822,000 of manhours worked. At an average cost of \$80,000 per workers compensation indemnity claim, the reduction in the loss rate from the June 1999-00 policy year to the June 2008-09 policy year produced annual direct savings of approximately \$22 million and indirect savings (e.g., hiring and training costs avoided) of up to twice that amount. Further, human suffering has been reduced, in that 280 lost time accidents did not take place at all during the June 2008-09 policy year, when compared with the June 1999-00 policy year rate.

We excel at post-loss claims handling with our innovative SWAT Team approach and aggressive follow through. We carefully define claims requiring a SWAT Team investigation to simplify and better communicate the approach. We conducted 12 and 14 SWAT Team investigations during 2009 and 2008, respectively.

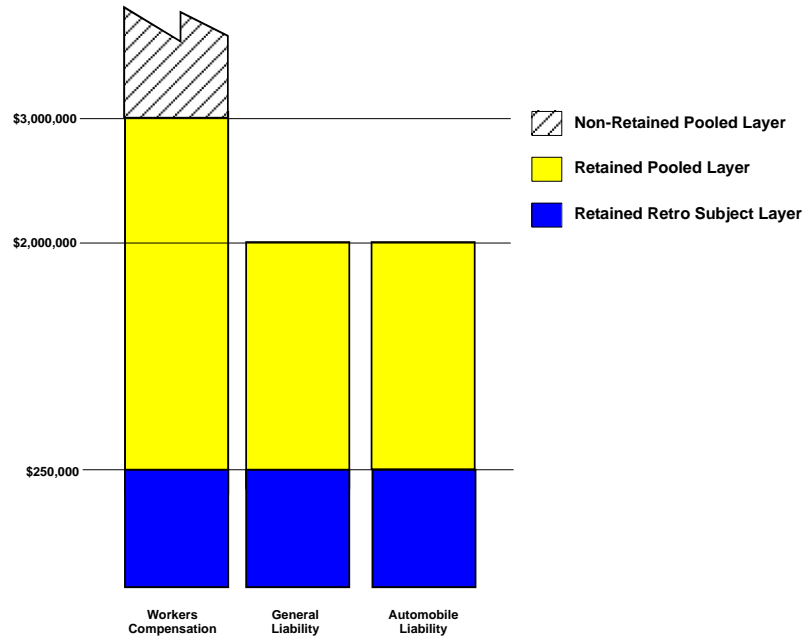
The long term trend of the average workers compensation cost per manhour is favorable in spite of payroll inflation and substantial medical cost inflation. We have implemented a medical cost containment initiative to manage this important driver of claim costs.

**Average Workers Compensation Cost Per Manhour  
(June 1 Policy Years, including IBNR reserves)**



# Sharing of Risks Among Members

The risk layers are shared among members as shown below:



The layer from the first dollar of loss to the contractor’s retro loss limit is the “retro subject layer of risk;” the layer above the contractor’s retained retro loss limit is the “pooled layer of risk.”

## *Retro Subject Layer of Risk*

Each contractor selects a retro loss limit generally equal to \$250,000 (or \$500,000 in some cases) per loss occurrence. Each contractor is primarily responsible for funding losses in its retro subject layer. This is largely accomplished through retrospective rating of losses. Further, the rating plan factors are set to produce an underwriting profit (i.e., modified standard premiums, +/- retro adjustments, less expenses and losses) equal to 10% of retro premiums for the first six years of participation and 5% thereafter.

Each contractor receives credit in the profit allocation for the underwriting profit it contributes. In addition, investment income earned in the retro subject layer is credited to that contractor’s equity account. Bottom line, the contractor receives all profits earned in the retro subject layer, less 14.9% of profits allocated to the Class A shareholder.

## *Pooled Layer of Risk*

ACIG retains the first \$3 million per loss occurrence for workers compensation risks and \$2 million per loss occurrence for general liability and automobile liability risks. The premium for the layer \$2,750,000 excess of \$250,000 (or \$2,500,000 excess of \$500,000 in some cases) per loss occurrence for workers compensation risks and \$1,750,000 excess of \$250,000 (or \$1,500,000 excess of \$500,000 in some cases) per loss occurrence for liability risks is “flat rated” and losses are not retrospectively rated. Underwriting profit (loss) and investment income for this layer are pooled and allocated among the members based on each member’s premium percentage (the pooling, premium percentages and allocations are done separately for some classes of risks).

ACIG reinsures workers compensation losses statutory excess of \$3 million per loss occurrence with Discover with the exception of exposures associated with petro chemical or chemical plant facilities. For such exposures, the reinsurance limit is \$100 million. In the event a workers compensation loss occurrence exceeds \$103 million for exposures associated with petro chemical or chemical plant facilities, ACIG retains such excess amount.

# Sharing of Profits Among Members

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ACIG has two classes of common stock outstanding: Class A and Class B. The Class A shareholder (McIntyre Construction Company, a division of International Risk Management Institute, Inc.) manages ACIG and receives 14.9% of voting rights, profits and equity transactions, and William S. McIntyre, one of the founders, serves as chairman and chief executive officer of ACIG.

The Class B shareholders (39 contractor members as of December 31, 2009), as a group, are entitled to 85.1% of the total voting power, dividends and distribution of net assets of the Company. Amongst themselves, each Class B shareholder is generally entitled to voting rights and distributions on the basis of individual underwriting profit and investment income contributions to the Company. Mechanically, each contractor receives equity in ACIG based on its "contribution" equal to the sum of:

- (a) its initial capital contribution (currently \$75,000) and any contributed capital; plus
- (b) its underwriting profit for the retro subject layer plus its allocation of underwriting profit for the pooled layer; plus
- (c) its investment income earned for the retro subject layer plus its allocation of investment income earned for the pooled layer; less
- (d) 14.9% of this total contribution allocated to the Class A shareholder.

The total equity of ACIG (before cumulative distributions) is greater than the sum of the contributions of the individual members. This difference relates to non-shareholder and pooled activities (other than the pooled layer allocated as noted in (b) and (c) above) and is allocated among the members on a basis as prescribed in the Company's Bye-Laws.

