HANLON SUSAN M
Form 4
October 26, 2011

FORM 4

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

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

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Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

(Print or Type Responses)

1. Name and Address of Reporting Person *
HANLON SUSAN M

(Last) (First) (Middle)

400 WOOD ROAD

(Street)

BRAINTREE, MA 02184

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
HAEMONETICS CORP [HAE]

3. Date of Earliest Transaction (Month/Day/Year)
10/25/2011

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
VP Finance

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	10/24/2011		D		73 (1)	D	$ 60.41	6,123 (2)	D	
Common Stock	10/25/2011		D		72 (1)	D	$ 61.03	6,051 (2)	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount Underlying Securitie (Instr. 3 and 4)	
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amou or Numb of Sha
Non-Qualified Stock Option (right to buy)	$ 26.105							(3)	05/05/2014	Common Stock	5,00
Non-Qualified Stock Option (right to buy)	$ 30.385							(3)	05/28/2012	Common Stock	3,00
Non-Qualified Stock Option (right to buy)	$ 41.15							(3)	07/27/2012	Common Stock	5,00
Non-Qualified Stock Option (right to buy)	$ 51.07							10/24/2008(3)	10/24/2014	Common Stock	3,56
Non-Qualified Stock Option (right to buy)	$ 52.76							05/05/2007(3)	05/05/2013	Common Stock	7,28
Non-Qualified Stock Option (right to buy)	$ 52.94							10/27/2010(3)	10/27/2016	Common Stock	7,34
Non-Qualified Stock Option (right to buy)	$ 54.55							10/22/2009(3)	10/22/2015	Common Stock	3,60
Non-Qualified Stock Option (right to buy)	$ 54.99							10/27/2011(3)	10/27/2017	Common Stock	11,1

Reporting Owners

Reporting Owner Name / Address	**Relationships**			
	Director	10% Owner	Officer	Other

HANLON SUSAN M
400 WOOD ROAD
BRAINTREE, MA 02184

VP Finance

Signatures

Susan M. Hanlon — 10/26/2011

**Signature of Reporting Person — Date

Explanation of Responses:

***** If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

****** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Pursuant to a 10b5-1 Plan.

(2) Total includes Restricted Stock Awards and/or Restricted Stock Units that are subject to restrictions until vesting requirements are met. Grant was made under 2005 Long Term Incentive Compensation Plan.

(3) Grant to reporting person of right to buy shares of common stock exercisable in annual increments of 25 percent beginning on the first anniversary of the date of grant.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
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Financial services

11,421 11,421

Other revenue

10,556 (10,583)**(e)** 254 281**(g)**

Total revenues

57,295 57,295 22,785 (10,302) 69,778

EXPENSES

Losses and loss adjustment expenses

29,880 29,880 29,880

Other underwriting expenses

10,536 10,536 (1,514)**(d)** 7,848 (6,815)**(e)** 281**(g)** 4,780**(h)** 580**(m)**

Amortization of deferred policy acquisition costs

(356) (356) (356)

General and administrative

9,984 (3,768)**(e)** 1,750 (4,780)**(h)** 314**(j)**

Financial services expenses							
	10,348	10,348					
Total expenses							
40,060	40,060	20,332	(10,922)	49,470			
Income from operations							
17,235	17,235	2,453	620	20,308			
Federal income tax expense							
5,832	5,832	882	515**(d)**	6,925	(197)**(m)**	(107)**(j)**	
Minority interests							
	2	2					
Net income							
$11,403	$ $11,403	$1,569	$409	$13,381			
Net Income per Share (Note 6)							
Basic							
$	$	$	$0.57	$ $2.75			
Diluted							
$	$	$	$0.53	$ $2.66			
Basic weighted average shares outstanding							
	2,773	2,087	4,860				
Diluted weighted average shares outstanding							
	2,942	2,087	5,029				

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Unaudited Pro Forma Condensed Consolidated Statement of Operations

For the Year Ended December 31, 2005

(In thousands, except per share data)

	APIE Historical 2005	Pro Forma Adjustments Conversion (Note 4)	APIC After Conversion	APSG Historical 2005	Pro Forma Adjustments Merger (Note 5)	Consolidated Pro Forma 2005
REVENUES						
Premiums and maintenance fees written	$ 79,301	$	$ 79,301	$	$	$ 79,301
Premiums ceded	(12,885)		(12,885)			(12,885)
Change in unearned premiums & maintenance fees	(2,233)		(2,233)			(2,233)
Net Premiums and maintenance fees earned	64,183		64,183			64,183
Investment income, net of investment expense of $520 in 2005	5,131		5,131	701		5,832
Realized capital gains, net	552		552	3,101		3,653
Financial services				18,459		18,459
Other revenue				15,514	(15,421)**(f)**	468
					375**(g)**	
Total revenues	69,866		69,866	37,775	(15,046)	92,595
EXPENSES						
Losses and loss adjustment expenses	43,976		43,976			43,976
Other underwriting expenses	12,767		12,767			7,963
					(11,045)**(f)**	
					375**(g)**	
					5,866**(h)**	
Amortization of deferred policy acquisition costs	(96)		(96)			(96)
General and administrative				12,999	(4,376)**(f)**	3,179
					(5,866)**(h)**	
					422**(j)**	
Financial services expenses				16,263		16,263
Total expenses	56,647		56,647	29,262	(14,624)	71,285
Income from operations	13,219		13,219	8,513	(422)	21,310
Federal income tax expense	4,188		4,188	3,039	(143)**(j)**	7,084
Minority interests				14		14
Net income	$ 9,031	$	$ 9,031	$ 5,460	$ (279)	$ 14,212
Net Income per Share (Note 6)						
Basic	$	$	$	$ 2.03	$	$ 2.98
Diluted	$	$	$	$ 1.86	$	$ 2.83
Basic weighted average shares outstanding				2,688	2,087	4,775
Diluted weighted average shares outstanding				2,931	2,087	5,018

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Notes to Unaudited Pro Forma Condensed Consolidated Financial Statements

1. Basis of Presentation

The accompanying unaudited pro forma balance sheet and statements of operations present the pro forma effects of the merger of APSG and APIE through the exchange of common and preferred shares of stock. The balance sheet is presented as though the merger occurred on September 30, 2006. The statements of operations for the nine months ended September 30, 2006 and the year ended December 31, 2005 are presented as though the merger occurred on January 1, 2005.

2. Method of Accounting for the Merger

APSG will account for the merger using the purchase method of accounting for business combinations. APSG is deemed to be the acquirer for accounting purposes based on a number of factors determined in accordance with accounting principles generally accepted in the United States of America (GAAP). The purchase method of accounting requires that APIE s assets acquired and liabilities assumed by APSG be recorded at their estimated fair values.

3. Adjustments to Historical Financial Statements for Comparability

APIE s balance sheet, in conformity with GAAP as applied to insurance companies, prepares its balance sheet without classification as to the short and long term nature of its assets and liabilities. Following the merger we will primarily be an insurance company and, accordingly, we have reclassified APSG s balance sheet and statements of operations in the unaudited pro forma financial information to conform to GAAP as applied to insurance companies.

4. Pro Forma Adjustments related to the Conversion

Pursuant to the plan of conversion, APIE will convert from a Texas reciprocal insurance exchange into a Texas stock insurance company called American Physicians Insurance Company, or APIC.

APIE eligible policyholders will receive their portion of the 10,000,000 shares of $1 par value APIC common stock as part of the conversion. Also, pursuant to the conversion, each holder of refundable deposit certificates representing unpaid surplus contributions which have not been fully refunded will receive one share of Series A redeemable preferred stock of APIC ($1 par value) for every $1,000 of unreturned surplus evidenced by the outstanding balance on the APIE s books as of the date of closing.

The pro forma adjustments related to the unaudited pro forma balance sheet and statements of operations as a result of the conversion are described below:

(a) Records the issuance of APIC common stock to eligible policyholders as a result of conversion

(b) Records the exchange of refundable subscriber deposits for APIC mandatory redeemable preferred stock as a result of the conversion

5. Pro Forma Adjustments Related to the Merger

Pursuant to the merger agreement, immediately following the conversion of APIE to APIC, APSG ACQCO, Inc., a newly formed, wholly owned subsidiary of APSG, will merge into APIC with APIC becoming a wholly owned subsidiary of APSG.

At the effective time of the merger, each share of common stock of APIC issued in the conversion will be converted into, and exchanged for, the right to receive the number of shares of APSG common stock based upon an exchange ratio to be calculated after the occurrence of certain events. The exchange ratio will be equal to a purchase price of $39,000,000 minus the agreed upon current value of the payments authorized by the Texas

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Department of Insurance that must be made by APSG to comply with the mandatory redemption features of the APIC Series A redeemable preferred stock issued pursuant to the conversion in exchange for the APIE refundable deposit certificates, divided by $14.28 (see Note 5(i)), divided by the 10,000,000 shares of APIC common stock being issued in the conversion. The exchange ratio may be adjusted, as of the effective time of the merger, in the event the market price for APSG s common stock fluctuates over or under a certain range. See The Merger Merger Consideration on page 123 for examples of the impact of such fluctuation on the market price of APSG s common stock.

Each share of Series A redeemable preferred stock of APIC that would be issued in the conversion will be converted into the right to receive one share of APSG Series A redeemable preferred stock. The shares of APSG common stock and Series A redeemable preferred stock issued in the merger will be subject to a 180-day lock-up period in which the holders of such shares are prohibited from transferring their shares. See The Merger Merger Consideration on page 123 and The Merger Federal Securities Laws; Stock Transfer Restrictions on page 125.

The pro forma calculations regarding the number of APSG common and Series A redeemable preferred shares to be issued in the merger are based on the following assumptions: (i) the discounted present value of the payments to the holders of shares of APIC Series A redeemable preferred stock, based on the outstanding balance of unreturned surplus on APIE s books as of the closing date of the conversion, is $9,204,000, (ii) the closing market price of APSG stock as of the effective time of the merger will not be more than 15% higher or lower than $14.28, resulting in an assumed exchange ratio, for the purposes of these pro forma calculations, of 0.210 shares of APSG common stock for every share of APIC common stock, and an issuance of approximately 2,087,000 shares of APSG common stock in the merger.

The purchase accounting and pro forma adjustments related to unaudited pro forma balance sheet and statements of operations as a result of the merger are described below:

(c) Eliminates inter-company receivables between APSG and APIE as of September 30, 2006.

(d) As of and for the nine months ended September 30, 2006, APIE had recorded the pro-rata portion of the annual profit sharing component of the management fee expense to APSG. APSG has not historically recognized any of the profit sharing component of the management fee revenue until December of each year. Consequently, to make the historical statements consistent and comparable to each other, $1,514,000 of other underwriting expense related to the profit sharing component of management fees has been eliminated and federal income tax expense has been adjusted accordingly ($515,000) for the nine months ended September 30, 2006. The balance sheet has been adjusted to reflect the reduced payable of $1,514,000, additional income taxes payable of $515,000 and the net effect to retained earnings of $999,000.

(e) Records the elimination of the revenue component of management fee and sub-producer commissions by APSG, the management fee expense by APIE and the sub-producer expenses by APSG for the period ending September 30, 2006.

(f) Records the elimination of both the revenue component and the profit sharing component of management fee by APSG and the management fee expense by APIE for the year ending December 31, 2005.

(g) Records commissions expense incurred by APIE that is currently reimbursed by APSG. There will be no reimbursement following the merger. The reimbursement was eliminated in the APSG financial statements.

(h) Reclassifies the remaining expenses of the attorney-in-fact that would remain as part of the combined entity such as salaries, marketing, professional fees, etc.

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(i) Records the APSG common stock and APSG preferred stock to be issued for APIC common stock and APIC preferred stock as part of the merger. Described below is the calculation of common stock as defined in The Merger Merger Consideration on page 123 and the basis of recording the APSG mandatorily redeemable preferred stock issued in the merger.

The APSG common stock component of the merger consideration, as follows:

Agreed price for APSG common and preferred stock:	$ 39,000,000
Less, value of the Series A preferred shares:	(9,204,000)
Value of the APSG common stock:	$ 29,796,000

The agreement specifies that the price per share of APSG common stock will be the average of the closing price of the stock over the twenty days including and preceding June 6, 2006, which was $14.28.

$$\frac{\$29{,}796{,}000}{\$14.28} = 2{,}087{,}000 \text{ shares}$$

Capital stock at $0.10 par value:	$ 209,000
Additional paid in capital:	
Value of the APSG common stock	$ 29,796,000
Less the par value	(209,000)
	$ 29,587,000

The value of the APSG Series A redeemable preferred stock is defined in the agreement as the value of the APIC Series A redeemable preferred stock, whose value in turn is based on the balance of APIE s refundable surplus at the closing date. Since payments on the refundable surplus are made only in limited circumstances, prior to the annual distribution proscribed by the Texas Department of Insurance, the amount of refundable surplus at closing is not expected to vary materially from the above example. More likely to vary over the period from the announcement of the merger until closing is the market value of the APSG common shares. The following table assumes the value of the APSG Series A convertible preferred to be $9,204,000 and shows a range of average market prices for the APSG common stock within the specified range of 25% above and below the $14.28 price defined in the Merger Agreement. For each value in the share price range the table discloses the impact on the number of shares issued, the value of the APSG common stock, and the total merger consideration. While the number of shares to be issued to each APIC shareholder may vary depending on the price of the APSG shares, the manner in which they are allocated will remain constant.

Percentage of $14.28	Average closing price	Shares to be issued	Value of common stock	Value of preferred stock	Total merger consideration
75%	$ 10.71(1)	2,365,000	25,330,000	9,204,000	34,534,000
80%	$ 11.42	2,218,000	25,330,000	9,204,000	34,534,000
85%	$ 12.14	2,087,000	25,330,000	9,204,000	34,534,000
100%	$ 14.28	2,087,000	29,796,000	9,204,000	39,000,000
115%	$ 16.42	2,087,000	34,261,000	9,204,000	43,465,000
120%	$ 17.14	1,999,000	34,261,000	9,204,000	43,465,000
125%	$ 17.85(1)	1,920,000	34,261,000	9,204,000	43,465,000

Note 1. These numbers represent the maximum stock price variance from the $14.28 contractual price before either party has the right to withdraw from the merger or renegotiate its terms.

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APSG will issue Series A redeemable preferred stock in exchange for APIC redeemable preferred stock as part of the consideration. APIC Series A redeemable preferred stock is created when holders of APIE refundable deposit certificates exchange those certificates for the Series A redeemable preferred at conversion. Under FAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* it requires an issuer to classify an instrument as a liability if it is issued in the form of shares that are mandatorily redeemable if it embodies an unconditional obligation that requires the issuer to redeem the shares by transferring the entity s assets at a specified or determinable date(s) or upon an event that is certain to occur. The preferred stock s mandatory cash redemption feature coupled with a fixed redemption date and fixed amount requires that it be classified as debt, rather than equity. Terms of the agreement call for the stock to be redeemed over ten years with a 3% dividend rate. Per FAS 150, the debt will be recorded at fair market value calculated at its present value of APSG s rate of return on investment assets, 5.35%, which is $9,204,000.

(j) Records the three percent (3%) dividend on the APSG Series A preferred stock and the imputed interest from recording the liability at fair value.

(k) Eliminates the beginning equity of APIC in consolidation.

(l) In June 2001, the Financial Accounting Standards Board issued Statement No. 141, *Business Combinations* and Statement 142, *Goodwill and Other Intangible Assets*. In accordance with these pronouncements, when there is an excess of fair value of acquired net assets over their cost, the excess shall be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to the non-current assets, except financial assets, assets to be disposed of by sale, deferred tax assets, and prepaid assets relating to pension or other postretirement benefits.

The excess of fair value of acquired net assets over cost is as follows:

Merger consideration	$ 39,000,000
Transaction costs	850,000
Total purchase price	$ 39,850,000
APIC stated equity	$ 30,143,000
Add: Adjustment of assets to fair value	417,000
Debt to be replaced by APSG Series A preferred stock	10,295,000
Net assets acquired at fair value	40,855,000
Excess of fair value of acquired net assets over cost	$ 1,005,000

Note: Transaction costs of $850,000 above consist of $532,000 which has been incurred and capitalized as of September 30, 2006 and $318,000 of anticipated additional fees, which are to be capitalized.

The allocation of excess fair value over costs to acquired APIC assets is as follows:

Asset classification	Total	Long-term Portion	%	Adjustment
Reinsurance recoverables	$ 29,674	$ 15,700	94%	($ 945)
Subrogation recoverables	761	761	5%	(50)
Other assets	818	236	1%	(10)

$ 31,253	$ 16,697	100%	($ 1,005)

The adjustment of assets to fair value shown above represents the adjustment to present value of a receivable with an interest rate in excess of current market interest rates. The carrying value of all other assets and liabilities was reviewed and determined to be an accurate representation of fair value. APIE has no fixed assets, a common area for adjustments, its largest asset, its investment portfolio, is adjusted to market in its GAAP financial

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statements, and its other assets and liabilities are of short duration and will be realized/paid at the carrying value. We also reviewed APIE for intangible assets that could result from the merger. We reviewed trademarks and trade names and determined that they would not carry over to the new entity. We considered customer lists and determined that there was no information that was not readily available from the Texas Board of Medical Examiners. We examined customer relationships and, while we consider them good, we do not believe they provide an advantage over our two larger competitors in this highly competitive environment. No other intangibles, as defined in Statement of Financial Accounting Standards No. 141 *Business Combinations* were determined to be applicable.

(m) Stock based compensation As an inducement to attract and retain physician members of the Advisory Board to be formed in conjunction with the merger and to compensate that Advisory Directors for future services, 148,000 of APSG common stock options are to be issued as part of the merger.

For the year ended December 31, 2005, we applied the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (Statement 123), but applied Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees , in accounting for our option plans.

On January 1, 2006 we adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* and included the fair value of stock options in our financial statements. The fair value of the common stock options was calculated using the Black-Scholes-Merton option pricing model, based on 148,000 options at an exercise price of $13.94, expected volatility of ..348, an expected life of 3.71 years, an expected dividend yield of 2.11%, a risk free rate of return of 4.69% and an estimated tax rate of 34%.

Fair value of options to be granted	$ 580,000
Tax at 34%	(197,000)
Fair value of options, net of related tax effects	$ 383,000

The net effect of $383,000 is recorded in the income statement and retained earnings.

6. Common Shares Outstanding

Pro forma net income per share for the nine months ended September 30, 2006 and the year ended December 31, 2005 have been calculated based on the weighted average number of shares outstanding as follows:

	Nine Months Ended September 30, 2006	Year Ended December 31, 2005
	(In thousands)	
Basic :		
APSG weighted average common shares outstanding	2,773	2,688
Shares to be issued in the merger transaction, based on $14.28/sh	2,087	2,087
Pro forma weighted average APSG shares outstanding	4,860	4,775
Diluted:		
APSG weighted average common shares outstanding	2,942	2,931
Shares to be issued in the merger transaction, based on $14.28/sh	2,087	2,087
Pro forma weighted average APSG shares outstanding	5,029	5,018

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The following table shows a range of shares that could be issued in the transaction, based on the market value of the APSG common shares, varying plus or minus 25% from the $14.28 price in the Merger Agreement. The following table shows how net income per share would vary as the number of shares issued varies, based on consolidated pro forma net income of $13,381,000 and $14,212,000 for the nine months ended September 30, 2006 and the year ended December 31, 2005, respectively:

		(In thousands)							
		Pro Forma weighted average shares outstanding				Consolidated Pro Forma Net Income Per Share			
		Basic		Diluted		Nine months ended September 30, 2006		Year ended December 31, 2005	
Percentage of $14.28	Range of shares to be issued	Sept 30, 2006	Dec 31, 2005	Sept 30, 2006	Dec 31, 2005	Basic	Diluted	Basic	Diluted
75%	2,365	5,138	5,053	5,307	5,296	2.60	2.52	2.81	2.68
80%	2,218	4,991	4,906	5,160	5,149	2.68	2.59	2.90	2.76
100%	2,087	4,860	4,775	5,029	5,018	2.75	2.66	2.98	2.83
120%	1,999	4,772	4,687	4,941	4,930	2.80	2.71	3.03	2.88
125%	1,920	4,693	4,608	4,862	4,851	2.85	2.75	3.08	2.93

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OTHER INFORMATION REGARDING

DIRECTORS, EXECUTIVE OFFICERS AND FIVE PERCENT SHAREHOLDERS OF APSG

The following table sets forth certain information as of September 30, 2006 regarding the amount and nature of the beneficial ownership of APSG common stock by (a) each person who is known by APSG to be the beneficial owner of more than five percent of the outstanding shares of its common stock, (b) each of APSG s directors, (c) each of the named executivse officers, and (d) all of APSG s officers and directors as a group:

	Pre Merger Number of Shares		Post Merger Number of Shares	
Beneficial Owner	**Beneficially Owned (1)**	**% of Class**	**Beneficially Owned**	**% of Class**
Hoak Public Equities, LP (2)	138,202	5.0%	138,202	2.9%
Boston Avenue Capital, LLC (3)	263,661	9.6%	263,661	5.5%
Daniel Zeff (4)	274,834	10.0%	274,834	5.7%
First Wilshire Securities Management, Inc. (5)	226,018	8.3%	226,018	4.7%
Kenneth S. Shifrin (6)	657,554	23.3%	657,554	13.4%
Lew N. Little, Jr.	26,500	1.0%	26,500	0.5%
Jackie Majors	41,500	1.5%	41,500	0.9%
William A. Searles	30,000	1.1%	30,000	0.6%
Cheryl Williams	31,063	1.1%	31,063	0.6%
Norris C. Knight, Jr., M.D. (7)			23,067	0.5%
William J. Peche, M.D. (7)			29,781	0.6%
W.H. Hayes	60,253	2.2%	60,253	1.2%
Maury L. Magids	91,000	3.2%	91,000	1.9%
Thomas R. Solimine	20,360	0.7%	20,360	0.4%
All officers and directors as a group	1,006,590	32.7%	1,059,438	20.3%

(1) Includes options exercisable within 60 days of September 30, 2006.
(2) The address for Hoak Public Equities, LP is 500 Crescent Court, Suite 220, Dallas, TX 75201. We have not been able to determine the person or persons controlling the fund through publicly available information.
(3) The address for Boston Avenue Capital, LLC is 415 South Boston, 9th Floor, Tulsa, Oklahoma 74103. Charles M. Gillman is the fund manager.
(4) The address for Daniel Zeff is c/o Zeff Holding Company, LLC, 50 California Street, Suite 1500, San Francisco, CA 94111.
(5) The address for First Wilshire Securities Management, Inc. is 600 South Lake Street, Suite 100, Pasadena, CA 91106. We have not been able to determine the person or persons controlling the fund through publicly available information.
(6) The address for Kenneth S. Shifrin is 1301 S. Capital of Texas Highway, Suite C-300, Austin, Texas 78746-6550.
(7) To be elected to the APSG board of directors at the effective time of the merger. Reflects shares acquirable under options pursuant to the merger agreement and an estimate of the shares received as merger consideration.