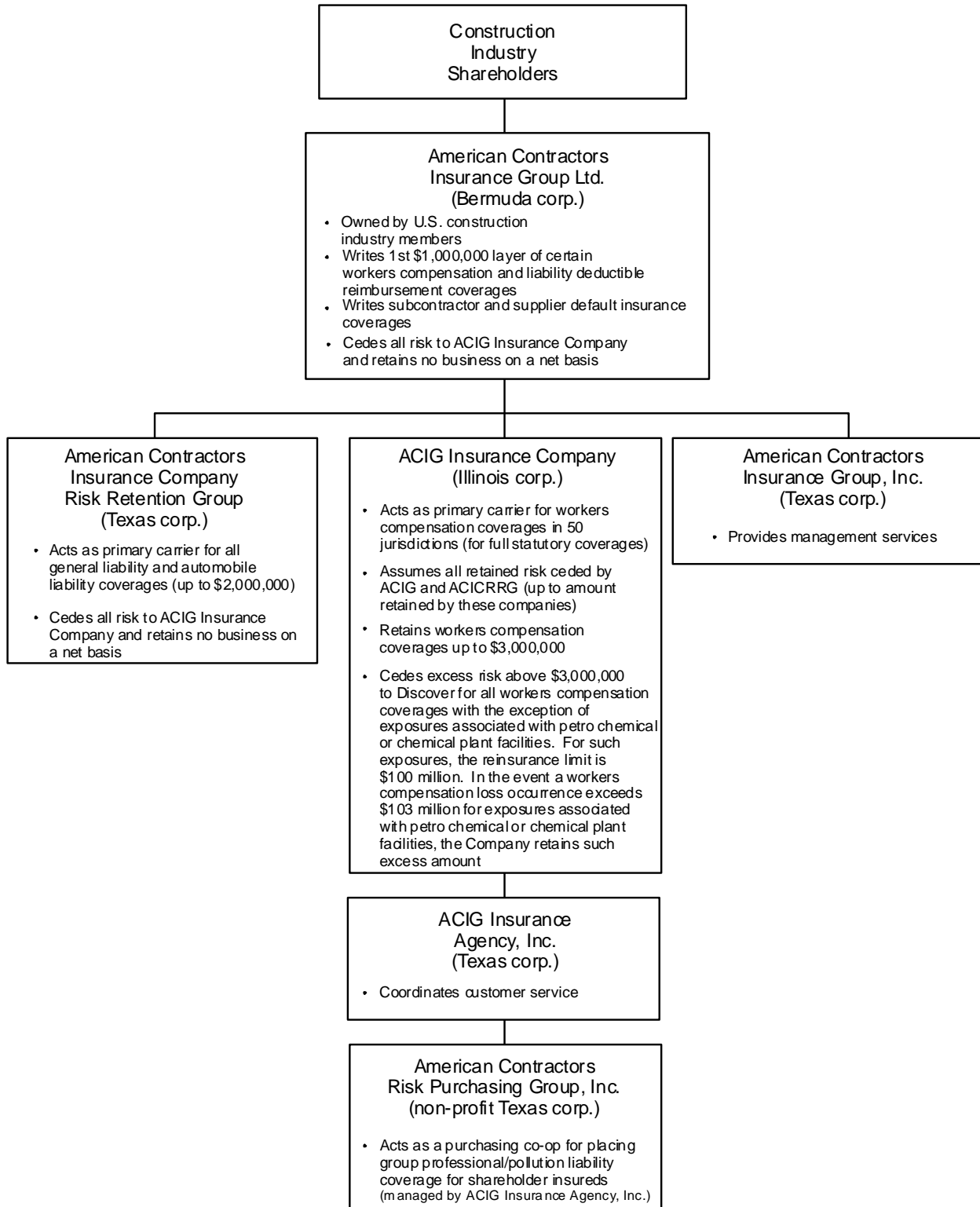
Of interest, approximately 40% of the total underwriting profit and investment income is expected to be earned from the retro subject layer of risk, and 60% of the total underwriting profit and investment income is expected to be earned from the pooled layer of risk.

ACIG maintains separate accounts for each member to properly allocate profits. ACIG's independent public accountants audit this profit allocation annually as of December 31.

Each contractor is a partner with the Class A shareholder in administering its insurance program, sharing profits 85.1%/14.9%. Risk sharing among the members in the retro subject layer is expected to be limited. The significant sharing among members takes place for:

- a. Operating expenses of ACIG - These are prorated among the members on an equitable basis; and
- b. Results of pooled layer - Underwriting profit (loss) and investment income in the pooled layer are shared on a prorated basis among the members.

# Organization Chart



# Directors and Officers

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## Directors:

**Ajax Paving Industries, Inc.**  
Mike Horan  
James A. Jacob

**BMW Constructors, Inc.**  
Peter J. Mariani  
Thomas E. O'Brien

**Berglund Construction Company**  
Fred Berglund  
Kevin Geshwender

**The Brady Companies**  
Ronald P. Brady  
John Dewey

**Cajun Industries, LLC**  
L. Lane Grigsby  
\* John K. Jacob

**Charles Pankow Builders, Ltd.**  
\* Richard M. Kunnath  
Richard G. Waltherhouse

**Clarkson Construction Company**  
William E. Clarkson, Jr.  
Eldon Eikenbary

**Danella Companies, Inc.**  
Dennis P. Daly  
\* James D. Danella

**Danis Building Construction Company**  
John S. Danis  
Tom Haverkos

**Dan's Excavating Inc.**  
Paul Navetta  
Chris Peyerk

**Forrester Construction Company**  
David Forrester  
Wayne Cabot

**Duininck Companies LLC**  
Christian G. Duinick  
Kyle N. Duinick

**G.A. & F.C. Wagman, Inc.**  
Joseph G. Wagman  
Richard E. Wagman

**Goodfellow Bros., Inc.**  
Steve Goodfellow  
Dan Reisenauer

**Graycor Services LLC**  
\* Melvin Gray  
Steven F. Gray

**The Haskell Company**  
Steven T. Halverson  
Greg Ferrell

**Herzog Contracting Corp.**  
Alan L. Landes  
Arthur W. Van Meter

**Hoar Construction, LLC**  
\* Robert O. Burton  
Doug Eckert

**Hoffman Corporation**  
\* Wayne A. Drinkward  
Dan D. Harmon

**J.D. Abrams, L.P.**  
Jon F. Abrams  
Dean D. Bernal

**J J White, Inc.**  
Edward W. Purdy, III  
James J. White IV

**J.T. Vaughn Enterprises, Inc.**  
Michael W. Simpson  
J. Thomas Vaughn

**Jaynes Companies**  
A. Wayne Davenport  
Rick Marquardt

**KS Industries, LP**  
Douglas A. Erickson  
\* Kevin Small

**Kitchell Corporation**  
Michael A. Rock  
\* James T. Swanson

**LeChase Construction Services, LLC**  
Will Mack  
William H. Goodrich

**McBride & Son Enterprises, Inc.**  
† David P. Marxkors  
John Eilermann

**McCarthy-Bush Corporation**  
Joseph D. Bush  
Lawrence P. Bush

**McGeorge Contracting Co., Inc.**  
Haskell L. Dickinson II  
W. Scott McGeorge

**McIntyre Construction Company**  
Shirley C. McIntyre  
\* William S. McIntyre IV

**Murphy Company**  
Robert L. Koester  
Patrick J. Murphy, Jr.

**Nabholz Construction Corporation**  
Bill W. Hannah  
Gregory J. Williams

**The Pepper Companies, Inc.**  
J. David Pepper  
\* Richard S. Pepper

**Phillips & Jordan, Inc.**  
Teddy Phillips  
Steve Thompson

**Roy Anderson Holding Corp**  
Roy Anderson III  
† Robert Vollenweider

**Shimmick Construction Company, Inc.**  
Paul A. Cocotis  
Scott Fairgrieve

**SpawGlass**  
Robert Blalock  
Fred Raley

**Sukut Construction, Inc.**  
Michael H. Crawford  
Paul Kuliev

**The Weitz Group, LLC**  
\* Craig Damos  
Len Martling

**William Charles Ltd.**  
Nathan J. Howard  
† Neil A. Maloney

**Williams Brothers Construction Co., Inc.**  
\* Doug Pitcock  
Randy Rogers

## Bermuda Directors:

**Appleby Spurling Hunter**  
Michael J. Burns

**Atlantic Security Ltd.**  
Stephen Palmer

## Officers:

**Chairman and CEO:**  
\* William S. McIntyre IV

**President:**  
Mike O'Neill

**Executive Vice President:**  
Brad Porter

**Senior Vice President:**  
Rob Hunt

\* Member of the Executive Committee

† Member of the Audit Committee

# **Administration**

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## **General**

The overall direction of ACIG is provided by the board of directors and committees of directors which regularly meet. The executive committee has 12 members and provides policy and operating direction. The investment committee has five members and provides direction on investment of ACIG's assets. The compensation committee has four members and provides direction on compensation of ACIG's employees. The audit committee has four members and provides financial support to ACIG's executive committee.

## **Directors**

The ACIG board of directors is made up of two directors nominated by each participating shareholder, and two local directors (Michael J. Burns of Appleby Spurling Hunter, and Stephen Palmer of Atlantic Security Ltd.). Each director can appoint an alternate director.

## **Corporate Office**

Canon's Court, 22 Victoria Street  
Hamilton, HM 12, Bermuda

## **Actuaries**

Towers Watson (Tillinghast) - Dallas, Texas

## **Independent Auditors**

BDO Seidman, LLP - Dallas, Texas

## **Administration** (Continued)

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### **Banks**

The Bank of N. T. Butterfield & Son Ltd. – Hamilton, Bermuda  
Morgan Guaranty Trust Company of New York – New York, New York  
The Northern Trust Company – Chicago, Illinois

### **Bermuda Counsel**

Appleby Spurling Hunter – Hamilton, Bermuda

### **Investment Consultant**

Angeles Investment Advisors LLC – Santa Monica, California

### **Investment Managers**

BlackRock Financial Management – New York, New York  
JP Morgan – New York, New York  
Dodge & Cox – San Francisco, California  
Calamos Advisors, LLC – Naperville, Illinois  
Vanguard Group – Valley Forge, Pennsylvania  
Wellington Management Company, LLP – Boston, Massachusetts  
Western Asset Management Company – Pasadena, California  
Zazove Associates – Chicago, Illinois

### **U. S. Counsel**

Pratt & Yungblut, P.C. – Dallas, Texas

### **Tax Advisors**

Gardere & Wynne – Dallas, Texas

**Consolidated Balance Sheets**

(Expressed in Thousands of U.S. Dollars)

	<i>December 31</i>	
	<u>2009</u>	<u>2008</u>
<b>ASSETS</b>		
Investments	\$ 284,710	\$ 249,996
Cash and cash equivalents	20,021	34,358
Accrued investment income	2,080	1,959
Deferred federal income taxes	7,650	13,749
Other assets	<u>5,498</u>	<u>490</u>
Total assets	<u>\$ 319,959</u>	<u>\$ 300,552</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Reserve for losses and loss adjustment expenses	\$ 178,649	\$ 189,371
Unearned premiums	18,287	25,666
Premiums payable (receivable)	4,742	(9,621)
Notes payable	569	711
Other liabilities	<u>5,747</u>	<u>6,092</u>
Total liabilities	207,994	212,219
Commitments and contingencies		
Shareholders' equity:		
Share capital	1,045	1,045
Share premium and contributed surplus	28,112	26,518
Retained earnings before distributions	195,297	188,453
Cumulative distributions	(123,270)	(121,944)
Net unrealized gains (losses) on investments, net of tax	<u>10,781</u>	<u>(5,739)</u>
Total shareholders' equity	<u>111,965</u>	<u>88,333</u>
Total liabilities and shareholders' equity	<u>\$ 319,959</u>	<u>\$ 300,552</u>

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

## Consolidated Statements of Income (Loss) and Comprehensive Income (Loss)

(Expressed in Thousands of U.S. Dollars)

	<i>For the Years Ended December 31</i>	
	<u>2009</u>	<u>2008</u>
<b>Revenues:</b>		
Standard premiums	\$ 128,296	\$ 161,610
Net retrospective rating and other adjustments	<u>(92,127)</u>	<u>(87,788)</u>
Net premiums earned	36,169	73,822
Investment income, net of interest and investment expenses of \$1,298 and \$1,432	8,841	8,780
Realized investment gains (losses), net	<u>8,420</u>	<u>(15,624)</u>
Total revenues	<u>53,430</u>	<u>66,978</u>
<b>Expenses:</b>		
Losses and loss adjustment expenses incurred	28,031	49,281
Other operating expenses	<u>19,480</u>	<u>19,735</u>
Total expenses	<u>47,511</u>	<u>69,016</u>
<b>Income (loss) before income taxes</b>	5,919	(2,038)
<b>Benefit for U. S. federal income taxes</b>	<u>(925)</u>	<u>(331)</u>
<b>Net income (loss)</b>	6,844	(1,707)
<b>Other comprehensive income (loss), net of tax:</b>		
Unrealized gains (losses) on securities:		
Unrealized holding gains (losses) arising during period	13,774	(13,180)
Reclassification adjustment for realized gains (losses) included in net income (loss)	<u>2,746</u>	<u>(5,637)</u>
<b>Other comprehensive income (loss)</b>	<u>16,520</u>	<u>(18,817)</u>
<b>Comprehensive income (loss)</b>	<u>\$ 23,364</u>	<u>\$ (20,524)</u>

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

**Consolidated Statements of Shareholders' Equity**

(Expressed in Thousands of U.S. Dollars)

*For the Years Ended  
December 31, 2009 and 2008*

	<u>Share Capital</u>	<u>Share Premium and Contributed Surplus</u>	<u>Retained Earnings Before Distributions</u>	<u>Cumulative Distributions</u>	<u>Net Unrealized Gains (Losses)</u>	<u>Total Shareholders' Equity</u>
<b>Balance, December 31, 2007</b>	\$ 1,020	\$ 19,802	\$ 190,160	\$ (120,577)	\$ 13,078	\$ 103,483
Net loss	-	-	(1,707)	-	-	(1,707)
Dividends to shareholders	-	-	-	(352)	-	(352)
Share capital issued	50	716	-	-	-	766
Capital contributions	-	6,000	-	-	-	6,000
Distribution to withdrawing shareholder	(25)	-	-	(1,015)	-	(1,040)
Net change in unrealized gains (losses)	-	-	-	-	(18,817)	(18,817)
<b>Balance, December 31, 2008</b>	1,045	26,518	188,453	(121,944)	(5,739)	88,333
Net income	-	-	6,844	-	-	6,844
Dividends to shareholders	-	-	-	(352)	-	(352)
Share capital issued	25	263	-	-	-	288
Capital contributions	-	1,356	-	-	-	1,356
Distribution to withdrawing shareholder	(25)	(25)	-	(974)	-	(1,024)
Net change in unrealized gains (losses)	-	-	-	-	16,520	16,520
<b>Balance, December 31, 2009</b>	<u>\$ 1,045</u>	<u>\$ 28,112</u>	<u>\$ 195,297</u>	<u>\$ (123,270)</u>	<u>\$ 10,781</u>	<u>\$ 111,965</u>