INTERESTS OF CERTAIN PERSONS IN THE MERGER

Directorship of APSG

Pursuant to the adoption of the merger agreement, APSG s board of directors has agreed to add Norris C. Knight, Jr., M.D. and William J. Peche, M.D., both current members of the board of directors of APIE, to the board of directors at the effective time of the merger, to serve until the next annual meeting of APSG shareholders or until their earlier death, resignation or removal or until their successors are duly elected and qualified in accordance with the articles of incorporation and bylaws of APSG.

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Consideration to the APIE Board of Directors

Pursuant to the merger agreement, APSG will issue options to each of the current members of the APIE board of directors to purchase a total of 148,000 shares of APSG common stock as follows:

Name	# Shares
Duane Kenneth Boyd, Jr.	2,000
Freddie Lee Contreras, M.D.	5,000
Thomas William Eades, M.D.	27,000
Michael Lewis Green, Jr. M.D.	2,000
Gregory Mann Jackson, M.D.	16,000
Norris Crockett Knight, Jr., M.D.	22,000
William Joseph Peche, M.D.	29,000
Lawrence Scott Pierce, M.D.	17,000
Richard Samuel Shoberg, Jr., M.D.	28,000
	148,000

Each of the options will have an exercise price of $13.94**,** will be exercisable for a period of 5 years and will be fully vested as of the date of the grant.

Each member of the APIE board of directors except Duane K. Boyd are APIE policyholders and will receive APSG common stock pursuant to the conversion and merger in the same manner as other APIE policyholders.

As described further below, it is anticipated that most or all of the current members of the APIE board of directors will receive fees from APIC after the merger for advisory services under the terms of the advisory services agreement. Additionally it is expected that Dr. Jackson will be designated as the medical director under the advisory services agreement and will be compensated in the amount of approximately $15,417 per month for such duties.

Advisory Services Agreement

Pursuant to the merger agreement, APIC will enter into an Advisory Services Agreement with API Advisory, LLC, or API Advisor, an entity to be formed and owned in equal interests of 11.11% each by the nine current members of the APIE board of directors. The Advisory Services Agreement is described in greater detail in the section entitled, The Merger Agreement The Advisory Services Agreement on page 132. Pursuant to this agreement, certain directors of API Advisor will be compensated directly for providing advisory and consulting services to APIC. These advisory services will include participation in committee meetings regarding claims, underwriting, rates and risk management. The committee members will be selected based on the vote of a majority of the board of directors of APIC. While not required under the terms of the Advisory Services Agreement, it is anticipated that most or all of the current members of the APIE board of directors will be the persons designated to provide these services and receive the related compensation from APIC. The compensation will be payable on a per meeting basis, as described below, and may vary amongst directors depending on the number of board and committee positions held and the frequency of meetings. Furthermore, Dr. Eades, Dr. Shoberg and Dr. Pierce will own interests in API Advisor and will serve on the board of APIC after the merger. The Advisory Services Agreement requires APIC to maintain customary officers and directors liability insurance with an endorsement naming, as additional insureds thereunder, the persons designated by API Advisor to provide advisory and consulting services to APIC, with respect to their services as advisory directors of APIC.

Under the terms of the Advisory Services Agreement, compensation for the directors is $2,500 for each board meeting attended in person and $250 per hour if attended by telephone with the same rates applicable to each committee of the board. API Advisor will be reimbursed for its out of pocket costs incurred in connection with the provision of the services, plus any amount paid to directors for board and committee meetings, medical director, or executive secretary if those are not paid directly by APIC.

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PROPOSALS TO AMEND THE

APSG 2005 INCENTIVE AND NON-QUALIFIED STOCK OPTION PLAN

APSG has adopted, with shareholder approval, the 2005 Incentive and Non-Qualified Stock Option Plan, which we refer to as the 2005 Incentive Plan. The 2005 Incentive Plan provides for the issuance of up to 350,000 shares of common stock to its directors, key employees and consultants and advisors. A total of 153,000 of these options have been granted as of November 6, 2006, 136,000 of which are currently exercisable.

In connection with the merger, APSG has agreed to grant options to purchase exactly 148,000 shares to the APIE board members, leaving only 49,000 options remaining to be granted under the terms of the current plan. The APSG board believes that it is in the best interests of the company to be able to continue to provide to the persons who are responsible for the continued growth of APSG s business an opportunity to acquire a proprietary interest in APSG, thereby creating an increased interest in and greater concern for the growth, success and welfare of the company.

APSG S BOARD OF DIRECTORS RECOMMENDS A VOTE FOR APPROVAL OF THE AMENDMENT TO INCREASE THE SHARES AVAILABLE FOR ISSUANCE UNDER THE 2005 INCENTIVE PLAN.

The 2005 Incentive Plan also currently provides for APSG to be able to, at any time, offer to exchange or buy out any previously granted stock option for a payment in cash, common stock of APSG or another stock option under the 2005 Incentive Plan. APSG s board of directors has determined that this exchange provision is deemed to be unfair to shareholders under current standards of corporate governance. The APSG board of directors has never utilized this provision and has no intention of doing so, but believes that deleting it from the 2005 Incentive Plan clarifies its position and better protects shareholders during the remaining life of the plan. The APSG board of directors continues to believe that it is in the best interests of all shareholders for employees and directors to have a direct financial stake in APSG through stock options and further believes that those option holders should share the same risks and rewards as all other shareholders.

APSG S BOARD OF DIRECTORS RECOMMENDS A VOTE FOR APPROVAL OF THE AMENDMENT TO ELIMINATE THE EXCHANGE PROVISION FROM THE 2005 INCENTIVE PLAN.

Therefore, the APSG board has determined that it is advisable, fair and in the best interests of APSG and its shareholders to amend the 2005 Incentive Plan to (i) provide for the issuance of up to an additional 300,000 shares of common stock to its directors, key employees and consultants and advisors; and (ii) eliminate the provision allowing APSG to exchange or buy out any previously granted stock option at any time.

The following is a brief summary of the 2005 Incentive Plan incorporating the proposed changes. The amendment is attached as Annex F to this joint proxy statement/prospectus and reference is made to such Appendix for a complete statement of the provisions of the amendment.

The 2005 Incentive Plan provides for the granting of options to purchase up to 650,000 shares of APSG common stock; provided that the maximum number of shares of common stock with respect to which options may be granted to any individual during any calendar year is 150,000. If any option expires or terminates prior to its exercise in full, the shares of APSG s common stock allocable to the unexercised portion of such option may again be available for options under the 2005 Incentive Plan. The plan will be administered by an administrative body, referred to as the Committee, designated by APSG s board of directors. The board may designate itself as the Committee or appoint two or more nonemployee and outside directors, within the meaning of the federal securities laws and the Internal Revenue Code of 1986, as amended, or the Code, to serve as the Committee. Participants under the 2005 Incentive Plan will be selected by the Committee upon the recommendation of APSG s management. All employees will be eligible for selection to participate in the 2005 Incentive Plan. The

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Committee will determine the number of shares underlying options granted to any individual under the plan, and options will vest and become exercisable in the manner and within the periods specified by the Committee in its discretion. The number and kind of shares subject to the 2005 Incentive Plan can be appropriately adjusted in the event of any change in the capital structure of the APSG (such as a stock split, reverse stock split, stock dividend, combination or reclassification of APSG s common stock).

The 2005 Incentive Plan enables APSG to grant either incentive stock options , as defined in Section 422 of the Code, or options that are not intended to be incentive stock options . Options may be granted only to APSG s employees, directors and consultants and advisors. No options may be granted under the 2005 Incentive Plan later than April 6, 2015. Any options granted under the 2005 Incentive Plan must have an exercise period of no more than ten years.

The exercise price per share for each option may not be less than the fair market value on the date of grant, as fair market value is defined in the 2005 Incentive Plan. The plan provides that payment of the exercise price may be made in cash, by delivery of already owned shares of APSG s common stock, valued at its fair market value on the exercise date, or through such cashless exercise procedures that are deemed acceptable by the Committee. Proceeds received from the optioned shares will be used for general corporate purposes. To the extent that the aggregate fair market value (determined as of the time such option is granted) of the common stock for which any employee may have incentive stock options vest in any calendar year exceeds $100,000, such excess incentive stock options will be treated as non-qualified options.

No options are assignable or transferable by the optionee except by will or by the laws of descent and distribution or by Committee approved transfer to a family member as defined in the 2005 Incentive Plan, and each option is exercisable during the lifetime of an optionee only by the optionee or the optionee s guardian or legal representative.

Upon a Change in Control (as defined in the 2005 Incentive Plan), dissolution or liquidation, corporate separation or division, or sale of substantially all assets, the Committee may provide for (1) the continuation of the then outstanding options (if APSG is the surviving corporation), (2) the assumption of the 2005 Incentive Plan and the then outstanding options by the surviving entity or its parent, (3) the substitution by the surviving entity or its parent of options with substantially similar terms as the then outstanding options, (4) the cancellation of outstanding options for a cash payment equal to the in-the-money value thereof or (5) the cancellation of outstanding options without payment of consideration. If vested options would be cancelled without payment, the option holder would have the right to exercise such options before such cancellation. In connection with the alternatives described above, the Committee may in its discretion accelerate unvested options.

The APSG s board of directors, subject to certain exceptions, may suspend, terminate or amend the 2005 Incentive Plan at its discretion.

The following awards have been made under the 2005 Incentive Plan as of November 6, 2006: Mr. Shifrin, 15,000 shares; Mr. Magids, 25,000 shares; Mr. Hayes, 5,000 shares; Mr. Solimine, 5,000 shares; Mr. Searles, 10,000 shares; all executive officers as a group, 60,000 shares; all directors, who are not executive officers, as a group, 45,000 shares; and all employees, including current officers who are not executive officers, as a group, 48,000 shares. Except with respect to the issuance of options covering 148,000 shares to the current directors of APIE pursuant to the plan of conversion and merger agreement, no determination has been made with respect to future recipients of options under the 2005 Incentive Plan and it is not possible to specify the names or positions of the persons to whom options may be granted, or the number of shares, within the limitations of the 2005 Incentive Plan, to be covered by such options.

Under currently applicable provisions of the Code, an optionee will not be deemed to receive any income for federal income tax purposes upon the grant of any option under the 2005 Incentive Plan, nor will APSG be entitled to a tax deduction at that time. Upon the exercise of a non-incentive option, the optionee will be deemed to have

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received ordinary income in an amount equal to the difference between the exercise price and the market price of the shares on the exercise date. APSG will be allowed an income tax deduction equal to the excess of market value of the shares on the date of exercise over the cost of such shares to the optionee. No income will be recognized by the optionee at the time of exercise of an incentive stock option. If the stock is held at least one year following the exercise date and at least two years from the date of grant of the option, the optionee will realize a capital gain or loss upon sale, measured as the difference between the exercise price and the sale price. If both of these holding period requirements are not satisfied, ordinary income tax treatment will apply to the amount of gain at sale or exercise, whichever is less. If the actual gain exceeds the amount of ordinary income, the excess will be considered short-term or long-term capital gain depending on how long the shares are actually held. No income tax deduction will be allowed by APSG with respect to shares purchased by an optionee upon the exercise of an incentive stock option, provided such shares are held for the required periods as described above.

Under the Code, an option will generally be disqualified from receiving incentive stock option treatment if it is exercised more than three months following termination of employment. However, if the optionee is disabled, such statutory treatment is available for one year following termination. If the optionee dies while employed by APSG or within three months thereafter, the statutory time limit is waived altogether. In no event do these statutory provisions extend the rights to exercise an option beyond those provided by its terms.

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LEGAL MATTERS

The validity of the APSG common stock and APSG Series A redeemable preferred stock offered hereby will be passed upon for APSG by Akin, Gump, Strauss, Hauer & Feld, L.L.P.

The validity of the APIC common stock and the APIC Series A redeemable preferred stock offered hereby will be passed upon for APIE by Graves, Dougherty, Hearon & Moody, P.C.

TAX MATTERS

Deloitte Tax LLP has delivered an opinion to APIE as to certain tax matters.

EXPERTS

APSG. The consolidated financial statements of American Physicians Service Group, Inc. as of December 31, 2005 and 2004, and for the years ended December 31, 2005, 2004 and 2003, have been included herein in reliance upon the report of BDO Seidman, LLP, independent registered public accountants, appearing elsewhere herein and upon the authority of said firm as experts in accounting and auditing.

APIE. The financial statements of American Physicians Insurance Exchange, as of December 31, 2005 and 2004 and for each of the three years in the period ended December 31, 2005, included in this prospectus have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report appearing herein, and are included in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

FUTURE SHAREHOLDER PROPOSALS

Any APSG shareholders meeting certain minimum stock ownership and holding period requirements may present a proposal to be included in APSG s proxy statement for action at the APSG annual meeting of shareholders to be held in 2007 pursuant to Rule 14a-8 of the Exchange Act. Such shareholder must deliver such proposal to APSG s principal executive offices no later than January 6, 2007, unless APSG notifies shareholders otherwise. Only those proposals that are appropriate for shareholder action and otherwise meet the requirements of Rule 14a-8 of the Exchange Act may be included in APSG s proxy statement.

An APSG shareholder who otherwise intends to present business, other than for the nomination of a person for election to APSG s board of directors, at its 2007 annual meeting of shareholders must comply with the requirements set forth in APSG s bylaws, which require, among other things, that to bring business before the 2007 annual meeting, a shareholder must give written notice that complies with APSG s bylaws to its Secretary at APSG s principal executive offices. A shareholder s notice shall be timely if received by APSG s Secretary no earlier then January 5, 2007 and no later than February 7, 2007, unless APSG notifies its shareholders otherwise.

An APSG shareholder who intends to nominate a person for election to the APSG board of directors at the 2007 annual meeting must give written notice that complies with APSG s bylaws to its Secretary at APSG s principal executive offices no earlier then January 5, 2007 and no later than February 7, 2007, unless APSG notifies its shareholders otherwise.

As a result, a notice of an APSG shareholder proposal for the 2007 annual meeting, submitted other than pursuant to Rule 14a-8, will be untimely if not received by APSG within the time deadlines required by its bylaws as described above. As to any such proposals, the proxies named in management s proxy for that meeting will be entitled to exercise their discretionary authority on that proposal unless APSG receives notice of the matter to be proposed within the time deadlines required by APSG s bylaws as described above. Even if proper notice is received on a timely basis, the proxies named in management s proxy for that meeting may nevertheless exercise their discretionary authority with respect to such matter by advising shareholders of such proposal and how they intend to exercise their discretion to vote on such matter to the extent permitted under Rule 14a-4(c)(2) of the Exchange Act.

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WHERE YOU CAN FIND MORE INFORMATION

APSG files reports, proxy statements and other information with the SEC under the Securities Exchange Act of 1934, as amended. You may read and copy any reports, statements or other information that APSG files with the SEC at the SEC s Public Reference Room at 100 F Street, N.E. Room 1580, Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains reports, proxy and information statements and other information about issuers that file electronically with the SEC. The address of the SEC s internet site is *www.sec.gov*.

Copies of the APSG documents may also be obtained without charge from APSG on the internet at *www.amph.com*, under the Investor Relations section, or by contacting American Physicians Service Group, Inc., 1301 S. Capital of Texas Highway, Suite C-300, Austin, Texas 78746, (512) 328-0888.

If you wish to obtain any of these documents from APSG, you should, to ensure timely delivery, make your request no later than , 2006.

APIE is subject to the laws and regulations of the State of Texas applicable to reciprocal insurance exchanges and, in accordance therewith, files financial reports and other public information with the Texas Department of Insurance. The publicly available financial reports and other information regarding APIE can be inspected at the offices of the Texas Department of Insurance at Financial Monitoring Section, Hobby Building Tower 3, 3rd Floor, 333 Guadalupe Street, Austin, Texas 78701, during normal business hours.

APIE filed an Application to Convert to a Stock Insurance Company with the Commissioner of Insurance of the State of Texas that describes the conversion and contains other information required by the Texas Insurance Code, including such information requested by the commissioner and other public materials submitted to the commissioner concerning the application.

Copies of certain APIE documents are available at no cost upon request by contacting APIE at American Physicians Insurance Exchange; Attn: Sharon Stripling; 1301 S. Capital of Texas Highway, Suite C-300, Austin, Texas 78746, or may be obtained on the internet at *www.apie.us*. Such documents include the bylaws of APIE, as amended, and the annual statement filed with the Texas Department of Insurance.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 30, 2006	December 31, 2005
	(In thousands)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 3,590	$ 6,231
Cash-restricted (Note 8)	3,523	449
Trade receivables, net	503	42
Notes receivable current	546	599
Management fees and other receivables	960	3,192
Deposit with clearing organization	501	501
Investment in available-for-sale fixed income securities current (Note 10)	13,435	9,662
Federal income tax receivable	483	
Net deferred income tax asset	345	355
Prepaid expenses and other (Note 11)	1,137	632
Total current assets	25,023	21,663
Notes receivable, less current portion	347	326
Property and equipment, net	588	687
Investment in available-for-sale equity securities (Note 9)	4,663	5,017
Investment in available-for-sale fixed income securities non-current (Note 10)	1,883	3,584
Net deferred income tax asset	555	686
Goodwill	1,247	1,247
Other assets	250	295
Total Assets	$ 34,556	$ 33,505

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS, continued

(Unaudited)

	September 30, 2006	December 31, 2005
	(In thousands, except share data)	
LIABILITIES, MINORITY INTERESTS AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,879	$ 736
Accrued incentive compensation	1,360	2,595
Accrued expenses and other liabilities (Note 12)	1,343	1,912
Federal income tax payable		71
Deferred gain	244	469
Total current liabilities	6,826	5,783
Total liabilities	6,826	5,783
Minority interests	20	15
Commitments and contingencies (Note 3)		
Shareholders Equity:		
Preferred stock, $1.00 par value, 1,000,000 shares authorized, none issued or outstanding		
Common stock, $0.10 par value, shares authorized 20,000,000; 2,793,418 and 2,784,120 issued and outstanding at 9/30/06 and 12/31/05, respectively	279	278
Additional paid-in capital	7,502	8,204
Retained earnings	19,486	18,737
Accumulated other comprehensive income, net of taxes	443	488
Total shareholders equity	27,710	27,707
Total Liabilities, Minority Interests and Shareholders Equity	$ 34,556	$ 33,505

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands, except per share data)			
Revenues:				
Insurance services	$ 3,726	$ 3,732	$ 10,556	$ 10,462
Financial services	3,043	5,450	11,421	12,415
Total revenues	6,769	9,182	21,977	22,877
Expenses:				
Insurance services	3,147	2,931	8,548	7,856
Financial services	2,905	4,788	10,348	11,009
General and administrative	436	573	1,436	1,961
Gain on sale of assets (Note 4)	(13)	(47)	(15)	(131)
Total expenses	6,475	8,245	20,317	20,695
Operating income	294	937	1,660	2,182
Gain on investments (Note 5)	90	1,114	110	3,091
Loss on impairment of investment (Note 6)		(96)		(193)
Gain on extinguishment of debt (Note 7)		24		24
Income from operations before interest, income taxes and minority interest	384	1,979	1,770	5,104
Interest income	248	166	668	413
Other income	16	3	26	87
Interest expense	9	6	11	10
Income tax expense	230	747	882	1,966
Minority interests			2	13
Net income	$ 409	$ 1,395	$ 1,569	$ 3,615

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS, continued

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands, except per share amounts)			
Net income per common share				
Basic:				
Net income	$ 0.15	$ 0.52	$ 0.57	$ 1.36
Diluted:				
Net income	$ 0.14	$ 0.48	$ 0.53	$ 1.24
Basic weighted average shares outstanding	2,767	2,702	2,773	2,667
Diluted weighted average shares outstanding	2,892	2,885	2,942	2,920

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended September 30,	
	2006	2005
	(in thousands)	
Cash flows from operating activities:		
Net Income	$ 1,569	$ 3,615
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	323	264
Extinguishment of debt and other	266	190
Common stock awarded	102	159
Gain on sale of assets	(15)	(131)
Gain on investments	(110)	(3,091)
Impairment of investment		193
Excess tax benefits from stock-based compensation	(456)	(408)
Stock options expensed	189	
Changes in operating assets and liabilities:		
Trade receivables	(461)	(394)
Income tax receivable	(298)	473
Deferred income tax	141	(789)
Receivable from clearing organization		(331)
Deferred compensation	22	
Management fees & other receivables	2,232	964
Prepaid expenses & other assets	(575)	(163)
Deferred income	(210)	(372)
Trade payables	69	519
Accrued expenses & other liabilities	(1,663)	(1,148)
Net cash provided by (used in) operating activities	1,125	(450)
Cash flows from investing activities:		
Capital expenditures	(131)	(247)
Proceeds from the sale of available-for-sale equity and fixed income securities	7,357	6,174
Purchase of available-for-sale equity securities	(8,946)	(8,483)
Funds loaned to others	(266)	(800)
Collection of notes receivable	32	249
Net cash used in investing activities	(1,954)	(3,107)
Cash flows from financing activities:		
Exercise of stock options	791	823
Purchase and cancellation of treasury stock	(2,239)	(1,574)
Excess tax benefits from stock-based compensation	456	408
Dividends paid	(820)	(671)
Net cash used in financing activities	(1,812)	(1,014)
Net change in cash and cash equivalents	(2,641)	(4,571)
Cash and cash equivalents at beginning of period	6,231	9,673

Cash and cash equivalents at end of period	$ 3,590	$ 5,102
Supplemental information:		
Cash paid for taxes	$ 754	$ 1,806
Cash paid for interest	11	10

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY AND

COMPREHENSIVE INCOME

For the nine months ended September 30, 2005 and September 30, 2006

(Unaudited)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Comprehensive Income (loss)	Accumulated Other Comprehensive Income (loss)	Treasury Stock	Total Shareholders Equity
				(In thousands)			
Balance December 31, 2004	$ 265	$ 7,919	$ 13,948	$	$ 2,081	$	$ 24,213
Comprehensive income:							
Net income			3,615	$ 3,615			3,615
Other comprehensive income:							
Unrealized loss on securities, net of taxes of $789				(1,532)	(1,532)		(1,532)
Comprehensive income				$ 2,083			
Stock options exercised	20	803					823
Tax benefit from exercise of stock options		408					408
Dividend paid (per share - $0.25)			(671)				(671)
Treasury stock purchase						(1,574)	(1,574)
Cancelled treasury stock	(13)	(1,561)				1,574	
Stock awarded	1	158					159
Balance September 30, 2005	$ 273	$ 7,727	$ 16,892	$	$ 549	$	$ 25,441
Balance December 31, 2005	$ 278	$ 8,204	$ 18,737	$	$ 488	$	$ 27,707
Comprehensive income:							
Net income			1,569	$ 1,569			1,569
Other comprehensive income:							
Unrealized gain on securities, net of taxes of $34				(45)	(45)		(45)
Comprehensive income				$ 1,524			
Stock options expensed		189					189
Stock options exercised	16	775					791
Tax benefit from exercise of stock options		456					456
Dividend paid (per share-$0.30)			(820)				(820)
Treasury stock purchases						(2,239)	(2,239)

Cancelled treasury stock	(16)	(2,224)				2,239	
Stock based compensation	1	101					102
Balance September 30, 2006	$ 279	$ 7,502	$ 19,486	$	$ 443	$	$ 27,710

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(Unaudited)

1. General

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) and pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The consolidated financial statements as of and for the three and nine month periods ended September 30, 2006 and 2005 reflect all adjustments which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. Such adjustments consist of only items of a normal recurring nature. These consolidated financial statements have not been audited by our independent registered public accounting firm. The operating results for the interim periods are not necessarily indicative of results for the full fiscal year.

The notes to consolidated financial statements appearing in our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities Exchange Commission should be read in conjunction with this Quarterly Report on Form 10-Q. There have been no significant changes in the information reported in those notes other than from normal business activities.

2. Management s Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

3. Contingencies

We are involved in various claims and legal actions that have arisen in the ordinary course of business. Management believes that any liabilities arising from these actions will not have a significant adverse effect on our financial condition or results of operations.

4. Gain on Sale of Assets

During the three and nine month periods ended September 30, 2006, we recognized approximately $141,000 and $422,000, respectively, of deferred gain related to the November 2001 sale and subsequent leaseback of real estate to Prime Medical (now called HealthTronics, Inc.). Recognition of deferred gains was nearly identical in both periods in 2005 as well. Due to our continuing involvement in the property, we deferred recognizing approximately $2,400,000 of the approximately $5,100,000 gain and recognized it in earnings, as a reduction of rent expense, monthly through September 2006. As of September 30, 2006 no more of these deferred gains remain to be recognized. In addition, 15% of the gain ($760,000) related to our then 15% ownership in the purchaser, was deferred. As our ownership percentage in HealthTronics declines through our sales of HealthTronics common stock, we recognize these gains proportionately to our reduction of our interest in HealthTronics. During the three and nine month periods ended September 30, 2006 we recognized approximately $13,000 and $15,000, respectively, of these deferred gains as a result of HealthTronics common stock sold in these periods. As of September 30, 2006, there remained a balance of approximately $31,000 in deferred gains to be recognized in future periods.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

5. Gain on Investments

Our gains resulted primarily from the sales of available-for-sale equity and fixed income securities. During the three and nine month periods ended September 30, 2006 we recognized gains of $90,000 and $110,000, respectively, resulting from sales of Healthtronics common stock and from scheduled maturities of fixed income securities. These gains are down substantially from the comparative periods in 2005 where we recognized $1,114,000 and $3,091,000 in the three and nine month periods, respectively, as a result of selling far fewer shares of an equity security in 2006 resulting from a drop in its market value.

6. Loss on Impairment of Investment

Although there has been no loss taken in 2006, we had a loss in 2005 due to the impairment in value of our investment in FIC common stock. During 2004, the value of our investment in FIC had declined significantly. In October 2004, we determined that this decline in market price should be considered other than temporary as defined in Statements of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as amended. Consequently, we recorded pre-tax charges to earnings totaling $2,567,000 in 2004. These charges reduced our cost basis in FIC from $5,647,000, or $14.67 per share, to $3,080,000, or $8.00 per share which was equal to the quoted market price of FIC shares on December 31, 2004. During the first nine months of 2005, we took additional pre-tax charges to earnings totaling $135,000 further reducing our cost basis in FIC to $2,945,000, or $7.65 per share. While we continue to have the ability and the intent to hold the stock indefinitely, we concluded that the additional uncertainty created by FIC s late SEC filings, together with the lack of its current financial information, dictated that the 2004 and 2005 declines should be viewed as other than temporary. In July 2005, FIC was able to file its 2003 Form 10-K and in October, 2006 FIC filed its 2004 Form 10-K, but it still has yet to file any 2005 Forms 10-Q or 10-K and thus continues to be de-listed on the NASDAQ Stock Market.

7. Gain on Forgiveness of Debt

The gain of $24,000 during the three and nine months ended September 30, 2005 represents that amount of liability that was released in the respective periods by participants in our loan to a former affiliate, net of any interest due them from prior period payments made by that affiliate. Due to poor operating results, a former affiliate, Uncommon Care, was in default and not making scheduled payments under its loan agreement with us in which the participations had been sold. As a result, the loan participants released us from any obligations under the participation agreements. The $24,000 recorded in the third quarter of 2005 represents the final loan obligation to be released. Accordingly, no such gains were recorded during 2006.

8. Cash Restricted

Restricted cash represents cash deposits advanced from customers for trade claim transactions that do not close by the end of the period. It occurs when a customer remits payment for a transaction by check instead of via wire transfer. As checks of this size normally take several business days to clear, we ask our customers to pay in advance for transactions expected to close in the near future. At the time of receipt, Cash Restricted and Accounts Payable are increased for an equal amount as no part of this cash is ours until the transaction closes.

9. Investment in Available-For-Sale Equity Securities

A portion of this balance sheet account is comprised of our investment in FIC common stock. As mentioned in Note 6 above, during 2005 and 2004, we recognized other than temporary impairment losses and, accordingly,

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

our original cost basis in the 385,000 shares of FIC common stock we own has been reduced from $14.67 per share to $7.65 per share during 2004 and 2005. The effect of any other than temporary impairment loss is to reclassify from accumulated other comprehensive income (loss) the unrealized loss to realized loss in the statement of operations. We classify all of these shares as securities available-for-sale and record temporary unrealized changes in their value, net of tax, in our balance sheet as part of Accumulated Other Comprehensive Income (Loss) in Stockholders Equity. Changes in their fair market value deemed to be other than temporary are charged to earnings in the period that the determination was made. As FIC has traded above $7.65 per share throughout 2006, no impairment charges were necessary for either the three or nine month periods ended September 30, 2006.

10. Investment in Available-For-Sale Fixed Income Securities

We have invested primarily in U.S. government-backed securities with maturities varying from one to two years, as well as three corporate bonds with Standard and Poor s ratings of no lower than B (investment grade).

11. Prepaid and Other Current Assets

In June 2006 we announced plans for a strategic merger with our medical malpractice partner, American Physicians Insurance Exchange (APIE). Both ours and APIE s Boards of Directors voted to approve the transaction subject to approval by the Texas Department of Insurance, necessary filings with the SEC and the approval of the shareholders of APS and subscriber-policyholders of APIE. We account for this transaction consistent with Statement of Financial Standards No. 141, *Business Combinations*, whereby direct costs of the business combination are capitalized and become part of the total purchase price. Should the merger not take place, these direct costs would be expensed in the period that it is determined that the merger will not occur. As of September 30, 2006, we have capitalized a total of $532,000, comprised primarily of legal, accounting, auditing and tax consulting fees incurred by us related to this proposed, pending transaction.

12. Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities consists of the following:

	September 30 2006	December 31 2005
Commissions payable	$ 920,000	$ 1,258,000
Taxes payable	73,000	219,000
Vacation	171,000	161,000
401(k) plan matching	169,000	208,000
Other accrued liabilities	10,000	66,000
	$ 1,343,000	$ 1,912,000

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

13. Net Income Per Share

Basic income per share is based on the weighted average shares outstanding without any dilutive effects considered. Diluted income per share reflects dilution from all contingently issuable shares, such as options and convertible debt. A reconciliation of income and weighted average shares outstanding used in the calculation of basic and diluted income per share from operations follows:

	For the Three Months Ended September 30, 2006		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS			
Net income	$ 409,000	2,767,000	$ 0.15
Diluted EPS			
Effect of dilutive securities		125,000	
Net income	$ 409,000	2,892,000	$ 0.14

	For the Three Months Ended September 30, 2005		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS			
Net income	$ 1,395,000	2,702,000	$ 0.52
Diluted EPS			
Effect of dilutive securities		183,000	
Net income	$ 1,395,000	2,885,000	$ 0.48

	For the Nine Months Ended September 30, 2006		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS			
Net income	$ 1,569,000	2,773,000	$ 0.57
Diluted EPS			
Effect of dilutive securities		169,000	
Net income	$ 1,569,000	2,942,000	$ 0.53

For the Nine Months Ended September 30, 2005

	Income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS			
Net income	$ 3,615,000	2,667,000	$ 1.36
Diluted EPS			
Effect of dilutive securities		253,000	
Net income	$ 3,615,000	2,920,000	$ 1.24

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

14. Segment Information

The Company s segments are distinct by type of service provided. Comparative financial data for the three and nine month periods ended September 30, 2006 and 2005 are shown as follows:

	Three Months Ended September 30, 2006	2005
Operating Revenue:		
Insurance services	$ 3,726,000	$ 3,732,000
Financial services	3,043,000	5,450,000
Corporate	300,000	600,000
Total Segment Revenues	$ 7,069,000	$ 9,782,000
Reconciliation to Consolidated Statement of Operations:		
Total segment revenues	$ 7,069,000	$ 9,782,000
Less: Intercompany dividends	(300,000)	(600,000)
Total Revenues	$ 6,769,000	$ 9,182,000
Operating Income		
Insurance services	$ 579,000	$ 662,000
Financial services	138,000	801,000
Corporate	(423,000)	(526,000)
Total segments operating income	294,000	937,000
Gain on investments	90,000	1,114,000
Loss on impairment of investment		(96,000)
Gain on extinguishment of debt		24,000
Income from operations before interest, income taxes and minority interest	384,000	1,979,000
Interest income	248,000	166,000
Other gain	16,000	3,000
Interest expense	9,000	6,000
Income tax expense	230,000	747,000
Net income	$ 409,000	$ 1,395,000

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

	Nine Months Ended September 30, 2006	2005
Operating Revenue:		
Insurance services	$ 10,556,000	$ 10,462,000
Financial services	11,421,000	12,415,000
Corporate	2,668,000	600,000
Total Segment Revenues	$ 24,645,000	$ 23,477,000
Reconciliation to Consolidated Statement of Operations:		
Total segment revenues	$ 24,645,000	$ 23,477,000
Less: Intercompany dividends	(2,668,000)	(600,000)
Total Revenues	$ 21,977,000	$ 22,877,000
Operating Income		
Insurance services	$ 2,008,000	$ 2,606,000
Financial services	1,073,000	1,406,000
Corporate	(1,421,000)	(1,830,000)
Total segments operating income	1,660,000	2,182,000
Gain on investments	110,000	3,091,000
Loss on impairment of investment		(193,000)
Gain on extinguishment of debt		24,000
Income from operations before interest, income taxes and minority interest	1,770,000	5,104,000
Interest income	668,000	413,000
Other gain	26,000	87,000
Interest expense	11,000	10,000
Income tax expense	882,000	1,966,000
Minority interest	2,000	13,000
Net income	$ 1,569,000	$ 3,615,000

15. Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123 (R)). The standard amends SFAS 123, *Accounting for Stock-Based Compensation*, and concludes that services received from employees in exchange for stock-based compensation results in a cost to the employer that must be recognized in the financial statements. The cost of such awards should be measured at fair value at grant date.

On January 1, 2006 we adopted SFAS No. 123R. We use the Black-Scholes-Merton option-pricing model to determine the fair value of stock-based awards, consistent with that used for pro forma disclosures under SFAS No. 123, *Accounting for Stock-Based Compensation*. We have elected the modified prospective transition method as permitted by SFAS No, 123R and accordingly prior periods have not been restated to reflect the impact of SFAS No. 123R. SFAS No. 123R requires that stock-based compensation be recorded for all new and unvested stock

options expected to vest as the requisite service is rendered beginning January 1, 2006, the first day of our 2006 fiscal year. Stock-based compensation expense for awards granted on or before December 31, 2005, but unvested as of that date, is based on the grant date fair value as determined under the pro forma provisions of

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

SFAS No. 123. For the three and nine months ended September 30, 2006 we recorded compensation cost related to stock options of $32,000 and $189,000 and a related reduction in income taxes of $11,000 and $64,000, respectively. The compensation cost is the total fair value, at date of grant, of shares that vested during the three and nine month periods. No compensation costs were capitalized in the three and nine month periods ended September 30, 2006.

During the three and nine month periods ended September 30, 2006, 48,000 and 159,000 options were exercised with an intrinsic value of $560,000 and $1,666,000, respectively. We received proceeds of $287,000 and $791,000 from the exercise of these options during the three and nine month periods ended September 30, 2006. Based on unvested options outstanding at September 30, 2006 compensation costs to be recorded in future periods are expected to be recognized as follows: 2006, $32,000; 2007, $21,000; 2008, $19,000; and 2009, $4,000.

We have adopted, with shareholder approval, the 2005 Incentive and Non-Qualified Stock Option Plan (Incentive Plan). The Incentive Plan provides for the issuance of up to 350,000 shares of common stock to our directors and key employees. A total of 153,000 of these options have been granted as of September 30, 2006 and 197,000 are available for grants. Of those granted, 5,000 shares have been exercised, 133,000 options are exercisable and 15,000 are not yet exercisable. The previous plan, 1995 Incentive and Non-Qualified Stock Option Plan , provided for the issuance of 1,600,000 shares of common stock to our directors and key employees. All of the approved options have been granted as of September 30, 2006, 1,136,000 shares have been exercized, 264,000 shares are exercisable, 41,000 are not yet exercisable and 159,000 options have been cancelled. Upon the exercise of an option we issue the shares from our authorized, but un-issued shares.

The exercise price for each non-qualified option share is determined by the Compensation Committee of the Board of Directors (the Committee). The exercise price of a qualified incentive stock option has to be at least 100% of the fair market value of such shares on the date of grant of the option. Under the Plans, option grants are limited to a maximum of ten-year terms; however, the Committee has issued all currently outstanding grants with five-year terms. The Committee also determines vesting for each option grant and traditionally has had options vest in three approximately equal annual installments beginning one year from the date of grant.

Presented below is a summary of the stock options held by our employees and our directors and the related transactions for the three and nine months ended September 30, 2006.

	Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Balance at Beg. of Period	501,000	$ 9.16	573,000	$ 7.92
Options granted			40,000	13.94
Options exercised	(48,000)	6.01	(159,000)	4.97
Options forfeited/expired				
Balance at end of period	453,000	$ 9.49	453,000	$ 9.49
Options exercisable	397,000	$ 9.35	397,000	$ 9.35

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

The weighted average fair value of Company stock options granted is $3.87 per option for the nine months ended September 30, 2006. No options were granted in the three month period ended September 30, 2006. The fair value of the options was calculated using the Black-Scholes-Merton option pricing model with the following assumptions:

	Nine months ended September 30, 2006
Expected option term:	3.7 years
Expected volatility	0.350
Expected dividend yield	2.01%
Risk-free rate of return	4.33%

The expected volatility assumptions we used are based on the historical volatility of our common stock over the most recent period commensurate with the estimated expected life of our stock options, such estimated life being based on the historical experience of our stock option exercises. The following table summarizes the Company s options outstanding and exercisable options at September 30, 2006:

Stock Options Outstanding				Stock Options Exercisable			
Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)	Average Remaining Contractual Life	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)	Average Remaining Contractual Life
453,000	$ 9.49	$ 3,238,000	2.8 yrs.	397,000	$ 9.35	$ 2,892,000	2.8 yrs.

(1) Based on the $16.63 closing price of our stock at September 30, 2006.

Prior to the adoption of SFAS No. 123R, we adopted the disclosure-only provision of SFAS No. 123, but applied APB Option No. 25, Accounting for Stock Issued to Employees , in accounting for our stock option plans. No compensation expense was recognized for the three and nine months ended September 30, 2005 under the provisions of APB No. 25. If we had elected to recognize compensation expense for options granted based on their fair values at the grant dates, consistent with Statement 123, net income and earnings per share would have changed to the pro forma amounts indicated below:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income as reported	$ 1,395,000	$ 3,615,000
Deduct: Total additional stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(45,000)	(180,000)
Pro forma net income	$ 1,350,000	$ 3,435,000
Net income per share		
Basic as reported	$ 0.52	$ 1.36

Basic pro forma	$ 0.50	$ 1.29
Diluted as reported	$ 0.48	$ 1.24
Diluted pro forma	$ 0.47	$ 1.18

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

16. Recent Accounting Pronouncements

In February, 2006 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards, or SFAS, No. 155, *Accounting for Certain Hybrid Financial Instruments*, an amendment of FASB Statements No. 133 and 140. SFAS 155 becomes effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. This Statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133; establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations or cash flows.

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109* (FIN 48), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. This interpretation is effective for fiscal years beginning after December 15, 2006. We have not yet determined the impact this interpretation will have on our results from operations or financial position.

In September, 2006 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards, or SFAS No. 157, *Accounting for Fair Value Measurements* , effective for fiscal years beginning after November 15, 2007. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, the Board having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations or cash flows.

In September, 2006 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards, or SFAS No. 158, *Accounting for Defined Benefit and Other Postretirement Plans* effective as of the end of the fiscal year ending after December 15, 2006. This Statement improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. This Statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations or cash flows.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

September 30, 2006

(Unaudited)

17. Plans for a Strategic Merger

On June 5, 2006 we announced plans for a strategic merger with our medical malpractice partner, American Physicians Insurance Exchange (APIE). Both APSG s and APIE s boards of directors voted to approve the transaction subject to approval by the Texas Department of Insurance, necessary filings with the SEC and the approval of the shareholders of APSG and subscriber-policyholders of APIE. The original purchase price was $33 million, comprised of approximately 1.7 million shares of APS common stock issued to the policyholders of APIE and the assumption of approximately $10.4 million in obligations, which will be converted to APS preferred stock with a cash redemption requirement. On August 24, 2006, we announced that we agreed to an increase in the purchase price of APIE, which was also approved by APIE. The revised purchase price is $39 million, comprised of approximately 2.1 million shares of APS common stock issued to the policyholders of APIE and the assumption of approximately $10.4 million in obligations, which will be converted to APS preferred stock with a 3% dividend and a cash redemption requirement payable over ten years. We can give no assurances that this merger will close, or if it does, that there will not be further changes to the terms of the deal. We will account for this transaction consistent with the Statement of Financial Standards No. 141, *Business Combinations* , whereby direct costs of the business combination are capitalized and become part of the total purchase price.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders

American Physicians Services Group, Inc.

Austin, Texas

We have audited the accompanying consolidated balance sheets of American Physicians Services Group, Inc. as of December 31, 2005 and 2004, and the related consolidated statements of income, stockholders equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2005. We have also audited the schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and schedule are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included 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. According, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedule, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements and schedule 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 Physicians Services Group, Inc. at December 31, 2005 and 2004, and the results of its operations and its cash flows for the each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the schedule presents fairly, in all material respects, the information set forth therein.