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

**Consolidated Statements of Cash Flows**

(Expressed in Thousands of U.S. Dollars)

	<i>For the Years Ended December 31</i>	
	<u>2009</u>	<u>2008</u>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 6,844	\$ (1,707)
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Realized investment (gains) losses	(8,420)	15,624
Depreciation and amortization	112	153
Deferred federal income taxes	127	(403)
Change in certain operating assets and liabilities:		
Premiums payable (receivable)	14,363	(23,107)
Accrued investment income	(121)	309
Reserve for losses and loss adjustment expenses	(10,722)	10,397
Unearned premiums	(7,379)	4,646
Other liabilities	(345)	(2,195)
	<u>(5,541)</u>	<u>3,717</u>
Net cash (used in) provided by operating activities		
<b>Cash flows from investing activities:</b>		
Proceeds from sales and maturities of investments	284,675	181,688
Payments for acquisition of investments	(288,477)	(168,846)
Change in other assets	(5,120)	(176)
	<u>(8,922)</u>	<u>12,666</u>
Net cash (used in) provided by investing activities		
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of notes payable	2,220	249
Repayment of notes payable	(2,362)	(1,001)
Share capital issued	288	766
Capital contributions	1,356	6,000
Dividends to shareholders	(352)	(353)
Distributions to withdrawing shareholders	(1,024)	(1,040)
	<u>126</u>	<u>4,621</u>
Net cash provided by financing activities		
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(14,337)</b>	<b>21,004</b>
<b>Cash and cash equivalents at beginning of year</b>	<b><u>34,358</u></b>	<b><u>13,354</u></b>
<b>Cash and cash equivalents at end of year</b>	<b><u>\$ 20,021</u></b>	<b><u>\$ 34,358</u></b>

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

# Notes to Consolidated Financial Statements

(Expressed in U.S. Dollars)

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## 1. Insurance business

American Contractors Insurance Group Ltd. (“ACIG” or, when referred to together with its subsidiaries collectively, the “Company”) is a construction industry owned insurance company domiciled in Bermuda. ACIG, through its subsidiaries, provides workers compensation, employers' liability, commercial general liability, business automobile liability and financial guaranty lines of coverage for its Class "B" shareholders (see note 6) and third parties.

ACIG owns all of the outstanding common stock of American Contractors Insurance Company Risk Retention Group, a Texas company, ACIG Insurance Company (“ACIGIC”), an Illinois company, and American Contractors Insurance Group, Inc., a Texas company.

## 2. Significant accounting policies

### Basis of reporting -

The accompanying consolidated financial statements include the accounts of ACIG and its subsidiaries, all of which are wholly owned. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications were made to 2008 amounts to conform with the 2009 presentation.

The accounts of the Company have been prepared in accordance with the accounting principles generally accepted in the United States of America (“GAAP”). In preparing the consolidated financial statements, management is required to make estimates and assumptions. Those estimates relate principally to the determination of the reserve for losses and loss adjustment expenses, premiums earned, income taxes and the fair value of financial instruments. Actual results could differ from those estimates.

### Investment securities -

Debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. Debt and equity securities not classified as either of the above are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity, net of tax. The Company accounts for its investment securities as available-for-sale securities (see note 3). The specific identification method is used to determine costs of investments sold.

### Computer and office equipment -

Computer and office equipment are recorded at cost and depreciated using an accelerated method over estimated useful lives of five to seven years. At December 31, 2009 and 2008, the Company had net computer and office equipment of approximately \$286,000 and \$390,000, respectively, which is included in other assets in the accompanying consolidated balance sheets.

### Reserve for losses and loss adjustment expenses -

The Company retains the first \$3 million per loss occurrence for workers compensation risks and \$2 million per loss occurrence for liability risks. The Company has reinsured workers compensation losses statutory excess of \$3 million per loss occurrence with the exception of exposures associated with petro chemical or chemical plant facilities. For such exposures, the reinsurance limit is \$100 million. In the event a workers compensation loss occurrence exceeds \$103 million for exposures associated with petro chemical or chemical plant facilities, the Company retains such excess amount.

**Notes to Consolidated Financial Statements**

(Continued)

Most of the Company's insurance policies are subject to retrospective adjustment with a retro loss limit generally equal to \$250,000 (or higher in some cases). The premium for the layer \$2,750,000 excess of \$250,000 per loss occurrence for workers compensation risks and \$1,750,000 excess of \$250,000 per loss occurrence for liability risks is flat rated and losses are not subject to retrospective rating.

The reserve for losses and loss adjustment expenses represents the estimated ultimate cost of all reported and unreported losses incurred through December 31. The Company does not discount loss and loss adjustment expense reserves. The reserve for unpaid losses and loss adjustment expenses is estimated using individual case-basis valuations, statistical analyses, and estimates based upon experience for unreported claims and loss adjustment expenses. Such estimates may be more or less than the amounts ultimately paid when the claims are settled. The estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, in the opinion of management, the reserve for losses and loss adjustment expenses is adequate to settle losses incurred at December 31, 2009; however, there can be no assurance that the ultimate liability will not exceed the current estimates. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

Activity in the reserve for losses and loss adjustment expenses is summarized as follows (dollar amounts in thousands):

	<u>2009</u>	<u>2008</u>
Balance at January 1	\$ 189,371	\$ 178,974
Incurred related to:		
Current year	54,836	73,227
Prior years	<u>(26,805)</u>	<u>(23,946)</u>
Total incurred	<u>28,031</u>	<u>49,281</u>
Paid related to:		
Current year	6,128	10,249
Prior years	<u>32,625</u>	<u>28,635</u>
Total paid	<u>38,753</u>	<u>38,884</u>
Balance at December 31	<u>\$ 178,649</u>	<u>\$ 189,371</u>

The Company's reserve for losses and loss adjustment expenses at December 31, 2007, decreased during 2008 by \$23,946,000 as a result of favorable loss development primarily for the 2005 and 2006 accident years. The Company's reserve at December 31, 2008, decreased during 2009 by \$26,805,000 as a result of favorable loss development primarily for the 2004-2007 accident years.

The Company reports its reserve for losses and loss adjustment expenses net of reinsurance recoverables on unpaid losses amounting to \$7,663,000 and \$4,708,000 at December 31, 2009 and 2008, respectively. In the event that any of the reinsuring companies might be unable to meet their obligations under existing reinsurance agreements, the Company would be liable for such defaulted amounts. The Company received approximately \$267,000 and \$285,000 of net reinsurance recoveries during 2009 and 2008, respectively.