BDO Seidman, LLP

Houston, Texas

March 2, 2006

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONSOLIDATED BALANCE SHEETS

	December 31, 2005	2004
	(In thousands)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 6,680	$ 9,673
Trade receivables, net	42	19
Management fees and other receivables	3,192	1,815
Notes receivable (Note 3)	599	777
Deposit with clearing organization	501	660
Investment in available-for-sale fixed income securities current	9,662	1,983
Federal income tax receivable		76
Net deferred income taxes	355	124
Prepaid expenses and other current assets	632	642
Total current assets	21,663	15,769
Notes receivable, less current portion (Note 3)	326	141
Property and equipment, net (Note 6)	687	619
Investment in available-for-sale securities:		
Equity	5,017	9,417
Fixed Income	3,584	2,920
Net deferred income tax asset	686	
Goodwill	1,247	1,247
Other assets	295	330
Total Assets	$ 33,505	$ 30,443

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONSOLIDATED BALANCE SHEETS, cont d

	December 31, 2005	2004
	(In thousands except share data)	
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable trade	$ 736	$ 266
Accrued incentive compensation	2,595	2,500
Accrued expenses and other liabilities (Note 7)	1,912	1,842
Deferred gain current	469	488
Federal income tax payable	71	
Total current liabilities	5,783	5,096
Payable under loan participation agreements		24
Deferred income tax liability		482
Deferred gain non-current		627
Total liabilities	5,783	6,229
Minority interests	15	1
Commitments and contingencies (Note 9)		
Shareholders Equity:		
Preferred stock, $1.00 par value, 1,000,000 shares authorized, none issued or outstanding		
Common stock, $0.10 par value, shares authorized 20,000,000; 2,784,120 and 2,624,372 issued and outstanding at 12/31/05 and 12/31/04, respectively (Note 18)	278	265
Additional paid-in capital	8,204	7,919
Retained earnings	18,737	13,948
Accumulated other comprehensive income, net of taxes	488	2,081
Total shareholders equity	27,707	24,213
Total Liabilities and Shareholders Equity	$ 33,505	$ 30,443

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2005	2004	2003
		(In thousands)	
REVENUES			
Financial services	$ 18,459	$ 16,705	$ 19,623
Insurance services	15,514	15,316	10,826
Total revenues	33,973	32,021	30,449
EXPENSES			
Financial services	16,263	14,538	16,584
Insurance services	10,262	9,968	7,841
General and administrative	2,737	2,227	2,069
Gain on sale of assets	(134)	(56)	(8)
Total expenses	29,128	26,677	26,486
Operating income	4,845	5,344	3,963
Gain on investments, net (Note 5)	3,160	245	127
Loss on impairment of investments (Note 5)	(217)	(2,567)	
Gain on extinguishment of debt	24	75	
Income from continuing operations before interest, income taxes, minority interests and equity in earnings of unconsolidated affiliates	7,812	3,097	4,090
Interest income	587	365	304
Other income (loss)	124	15	(38)
Interest expense	10	7	7
Income tax expense (Note 10)	3,039	1,317	1,640
Minority interests	14	1	197
Equity in earnings of unconsolidated affiliates (Note 15)			260
Income from continuing operations	5,460	2,152	2,772
Discontinued operations (Note 13):			
Gain on disposal of discontinued segment net of income tax expense of $14 in 2003			27
Net income	$ 5,460	$ 2,152	$ 2,799

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS, continued

(In thousands, except per share amounts)

	Year Ended December 31,		
	2005	**2004**	**2003**
Net income per common share:			
Basic:			
Income from continuing operations	$ 2.03	$ 0.85	$ 1.26
Discontinued operations			0.01
Net income	$ 2.03	$ 0.85	$ 1.27
Diluted:			
Income from continuing operations	$ 1.86	$ 0.76	$ 1.13
Discontinued operations			0.01
Net income	$ 1.86	$ 0.76	$ 1.14
Basic weighted average shares outstanding	2,688	2,545	2,207
Diluted weighted average shares outstanding	2,931	2,838	2,449

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

	Year Ended December 31,		
	2005	2004	2003
	(In thousands)		
Cash flows from operating activities:			
Net Income	$ 5,460	$ 2,152	$ 2,799
Adjustments to reconcile net income to cash provided by (used in) operating activities:			
Depreciation and amortization	364	304	206
Extinguishment of debt and other	297	39	164
Common stock awarded	159	231	
Deferred compensation	150		
Minority interest in consolidated earnings	14	1	197
Undistributed earnings of affiliates			(260)
Loss (gain) on sale of assets	(134)	(56)	(8)
Deferred gain on sale of building	(513)	(488)	(488)
Tax benefit from exercise of stock options	708	589	
Impairment of investment	217	2,567	
Gain on investments	(3,160)	(245)	(127)
Provision for bad debt		20	(58)
Changes in operating assets and liabilities:			
Trade and other receivables	(23)	(179)	(325)
Trading account securities		67	66
Income tax receivable	(28)	1,602	(996)
Deferred income tax	(577)	744	2,511
Management fees & other receivables	(1,377)	(746)	(316)
Prepaid expenses & other assets	(81)	(74)	207
Receivable from clearing organization	159		
Trade accounts payable	470	66	(138)
Deferred income			(122)
Accrued expenses & other liabilities	208	(1,137)	1,331
Net cash provided by operating activities	2,313	5,457	4,643
Cash flows from investing activities:			
Capital expenditures	(307)	(421)	(319)
Proceeds from the sale of available-for-sale equity and fixed income securities	8,503	1,116	4,080
Purchase of available-for-sale equity securities	(11,688)	(4,405)	(5,697)
Purchase of minority interest			(2,050)
Receipts from (advances to) affiliate			175
Funds loaned to others	(810)	(620)	(155)
Collection of notes receivable	346	20	745
Net cash used in investing activities	(3,956)	(4,310)	(3,221)
Cash flows from financing activities:			
Payment of long-term debt			
Exercise of stock options	1,036	758	1,351
Purchase and cancellation of treasury stock	(1,715)	(703)	(285)
Dividends paid	(671)	(518)	
Distribution to minority interest			(190)
Net cash provided by (used in) financing activities	(1,350)	(463)	876

Net change in cash and cash equivalents	(2,993)	684	2,298
Cash and cash equivalents at beginning of year	9,673	8,989	6,691
Cash and cash equivalents at end of year	$ 6,680	$ 9,673	$ 8,989

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY AND

COMPREHENSIVE INCOME (LOSS)

(In thousands)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Comprehensive Income	Accumulated Other Comprehensive Income (loss)	Treasury Stock	Total Shareholders Equity
Balance December 31, 2002	$ 213	$ 5,584	$ 9,515	$	$ 1,830	$	$ 17,142
Comprehensive income:							
Net income			2,799	2,799			2,799
Other comprehensive income, net of tax:							
Unrealized loss on securities, net of reclassification adjustment (Note 21)				(2,201)	(2,201)		(2,201)
Comprehensive income				598			
Treasury stock purchases						(284)	(284)
Retired treasury stock	(6)	(279)				284	
Stock options exercised	38	1,313					1,351
Tax benefit from exercise of stock options		300					300
Balance December 31, 2003	$ 245	$ 6,918	$ 12,314	$	($371)	$	$ 19,106
Comprehensive income:							
Net income			2,152	2,152			2,152
Other comprehensive income, net of tax:							
Unrealized gain on securities, net of reclassification adjustment (Note 21)				2,452	2,452		2,452
Comprehensive income				4,604			
Treasury stock purchases						(703)	(703)
Retired treasury stock	(7)	(696)				703	
Stock options exercised	25	733					758
Tax benefit from exercise of stock options		589					589
Dividend paid (per share $0.20)			(518)				(518)
Stock awarded	2	229					231
Forgiveness of Uncommon Care Debt		146					146
Balance December 31, 2004	$ 265	$ 7,919	$ 13,948	$	$ 2,081	$	$ 24,213

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY AND

COMPREHENSIVE INCOME (LOSS), continued

(In thousands, except per share amounts)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Comprehensive Income	Accumulated Other Comprehensive Income (loss)	Treasury Stock	Total Shareholders Equity
Balance December 31, 2004	$ 265	$ 7,919	$ 13,948	$	$ 2,081	$	$ 24,213
Comprehensive income:							
Net income			5,460	5,460			5,460
Other comprehensive income, Unrealized loss on securities, net of taxes of $821				(1,593)	(1,593)		(1,593)
Comprehensive income				3,867			
Treasury stock purchases						(1,715)	(1,715)
Stock options exercised	25	1,011					1,036
Tax benefit from exercise of stock options		708					708
Dividend paid (per share $0.25)			(671)				(671)
Cancelled treasury stock	(14)	(1,701)				1,715	
Forgiveness of Uncommon Care debt		(40)					(40)
Stock awarded	1	158					159
Deferred Compensation	1	149					150
Balance December 31, 2005	$ 278	$ 8,204	$ 18,737	$	$ 488	$	$ 27,707

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

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005, 2004 and 2003

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) General

We, through our subsidiaries, provide financial services that include brokerage and asset management services to individuals and institutions, and insurance services that consist of management services for a malpractice insurance company. The financial services business has clients nationally. Insurance management is a service provided primarily in Texas, but is available to clients nationally. During the three years presented in the financial statements, financial services generated 54%, 52% and 64% of total revenues and insurance services generated 46%, 48% and 36% in 2005, 2004 and 2003, respectively.

(b) Management s Estimates and Assumptions

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(c) Principles of Consolidation

The consolidated financial statements include our accounts and the accounts of our subsidiary companies more than 50% owned. Investments in affiliated companies and other entities, in which our investment is less than 50% of the common shares outstanding and where we exert significant influence over operating and financial policies, are accounted for using the equity method. Investments in other entities in which our investment is less than 20%, and in which we do not have the ability to exercise significant influence over operating and financial policies, are accounted for using the cost method. In the event that we retain sufficient risk of loss in a disposed subsidiary to preclude us from recognizing the transaction as a divestiture, we would continue to consolidate the subsidiary as an entity in which we have a variable interest under the guidance of FIN 46R.

We own 100% of our insurance services segment after repurchasing the 20% formerly owned by Florida Physicians Insurance Group, Inc. (FPIC), on September 30, 2003 (see Note 14). Before this date, we recorded minority interest to reflect the 20% of its net income or loss attributable to the minority shareholder.

All significant intercompany transactions and balances have been eliminated from the accompanying consolidated financial statements.

(d) Revenue Recognition

Our investment services revenues related to securities transactions are recognized on a trade date basis. Asset management revenues are recognized monthly based on the amount of funds under management.

Our insurance services revenues related to management fees are recognized monthly as a percentage of the earned insurance premiums of the managed company. The profit sharing component of the management services agreement is recognized when it is reasonably certain that the managed company will have an annual profit, generally in the fourth quarter of each year.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

(e) Marketable Securities

Our investments in debt and equity securities are classified in three categories and accounted for as follows:

Classification	Accounting
Held-to-maturity	Amortized cost
Trading securities	Fair value, unrealized gains and losses included in earnings
Available-for-sale	Fair value, unrealized gains and losses excluded from earnings and reported in equity as a component of accumulated other comprehensive income, net of applicable income taxes. Realized gains and losses are included in earnings.

We have included our marketable securities, held as inventory at our broker/dealer, in the trading securities category. We have included investments in marketable securities not held as inventory at our broker/dealer in the available-for-sale securities category.

We account for our equity and fixed income securities as available-for-sale. In the event a decline in fair value of an investment occurs, management may be required to determine if the decline in market value is other than temporary. Management s assessments as to the nature of a decline in fair value are based on the quoted market prices at the end of a period, the length of time an investment s fair value has been in decline and our ability and intent to hold the investment. If the fair value is less than the carrying value and the decline is determined to be other than temporary, an appropriate write-down is recorded against earnings.

(f) Property and Equipment

Property and equipment is stated at cost net of accumulated depreciation. Property and equipment is depreciated using the straight-line method over the estimated useful lives of the respective assets (3 to 5 years). Leasehold improvements are depreciated using the straight-line method over the life of the lease or their expected useful life, whichever is shorter.

(g) Long-Lived Assets

Long-lived assets, principally property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of the expected future undiscounted cash flows is less than the carrying amount of the asset, a loss is recognized if there is a difference between the fair value and carrying value of the asset.

Investments are evaluated for impairment in the event of a material change in the underlying business. Such evaluation takes into consideration our intent and time frame to hold or to dispose of the investment and takes into consideration available information, including recent transactions in the stock, expected changes in the operations or cash flows of the investee, or a combination of these and other factors. Management s evaluation of our investments resulted in impairment charges in both 2005 and 2004, as detailed in Note 5 to these consolidated financial statements.

(h) Goodwill and Other Intangible Assets

Goodwill represents the excess of cost over the fair value of net assets acquired. We account for goodwill and other intangible assets according to the Statement of Financial Accounting Standards (SFAS) No. 142,

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

Goodwill and Other Intangible Assets , which addresses financial accounting and reporting matters for acquired goodwill and other intangible assets. Under the provision of SFAS No. 142, goodwill is not amortized, but is evaluated annually for impairment or more frequently if circumstances indicate that impairment may exist. The goodwill valuation is largely influenced by projected future cash flows and, therefore, is significantly impacted by estimates and judgments.

We amortize other identifiable intangible assets on a straight-line basis over the periods expected to be benefited. The components of these other intangible assets, recorded in Other Assets in the accompanying consolidated balance sheets, consist primarily of a non-compete agreement.

(i) Allowance for Doubtful Accounts

When applicable, we record an allowance for doubtful accounts based on specifically identified amounts that we believe to be uncollectible. If our actual collections experience changes, revisions to our allowance may be required. We have a limited number of customers with individually large amounts due at any given balance sheet date. Any unanticipated change in one of those customers credit standing or rating could have a material affect on our results of operations in the period in which such changes or events occur. After all attempts to collect a receivable have failed, the receivable is written off against the allowance.

(j) 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 carryforwards. 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. 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. A valuation allowance is provided for deferred tax assets to the extent realization is not judged to be more likely than not.

(k) Cash and Cash Equivalents

Cash and cash equivalents include cash and highly liquid investments with a maturity date at purchase of 90 days or less. We deposit our cash and cash equivalents with high credit quality institutions. Periodically such balances may exceed applicable FDIC insurance limits. Management has assessed the financial condition of these institutions and believes the possibility of credit loss is minimal.

(l) Notes Receivable

Notes receivable are recorded at cost, less allowances for doubtful accounts when deemed necessary. Management, considering current information and events regarding the borrowers ability to repay their obligations, considers a note to be impaired when it is probable that we will be unable to collect all amounts due according to the contractual terms of the note agreement. When a loan is considered to be impaired, the amount of the impairment is measured based on the present value of expected future cash flows discounted at the note s effective interest rate. Impairment losses are included in the allowance for doubtful accounts through a charge to bad debt expense. The present value of the impaired loan will change with the passage of time and may change because of revised estimates of cash flows or timing of cash flows. Such value changes are reported as bad debt expense in the same manner in which impairment initially was recognized. No interest income is accrued on impaired loans. Cash receipts on impaired loans are recorded as reductions of the principal amount.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

(m) Stock-Based Compensation

We have adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (Statement 123), but apply Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, in accounting for our stock option plans. In 2003 we purchased 15,000 unexpired options from a grantee. This purchase in effect modified the terms of the option and, accordingly, we recognized $34,000 of compensation expense in 2003, as required for a modification of terms under FIN 44. No other compensation expense from stock-based compensation awards was recognized in 2005, 2004 and 2003. If we had elected to recognize compensation expense for options granted based on their fair values at the grant dates, consistent with Statement 123, net income and earnings per share would have changed to the pro forma amounts indicated below:

	Year Ended December 31,		
	2005	2004	2003
Net income, as reported	$ 5,460,000	$ 2,152,000	$ 2,799,000
Add: Stock-based employee compensation expense included in net income, net of tax			22,000
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(421,000)	(550,000)	(241,000)
Pro forma net income	$ 5,039,000	$ 1,602,000	$ 2,580,000
Net income per share			
Basic as reported	$ 2.03	$ 0.85	$ 1.27
Basic pro forma	$ 1.87	$ 0.63	$ 1.17
Diluted as reported	$ 1.86	$ 0.76	$ 1.14
Diluted pro forma	$ 1.72	$ 0.56	$ 1.05

The stock-based employee compensation expense above was determined using the Black Scholes option- pricing model with the following assumptions:

	2005	2004	2003
Risk-free interest rate	4.33%	3.03%	2.44%
Expected holding period	3.6 years	3.8 years	3.8 years
Expected volatility	.363	.429	.407
Expected dividend yield	2.15%	-0-	-0-

(n) Recently Issued Accounting Pronouncements

In December 2004, the FASB issued SFAS 153, *Exchanges of Nonmonetary Assets*, an amendment of APB No. 29, Accounting for Nonmonetary Transactions. SFAS 153 requires exchanges of productive assets to be accounted for at fair value, rather than at carryover basis, unless (1) neither the asset received nor the asset surrendered has a fair value that is determinable within reasonable limits or (2) the transactions lack commercial substance. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005.

The Company does not expect the adoption of this standard to have a material effect on its financial position, results of operations or cash flows.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

In December 2003, the Financial Accounting Standards Board published FIN No. 46-R, Consolidation of Variable Interest Entities (revised December 2003), superseding FIN 46, and exempting certain entities from the provisions of FIN 46. Generally, application of FIN 46-R is required in financial statements of public entities that have interests in structures commonly referred to as special-purpose entities for periods ending after December 15, 2003, and for other types of VIEs for periods ending after March 15, 2004. We currently do not have any variable interest entities therefore the adoption of this standard did not have a material effect on our financial position, results of operations or cash flows.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards, or SFAS, No. 123 (revised 2004), *Share-Based Payment*. Statement 123(R) will provide investors and other users of financial statements with more complete and neutral financial information by requiring that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments used. Statement 123(R) covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Statement 123(R) replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees . Statement 123, as originally issued in 1995, established as preferable a fair-value-based method of accounting for share-based payment transactions with employees. However, that Statement permitted entities the option of continuing to apply the guidance in Opinion 25, as long as the footnotes to financial statements disclosed what net income would have been had the preferable fair-value-based method been used. We are required to apply Statement 123(R) as of the first interim or annual reporting period that begins after December 15, 2005. We estimate that our pre-tax expense from applying 123 (R) in 2006 and 2007 will be $109,000 and $2,000 respectively, based on unvested options at December 31, 2005. We are unable to estimate the expense of any options that may be issued in 2006 and subsequent years due to the uncertainties of quantity, stock prices, and all other variables affecting such an estimate.

(o) Reclassification

Certain reclassifications have been made to amounts presented in 2004 and 2003 to be consistent with the 2005 presentation.

(2) MANAGEMENT FEES AND OTHER RECEIVABLES

Management fees and other receivables consist of the following:

	December 31,	
	2005	**2004**
Management fees receivable	$ 2,723,000	$ 1,667,000
Accrued interest receivable	125,000	67,000
Other receivables	344,000	81,000
	$ 3,192,000	$ 1,815,000

We earn management fees by providing management services to American Physicians Insurance Exchange (APIE) under the direction of APIE s Board of Directors. APIE is a reciprocal insurance exchange, which is wholly owned by its subscriber physicians. Subject to the direction of APIE s Board, and subject to a management services agreement, FMI sells and issues medical insurance policies, investigates, settles and defends claims, and otherwise manages APIE s affairs. The management agreement with FMI obligates APIE to

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

pay management fees to FMI based on a percentage of APIE s earned premiums before payment of reinsurance premiums. In addition, the management agreement provides that any profits, as defined, of APIE will be shared equally with FMI so long as the total payment (fees and profit sharing) does not exceed a cap based on premium levels. Management fees attributable to profit sharing were $2,007,000, $1, 929, 000, and $722,000 for the years ended December 31, 2005, 2004 and 2003. We earned total management fees and other related income of $15,514,000, $15,316,000, and $10,826,000, including management fee income of $11,038,000, $10,609,000, and $7,276,000 and including expense reimbursements, principally for our independent agents commissions, of $4,376,000, $4,482,000, and $3,373,000 for the years ended December 31, 2005, 2004 and 2003, respectively, related to these agreements.

The summarized financial information for APIE as of and for the year ended December 31, 2005, 2004 and 2003 is as follows:

	2005	2004	2003
Total Investments	$ 113,233,000	$ 97,874,000	$ 78,539,000
Other assets	61,600,000	47,854,000	44,981,000
Total Assets	$ 174,833,000	$ 145,728,000	$ 123,520,000
Total liabilities	$ 155,591,000	$ 133,827,000	$ 117,616,000
Member s Equity	19,242,000	11,901,000	5,904,000
Total liablilities and member s equity	$ 174,833,000	$ 145,728,000	$ 123,520,000
Total revenue	$ 69,866,000	$ 69,313,000	$ 56,148,000
Net income	$ 9,031,000	$ 5,815,000	$ 692,000

Other receivables in 2005, 2004 and 2003 are primarily from our brokerage and investment advisory services and are principally comprised of commissions earned by our brokers for trades in the last week of December 2005, 2004 and 2003.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

(3) NOTES RECEIVABLE

Notes receivable consist of the following:

	December 31, 2005	2004
FemPartners, Inc. (Formerly due from Syntera HealthCare Corporation) Originally due September 1, 2004, the note has been amended three times since December 2003. Each amendment has extended the note and modified the payment terms. The current amendment calls for payments of interest plus principal of $10,000, quarterly, through 2006. The note is scheduled to be repaid in full in 2007 in three quarterly payments. The note contains an acceleration clause in the event that FemPartners conducts an initial public offering or other public sale.	$ 390,000	$ 420,000
APS Financial Joint Venture Partner Unsecured term note, principal and interest, at 8% payable monthly until maturity on October 15, 2005. This note was written off in 2005 with a total charge at the time of write-off amounting to $160,000.	- 0 -	235,000
Alianza Alianza identifies under-payments from insurance companies to medical providers and recovers the additional amounts. Our loan is to be repaid from recovery proceeds, with APS receiving a higher percentage of proceeds if the advances are not repaid within twelve months. In lieu of interest, we are to receive 15% of gross recoveries.	301,000	- 0 -
Employees Loans are periodically made to non-officer employees, primarily as employment retention inducements. Employee notes receivable at December 31, 2005 consisted of three notes of $73,000, $86,000, and $75,000, which are being amortized through May 2006, December 2006, and June 2007, respectively, provided the employees remain with us; and a note for $8,000 due currently.		
Employee notes receivable at December 31, 2004 consisted of two notes of $2,000 and $248,000, which are being amortized through October 31, 2005 and June 30, 2006, respectively, provided the employees remain with us; a note for $14,000 due currently; and two loans totaling $13,000 to a key employee for advanced education fees. The latter two notes are forgivable in the amount of approximately $13,000 on each January 1st that the employee is employed by the Company beginning in 2001 and continuing through 2005. They are due within 90 days should the employee terminate employment.	242,000	277,000
	933,000	932,000
Less current portion and allowance for doubtful accounts of $8,000 and $14,000 in 2005 and 2004, respectively.	(607,000)	(791,000)
Long term portion	$ 326,000	$ 141,000

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

(4) FAIR VALUE OF FINANCIAL INSTRUMENTS

For financial instruments the estimated fair value equals the carrying value as presented in the consolidated balance sheets. Fair value estimates, methods, and assumptions are set forth below for our financial instruments.

Notes Receivable

The fair value of notes has been determined using discounted cash flows based on our management s estimate of current interest rates for notes of similar credit quality. The carrying value of notes receivable approximates their fair value.

Deposit with Clearing Organization

The carrying amounts approximate fair value because the funds can be withdrawn on demand and there is no unanticipated credit concern.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. Fair value estimates are based on existing financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the aforementioned estimates.

(5) MARKETABLE SECURITIES

The following table summarizes by major security type the cost, fair market value, and unrealized gains and losses of the investments that we have classified as available-for-sale:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2005				
Governmental obligations	$ 12,418,000	$ 12,000	$ (60,000)	$ 12,370,000
Corporate obligations	888,000	1,000	(13,000)	876,000
Equity securities	4,217,000	800,000		5,017,000
Total	$ 17,523,000	$ 813,000	$ (73,000)	$ 18,263,000
December 31, 2004				
Governmental obligations	$ 3,492,000	$	$ (26,000)	$ 3,466,000
Corporate obligations	1,406,000	51,000	(20,000)	1,437,000
Equity securities	6,268,000	3,149,000		9,417,000
Total	$ 11,166,000	$ 3,200,000	$ (46,000)	$ 14,320,000

Amounts reflected in the table above include equity securities of HealthTronics with a fair value of $1,095,000 and $5,900,000 and corporate obligations of HealthTronics with a fair value of zero and $944,000 at December 31,

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

2005 and 2004, respectively. At December 31, 2005 and 2004, amounts also include equity securities of Financial Industries Corporation (FIC) with a fair value of $3,196,000 and $3,080,000, respectively.

Maturities of fixed income securities were as follows at December 31, 2005:

	Cost	Fair Value
Due within one year	$ 9,689,000	$ 9,662,000
Due after one year	3,617,000	3,584,000
Total	$ 13,306,000	$ 13,246,000

HealthTronics is the largest provider of lithotripsy (a non-invasive method of treating kidney stones) services in the United States and is an international supplier of specialty vehicles for the transport of high technology medical, broadcast/communications and homeland security equipment. Through selling of shares since our initial investment of 3,540,000 shares in 1989, our holdings of common stock at December 31, 2005 stood at 143,000, or less than 1% of the common stock outstanding. We account for HealthTronics as an available-for-sale equity security and record changes in its value, net of tax, in our balance sheet as part of accumulated other comprehensive income.

Financial Industries Corporation (FIC) is a holding company primarily engaged in the life insurance business through ownership of several life insurance companies. In June 2003, we purchased from FIC and the Roy F. and Joann Mitte Foundation, 339,879 shares of FIC s common stock as an investment. Earlier in 2003 we had purchased 45,121 FIC shares in the open market. The 385,000 shares represented an approximate $5,647,000, which was all sourced from our cash reserves. During 2004, the value of our investment in FIC had declined significantly. In October 2004, we determined that this decline in market price was other than temporary as defined in Statements of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities, as amended. Consequently, we recorded pretax charges to earnings totaling $2,567,000 in 2004. These charges reduced our cost basis in FIC from $5,647,000, or $14.67 per share, to $3,080,000, or $8.00 per share which was equal to the quoted market price of FIC shares on December 31, 2004. During 2005, we took additional pretax charges to earnings totaling $135,000, further reducing our cost basis in FIC to $2,945,000, or $7.65 per share. While we currently continue to have the ability and the intent to hold the stock indefinitely, we concluded that the additional uncertainty created by FIC s late filings, together with the lack of its current financial information, dictated that the 2004 and 2005 declines should be viewed as other than temporary. In July, 2005 FIC was able to file its 2003 Form 10-K but has yet to file any 2004 or 2005 Forms 10-Q or 10-K and thus continues to be de-listed on the NASDAQ Stock Market. We will continue to monitor and evaluate the situation at FIC and further determine if changes in fair market value of the investment are temporary or other than temporary .

The following table summarizes our recognized gains and losses on investments. Costs on assets sold were determined on the basis of specific identification.

	Year ended December 31,		
	2005	2004	2003
Proceeds from sales	$ 8,503,000	$ 1,116,000	$ 4,080,000
Gain on investments, net	3,160,000	245,000	127,000
Loss on impairment of investments	(217,000)	(2,567,000)	

Net gains (losses)	$ 2,943,000	$ (2,322,000)	$ 127,000

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

(6) PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	December 31,	
	2005	**2004**
Equipment	$ 1,289,000	$ 1,150,000
Furniture	647,000	628,000
Software	783,000	643,000
Leasehold improvements	332,000	332,000
	3,051,000	2,753,000
Accumulated depreciation	(2,364,000)	(2,134,000)
	$ 687,000	$ 619,000

Property and equipment are stated at cost. Depreciation expense of $239,000, $181,000 and $173,000 in 2005, 2004 and 2003, respectively, is computed principally on the straight-line method over the estimated useful lives of the assets. The useful lives for equipment ranges from three to five years, furniture ranges from five to seven years, software is depreciated over three years, and leasehold improvements are depreciated over the life of the lease or their expected useful life, whichever is shorter.

(7) ACCRUED EXPENSES AND OTHER LIABILITIES

Accrued expenses and other liabilities consist of the following as of December 31:

	2005	**2004**
Commissions payable	$ 1,258,000	$ 1,260,000
Taxes payable	219,000	205,000
401(k) plan matching	208,000	169,000
Vacation payable	161,000	153,000
Other	66,000	55,000
	$ 1,912,000	$ 1,842,000

(8) DEFERRED GAIN

In November 2001 we sold all of the remaining 46,000 square feet of condominium space we owned in an office project located in Austin, Texas to our former affiliate, HealthTronics. In conjunction with the sale we leased back approximately 23,000 square feet that housed our operations prior to the sale. Gain on the sale amounted to approximately $5.1 million, of which $1.9 million was recognized in 2001 and the balance of gain was deferred. Deferred income of approximately $2.4 million related to our continuing involvement in 50% of the useable space was recorded and is being recognized monthly over the five-year lease term through September 2006. Income recognition related to this deferral was $512,692 in 2005, and $488,000 in 2004 and 2003. In addition, 15% of the gain ($0.76 million) related to our then 15% ownership in the purchaser was

deferred as we accounted for HealthTronics using the equity method of accounting through the year ended December 31, 2001. We reduced our investment in HealthTronics and subsequently recognized a proportionate percentage of the deferred gain, amounting to $133,000, $56,000 and $8,000 in 2005, 2004, and 2003, respectively. Recognition of the deferred gain is recorded as a reduction of rent expense in operating expenses in the accompanying financial statements.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

(9) COMMITMENTS AND CONTINGENCIES

Rental expenses under all operating leases were $1,133,000, $1,098,000, and $997,000, for the years ended December 31, 2005, 2004 and 2003, respectively. Future minimum payments for leases that extend for more than one year through 2010 were $278,000; $164,000; $34,000; $5,000, $0 for 2006, 2007, 2008, 2009 and 2010, respectively.

We are involved in various claims and legal actions that have arisen in the ordinary course of business. Management believes that any liabilities arising from these actions will not have a significant adverse effect on our consolidated financial condition or results of operations.

(10) INCOME TAXES

Income tax expense consists of the following:

	Year Ended December 31,		
	2005	**2004**	**2003**
Continuing Operations:			
Federal			
Current	$ 2,577,000	$ 1,049,000	$ (978,000)
Tax benefit of stock options	708,000	589,000	
Deferred	(446,000)	(505,000)	2,511,000
State-Current	200,000	184,000	107,000
Total from Continuing Operations	3,039,000	1,317,000	1,640,000
Discontinued Operations			14,000
	$ 3,039,000	$ 1,317,000	$ 1,654,000

A reconciliation of expected income tax expense computed by applying the United States federal statutory income tax rate of 34% to earnings from continuing operations before income taxes to tax expense from continuing operations in the accompanying consolidated statements of operations follows:

	Year Ended December 31,		
	2005	**2004**	**2003**
Expected federal income tax expense from continuing operations	$ 2,889,000	$ 1,179,000	$ 1,500,000
State taxes	132,000	121,000	72,000
Minority interest			67,000
Other, net	18,000	17,000	1,000
	$ 3,039,000	$ 1,317,000	$ 1,640,000

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

The tax effect of temporary differences that gives rise to significant portions of deferred tax assets and deferred tax liabilities at December 31, 2005 and 2004 are presented below:

	Year Ended December 31,	
	2005	**2004**
Current deferred tax assets (liabilities):		
Accrued expenses	$ 334,000	$ 113,000
Allowance for doubtful accounts	21,000	11,000
Total current deferred tax asset	355,000	124,000
Non-current deferred tax assets (liabilities):		
Write-off of investment in excess of tax loss	946,000	873,000
Other investments		8,000
Sales/Leaseback deferred income	159,000	378,000
Investment in available-for-sale securities	(175,000)	(677,000)
Market value allowance on investments	(251,000)	(1,072,000)
Other	168,000	136,000
Tax depreciation in excess of book	(161,000)	(128,000)
Total non-current net deferred tax liability	686,000	(482,000)
Net deferred tax asset (liability)	$ 1,041,000	$ (358,000)

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods that the deferred tax assets are deductible, management believes it is more likely than not that we will realize the benefits of these deductible differences at December 31, 2005.

(11) EMPLOYEE BENEFIT PLANS

We have an employee benefit plan qualifying under Section 401(k) of the Internal Revenue Code for all eligible employees. Employees become eligible upon meeting certain service and age requirements. Employee deferrals may not exceed $14,000 in 2005 unless participant is over age 50, in which case the maximum deferral is $18,000. We may, at our discretion, contribute up to 200% of the employees deferred amount. For the years ended December 31, 2005, 2004 and 2003 our contributions aggregated $208,000, $170,000 and $176,000, respectively.

In December 2004, the Board of Directors approved the American Physicians Service Group, Inc. Affiliate Group Deferred Compensation Master Plan (Deferred Compensation Plan), a non-qualified compensation plan designed to give us more flexibility in compensating key employees and directors through ownership of our common stock. The adoption of the Deferred Compensation Plan was approved by our shareholders at the 2005 Annual Meeting. Under the Deferred Compensation Plan we may elect to defer a portion of an employee s incentive compensation or director s board compensation in the form of a deferred stock grant. Shares become eligible for withdrawal with the passage of time and participants may withdraw eligible shares upon attaining the

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

age of sixty or upon leaving our service. Plan participants may withdraw all shares granted to them ratably over four years, provided they have entered into a non-competition agreement with us. We plan for this to be an unfunded plan. Shares to be withdrawn will be purchased in the open market or issued from the authorized shares. In 2005, a total of 21,108 shares were awarded, for which we recorded an expense of $252,000.

(12) STOCK OPTIONS

We have adopted, with shareholder approval, the 2005 Incentive and Non-Qualified Stock Option Plan (Incentive Plan). The Incentive Plan provides for the issuance of up to 350,000 shares of common stock to our directors and key employees. A total of 113,000 of these options have been granted as of December 31, 2005, all of which are exercisable. Simultaneously with shareholder approval of the Incentive Plan, we cancelled the 149,000 shares not granted under the 1995 Incentive and Non-Qualified Stock Option Plan (the 1995 Plan). Under the 1995 Plan 460,000 options remain unexercised, of which 370,000 are exercisable at December 31, 2005.

The exercise price for each non-qualified option share is determined by the Compensation Committee of the Board of Directors (the Committee). The exercise price of a qualified incentive stock option has to be at least 100% of the fair market value of such shares on the date of grant of the option. Under the Plans, option grants are limited to a maximum of ten-year terms; however, the Committee has issued all currently outstanding grants with five-year terms. The Committee also determines vesting for each option grant and substantially all outstanding options vest in two or three approximately equal annual installments beginning one year from the date of grant.

Presented below is a summary of the stock options held by our employees and our directors and the related transactions for the years ended December 31, 2005, 2004 and 2003.

	Years Ended December 31,					
	2005		2004		2003	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Balance at January 1	721,000	$ 6.04	815,000	$ 4.49	939,000	$ 3.51
Options granted	113,000	11.60	146,000	9.93	330,000	6.46
Options exercised	(251,000)	4.13	(240,000)	3.16	(378,000)	3.57
Options repurchased					(15,000)	4.29
Options forfeited/expired	(10,000)	9.10			(61,000)	5.73
Balance at December 31	573,000	$ 7.92	721,000	$ 6.04	815,000	$ 4.49
Options exercisable	483,000	$ 7.96	389,000	$ 5.80	289,000	$ 3.01

The weighted average fair value (the theoretical option value calculated using the Black Scholes option pricing model) of Company stock options granted is $3.19, $3.58 and $2.20 per option during the years ended December 31, 2005, 2004 and 2003, respectively. In this case, as of December 31, 2005, the weighted average theoretical option value per share of Company stock options ($14.79) less the weighted average exercise price of options granted ($11.60) equals the weighted average fair value of options granted ($3.19).

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

The following table summarizes the Company s options outstanding and exercisable options at December 31, 2005:

	Stock Options Outstanding			Stock Options Exercisable	
Range of Exercise Prices	Shares	Average Remaining Contractual Life	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
$2.50 to $9.00	209,000	1.6 years	$ 4.00	179,000	$ 3.95
$9.01 to $11.95	364,000	3.8 years	$ 10.17	304,000	$ 10.31
Total	573,000			483,000	

(13) DISCONTINUED OPERATIONS

Effective November 1, 2002, we completed the sale of APS Consulting to its management as we determined the division s operations were not consistent with our long-term strategic plan. We sold all of our APS Consulting shares for a de minimus amount of cash plus a $250,000 seven-year term note at the prime rate plus 3%. Our existing contract, which was entered into October 1, 2002, provides administrative support services to APS Consulting for a period of approximately seven years, and remained in effect. Fees under this contract are dependent on APS Consulting s pre-tax earnings but may not be less than $200,000 or more than $518,000 over the life of the agreement. Because we were dependent upon the future successful operation of the division to collect our proceeds from the disposal and because we had a security interest in the assets of the division, we had retained a sufficient risk of loss to preclude us from recognizing the divestiture of APS Consulting under the guidance of FASB Interpretation No 46. Accordingly, we did not recognize the divestiture of APS Consulting and continued to consolidate the division as an entity in which we have a variable interest that will absorb the majority of the entity s operating losses if they occurred.

Effective November 1, 2003, APS Consulting was able to obtain third party financing and repay their note payable to us in exchange for our agreeing to discount the note by $35,000. We provided no guarantees or credit enhancements in connection with APS Consulting securing this financing. Accordingly, we no longer have a risk of loss related to these operations and have recognized the transaction as a divestiture. As a result, we ceased consolidation of APS Consulting financial statements effective November 1, 2003. In addition, we were able to recognize a gain of $27,000, net of tax, and administrative support fees totaling $84,000 for the period from November 1, 2002 through October 31, 2003 that had previously been eliminated as intercompany revenues. The accompanying financial statements reflect the financial position, results of operations and cash flows of APS Consulting as discontinued operations.

(14) REPURCHASE OF MINORITY INTEREST

On October 1, 2003 we purchased for $2,050,000 cash the 20% interest in APS Insurances Services, Inc., which was owned by FPIC Insurance Group, Inc. (FPIC). We believe the acquisition provided us more control over operating decisions and improved our earnings and return on capital with minimal risk. As a result of this transaction, we now own a 100% interest in APS Insurance Services. Prior to our repurchase of the minority interest, we consolidated the assets, liabilities and operations of APS Insurance Services and recorded 20% of its after tax net income as minority interest. As a part of the purchase agreement we maintained an agreement with FPIC that limits them from competing with us in Texas through February 2007. The Company has assigned a value of $410,000 to this non-compete agreement based on a determination by an outside consulting firm. The agreement is being amortized on the straight-line method through its expiration in 2007.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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The total cost of the acquisition was $2,050,000 and was allocated to the 20% interest acquired in APS Insurance Services based on the fair values of its net assets on the date of acquisition, in accordance with the purchase method of accounting for business combinations.

A summary of the purchase price allocation for this transaction is as follows:

Purchase price of 20% interest	$ 2,050,000
Basis of recorded minority interest	(393,000)
Allocated to non-competition agreement	(410,000)
Excess of purchase price over assets acquired (goodwill)	$ 1,247,000

Other intangible assets as of December 31, 2005 and 2004, subject to amortization expense, contains the following:

	Gross Carrying Amount	Accumulated Amortization	Net
For the year ended December 31, 2005			
Non-compete	$ 410,000	$ 270,000	$ 140,000
Managing general agent license	160,000	38,000	122,000
Total	570,000	308,000	262,000
For the year ended December 31, 2004			
Non-compete	$ 410,000	$ 149,000	$ 261,000
Managing general agent license	160,000	34,000	126,000
Total	570,000	183,000	387,000

We assume no residual value and estimate annual amortization expense over the remaining life of the non-compete agreement to be as follows:

Year	Amount
2006	120,000
2007	20,000

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The unaudited pro forma income statement data below for the year ended December 31, 2003 show the impact of the repurchase as if it had happened prior to the reporting periods:

	2003
Revenue:	
As reported	$ 30,449,000
Pro forma	30,449,000
Net earnings as reported	$ 2,799,000
Add: Minority Interest attributable to APS Insurance Services, net of income taxes	197,000
Pro forma net earnings	$ 2,996,000
Earnings per share:	
Basic as reported	$ 1.27
Basic pro forma	$ 1.36
Diluted as reported	$ 1.14
Diluted pro forma	$ 1.22

(15) INVESTMENT IN UNCONSOLIDATED AFFILIATES

For the year ended December 31, 2005, 2004 and 2003, respectively, our equity in the earnings of unconsolidated affiliates consisted of the following:

	December 31,		
	2005	2004	2003
Prime Medical Services, Inc.	$	$	$
Uncommon Care			$ 260,000
Earnings	$	$	$ 260,000

On October 12, 1989, we purchased 3,540,000 shares (42%) of the common stock of Prime Medical. In the ensuing years, the sale of stock, stock exchanges and stock issuances reduced our ownership and at December 31, 2005 our holdings stood at 143,000 or less than 1% of the common stock outstanding.

In connection with the sales of Prime Medical (or HealthTronics as of 2004) shares during the year, we recognized gains of $3,020,000 in 2005, $245,000 in 2004, and $64,000 in 2003. The gains are classified as Gain on Sale of Investments in the accompanying consolidated financial statements. Changes in market value of our HealthTronics shares are included in shareholders equity as accumulated other comprehensive income.

HealthTronics is an SEC registrant and additional information on the company can be found on the SEC s web site at www.sec.gov.

On January 1, 1998 we invested approximately $2,078,000 in the convertible preferred stock of Uncommon Care, Inc. and extended notes totaling $4,430,000. Uncommon Care is a developer and operator of Alzheimer s care facilities. We accounted for Uncommon Care using the equity method.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

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Recording our share of Uncommon Care s accumulated losses had reduced the carrying value of our investment and our notes to zero by December 31, 2002. Following Uncommon Care s payment default to its senior lender in 2003 we sold our interest for a de minimus amount and wrote off the notes.

Some of our officers and directors participated in the $2,400,000 line of credit to Uncommon Care. For financial purposes this participation has been treated as a secured borrowing. In the aggregate, these officers and directors contributed approximately $259,000 to fund a 10.8% interest in the loan. They participate in the loan under the same terms as the Company.

We recorded $24,000 and $75,000 in 2005 and 2004, respectively, as gain on forgiveness of debt. These gains represent that amount of liability that was released in the respective periods by participants in our loan to a former affiliate, net of any interest due them fro prior period payments made by that affiliate. Due to poor operating results, Uncommon Care was in default and not making scheduled payments under its loan agreement with us in which the participations had been sold. As a result, the loan participants released us from any obligations under thee participation agreements. The $24,000 recorded in 2005 represents the final loan obligation to be released.

During 2003 we decided not to extend any future cash advances to Uncommon Care. Consequently, we took into income cash payments previously received from Uncommon Care. Total cash receipts recorded as equity in earnings of unconsolidated affiliates was $260,000 in 2003.

(16) SEGMENT INFORMATION

Our segments are distinct by type of service provided. Each segment has its own management team and separate financial reporting. Our Chief Executive Officer allocates resources and provides overall management based on the segments financial results.

Our financial services segment includes brokerage and asset management services to individuals and institutions.

Our insurance services segment includes financial management for an insurance company that provides professional liability insurance to doctors.

Corporate is the parent company and derives its income from interest, investments and dividends paid by the other segments.

Income from the discontinued consulting segment was derived from operations in 2002 and from gains on disposal in 2003.