Premiums earned -

Premiums earned are reported and recorded monthly and include estimates of amounts to be reported by the Company's insureds through December 31, 2009. Premiums earned are subject to retrospective adjustment, based upon the actual loss experience of the insured parties, as well as policyholder dividends and refunds. Retro adjustments are subject to contractual limits and have been recorded using estimates of ultimate losses. Unpaid retro adjustments are recorded as a component of premiums payable (receivable). Policyholder dividends and premium refunds are recorded when declared and/or paid. In 2009 and 2008, approximately \$30,072,000 and \$34,067,000, respectively, of premium refunds were recorded in net retrospective rating and other adjustments in the consolidated statements of income (loss) and comprehensive income (loss). Adjustments to the

# Notes to Consolidated Financial Statements

(Continued)

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amounts recorded as of December 31, 2009 and 2008, resulting from changes in estimates and future reviews of loss experience will be reflected in the Company's consolidated financial statements in the periods when such adjustments first become known. The Company ceded premiums to reinsurers of approximately \$4,185,000 and \$4,034,000 in 2009 and 2008, respectively.

## Reinsurance -

In the normal course of business, the Company seeks to reduce the loss that may arise from events that cause unfavorable underwriting results by reinsuring certain levels of risk with other insurance enterprises or reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy.

## Income taxes -

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided to reduce deferred tax assets if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Effective January 1, 2009, the Company adopted Financial Accounting Standards Board ("FASB") ASC 740-10-25 (formerly FIN 48, *Accounting for Uncertainty in Income Taxes*) and it did not have a material impact on the Company's financial statements. FASB ASC 740-10-25 clarifies the accounting for uncertainty in income tax recognized in a company's financial statements and requires companies to determine whether it is "more likely than not" that a tax position will be sustained upon examination by the appropriate taxing authorities before any part of the benefit can be recorded in the financial statements. It also provides guidance on the recognition, measurement, and classification of income tax uncertainties, along with any related interest and penalties. Previously recorded income tax benefits that no longer meet this standard are required to be charged to earnings in the period that such determination is made.

## Accounting standards codification -

In June 2009, the FASB issued guidance on the accounting standards codification and the hierarchy of GAAP. The accounting standards codification is intended to be the source of authoritative GAAP and reporting standards as issued by the FASB. Its primary purpose is to improve clarity and use of existing standards by grouping authoritative literature under common topics. This Statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The accounting standards codification does not change or alter existing GAAP, and there is no expected impact on the Company's balance sheets, statements of income, or cash flows.

In May 2009, the FASB issued new guidance for accounting for subsequent events. The new guidance incorporates guidance into accounting literature that was previously addressed only in auditing standards. The statement refers to subsequent events that provide additional evidence about conditions that existed at the balance-sheet date as "recognized subsequent events". Subsequent events which provide evidence about conditions that arose after the balance-sheet date but prior to the issuance of the financial statements are referred to as "non-recognized subsequent events". It also requires companies to disclose the date through which subsequent events have been evaluated and whether this date is the date the financial statements were issued or the date the financial statements were available to be issued. This guidance is effective for annual periods ending after June 15, 2009. The Company evaluated subsequent events up through the day the financial statements were issued.

# Notes to Consolidated Financial Statements

(Continued)

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## Statements of cash flows -

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. The Company paid interest of approximately \$54,000 and \$112,000 and paid U. S. federal income taxes of approximately \$2,217,000 and \$2,617,000 for the years ended December 31, 2009 and 2008, respectively.

### **3. Investments**

The Company purchases debt securities for investment purposes with the intent to hold them to maturity. However, considering potential liquidity needs, the Company has designated all debt and equity securities as available-for-sale.

The FASB revised the other-than-temporary impairment (“OTTI”) model for investments in debt securities with the issuance of FASB ASC 320-10-35, paragraph 17 to 34E (formerly FAS 115-2 and 124-2 *Revenue Recognition of Other-Than-Temporary Impairments*). An OTTI is triggered if (1) a company has the intent to sell the security, (2) it is more likely than not that it will be required to sell the security before recovery, or (3) it does not expect to recover the entire amortized cost basis of the security.

Under the revised OTTI model for debt securities, if the company has the intent to sell the security or it is more likely than not that it will be required to sell the security, the entire impairment (amortized cost basis over fair value) will be recognized in earnings. However, if the company does not intend to sell the security and it is not more likely than not that the company will be required to sell the security, but the security has suffered a credit loss, the impairment charge will be separated into the credit loss component, which is recorded in earnings, and the remainder of the impairment charge, which is recorded in other comprehensive income (OCI).

A decline in the market value of any available-for-sale security below cost that is deemed to be other-than-temporary results in an impairment to reduce the carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year-end, forecasted performance of the investee, and the general market condition in the geographic area of industry the investee operates in.

To execute its strategy of maximizing total return from investments, the Company retains third party investment managers to make investment decisions on behalf of the Company. The Company provides guidelines to the managers to authorize investment types and actions. The Company limits to zero the net losses that can be realized by its investment managers from trading and, as a result, does not consider unrealized losses as other-than-temporary declines in value. However, the Company, after consultation with its investment managers, identified certain debt and equity securities that were expected to be sold during 2009 as part of a restructuring of the Company’s investment portfolio. For these securities expected to be sold during 2009, the amortized cost exceeded fair value by \$2,915,000 as of December 31, 2008. Other-than-temporary declines in value were attributed to these securities and realized losses of \$2,915,000 were recognized during 2008.

As part of its normal investment strategy, the Company purchases investment securities that contain embedded derivative contracts. These are primarily related to debt securities with equity conversion features. These investments are bifurcated between the debt security portion and the convertible equity portion. All unrealized gains on the debt securities are excluded from earnings and reported in a separate component of shareholders’ equity, net of tax. The equity conversion portions are not designated as hedges and, accordingly, all changes in the fair value are recognized as a realized gain or loss in the consolidated statements of income (loss) and comprehensive income (loss) in the period in which the change in market value occurs.

**Notes to Consolidated Financial Statements**

(Continued)

The investments owned by the Company as of December 31, 2009 and 2008, are summarized below (dollar amounts in thousands):

Type	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
2009 -				
Debt securities -				
U. S. Treasury bonds	\$ 17,831	\$ 594	\$ (2)	\$ 18,423
Mortgage-backed obligations of U.S. government agencies	39,627	515	(153)	39,989
Obligations of states and political subdivisions	91,838	3,773	(168)	95,443
Convertible bonds	16,306	1,765	(38)	18,033
Corporate and other	<u>67,447</u>	<u>1,731</u>	<u>(611)</u>	<u>68,567</u>
Total debt securities	233,049	8,378	(972)	240,455
Common stocks	32,492	8,655	(77)	41,070
Preferred stocks	<u>2,981</u>	<u>320</u>	<u>(116)</u>	<u>3,185</u>
Total investments	<u>\$ 268,522</u>	<u>\$ 17,353</u>	<u>\$ (1,165)</u>	<u>\$ 284,710</u>
2008 -				
Debt securities -				
U. S. Treasury bonds	\$ 12,697	\$ 1,251	\$ -	\$ 13,948
Mortgage-backed obligations of U.S. government agencies	14,341	241	(6)	14,576
Obligations of states and political subdivisions	96,009	3,155	(401)	98,763
Convertible bonds	16,458	1,020	(1,009)	16,469
Corporate and other	<u>73,886</u>	<u>509</u>	<u>(6,708)</u>	<u>67,687</u>
Total debt securities	213,391	6,176	(8,124)	211,443
Common stocks	38,018	410	(4,086)	34,342
Preferred stocks	<u>4,873</u>	<u>243</u>	<u>(905)</u>	<u>4,211</u>
Total investments	<u>\$ 256,282</u>	<u>\$ 6,829</u>	<u>\$ (13,115)</u>	<u>\$ 249,996</u>

**Notes to Consolidated Financial Statements**

(Continued)

Effective January 1, 2008, the Company adopted FASB ASC 820 (formerly SFAS No. 157) which defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair-value measurements. It requires the Company to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The Company adopted FASB ASC 820 in 2009 for non-financial assets and non-financial liabilities which did not have a material effect on the Company's financial statements.