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

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	2005	2004	2003
Operating Revenues			
Financial services	$ 18,459,000	$ 16,705,000	$ 19,623,000
Insurance services	15,514,000	15,316,000	10,826,000
Other	1,600,000	4,760,000	2,567,000
	$ 35,573,000	$ 36,781,000	$ 33,016,000
Reconciliation to Consolidated Statements of Operations:			
Total segment revenues	35,573,000	36,781,000	33,016,000
Less: intercompany dividends	(1,600,000)	(4,760,000)	(2,567,000)
Total Revenues	$ 33,973,000	$ 32,021,000	$ 30,449,000
Operating Income (Loss):			
Financial services	2,196,000	2,167,000	3,039,000
Insurance services	5,252,000	5,348,000	2,985,000
Other	(1,003,000)	2,589,000	506,000
	$ 6,445,000	$ 10,104,000	$ 6,530,000
Reconciliation to Consolidated Statements of Operations:			
Total segment operating profit	$ 6,445,000	$ 10,104,000	$ 6,530,000
Less: intercompany dividends	(1,600,000)	(4,760,000)	(2,567,000)
Operating income	4,845,000	5,344,000	3,963,000
Gain (loss) on investments	2,943,000	(2,322,000)	127,000
Gain on extinguishment of debt	24,000	75,000	
Income from continuing operations before interest, income taxes, minority interests and equity in gain and loss of unconsolidated affiliates	7,812,000	3,097,000	4,090,000
Interest income	587,000	365,000	304,000
Other income	124,000	15,000	(38,000)
Interest expense	10,000	7,000	7,000
Income tax expense	3,039,000	1,317,000	1,640,000
Minority interests	14,000	1,000	197,000
Equity in profit (loss) of affiliates			260,000
Income from continuing operations	5,460,000	2,152,000	2,772,000
Gain on disposal of discontinued operations, net of income tax			27,000
Net income	$ 5,460,000	$ 2,152,000	$ 2,799,000

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

	2005	2004	2003
Identifiable assets:			
Financial services	$ 6,061,000	$ 5,106,000	$ 4,970,000
Insurance services:			
Intangible assets	1,387,000	1,507,000	1,627,000
Other	5,033,000	4,526,000	3,965,000
Corporate:			
Investment in available for sale securities	18,263,000	14,320,000	9,626,000
Other	2,761,000	4,984,000	5,450,000
	$ 33,505,000	$ 30,443,000	$ 25,638,000
Capital expenditures:			
Financial services	$ 47,000	$ 10,000	$ 32,000
Insurance Services	187,000	362,000	160,000
Corporate	73,000	49,000	31,000
Discontinued Operations			96,000
	$ 307,000	$ 421,000	$ 319,000
Depreciation/amortization expenses:			
Financial services	$ 28,000	$ 27,000	$ 31,000
Insurance Services	274,000	217,000	110,000
Corporate	62,000	60,000	65,000
Discontinued Operations			
	$ 364,000	$ 304,000	$ 206,000

During the years ended December 31, 2005, 2004 and 2003, a single customer represented 46% ($15,514,000), 48% ($15,316,000) and 36% ($10,826,000) of our consolidated revenues.

At December 31, 2005, 2004 and 2003 we had long-term contracts with that customer and were therefore not vulnerable to the risk of a near-term severe impact from a reasonably possible loss of the revenue. However, should that customer default or be unable to satisfy its contractual obligations, there would be a material adverse effect on our financial condition and results of operations.

Operating income (loss) is operating revenues less related expenses and is all derived from domestic operations. Identifiable assets are those assets that are used in the operations of each business segment (after elimination of investments in other segments). Corporate assets consist primarily of cash and cash equivalents, notes receivable, investments in available-for-sale securities, investments in affiliates and intangible assets.

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(17) NET INCOME PER SHARE

Basic income per share are based on the weighted average shares outstanding without any dilutive effects considered. Diluted earnings per share reflects dilution from all contingently issuable shares, including options. A reconciliation of income and average shares outstanding used in the calculation of basic and diluted earnings per share from continuing and discontinued operations follows:

	For the Year Ended December 31, 2005		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Income from continuing operations	$ 5,460,000		
Basic EPS:			
Income available to common stockholders	5,460,000	2,688,000	$ 2.03
Effect of dilutive securities		243,000	
Diluted EPS:			
Income available to common stockholders	$ 5,460,000	2,931,000	$ 1.86

	For the Year Ended December 31, 2004		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Income from continuing operations	$ 2,152,000		
Basic EPS:			
Income available to common stockholders	2,152,000	2,545,000	$ 0.85
Effect of dilutive securities		293,000	
Diluted EPS:			
Income available to common stockholders	$ 2,152,000	2,838,000	$ 0.76

	For the Year Ended December 31, 2003		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Income from continuing operations	$ 2,772,000		
Discontinued operations, net of tax	27,000		
Basic EPS:			
Income available to common stockholders	2,799,000	2,207,000	$ 1.27
Effect of dilutive securities		242,000	

Diluted EPS:			
Income available to common stockholders	$ 2,799,000	2,449,000	$ 1.14

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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(18) SHAREHOLDERS EQUITY

The following table presents changes in shares outstanding for the period from December 31, 2003 to December 31, 2005:

	Common Shares Outstanding	Treasury Stock
Balance December 31, 2002	2,133,843	
Options excercised	377,800	
Treasury stock purchases		56,976
Treasury stock retirements	(56,976)	(56,976)
Balance December 31, 2003	2,454,667	
Options excercised	240,200	
Treasury stock purchases		70,495
Treasury stock retirements	(70,495)	(70,495)
Balance December 31, 2004	2,624,372	
Options excercised	251,000	
Deferred compensation	47,855	
Treasury stock purchases		139,107
Treasury stock retirements	(139,107)	(139,107)
Balance December 31, 2005	2,784,120	

(19) SUPPLEMENTAL CONSOLIDATED QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarter to quarter comparisons of results of operations have been and may be materially impacted by bond market conditions and whether or not there are profits at the medical malpractice insurance company which we manage and whose profits we share. We believe that the historical pattern of quarterly sales and income as a percentage of the annual total may not be indicative of the pattern in future years. The following tables set forth selected quarterly consolidated financial information for the years ended December 31, 2005, 2004 and 2003:

2005	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands, except per share data)			
Revenues	$ 6,662	$ 7,033	$ 9,182	$ 11,096
Net Income	853	1,367	1,395	1,845
Basic net income per share:	$ 0.32	$ 0.51	$ 0.52	$ 0.67
Diluted income per share:	$ 0.30	$ 0.48	$ 0.48	$ 0.64

2004

Revenues	$ 7,290	$ 7,295	$ 7,593	$ 9,843
Net Income	694	689	(834)	1,603
Basic net income per share:	$ 0.28	$ 0.28	$ (0.32)	$ 0.62
Diluted income per share:	$ 0.25	$ 0.25	$ (0.32)	$ 0.58

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AMERICAN PHYSICIANS SERVICE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2005, 2004 and 2003

Results for the fourth quarter of 2005, 2004 and 2003 include profit sharing with APIE totaling $2,007,000, $1,929,000 and $722,000, respectively.

Certain amounts previously classified as cost of revenues at Insurance Services have been classified as general and administrative in the consolidated statements of income for the years ended 2004 and 2003. For the year ended December 31, 2004 the amount of reclassifications totaled $590,000. For the year ended December 31, 2003 the amount of reclassifications totaled $741,000.

(20) CONCENTRATION OF CREDIT RISK

Marketable securities

As of December 31, 2005 we owned marketable securities of HealthTronics and Financial Industries Corporation with a combined fair market value of $4,291,000, or approximately 13% of our total assets. An event having a material adverse effect on HealthTronics and/or Financial Industries, and resulting in a devaluation of their securities could also have a material adverse effect on our results of operations.

Geographic concentration of insurance services

Most of the managed insurance company s business is concentrated in Texas. Regulatory or judicial actions in that state that affected rates, competition, or tort law could have a significant impact on the insurance company s business. Consequently, our insurance management business, which is based on the premiums and profitability of the managed company, could be adversely affected.

Financial market concentration of investment services

Investment Services derives most of its revenue through commissions earned on the trading of fixed-income securities. Should conditions reduce the market s demand for fixed-income products, and should Investment Services be unable to shift it emphasis to other financial products, it could have a material adverse impact on our financial condition and results of operations.

(21) OTHER COMPREHENSIVE INCOME

The following chart discloses the reclassification adjustments for gains and losses included in net income during the years ended December 31:

	Before-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
2005			
Unrealized holding gains arising during the period	$ 254	$ (87)	$ 167
Reclassification adjustment for gains included in net income	(2,667)	907	(1,760)
Net unrealized losses on securities	$ (2,413)	$ 820	$ (1,593)
2004			
Unrealized holding gains arising during the period	$ 1,393	$ (474)	$ 919
Reclassification adjustment for losses included in net income	2,322	(789)	1,533

Net unrealized gains on securities	$ 3,715	$ (1,263)	$ 2,452
2003			
Unrealized holding losses arising during the period	$ (3,246)	$ 1,104	$ (2,142)
Reclassification adjustment for gains included in net income	(89)	30	(59)
Net unrealized losses on securities	$ (3,335)	$ 1,134	$ (2,201)

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SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS

American Physicians Service Group, Inc. and Subsidiaries

Years Ended December 31, 2005, 2004 and 2003

	Balance at Beginning of Years	Costs and Expenses	Deductions	Balance at End of Year
		(in thousands)		
Allowance for Doubtful Accounts				
2005	$ 14	$	$ 6	$ 8
2004	$	$ 47	$ 33	$ 14
2003	$ 64	$ 15	$ 79	$

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

CONDENSED BALANCE SHEETS

AS OF SEPTEMBER 30, 2006 AND DECEMBER 31, 2005

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
INVESTMENTS:		
Fixed maturities available for sale at fair value	$ 128,221,316	$ 106,118,180
Equity securities at fair value	5,878,527	5,153,180
Short-term investments		798,599
Other invested assets	1,119,476	1,162,835
Total investments	135,219,319	113,232,794
CASH AND CASH EQUIVALENTS	3,925,961	3,515,844
ACCRUED INVESTMENT INCOME	559,857	456,372
PREMIUM AND MAINTENANCE FEES RECEIVABLE	20,833,044	13,703,089
OTHER AMOUNTS RECEIVABLE UNDER REINSURANCE CONTRACTS	5,014,181	6,802,295
REINSURANCE RECOVERABLES ON UNPAID LOSS AND LOSS ADJUSTMENT EXPENSES	29,597,742	27,588,622
REINSURANCE RECOVERABLES ON PAID LOSS AND LOSS ADJUSTMENT EXPENSES	76,530	261,750
PREPAID REINSURANCE PREMIUMS	363,797	507,247
DEFERRED POLICY ACQUISITION COSTS	2,861,899	2,506,057
DEFERRED TAX ASSET	4,204,803	3,221,185
SUBROGATION RECOVERABLES	761,433	1,587,957
FEDERAL INCOME TAXES RECOVERABLE		515,752
OTHER ASSETS	817,688	933,628
TOTAL	$ 204,236,254	$ 174,832,592
LIABILITIES AND MEMBERS EQUITY		
LIABILITIES:		
Reserve for losses and loss adjustment expenses	$ 109,414,237	$ 95,371,649
Unearned premiums and maintenance fees	44,083,358	40,698,631
Reinsurance premiums payable	132,830	669,578
Funds held under reinsurance treaties	3,738,103	1,521,225
Amounts withheld or retained by the Exchange	1,566,351	3,333,856
Refundable subscriber deposits	10,294,802	10,567,520
Federal income taxes payable	2,073,761	
Other liabilities	2,790,061	3,428,077
Total liabilities	174,093,503	155,590,536

COMMITMENTS AND CONTINGENCIES (Note 8)		
MEMBERS EQUITY:		
Retained earnings	31,994,376	20,591,546
Accumulated other comprehensive income (loss), net of deferred tax expense (benefit) of ($953,869) and ($695,193)	(1,851,625)	(1,349,490)
Total members equity	30,142,751	19,242,056
TOTAL	$ 204,236,254	$ 174,832,592

See notes to condensed financial statements.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

CONDENSED STATEMENTS OF OPERATIONS

FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Unaudited)

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
REVENUES:				
Gross premiums and maintenance fee written direct and assumed	$ 24,121,344	$ 26,921,100	$ 61,560,465	$ 64,821,303
Premiums ceded	(3,372,232)	(3,725,550)	(5,627,157)	(11,332,948)
Change in unearned premiums and maintenance fees	(5,666,662)	(8,034,785)	(3,528,178)	(5,235,360)
Net premiums and maintenance fees earned	15,082,450	15,160,765	52,405,130	48,252,995
Investment income, net of investment expenses	1,638,710	1,469,101	4,624,287	3,883,403
Realized capital gains net	124,012	201,767	265,175	270,416
Total revenues	16,845,172	16,831,633	57,294,592	52,406,814
EXPENSES:				
Losses and loss adjustment expenses	10,680,873	11,650,467	29,879,458	35,535,207
Other underwriting expenses	4,113,914	3,689,390	10,536,333	9,429,452
Net change in deferred acquisition costs	(426,949)	(650,991)	(355,841)	(368,786)
Total expenses	14,367,838	14,688,866	40,059,950	44,595,873
INCOME FROM OPERATIONS	2,477,334	2,142,767	17,234,642	7,810,941
FEDERAL INCOME TAX EXPENSE (BENEFIT):				
Current	924,905	545,627	6,556,756	2,550,865
Deferred	(88,146)	187,945	(724,944)	(174,612)
Total federal income tax expense	836,759	733,572	5,831,812	2,376,253
NET INCOME	$ 1,640,575	$ 1,409,195	$ 11,402,830	$ 5,434,688

See notes to condensed financial statements.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

CONDENSED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Unaudited)

	NINE MONTHS ENDED	
	September 30, 2006	September 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 11,402,830	$ 5,434,688
Adjustments to reconcile net income to cash provided by operating activities:		
Amortization and accretion of investments	(37,990)	(34,032)
Net realized gains on investments	(265,175)	(270,416)
Deferred policy acquisition costs net of related amortization	(355,841)	(368,786)
Deferred income tax benefit	(724,944)	(174,612)
Changes in operating assets and liabilities:		
Premium and maintenance fee receivables net	(7,129,955)	1,688,593
Accrued investment income	(103,485)	(63,482)
Other amounts receivable under reinsurance contracts	1,788,114	1,504,821
Reinsurance recoverables on unpaid loss and loss expenses	(2,009,120)	(1,087,305)
Reinsurance recoverables on paid loss and loss expenses	185,220	491,760
Federal income taxes recoverable	515,752	(184,288)
Other assets	1,095,484	(79,555)
Reinsurance payables	(536,748)	(4,180,291)
Losses and loss adjustment expenses	14,042,590	8,859,565
Unearned premiums and maintenance fees	3,384,727	5,422,949
Federal income taxes payable	2,073,761	(2,030,409)
Other liabilities	(188,644)	(5,521,387)
Net cash provided by operating activities	23,136,576	9,407,813
CASH FLOWS FROM INVESTING ACTIVITIES:		
Sale and maturities of investments	13,157,462	21,826,253
Purchases of investments	(35,611,203)	(36,630,259)
Net cash used in investing activities	(22,453,741)	(14,804,006)
CASH FLOWS FROM FINANCING ACTIVITIES Subscriber deposits refunded	(272,718)	(163,756)
NET CHANGE IN CASH AND CASH EQUIVALENTS	410,117	(5,559,949)
CASH AND CASH EQUIVALENTS Beginning of year	3,515,844	8,583,855
CASH AND CASH EQUIVALENTS End of year	$ 3,925,961	$ 3,023,906
SUPPLEMENTAL INFORMATION Cash paid (received) for:		
Federal income taxes paid	$ 4,000,000	$ 4,855,408
Federal income tax refunds received	$ 122,606	$

See notes to condensed financial statements.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

CONDENSED STATEMENTS OF CHANGES IN MEMBERS EQUITY

FOR THE YEAR ENDED DECEMBER 31, 2005 AND THE NINE MONTHS

ENDED SEPTEMBER 30, 2006 (Unaudited)

	Accumulated Other Comprehensive Income	Retained Earnings	Total
BALANCE January 1, 2005	$ 339,762	$ 11,561,020	$ 11,900,782
Net income		9,030,526	9,030,526
Other comprehensive income net of tax	(1,689,252)		(1,689,252)
BALANCE December 31, 2005	$ (1,349,490)	$ 20,591,546	$ 19,242,056
Net income		11,402,830	11,402,830
Other comprehensive income net of tax	(502,135)		(502,135)
BALANCE September 30, 2006	$ (1,851,625)	$ 31,994,376	$ 30,142,751

See notes to condensed financial statements.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO CONDENSED FINANCIAL STATEMENTS

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Unaudited)

1. NATURE OF OPERATIONS

American Physicians Insurance Exchange (APIE or the Exchange) is a reciprocal insurance exchange. The Exchange was organized in the State of Texas on November 23, 1975, and commenced operations on June 1, 1976. APIE is licensed as a multiple-line insurer under the provisions of the Texas Insurance Code.

A reciprocal insurance exchange is an organization under which policyholders (members) effectively exchange insurance contracts and thereby insure each other and become members of the Exchange. The Exchange is managed by its attorney-in-fact, APS Facilities Management, Inc. (FMI), subject to the direction of the Exchange s board of directors.

APIE principally writes professional liability insurance coverage for physician groups, individual physicians and other healthcare providers in the states of Texas (99%) and Arkansas (1%). Most of the Exchange s coverage is written on a claims-made and reported basis. The coverage is provided only for claims that are first reported to the Exchange during the insured s coverage period and that arise from occurrences during the insured s coverage period. The Exchange also makes extended or tail coverage available for purchase by policyholders in order to cover claims that arise from occurrences during the insured s coverage period, but that are first reported to the Exchange after the insured s coverage period and during the term of the applicable tail coverage.

2. BASIS OF PRESENTATION

The accompanying unaudited condensed financial statements include the accounts and operations of American Physicians Insurance Exchange. These statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006. For example, the timing and magnitude in determining the claim losses incurred by our insurance operations due to the estimation process inherent in determining the liability for losses and loss adjustment expenses can be relatively more significant to results of interim periods than to results for a full year. The accompanying condensed financials statements should be read in conjunction with the December 31, 2005 audited financial statements and notes thereto.

3. PLAN OF CONVERSION AND PLAN OF MERGER

Effective June, 1 2006, the Board of Directors of the Exchange adopted a plan of conversion and a plan of merger with APS Facilities Management, Inc s. (FMI) parent company, American Physicians Service Group, Inc. (APSG), a publicly traded company on the National Association of Securities Dealer and Automated Quotation System (NASDAQ) under the NASDAQ symbol AMPH. The plan of conversion and plan of merger are subject to the approval by the Exchange s policyholders, APSG s shareholders and the Texas Department of Insurance.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Unaudited)

4. INVESTMENTS

The amortized cost and estimated fair values of investments in debt securities at September 30, 2006 and December 31, 2005 are as follows (in thousands):

September 30, 2006	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities:				
U.S treasury notes	$ 1,059	$ 18	$ 6	$ 1,071
U.S government agency bonds	2,852	41		2,893
U.S government agency mortgage-backed bonds	22,172	9	653	21,528
U.S. government agency collateralized mortgage obligations	50,428	68	1,065	49,431
Collateralized mortgage obligations	55,121	10	1,833	53,298
Total fixed maturities	131,632	146	3,557	128,221
Equity securities	5,273	794	188	5,879
Total fixed maturities and equity securities	$ 136,905	$ 940	$ 3,745	$ 134,100

December 31, 2005	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities:				
U.S treasury notes	$ 522	$ 19	$ 3	$ 538
U.S government agency mortgage-backed bonds	19,515	1	568	18,948
U.S. government agency collateralized mortgage obligations	44,567		1,163	43,404
Collateralized mortgage obligations	44,322	20	1,114	43,228
Total fixed maturities	108,926	40	2,848	106,118
Equity securities	4,390	814	51	5,153
Total fixed maturities and equity securities	$ 113,316	$ 854	$ 2,899	$ 111,271

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Unaudited)

Gross realized gains and losses on fixed maturity and equity securities for the three and nine months ended September 30, 2006 and 2005 were as follows (in thousands):

	Three Months ended		Nine Months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Realized gains (losses):				
Fixed maturities:				
Gross realized gains	$	$ 15	$ 10	$ 27
Gross realized losses				
Net realized gains (losses)		15	10	27
Equities:				
Gross realized gains	124	187	307	291
Gross realized losses			(52)	(48)
Net realized gains (losses)	124	187	255	243
Total net realized gains	$ 124	$ 202	$ 265	$ 270

The major categories of the Exchange s net investment income are summarized for the three and nine months ended September 30, 2006 and 2005, as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Investment income:				
Fixed maturities	$ 1,599	$ 1,314	$ 4,482	$ 3,463
Equity securities	21	12	64	28
Short-term investments and other	68	45	168	95
Finance charges on premiums receivable	57	144	238	444
Structured annuity	23	23	67	67
Total investment income	1,768	1,538	5,019	4,097
Investment expense	(129)	(69)	(395)	(214)
Net investment income	$ 1,639	$ 1,469	$ 4,624	$ 3,883

The increases in gross unrealized losses from $2.8 million at December 31, 2005 to $3.6 million at September 30, 2006 in fixed maturity investments are primarily the result of rising interest rates. The fixed maturity investments are all investment grade securities. The Exchange has

the ability and intent to hold securities with unrealized losses until they recover their value, which may be maturity. As of September 30, 2006 and December 31, 2005, there have been no impairments in value or write-downs for these securities. In the future, information may come to light or circumstances may change that would cause the Exchange to write-down or sell these securities and incur a realized loss.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Unaudited)

Provided below is a summary of securities which were in an unrealized loss position at September 30, 2006 and December 31, 2005. The Exchange believes the deterioration in value is attributable to changes in market interest rates and not credit quality of the issuer and therefore considers these investments to be only temporarily impaired.