FASB ASC 820 defines fair value as the exit price, which is the price that would be received to sell an asset or paid to transfer a liability in a transaction between market participants at the measurement date. ASC 820 establishes a three-tier fair value hierarchy that prioritizes inputs to valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. This hierarchy requires the use of observable market data when available. Observable inputs reflect market data obtained from outside sources, while unobservable inputs reflect the Company's market assumptions. These two types of inputs have created the following fair-value hierarchy:

- Level 1 – Quoted prices for identical instruments in active markets.
- Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.
- Level 3 – Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

When available, the Company generally uses quoted market prices and prices provided by pricing services to determine fair value, and classifies such items in Level 1. In some cases where a market price is not available the Company will make use of acceptable practical expedients (such as matrix pricing) to calculate fair value, in which case the items are classified in Level 2. All significant inputs are observable, or derived from observable information in the marketplace, or are supported by observable levels at which transactions are executed in the market place. In other cases where the market price is based on non-binding broker prices or by model driven valuations that utilize significant inputs not based on, or corroborated by readily available market information to calculate fair value, the items are classified in Level 3.

The estimated fair values of investments are measured based on the following criteria (dollar amounts in thousands):

Level	Measurement	Fair Value
Level 1	Quoted prices in active markets for identical assets	\$ 40,469
Level 2	Significant other observable inputs	244,241
	Total investments	<u>\$ 284,710</u>

**Notes to Consolidated Financial Statements**

(Continued)

The amortized cost and estimated fair value of debt securities at December 31, 2009, by contractual maturity, are shown below (dollar amounts in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

<u>Maturity</u>	<u>Amortized Cost</u>	<u>Estimated Fair Value</u>
Due within one year	\$ 8,474	\$ 8,578
Due after one but within five years	87,485	91,352
Due after five but within ten years	20,740	21,954
Due after ten years	76,723	78,582
Mortgage-backed obligations	39,627	39,989
	<u>\$ 233,049</u>	<u>\$ 240,455</u>

Proceeds from sales of investments during 2009 and 2008 were approximately \$284,675,000 and \$181,688,000, respectively. Gross gains of approximately \$15,721,000 and \$4,443,000 and gross losses of approximately \$10,444,000 and \$16,297,000 were realized on those sales during 2009 and 2008, respectively. Additionally, realized gains (losses) of \$3,143,000 and (\$3,770,000) were recognized during 2009 and 2008, respectively, on the embedded equity conversion derivatives that are part of certain debt securities held by the Company.

The ratings assigned to these debt securities by Moody's Investors Service Inc. or the Company's independent investment managers are distributed as follows: Aaa, 46%; Aa, 17%; A, 26%; Baa, 4%; and less than investment grade, 7%.

The common stocks owned by the Company are held through investments in two mutual funds, a separate account and a commingled account.

The Company assumes insurance written by unrelated U.S. insurance companies predominantly for its Class "B" shareholders (see note 6). Pursuant to agreement with one of these insurers, the Company was required to maintain, in trust, portions of its investment portfolio with a bank for the benefit of the insurer. At December 31, 2009 and 2008, approximately \$6,929,000 and \$6,815,000, respectively, of the Company's debt securities and cash were deposited under this agreement. In addition, the Company provided, respectively, \$2.7 million and \$1.8 million letters of credit to one of the insurance companies as of December 31, 2009 and 2008, respectively. Common stocks and cash with an aggregate carrying value of \$7,052,000 and \$6,229,000, respectively, as of December 31, 2009 and 2008 were pledged to a bank as collateral for the letter of credit. In addition, debt securities and certificates of deposit with an amortized cost of approximately \$23,748,000 and \$23,147,000 at December 31, 2009 and 2008, respectively, were pledged to various state insurance commissioners to meet statutory deposit requirements.

**Notes to Consolidated Financial Statements**

(Continued)

**4. Statutory capital and surplus**

ACIG is registered under The Bermuda Insurance Act 1978 and Related Regulations (the Act) and is obligated to comply with various provisions of the Act regarding solvency and liquidity. These provisions have been met and the required minimum statutory capital and surplus as of December 31, 2009, is approximately \$250,000. ACIG's actual statutory capital and surplus as of that date is approximately \$106,876,000 and, accordingly, there are no statutory restrictions on the payment of dividends to the shareholders. ACIG's insurance subsidiaries are subject to similar regulatory restrictions imposed by the states of domicile which limit their ability to pay dividends to ACIG. At December 31, 2009, ACIG's insurance subsidiaries met their statutory capital and surplus requirements.

ACIG's ability to pay dividends to its shareholders is limited by the availability of unrestricted funds and the ability of its subsidiaries to declare and remit dividends.

**5. Notes payable**

Notes payable consist of \$569,000 of unsecured notes to the shareholders of ACIG.

The amounts due by maturity year as of December 31, 2009, for the unsecured notes to certain shareholders of ACIG are summarized below (dollar amounts in thousands):

<u>Maturity</u> (Various Dates)	<u>Amount</u>
2011	\$ 100
2018	249
2019	<u>220</u>
	<u>\$ 569</u>

The notes bear interest at the prime rate (3.25% at December 31, 2009) which is adjusted at the beginning of each quarter.

ACIGIC has available a \$6,000,000 revolving line of credit which bears interest at the prime rate or LIBOR plus 1%, at ACIGIC's option, and is due on demand. Investments and cash with an aggregate carrying value of \$48,212,000 have been pledged to a bank as collateral for the line of credit. At December 31, 2009, no amount was drawn on this line of credit.

Total interest expense on these and other notes outstanding during the year totaled approximately \$54,000 and \$112,000 for the years ended December 31, 2009 and 2008, respectively.