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
September 30, 2006:						
U.S. treasury notes	$ 964	$ 3	$ 106	$ 3	$ 1,070	$ 6
U.S. government agency bonds	2,893				2,893	
U.S. government agency mortgage-backed bonds	5,451	18	16,078	635	21,529	653
U.S. government agency collateralized mortgage obligations	22,759	180	26,673	885	49,432	1,065
Collateralized mortgage obligations	15,586	391	37,711	1,442	53,297	1,833
Equity Securities	4,487	185	1,392	3	5,879	188
Total temporarily impaired securities	$ 52,140	$ 777	$ 81,960	$ 2,968	$ 134,100	$ 3,745

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
December 31, 2005:						
U.S. treasury notes	$ 281	$ 3	$	$	$ 281	$ 3
U.S. government agency mortgage-backed bonds	4,087	95	14,465	473	18,552	568
U.S. government agency collateralized mortgage obligations	26,713	597	16,690	566	43,403	1,163
Collateralized mortgage obligations	24,912	753	15,373	361	40,285	1,114
Equity Securities	1,144	41	202	10	1,346	51
Total temporarily impaired securities	$ 57,137	$ 1,489	$ 46,730	$ 1,410	$ 103,867	$ 2,899

At September 30, 2006 and December 31, 2005, investments with a fair market value of $1,039,577, and $1,048,700, respectively, were on deposit with state insurance departments to satisfy regulatory requirements.

5. UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSE RESERVES

The reserve for unpaid losses and loss adjustment expenses represent the estimated liability for unpaid claims reported to the Exchange, plus claims incurred but not reported (IBNR) and the related estimated loss adjustment expenses. The reserve for losses and loss adjustment expenses is determined based on the Exchange s actual experience, available industry data and projections as to future claims frequency, severity, inflationary trends and settlement patterns.

The Exchange writes medical malpractice policies which have a lengthy period for reporting a claim (tail coverage) and a long process of litigating a claim through the courts and whose risk factors expose its reserves for loss and loss adjustment expenses to significant variability. These conditions subject the Exchange s open reported claims and incurred but not reported claims to increases due to inflation, changes in legal

proceedings, and changes in the law. While the anticipated effects of inflation is implicitly considered when estimating reserves for loss and loss adjustment expenses, the increase in average severity of claims is caused by a number

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Unaudited)

of factors. Future average severities are projected based on historical trends adjusted for changes in underwriting standards, policy provisions, and general economic trends. Those anticipated trends are monitored based on actual experience and are modified as necessary to reflect any changes in the development of ultimate losses and loss adjustment expenses to the Exchange. These specific risks, combined with the variability that is inherent in any reserve estimate, could result in significant adverse deviation from the Exchange s carried net reserve amounts. Settlement of the Exchange s claims is subject to considerable uncertainty. The Exchange s management believes the reserves for loss and loss adjustment expenses are reasonably stated for all obligations of the Exchange as of September 30, 2006 and December 31, 2005.

The following table reflects the activity in the liability for reserve for losses and loss adjustment expenses showing the changes for the twelve month periods beginning January 1, 2005 and ending December 31, 2005 and the nine month period ending September 30, 2006 (in thousands):

	September 30, 2006	2005
Reserve for losses and loss adjustment expenses January 1	$ 95,372	$ 69,445
Less reinsurance recoverable on paid losses and unpaid losses	27,850	11,203
Net balance January 1	67,522	58,242
Incurred net of reinsurance related to:		
Current years	31,081	28,261
Prior years	(1,202)	15,715
Net incurred	29,879	43,976
Paid net of reinsurance related to:		
Current years	3,361	4,062
Prior years	14,300	30,634
Net paid	17,661	34,696
Net balance September 30 and December 31	79,740	67,522
Plus reinsurance recoverable on paid losses and unpaid losses	29,674	27,850
Reserve for losses and loss adjustment expenses September 30 and December 31	$ 109,414	$ 95,372

After evaluation of open claims and trend assumptions, APIE recorded a decrease of $1,200,000 for the nine months ended September 30, 2006 for incurred loss and loss adjustment expenses for prior-year development as a result of favorable trends in the underlying claims data. The adjustment was due to accident years 2004 and 2005 developing favorably by $8,200,000 most of which is attributable to the passage of Texas tort reform effective September 1, 2003, offset by $7,000,000 of adverse development for pre-tort reform years which continue to develop unfavorably with increasing levels of severity and loss expenses.

6. REINSURANCE AGREEMENTS

Reinsurance Ceded Certain premiums are ceded to other insurance companies under various reinsurance agreements. These reinsurance agreements provide the Exchange with increased capacity to write additional risk and the ability to write specific risk within its capital resources and underwriting guidelines. The Exchange enters into reinsurance contracts, which provide coverage for losses in excess of the Exchange s

retention of $250,000 on individual claims and beginning in 2002, $350,000 on multiple insured claims related to a single occurrence. The reinsurance contracts for 2002 through 2006 contain variable premium ceding rates based on loss experience. The ceded premium charged under these contracts will depend upon the development of ultimate

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO CONDENSED FINANCIAL STATEMENTS (Continued)

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005 (Unaudited)

losses ceded to the reinsurers under their retrospective treaties. Estimates of ultimate reinsurance ceded premium amounts compared to the amounts paid on a provisional basis are reviewed by treaty year, with each treaty year giving rise to either an asset or liability on the balance sheet. For the nine months ended September 30, 2006, the Exchange recorded favorable net development reducing ceded premiums by $2,840,848. Additionally, each treaty year requires a 24 or 36-month holding period before any cash can be returned or paid. During the nine months ending September 30, 2006, the exchange received $6.1 million due to the expiration of the 2002 treaty year 36-month holding period. As a result, at September 30, 2006, the Exchange had an asset (Other Amounts Receivable Under Reinsurance Contracts) of $5,014,181 and a liability (Funds Held Under Reinsurance Treaties) of $3,738,103.

7. TRANSACTIONS WITH AFFILIATES AND RELATED PARTIES

The Exchange s management contract with its attorney-in-fact, FMI, is treated as an affiliated transaction. However, there is no ownership between the two entities. They have separate boards of directors and their duties to each other are based on the management contract. Transactions with parties related to FMI are also treated as affiliated transactions. American Physicians Insurance Agency, Inc. (APIA), and APS Financial Corporation (APS) are considered affiliates of FMI through common ownership.

FMI serves as the attorney-in-fact for the Exchange. In accordance with the terms of a management agreement, FMI performs the administrative functions related to the operations of the Exchange. FMI receives a management fee from the Exchange for providing these services. The management fee, which is calculated as a percentage of the direct gross earned premiums and statutory net income including contingent management fees of the Exchange, were $2,699,400 and $2,731,400 for the three months ended September 30, 2006 and 2005, respectively. Management fees for the nine months ended September 30, 2006 and 2005 were $6,814,500 and $6,833,200, respectively. Contingent management fees are based upon the financial performance of the Exchange. The Exchange recorded amounts payable to affiliates of $2,266,000 and $2,723,200 as of September 30, 2006 and December 31, 2005, respectively, and are included in other liabilities in the balance sheets.

In addition to the management fees paid to FMI, the Exchange received reimbursement of commission expenses from FMI in the amount of $375,000 in 2006 and 2005, respectively.

APS manages the bond portfolio within the investment guidelines established by the Board of Directors, provides advisory services on key investment decisions and manages accounting services for the Exchange. The Exchange pays APS standard markup fees on trades of fixed-income securities.

8. COMMITMENTS AND CONTINGENCIES

The Exchange is named as a defendant in various legal actions primarily arising from claims made under insurance policies and contracts. These actions are considered by the Exchange in estimating the loss and loss adjustment expense reserves. The Exchange s management believes that the resolution of these actions will not have a material adverse effect on the Exchange s financial position or results of operations. There are no other material commitments or contingencies as of September 30, 2006.

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INDEPENDENT AUDITORS REPORT

To the Board of Directors of

American Physicians Insurance Exchange

Austin, Texas

We have audited the accompanying balance sheets of American Physicians Insurance Exchange (the Exchange) as of December 31, 2005 and 2004, and the related statements of operations, members equity, and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Exchange 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, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

Dallas, Texas

August 9, 2006

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

BALANCE SHEETS

AS OF DECEMBER 31, 2005 AND 2004

	2005	2004
ASSETS		
INVESTMENTS:		
Fixed maturities available for sale at fair value	$ 106,118,180	$ 91,853,806
Equity securities at fair value	5,153,180	3,362,945
Short-term investments	798,599	1,584,415
Other invested assets	1,162,835	1,072,385
Total investments	113,232,794	97,873,551
CASH AND CASH EQUIVALENTS	3,515,844	8,583,855
ACCRUED INVESTMENT INCOME	456,372	384,213
PREMIUM AND MAINTENANCE FEES RECEIVABLE	13,703,089	14,971,065
OTHER AMOUNTS RECEIVABLE UNDER REINSURANCE CONTRACTS	6,802,295	4,959,418
REINSURANCE RECOVERABLES ON UNPAID LOSS AND LOSS ADJUSTMENT EXPENSES	27,588,622	10,631,250
REINSURANCE RECOVERABLES ON PAID LOSS AND LOSS ADJUSTMENT EXPENSES	261,750	571,828
PREPAID REINSURANCE PREMIUMS	507,247	387,774
DEFERRED POLICY ACQUISITION COSTS	2,506,057	2,409,908
DEFERRED TAX ASSET	3,221,185	2,229,993
SUBROGATION RECOVERABLES	1,587,957	1,893,366
FEDERAL INCOME TAXES RECOVERABLE	515,752	89,847
OTHER ASSETS	933,628	742,047
TOTAL	$ 174,832,592	$ 145,728,115
LIABILITIES AND MEMBERS EQUITY		
LIABILITIES:		
Reserve for losses and loss adjustment expenses	$ 95,371,649	$ 69,444,502
Unearned premiums and maintenance fees	40,698,631	38,345,518
Reinsurance premiums payable	669,578	3,640,011
Funds held under reinsurance treaties	1,521,225	64,583
Amounts withheld or retained by the Exchange	3,333,856	3,866,838
Refundable subscriber deposits	10,567,520	11,001,133
Federal income taxes payable		2,030,409
Other liabilities	3,428,077	5,434,339
Total liabilities	155,590,536	133,827,333
CONTINGENCIES (Note 12)		
MEMBERS EQUITY:		
Retained earnings	20,591,546	11,561,020
Accumulated other comprehensive income (loss), net of deferred tax expense (benefit) of ($695,193) and $175,029	(1,349,490)	339,762
Total members equity	19,242,056	11,900,782
TOTAL	$ 174,832,592	$ 145,728,115

See notes to financial statements.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

	2005	2004	2003
REVENUES:			
Gross premiums and maintenance fees written direct and assumed	$ 79,301,001	$ 84,570,995	$ 70,993,380
Premiums ceded	(12,884,812)	(12,878,126)	(10,351,899)
Change in unearned premiums and maintenance fees	(2,233,640)	(7,076,744)	(7,797,809)
Net premiums and maintenance fees earned	64,182,549	64,616,125	52,843,672
Investment income, net of investment expenses of $520,400 in 2005, $301,300 in 2004, and $212,400 in 2003	5,131,170	4,088,778	3,119,389
Realized capital gains net	552,460	608,284	184,949
Total revenues	69,866,179	69,313,187	56,148,010
EXPENSES:			
Losses and loss adjustment expenses	43,976,005	48,654,932	44,545,795
Other underwriting expenses	12,767,518	12,102,544	9,804,313
Net change in deferred acquisition costs	(96,149)	(680,890)	(105,685)
Total expenses	56,647,374	60,076,586	54,244,423
INCOME FROM OPERATIONS	13,218,805	9,236,601	1,903,587
FEDERAL INCOME TAX EXPENSE (BENEFIT):			
Current	4,309,247	3,624,566	1,765,028
Deferred	(120,968)	(203,344)	(553,851)
Total federal income tax expense	4,188,279	3,421,222	1,211,177
NET INCOME	$ 9,030,526	$ 5,815,379	$ 692,410

See notes to financial statements.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

	2005	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 9,030,526	$ 5,815,379	$ 692,410
Adjustments to reconcile net income to cash provided by operating activities:			
Amortization and accretion of investments	(65,935)	274,563	462,657
Net realized gains on investments	(552,460)	(608,284)	(184,949)
Deferred policy acquisition costs net of related amortization	(96,149)	(680,890)	(105,685)
Deferred income tax benefit	(120,968)	(203,344)	(553,851)
Changes in operating assets and liabilities:			
Premium receivables net	1,163,607	(4,742,861)	(1,764,695)
Maintenance fee receivables	104,369	125,481	(294,933)
Accrued investment income	(72,159)	(89,400)	(60,659)
Other amounts receivable under reinsurance contracts	(1,842,877)	(1,617,734)	(1,608,874)
Reinsurance recoverables on unpaid loss and loss expenses	(16,957,372)	3,901,915	2,047,329
Reinsurance recoverables on paid loss and loss expenses	310,078	(125,342)	896,598
Federal income taxes recoverable	(425,905)	109,491	273,097
Other assets	(5,645)	1,806,956	(2,839,622)
Reinsurance payables	(2,970,433)	3,375,126	(1,328,379)
Losses and loss adjustment expenses	25,927,147	5,731,847	9,525,919
Unearned premiums and maintenance fees	2,353,113	7,310,292	7,812,562
Federal income taxes payable	(2,030,409)	1,173,970	856,439
Other liabilities	(1,082,602)	1,087,905	1,591,346
Net cash provided by operating activities	12,665,926	22,645,070	15,416,710
CASH FLOWS FROM INVESTING ACTIVITIES:			
Sale and maturities of investments	27,474,351	35,346,530	59,809,505
Purchases of investments	(44,774,675)	(56,079,834)	(81,895,324)
Net cash used in investing activities	(17,300,324)	(20,733,304)	(22,085,819)
CASH FLOWS FROM FINANCING ACTIVITIES Subscriber deposits refunded	(433,613)	(460,232)	(116,461)
NET CHANGE IN CASH AND CASH EQUIVALENTS	(5,068,011)	1,451,534	(6,785,570)
CASH AND CASH EQUIVALENTS Beginning of year	8,583,855	7,132,321	13,917,891
CASH AND CASH EQUIVALENTS End of year	$ 3,515,844	$ 8,583,855	$ 7,132,321
SUPPLEMENTAL INFORMATION Cash paid (received) for:			
Federal income taxes paid	$ 6,855,408	$ 2,450,596	$ 909,476
Federal income taxes refunds received	$	$ (109,491)	$ (164,507)

See notes to financial statements.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

STATEMENTS OF CHANGES IN MEMBERS EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

	Accumulated Other Comprehensive Income	Retained Earnings	Total
BALANCE January 1, 2003	$ 119,100	$ 5,053,232	$ 5,172,332
Net income		692,410	692,410
Other comprehensive income net of tax	38,974		38,974
BALANCE December 31, 2003	158,074	5,745,642	5,903,716
Net income		5,815,378	5,815,378
Other comprehensive income net of tax	181,688		181,688
BALANCE December 31, 2004	339,762	11,561,020	11,900,782
Net income		9,030,526	9,030,526
Other comprehensive income (loss) net of tax	(1,689,252)		(1,689,252)
BALANCE December 31, 2005	$ (1,349,490)	$ 20,591,546	$ 19,242,056

See notes to financial statements.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

1. NATURE OF OPERATIONS

American Physicians Insurance Exchange (APIE or the Exchange) is a reciprocal insurance exchange. The Exchange was organized in the State of Texas on November 23, 1975, and commenced operations on June 1, 1976. APIE is licensed as a multiple-line insurer under the provisions of the Texas Insurance Code.

A reciprocal insurance exchange is an organization under which policyholders (members) effectively exchange insurance contracts and thereby insure each other and become members of the Exchange. The Exchange is managed by its attorney-in-fact, APS Facilities Management, Inc. (FMI), subject to the direction of the Exchange s board of directors.

APIE principally writes professional liability insurance coverage for physician groups, individual physicians and other healthcare providers in the states of Texas (99%) and Arkansas (1%). Most of the Exchange s coverage is written on a claims-made and reported basis. The coverage is provided only for claims that are first reported to the Exchange during the insured s coverage period and that arise from occurrences during the insured s coverage period. The Exchange also makes extended or tail coverage available for purchase by policyholders in order to cover claims that arise from occurrences during the insured s coverage period, but that are first reported to the Exchange after the insured s coverage period and during the term of the applicable tail coverage.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of GAAP financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates included in the accompanying financial statements are the reserve for losses and loss adjustment expenses, provision for federal income taxes, reinsurance premiums recoverable/payable, and premiums ceded. The significant accounting policies followed by the Exchange are summarized below:

Investments The Exchange classifies all of its investments in bonds or fixed maturity investments as available-for-sale. Investments classified as available-for-sale are reported at fair value, and unrealized gains and losses on such available-for-sale securities are excluded from earnings and included, net of related income tax effects, in equity as accumulated other comprehensive income (loss) until realized. Amortization of premium and accretion of discount are included in net investment income.

All single class and multi-class mortgage-backed and collateralized mortgage obligations (CMOs) are adjusted for the effects of changes in prepayment assumptions on the related accretion of discount or amortization of premium of such securities using the prospective method. If high credit quality securities are adjusted, the retrospective method is used. If it is determined that a decline in fair value is other-than-temporary, the cost basis of the security is written down to the undiscounted estimated future cash flows.

Investments in equity securities are carried at fair value based on publicly quoted markets. The change in fair value of common stocks, net of related tax effects, is recorded as a component of accumulated other comprehensive income (loss) .

Net realized gains or losses on investments sold are determined by the specific identification method and are recorded on the trade date. If it is determined that a decline in fair value is other-than-temporary, the cost basis of

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

the security is written down to the fair value at the time such determination is made. Bonds are considered impaired if it is probable that the Exchange will be unable to collect all amounts due according to the contractual terms of the security in effect at the date of acquisition of the bond. Common stocks are considered to be impaired if the decline in fair value of the stock is considered other-than-temporary. Impairment charges are recorded as realized losses in the period determined.

The Exchange owns a structured annuity which is classified as an other invested asset. During 1985, the Exchange purchased a structured annuity to settle a claim. Under the terms of the structured annuity, upon the death of the claimant, payments under the terms of the structured annuity are payable to the Exchange. As of December 31, 2005, the Exchange expects to receive future payments totaling $3,660,000 through 2043.

Cash equivalents are short-term highly liquid investments with original maturities of three months or less.

Premiums and Maintenance Fees Receivable The Exchange allows its policyholders to pay their premiums and maintenance fees in installments, recording the policy premium and maintenance fees in full at issue and collecting the premium over the policy term. Some of these receivables may not be collected due to policy cancellations or nonpayment by the policyholder. The Exchange records an allowance for doubtful premiums and maintenance fees that are past due. As of December 31, 2005 and 2004, the Exchange did not have any accounts over 90 days past due and management has determined that no allowance was necessary.

Reinsurance The Exchange enters into reinsurance agreements whereby other insurance entities agree to assume a portion of the risk associated with the policies issued by the Exchange. In return, the Exchange agrees to pay a premium to the reinsurers. The Exchange utilizes reinsurance to provide for greater diversification of business, which allows management to control exposure to potential losses arising from large risks, and allows APIE to have additional capacity for growth.

Reinsurance recoveries are the estimated amount of future loss payments that will be recoverable from reinsurers, and represent the portion of losses incurred during the period that are estimated to be allocable to reinsurers. Premiums ceded are the estimated premiums that will be due to reinsurers with respect to premiums earned and losses incurred during the period.

These estimates are based upon management s estimates of ultimate losses and loss adjustment expenses and the portion of those losses and loss adjustment expenses that are allocable to reinsurers under the terms of the related reinsurance agreements. Given the uncertainty of the ultimate amounts of losses and loss adjustment expenses, these estimates may vary significantly from the ultimate outcome. Management regularly reviews these estimates and any adjustments necessary are reflected in the period in which the change in estimate is determined. Adjustment to the estimated reinsurance recoverable balance could have a material effect on the Exchange s results of operations for the period in which the change is made.

Reinsurance contracts do not relieve the Exchange from its obligations to policyholders. The Exchange continually monitors its reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. Any amount found to be uncollectible is written off in the period in which the uncollectible amount is identified. The Exchange requires letters of credit from any reinsurance company that does not meet certain regulatory requirements, and or credit ratings. As of December 31, 2005 and 2004, all of the Exchanges reinsurance contracts were with companies in strong financial condition, and management felt there was not any need to establish an allowance for uncollectible reinsurance recoverable.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

Deferred Policy Acquisition Costs The costs of acquiring and renewing insurance business that vary with and are directly related to the production of such business are deferred and amortized ratably over the period the related premiums are earned. Such costs include commissions, premium taxes, and certain underwriting and policy issuance costs. Deferred acquisition costs are recorded net of ceding commissions. Deferred policy acquisition costs are reviewed to determine if they are recoverable from future income, including investment income. If such costs are estimated to be unrecoverable, they are expensed in the period the determination is made.

Subrogation Recoverable A portion of the insurance claims settled by the Exchange are recoverable from third parties. The Exchange estimates the amount of the subrogation using a case-basis method. The recoverable amounts are reported net of an allowance for doubtful collections.

Reserve for Losses and Loss Adjustment Expenses Loss and loss adjustment expense reserves represent management s best estimate of the ultimate cost of all reported and unreported losses incurred. The reserves for unpaid losses and loss adjustment expenses are estimated using individual case-basis valuations and statistical analyses. Those estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes the reserves for losses and loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in income in the period the need for an adjustment is determined. The effects of inflation are implicitly considered in the reserving process and are part of the recorded reserve balance. Ceded reserves for loss and loss adjustment expenses are included within reinsurance recoverables. Additionally, the Exchange writes insurance coverage with claim deductibles for which the policyholder is liable. The Exchange pays all loss and loss adjustment expenses upfront in the process of litigating and settling claims against its policyholders. The deductible portion is then invoiced to the policyholder for collection. The Exchange is at risk of the policyholder defaulting on paying the deductible to the Exchange. The Exchange mitigates this risk by requiring letters of credit and escrow balances on any accounts with large deductibles therefore no allowance for doubtful accounts is needed. The Exchange also invoices and collects a majority of the deductibles prior to final settlement of a claim.