**Notes to Consolidated Financial Statements**

(Continued)

**6. Share capital**

Share capital consists of the following:

Authorized -

Class "A" - 1,800 common shares with a par value of \$25 each

Class "B" - 46,000 common shares with a par value of \$25 each

Issued, Subscribed and Fully Paid -

	Shares		Amount (in Thousands)	
	2009	2008	2009	2008
Class "A"	1,800	1,800	\$ 45	\$ 45
Class "B"	40,000	40,000	1,000	1,000
	<u>41,800</u>	<u>41,800</u>	<u>\$ 1,045</u>	<u>\$ 1,045</u>

The Class "A" shareholder is entitled to 14.9% of the total voting power, dividends and distributions of net assets of the Company. Pursuant to the Bye-Laws of the Company, dated as of February 20, 2009, such shares may generally be transferred only with the approval of the board of directors of the Company. At any time, the Class "A" shareholder may, with certain limitations as delineated in the Bye-Laws, elect to withdraw and liquidate its interest in the Company for consideration equal to 14.9% of the book value of common shares at the time of withdrawal.

The Class "B" shareholders are obligated, except under certain circumstances, to place a specified minimum amount of insurance with U. S. casualty insurance companies, designated by the Company, and the Company will reinsure a portion of the risks under such insurance. The Class "B" shareholders, as a group, are entitled to 85.1% of the total voting power, dividends and distributions of net assets of the Company. Amongst themselves, each Class "B" shareholder is generally entitled to voting rights and such distributions on the basis of individual underwriting profit and investment income contributions to the Company. As provided in the Bye-Laws, Class "B" shares generally may be transferred only with the approval of the board of directors of the Company.

At any time after the third year in which the risks of a Class "B" shareholder are reinsured by the Company, such shareholder may, with certain limitations as delineated in the Bye-Laws, elect to withdraw and liquidate its equity interest in the Company for consideration equal to the book value of the common shares multiplied by the percentage of ownership, as defined, of such shareholder.

**7. Income taxes**

Prior to January 1, 1998, ACIG was a non-controlled foreign corporation and did not carry on a U. S. trade or business. As such, its income was not subject to U. S. taxation until actually distributed to its U. S. shareholders. Accordingly, no taxes were provided on accumulated earnings aggregating approximately \$12,087,000 for years prior to 1998. ACIG elected under section 953(d) of the Internal Revenue Code of 1986, as amended, to be taxed as a U. S. corporation effective January 1, 1998.

At the present time, no income, profit or capital gains taxes are levied in Bermuda and, accordingly, no provision for such taxes has been recorded by the Company. In the event that such taxes are levied, the Company has received an undertaking from the Bermuda Government exempting it from all such taxes until March 28, 2016.

**Notes to Consolidated Financial Statements**

(Continued)

The Federal and state income tax returns of the Company for 2006 and subsequent years remain subject to examination by tax authorities. The Company is currently under examination by the Internal Revenue Service (the "IRS") for its 2006-2008 Federal tax returns. The Company does not expect any material adjustments resulting from the IRS examination. Adjustments to previously reported taxable income, if any, are recorded in the consolidated financial statements when they become known.

ACIG and its subsidiaries collectively join in filing a consolidated U.S. federal income tax return.

Deferred federal income taxes result from temporary differences in the bases of assets and liabilities for income tax and financial reporting purposes of ACIG and its subsidiaries. A valuation allowance was provided at December 31, 2008 on net unrealized losses on investments to reduce the deferred tax asset to the amount that was more likely than not to be realized. The components of the deferred income tax asset as of December 31, 2009 and 2008 are as follows (dollar amounts in thousands):

	2009	2008
Discount of loss reserves for income tax purposes	\$ 8,680	\$ 9,712
Net unrealized (gains) losses on investments	(4,422)	5,061
Advance premiums for income tax purposes	1,981	1,887
Capital loss carryover	621	-
Accrual of salvage and subrogation recoverable for income tax purposes	325	194
Other	465	72
Subtotal	<u>7,650</u>	<u>16,926</u>
Less: valuation allowance	-	(3,177)
Net	<u>\$ 7,650</u>	<u>\$ 13,749</u>

The components of the benefit for U.S. federal income taxes and the reconciliation of the actual benefits for U.S. federal income taxes to the amounts computed by applying the federal statutory rate to income (loss) before income taxes follows for the years ended December 31, 2009 and 2008 (dollar amounts in thousands):

	2009	2008
Current tax (benefit) provision	\$ (1,052)	\$ 72
Deferred tax provision (benefit)	<u>127</u>	<u>(403)</u>
Total income tax benefit	<u>\$ (925)</u>	<u>\$ (331)</u>
Tax expense (benefit) at statutory rate	\$ 2,012	\$ (693)
Tax-exempt municipal income	(1,074)	(1,254)
Valuation allowance for non-deductible investment losses	(1,604)	1,604
Other	<u>(259)</u>	<u>12</u>
Total income tax benefit	<u>\$ (925)</u>	<u>\$ (331)</u>

## Notes to Consolidated Financial Statements

(Continued)

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### 8. Compensation arrangements

The Company has entered into deferred compensation agreements with several of its officers. Under those agreements, the officers are entitled to \$190,000 in each of December 2007-2011, provided they are employed by the Company at the date of payment. The Company recorded \$190,000 of expense related to these agreements in each of 2009 and 2008 that is included in other operating expenses in the accompanying consolidated statements of income (loss) and comprehensive income (loss). As of December 31, 2009, the Company had accrued \$380,000 related to these deferred compensation agreements which is recorded in the accompanying consolidated balance sheets in other liabilities.

The Company maintains a 401(k) plan (the "Plan") for employees whereby participants of the Plan may make voluntary contributions, within certain limitations. The Company has agreed to match 100% of the employee contributions up to 3% of salary. Additionally, the Company makes discretionary contributions into the Plan equal to 7% of each employee's salary. During 2009 and 2008, the Company recorded compensation expense of approximately \$636,000 and \$588,000, respectively, related to the matching and discretionary contributions that have been recorded in the accompanying consolidated statements of income (loss) and comprehensive income (loss).

Additionally, certain officers of the Company participate in executive bonus plans. The plans are based on attaining certain goals as established by the Compensation Committee of the Board of Directors.

### 9. Commitments and contingencies

#### Lease -

The Company has entered into noncancelable lease agreements for office space expiring on December 31, 2013. Future minimum rentals are \$381,000 in each of 2010-2013. Rental expense charged to operations was approximately \$504,000 and \$415,000 for the years ended December 31, 2009 and 2008, respectively.

#### Contingencies -

The Company is involved in certain claims and lawsuits arising in the ordinary course of business. In the opinion of management, based in part on the advice of legal counsel, potential liabilities arising from these claims, if any, would not have a significant effect on the Company's consolidated financial position or results of future operations.

### 10. Fair value of financial instruments

Disclosure of certain information regarding the fair value of the Company's financial instruments is presented below. A financial instrument is defined as cash, evidence of an ownership interest in an entity or a contractual arrangement that involves cash or another financial instrument. Market prices are the best evidence of the fair value of financial instruments.

Management believes it has taken reasonable efforts to ensure that fair value estimates presented are accurate; however, adjustments to fair value estimates may occur in the future, and actual amounts realized from financial instruments held as of December 31, 2009 and 2008, may differ from the amounts discussed below.

# Notes to Consolidated Financial Statements

(Continued)

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The following methods and assumptions were used to estimate fair value of each class of financial instruments:

**Cash and cash equivalents:** Carrying amount approximates fair value.

**Investments:** The estimated fair values of investments are provided in Note 3 to the financial statements. These are based on quoted market prices, when available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

**Accrued investment income:** Carrying amount approximates fair value.

**Notes payable:** Carrying amount approximates fair value.

## 11. Subsequent event

The Company has evaluated all subsequent events through February 26, 2010, the date the consolidated financial statements were issued.

# Independent Auditors' Report

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To the Shareholders of  
American Contractors Insurance Group Ltd.:

We have audited the accompanying consolidated balance sheets of American Contractors Insurance Group Ltd. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income (loss) and comprehensive income (loss), shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of American Contractors Insurance Group Ltd. and subsidiaries at December 31, 2009 and 2008, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*BDO Seidman, LLP*

Dallas, Texas  
February 26, 2010

# Members of ACIG

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<u>Name</u>	<u>Predominant Type of Construction</u>	<u>Headquarters</u>	<u>Entry Date</u>
The Pepper Companies, Inc.	General	Chicago, IL	1981
Williams Bros. Construction Co., Inc.	Street & Road	Houston, TX	1981
McIntyre Construction Company	General	Dallas, TX	1981
Kitchell Corporation	General	Phoenix, AZ	1984
Hoffman Corporation	General	Portland, OR	1985
Herzog Contracting Corp.	Railroad	St. Joseph, MO	1985
Graycor Services L.L.C.	General	Chicago, IL	1986
Duininck Companies, LLC	Street & Road	Prinsburg, MN	1987
The Brady Companies, Inc.	Specialty	La Mesa, CA	1989
G.A. & F.C. Wagman, Inc.	Street & Road	York, PA	1990
Clarkson Construction Company	Street & Road	Kansas City, MO	1991
The Weitz Group, LLC	General	Des Moines, IA	1993
Ajax Paving Industries, Inc.	Street & Road	Troy, MI	1995
The Danella Companies, Inc.	Utility	Plymouth Meeting, PA	1995
Phillips and Jordan, Incorporated	Excavation/Heavy	Knoxville, TN	1996
McCarthy-Bush Corporation	Mining/Street & Road	Davenport, IA	1996
William Charles, Ltd.	Street & Road	Loves Park, IL	1997
Murphy Company	Industrial	St. Louis, MO	1997
Danis Building Construction Company	General	Dayton, OH	1997
BMW Constructors, Inc.	Industrial	Indianapolis, IN	1999
McBride & Son Enterprises, Inc.	Residential	St. Louis, MO	2000
Hoar Construction, LLC	General	Birmingham, AL	2001
Nabholz Construction Corporation	General	Conway, AR	2001
J.D. Abrams, L.P.	Street & Road	Austin, TX	2001
Charles Pankow Builders, Ltd.	General	Pasadena, CA	2002
Dan's Excavating, Inc.	Excavation/Heavy	Shelby Township, MI	2002
Berglund Construction Company	General	Chicago, IL	2002
Jaynes Companies	General	Albuquerque, NM	2002
LeChase Construction Services, LLC	General	Rochester, NY	2002
Roy Anderson Corp	General	Gulfport, MS	2003
J J White, Inc.	Commercial/Industrial/ Mechanical/General	Philadelphia, PA	2003
KS Industries, LP	Industrial/Specialty	Bakersfield, CA	2003
Sukut Construction, Inc.	Excavation/Heavy	Santa Ana, CA	2005
J.T. Vaughn Construction, LLC	Institutional	Houston, TX	2005
McGeorge Contracting Co., Inc.	Heavy/Street & Road/ Quarries	Pine Bluff, AR	2005
Cajun Industries, LLC	Industrial	Baton Rouge, LA	2005
The Haskell Company	General	Jacksonville, FL	2006
Forrester Construction Company	General	Rockville, MD	2008
Goodfellow Bros., Inc.	Excavation/Heavy/ Street & Road	Wenatchee, WA	2008
SpawGlass	General	Selma, TX	2009
Shimmick Construction Company, Inc.	Excavation/Heavy/ Street & Road	Oakland, CA	2010



# Shareholders' Addresses

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**Ajax Paving Industries, Inc.**  
P.O. Box 7058  
Troy, MI 48007  
248/244-3300

**BMW Constructors, Inc.**  
P.O. Box 22210  
Indianapolis, IN 46222-0210  
317/267-0400

**Berglund Construction Company**  
8410 South Chicago Avenue  
Chicago, IL 60617  
773/374-1000

**The Brady Companies, Inc.**  
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619/589-7575

**Cajun Industries, LLC**  
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Baton Rouge, LA 70821  
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**Clarkson Construction Company**  
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**Danella Companies, Inc.**  
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610/828-6200

**Danis Building Construction Co.**  
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Miamisburg, OH 45342  
937/228-1225

**Dan's Excavating Inc.**  
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Shelby Township, MI 48315  
586/254-2040

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P.O. Box 208  
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320/978-6011

**Forrester Construction Company**  
12231 Parklawn Drive  
Rockville, MD 20852-1723  
301/816-1700

**Goodfellow Bros., Inc.**  
P.O. Box 598  
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**G.A. & F.C. Wagman, Inc.**  
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York, PA 17405-7076  
717/764-8521

**Graycor Services L.L.C.**  
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708/206-0500

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111 Riverside Avenue  
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904/791-4500

**Herzog Contracting Corp.**  
P.O. Box 1089  
St. Joseph, MO 64502-1089  
816/233-9001

**Hoar Construction, LLC**  
P.O. Box 660400  
Birmingham, AL 35266-0400  
205/803-2121

**Hoffman Corporation**  
805 SW Broadway, Suite 2100  
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503/221-8811

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**J J White, Inc.**  
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215/722-1000

**J.T. Vaughn Construction, LLC**  
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713/243-8300

**Jaynes Companies**  
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**KS Industries, LP**  
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Phoenix, AZ 85016  
602/264-4411

**LeChase Construction Services, LLC**  
300 Trolley Blvd.  
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585/254-3510

**McBride & Son Enterprises, Inc.**  
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St. Louis, MO 63005  
636/537-2000

**McCarthy-Bush Corporation**  
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**McGeorge Contracting Co., Inc.**  
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870/534-7120

**McIntyre Construction Company**  
12222 Merit Drive, Suite 1660  
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972/702-9004

**Murphy Company**  
1233 North Price Road  
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314/997-6600

**Nabholz Construction Corporation**  
P.O. Box 2090  
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501/505-5800

**The Pepper Companies, Inc.**  
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**Phillips and Jordan, Incorporated**  
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**Roy Anderson Holding Corp**  
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**SpawGlass**  
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**The Weitz Company, LLC**  
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Des Moines, IA 50003  
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**William Charles, Ltd.**  
1401 North Second Street  
Rockford, IL 61107  
815/963-7400

**Williams Brothers Construction Co., Inc.**  
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Houston, TX 77266  
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**American Contractors Insurance Group Ltd.**  
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