Death, Disability, and Retirement Reserves The Exchange has established a death, disability, and retirement reserve for policyholders, which is intended to set aside a portion of the policy premium to account for the coverage provided for the extended reporting period or tail coverage offered by the Exchange upon the death and/or disability and/or retirement of a policyholder which is provided at no additional cost to the policyholder. The death, disability, and retirement reserve is included in unearned premiums.

Funds Held or Retained by the Exchange The Exchange records as a liability funds received but not earned in advance of the policy coverage period. Additionally, the exchange holds certain funds under escrow agreements related to certain high-deductible policies. These escrow accounts will be held until all claims incurred under the agreement are settled.

Refundable Subscriber Deposits The Exchange was initially capitalized by contributions from the policy holders. While no new deposits have been required since 1992, the exchange has an obligation to repay these amounts and has classified these as a liability. As more fully described under new accounting standards, Statement of Financial Accounting Standards (SFAS) No. 150, *Accounting of Certain Financial Instruments with characteristics of both Liabilities and Equity* has been adopted. Additionally, see Note 8 for more complete information.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

Revenue Recognition The Exchange issues policies written on a claims-made basis. A claims-made policy provides coverage for claims reported during the policy year. The Exchange charges both a base premium and a premium maintenance fee. Policies are written for a one-year term and premiums and maintenance fees are earned on a pro-rata basis over the term of the policy. Premium maintenance fees are charged to offset the costs incurred by the Exchange to issue and maintain policies. Unearned premiums and maintenance fees are determined on a monthly pro-rata basis. Upon termination of coverage, members may purchase an extended reporting period (tail) endorsement for additional periods of time. These extended reporting period coverage endorsement premiums are earned when written.

Income Taxes The Exchange computes income taxes utilizing the asset and liability method. The Exchange recognizes current and deferred income tax expense, which is comprised of estimated provisions for Federal income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis 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. 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. A valuation allowance against deferred tax assets is recorded if it is more likely than not that all or some portion of the benefits related to the deferred tax assets will not be realized. The Exchange has not established a valuation allowance because it believes it is more likely than not the Exchange s deferred tax assets will be fully recovered.

Fair Values of Financial Instruments Fair value for cash, short-term investments, receivables and payables approximates carrying value. Fair values for investment securities are based on quoted market prices, where available. Otherwise, fair values are based on quoted market prices of comparable instruments. The fair value of the structured annuity is based upon the present value of the future payments discounted at current market interest rates for annuities.

Concentration of Credit Risk Financial instruments subject the Exchange to concentration of credit risk. These risks occur principally with fixed-maturity investments. Concentration of credit risk with respect to fixed maturities, are limited by the volume of such investments and their distribution across different issues and geographic areas.

The Exchange also has exposure to concentration of credit risk with its ceded reinsurance agreements. Ceded reinsurance is placed with a number of individual companies and also syndicates associated with Lloyd s of London to minimize the concentration of credit risk. A majority of the Exchange s reinsurance agreements are with companies that are rated A- or better by A.M. Best. Less than 1% of the recoverables are with lower rated reinsurance companies and the Exchange has letters of credit with these companies back their risk.

New Accounting Standards Since its inception in 1975 through March 1992, members of the Exchange were required to make refundable subscriber deposits to become eligible to purchase insurance issued by the Exchange. The Exchange adopted SFAS No. 150, *Accounting of Certain Financial Instruments with characteristics of both Liabilities and Equity* (SFAS No. 150), as of January 1, 2004, and recorded these subscriber deposits as a liability. SFAS No. 150 established standards as to how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability. The Exchange has determined that its refundable subscriber deposits fall within the scope of SFAS No. 150. The Exchange discontinued requiring refundable subscriber deposits in 1992. The exchange may return full subscriber deposits to active policyholders upon death,

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

disability, and retirement and may elect to refund up to $200,000 per year to former subscribers without approval from the Texas Department of Insurance (TDI) subject to Board of Director approval of the Exchange and specific TDI requirements.

In November 2005, the FASB issued Staff Position No. FSP 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* (FSP 115-1 and 124-1). FSP 115-1 and 124-1 supersedes Emerging issues Task Force Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* and amends SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* and Accounting Principles Board No. 18, *The Equity Method of Accounting for Investments in Common Stock*. FSP 115-1 and 124-1 address the determination as to when an investment is considered impaired, whether that impairment is other-than-temporary and the measurement of an impairment loss. FSP 115-1 and 124-1 also includes provision for accounting considerations subsequent to the recognition of an other-than temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. FSP 115-1 and 124-1 is effective for periods beginning after December 15, 2005, with earlier adoption permitted. The Company adopted FSP 115-1 and 124-1 during the fiscal quarter ended December 31, 2005. The adoption of FSP 115-1 and 124-1 did not have a material effect on the Exchange s financial position or results of operations.

Statutory Accounting The Exchange is required to file statutory financial statements with state insurance regulatory authorities. Accounting principles used to prepare these statutory financial statements differ from GAAP. Statutory net income was $8,704,700, $4,296,200 and $1,299,400 for the years ended December 31, 2005, 2004, and 2003, respectively. The Exchange s members equity on a statutory basis was $29,789,100 and $21,237,800, at December 31, 2005 and 2004, respectively. Additionally under statutory accounting refundable subscriber deposits collected from current and former policyholders are treaty as a component of surplus. Under GAAP accounting, these refundable subscriber deposits are treated as liabilities of the Exchange (see Note 8).

3. INVESTMENTS

The amortized cost and estimated fair values of investments in debt securities at December 31, 2005 and 2004, are as follows (in thousands):

2005	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities:				
U.S treasury notes	$ 522	$ 19	$ 3	$ 538
U.S government agency mortgage-backed bonds	19,515	1	568	18,948
U.S. government agency collateralized mortgage obligations	44,567		1,163	43,404
Collateralized mortgage obligations	44,322	20	1,114	43,228
Total fixed maturities	108,926	40	2,848	106,118
Equity securities	4,390	814	51	5,153
Total fixed maturities and equity securities	$ 113,316	$ 854	$ 2,899	$ 111,271

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

2004	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Fixed maturities:				
U.S government agency mortgage-backed bonds	$ 18,650	$ 42	$ 159	$ 18,533
U.S. government agency collateralized mortgage obligations	32,711	98	234	32,575
Collateralized mortgage obligations	40,829	176	259	40,746
Total fixed maturities	92,190	316	652	91,854
Equity securities	2,513	901	51	3,363
Total fixed maturities and equity securities	$ 94,703	$ 1,217	$ 703	$ 95,217

A summary of the amortized cost and fair value of the Exchange s investments in fixed maturities at December 31, 2005, by contractual maturity, is as follows (in thousands):

	Amortized Cost	Estimated Fair Value
Due after one year though five years	$ 109	$ 106
Due after five years through ten years	175	175
Due after ten years	238	257
	522	538
Mortgage-backed securities	108,404	105,580
Total	$ 108,926	$ 106,118

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.

Proceeds from sales of investments in debt securities in 2005, 2004, and 2003 were $2,580,800, $4,533,300, and $58,688,100, respectively. Gross gains of $22,500, $32,500, and $166,500 and gross losses of $0, $0, and $40,000 were realized in 2005, 2004, and 2003, respectively.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

Provided below is a summary of securities which were in an unrealized loss position at December 31, 2005 and 2004 (in thousands). The unrealized losses are comprised of securities in a continuous loss position for less than 12 months, which consisted primarily of CMOs. The Exchange believes the decrease in fair value is attributable to changes in market interest rates and not credit quality of the issuer and therefore considers these investments to be only temporarily impaired. During 2005, 2004 and 2003, the Exchange did not record any impairments for other-than-temporary declines in the value of investments as the Exchange has the intent and ability to hold these securities until they recover their value, which may be maturity.

	Less Than 12 Months		12 Months or More		Total	
2005	**Estimated Fair Value**	**Unrealized Loss**	**Estimated Fair Value**	**Unrealized Loss**	**Estimated Fair Value**	**Unrealized Loss**
U.S. treasury notes	$ 281	$ 3	$	$	$ 281	$ 3
U.S. government agency mortgage-backed bonds	4,087	95	14,465	473	18,552	568
U.S. government agency collateralized mortgage obligations	26,713	597	16,690	566	43,403	1,163
Collateralized mortgage obligations	24,912	753	15,373	361	40,285	1,114
Equity securities	1,144	41	202	10	1,346	51
Total temporarily impaired securities	$ 57,137	$ 1,489	$ 46,730	$ 1,410	$ 103,867	$ 2,899

	Less Than 12 Months		12 Months or More		Total	
2004	**Estimated Fair Value**	**Unrealized Loss**	**Estimated Fair Value**	**Unrealized Loss**	**Estimated Fair Value**	**Unrealized Loss**
U.S. government agency mortgage-backed bonds	$ 12,477	$ 149	$ 2,200	$ 10	$ 14,677	$ 159
U.S. government agency collateralized mortgage obligations	4,526	35	11,388	198	15,914	233
Collateralized mortgage obligations	11,927	107	14,489	153	26,416	260
Equity securities	351	50	17	1	368	51
Total temporarily impaired securities	$ 29,281	$ 341	$ 28,094	$ 362	$ 57,375	$ 703

At December 31, 2005, the carrying value of the fixed maturities was $106,118,180, representing 93.7% of the total investment portfolio. The net unrealized position associated with the fixed maturity portfolio included $2,848,000 in unrealized losses consisting of 0.5% U.S. treasury notes, 17.8% U.S. government agency mortgage-back bonds, 40.9% U.S. government agency mortgage-back CMOs and 40.8% non-government backed CMOs. Gross unrealized losses in any single issuer were less than 2.0% of the carrying of the total general account fixed maturity portfolio.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

The following tables summarize fixed maturity and equity securities in an unrealized loss position at December 31, 2005 and 2004, the aggregate fair value and gross unrealized loss by length of time those securities have been continuously in an unrealized loss position (in thousands).

	2005		2004	
	Estimated Fair Value	Gross Unrealized Loss	Estimated Fair Value	Gross Unrealized Loss
Fixed maturity securities:				
0 6 months	$ 46,777	$ 1,057	$ 16,275	$ 150
7 12 months	22,490	642	12,655	140
13 24 months	15,482	524	28,077	362
Greater than 24 months	17,772	625		
Total fixed maturity securities	102,521	2,848	57,007	652
Equity securities:				
0 6 months	677	29	223	40
7 12 months	664	21	128	10
13 24 months	5	1		
Greater than 24 months			17	1
Total equity securities	1,346	51	368	51
Total fixed maturity and equity securities	$ 103,867	$ 2,899	$ 57,375	$ 703

Gross realized gains and losses on fixed maturity and equity securities were as follows (in thousands):

	2005	2004	2003
Realized gains (losses):			
Fixed maturities:			
Gross realized gains	$ 27	$ 32	$ 167
Gross realized losses			(40)
Net realized gains (losses)	27	32	127
Equities:			
Gross realized gains	586	585	177
Gross realized losses	(61)	(9)	(119)
Net realized gains (losses)	525	576	58
Total net realized gains	$ 552	$ 608	$ 185

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

The major categories of the Exchange s net investment income are summarized at December 31, 2005, 2004, and 2003, as follows (in thousands):

	2005	2004	2003
Investment income:			
Fixed Maturities	$ 4,785	$ 3,495	$ 2,368
Equity securities	44	47	33
Short-term investments and other	143	96	141
Finance charges on premiums receivable	589	668	710
Structured annuity	90	84	79
Total investment income	5,651	4,390	3,331
Investment expense	(520)	(301)	(212)
Net investment income	$ 5,131	$ 4,089	$ 3,119

At December 31, 2005 and 2004, investments with a fair market value of $1,048,700, and $1,050,500, respectively, were on deposit with state insurance departments to satisfy regulatory requirements.

4. OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income (loss) shown in the statement of members equity is comprised of net unrealized gains (losses) on securities available for sale, net of taxes. The components of other comprehensive income (loss) at December 31, 2005, 2004, and 2003, (in thousands) are as follows:

	2005	2004	2003
Unrealized holdings gains (losses) before taxes	$ (2,117)	$ 684	$ 273
Tax (expense) benefit	719	(232)	(93)
Net gain (loss) after tax	(1,398)	452	180
Less reclassification adjustments for gains (losses) included in net income	442	409	214
Tax (expense) benefit thereon	(151)	(139)	(73)
Other comprehensive income (loss) net of tax	$ (1,689)	$ 182	$ 39

5. UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSE RESERVES

The reserve for unpaid losses and loss adjustment expenses represent the estimated liability for unpaid claims reported to the Exchange, plus claims incurred but not reported (IBNR) and the related estimated loss adjustment expenses. The reserve for losses and loss adjustment expenses is determined based on the Exchange s actual experience and available industry data.

The Exchange writes medical malpractice policies which have a lengthy period for reporting a claim (tail coverage) and a long process of litigating a claim through the courts and whose risk factors expose its reserves for loss and loss adjustment expenses to significant variability. These conditions subject the Exchange s open reported claims and incurred but not reported claims to increases due to inflation, changes in legal proceedings, and changes in the law. While the anticipated effects of inflation is implicitly considered when estimating

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NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

reserves for loss and loss adjustment expenses, the increase in average severity of claims is caused by a number of factors. Future average severities are projected based on historical trends adjusted for changes in underwriting standards, policy provisions, and general economic trends. Those anticipated trends are monitored based on actual experience and are modified as necessary to reflect any changes in the development of ultimate losses and loss adjustment expenses to the Exchange. These specific risks, combined with the variability that is inherent in any reserve estimate, could result in significant adverse deviation from the Exchange s carried net reserve amounts. Settlement of the Exchange s claims is subject to considerable uncertainty. Actual developments will likely vary, perhaps significantly, from the current estimated amounts reflected in the accompanying financial statements. The Exchange s management estimated the reserves for loss and loss adjustment expenses with the assistance of its independent actuaries. Management believes the reserves for loss and loss adjustment expenses are reasonably stated for all obligations of the Exchange as of December 31, 2005 and 2004.

Activity in the reserves for losses and loss adjustment expenses for the years ended December 31, 2005, 2004, and 2003, are summarized as follows (in thousands):

	2005	2004	2003
Reserve for loss and loss adjustment expenses January 1	$ 69,445	$ 63,713	$ 54,187
Less reinsurance recoverable on paid losses and unpaid losses	11,203	14,980	17,924
Net balance January 1	58,242	48,733	36,263
Incurred net of reinsurance related to:			
Current years	28,261	29,305	33,650
Prior years	15,715	19,350	10,896
Net incurred	43,976	48,655	44,546
Paid net of reinsurance related to:			
Current years	4,062	4,181	5,371
Prior years	30,634	34,965	26,705
Net paid	34,696	39,146	32,076
Net balance December 31	67,522	58,242	48,733
Plus reinsurance recoverable on paid losses and unpaid losses	27,850	11,203	14,980
Reserve for loss and loss adjustment expenses December 31	$ 95,372	$ 69,445	$ 63,713

The estimates used in establishing these reserves are continually reviewed and updated and any resulting adjustments are reflected in current operations. Due to the nature of insurance risks written, including the impact of changes in claims severity, frequency, and other factors, the reserves established for losses and loss adjustment expenses may be more or less than the amount ultimately paid upon settlement of the claims.

During 2004, after careful evaluation of open claims and trend assumptions, the Exchange determined that the length of time needed to litigate 2003 pre-tort reform claims would continue to increase due to the potential financial impact of these claims in relation to post-tort reform claims. As a result, the Exchange increased the estimate for ultimate losses and loss adjustment expenses for claims incurred in 2003 and prior years by $19,350,000. During 2005, the Exchange continued to review the impact of tort reform and while current accident year reported claims were substantially lower, loss costs and legal expenses on prior-year claims continued to trend significantly higher. The Exchange determined that the

effect of tort reform not only increased

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the number of claims reported in 2003, but also increased the cost of litigating remaining open cases for other open prior accident years as well. As a result, during 2005, the Exchange continued to increase incurred loss and loss adjustment expense reserves related to prior accident years by $15,715,000. The net incurred increase in claim estimates related to prior years did not result in any direct accrual of additional premiums nor did it result in any additional ceded premiums during 2005 and 2004.

For the 2003 year, the Exchange increased incurred loss and loss adjustment expenses by $10,896,000 for prior-year development as a result of unfavorable trends in the underlying claims data including a slowdown in the overall closure rate of pending claims, and an increase in the severity of indemnity paid during 2003 relating to prior periods. Tort reform increased the number of claims reported during 2003 as many cases were filed to beat the filing deadline and made existing claims for prior years more difficult to settle due to the time devoted to the number of new filings. As a result, reserves for prior-year open accident years were increased to appropriately reflect the frequency and potential severity of claims filed prior to the passage of tort reform.

6. DEFERRED POLICY ACQUISITION COSTS

Underwriting and insurance costs directly related to the production of new and renewal premiums are considered as acquisition costs and are capitalized and amortized to expense over the period in which the related premiums are earned.

A summary of deferred acquisition costs deferred and amortized for the years ended December 31, 2005, 2004, and 2003, is as follows (in thousands):

	2005	2004	2003
Balance beginning of year	$ 2,410	$ 1,729	$ 1,623
Costs deferred	5,362	5,447	3,832
Costs amortized	(5,266)	(4,766)	(3,726)
Balance end of year	$ 2,506	$ 2,410	$ 1,729

7. REINSURANCE AGREEMENTS

Reinsurance Ceded Certain premiums and benefits are ceded to other insurance companies under various reinsurance agreements. These reinsurance agreements provide the Exchange with increased capacity to write additional risk and the ability to write specific risk within its capital resources and underwriting guidelines. The Exchange enters into reinsurance contracts, which provide coverage for losses in excess of the Exchange s retention of $250,000 on individual claims and beginning in 2002, $350,000 on multiple insured claims related to a single occurrence. The reinsurance contracts for 2002 through 2005 contain variable premium ceding rates based on loss experience. The actual percentage rate charged under these contracts will depend upon the development of ultimate losses ceded to the reinsurers under their retrospective treaties. Estimates of ultimate reinsurance ceded premium amounts compared to the amounts paid on a provisional basis, give rise to an asset or liability on the balance sheet. As a result, at December 31, 2005, the Exchange had an asset of $6,802,300 and a liability of $1,521,200. As of December 31, 2004, the Exchange recorded an asset of $4,959,400 and a liability of $64,600.

The Exchange has also entered into reinsurance agreements relating to its non-standard policies, legal defense endorsements, and certain dental policies. Reinsurance premiums ceded under these reinsurance agreements are $1,144,200, $798,000, and $319,800 for the years ended December 31, 2005, 2004, and 2003, respectively. Losses incurred were $445,909, $253,093, and $152,142 for 2005, 2004, and 2003, respectively.

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NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

Unsecured reinsurance recoverables at December 31, 2005, that exceeded 10% of total reinsurance on paid and unpaid loss and loss adjustment expenses are summarized as follows (in thousands):

Company Name	2005
Transatlantic Reinsurance	$ 3,872
Swiss Reinsurance	16,791

The Exchange requires letters of credit from any reinsurance company that does not meet certain regulatory requirements, and/or credit ratings. As of December 31, 2005, all of the Exchange s reinsurance contracts were with companies in strong financial condition, and Management felt there was not any need to establish an allowance for doubtful reinsurance recoverable.

Total losses and loss adjustment expenses incurred by the Exchange under reinsurance agreements was $20,723,000, $(1,669,000), and $1,000,000 for the years ended December 31, 2005, 2004, and 2003 respectively.

The effect of reinsurance on premiums written and earned is as follows (in thousands):

	2005		2004		2003	
	Written	Earned	Written	Earned	Written	Earned
Direct premium and maintenance fees including converted surplus deposits	$ 79,301	$ 76,948	$ 84,571	$ 77,027	$ 67,682	$ 59,885
Assumed					3,311	3,311
Ceded	(12,885)	(12,765)	(12,878)	(12,411)	(10,352)	(10,352)
Net premiums	$ 66,416	$ 64,183	$ 71,693	$ 64,616	$ 60,641	$ 52,844

Reinsurance Assumed The Exchange had assumed reinsurance liabilities on medical professional liability policies written by other insurance companies in the state of Texas. In the course of assuming this business, the Exchange has established letters of credit for the benefit of those ceding companies in the amount of $3.0 million and pledged assets in the amount of $3.2 million to secure those letters of credit as of December 31, 2005. Losses and loss adjustment expenses assumed were $1,262,700, $6,259,900, and $2,576,500 for 2005, 2004, and 2003, respectively. Reserves for losses and loss adjustment expenses assumed were $2,228,900 and $5,409,100 at December 31, 2005 and 2004, respectively.

8. REFUNDABLE SUBSCRIBER DEPOSITS

From inception of the Exchange through March 1992, as periodically determined and approved by the Exchange s Board of Directors, eligible physicians desiring to purchase insurance through the Exchange were required to make a refundable subscriber deposit. For refundable deposits made to the Exchange prior to January 1, 1987, interest was accrued on the outstanding balance. Effective January 1, 1989, accrual of interest on refundable deposits was suspended by the Exchange s Board of Directors. Refundable deposits made subsequent to January 1, 1987, were noninterest bearing. As of December 31, 2005 and 2004, the Exchange had surplus deposits of $10,567,520 and $11,001,133, respectively, which included accrued interest of $45,600 and $45,900, respectively. These deposits are included in the accompanying financial statements as a liability in accordance with SFAS No. 150.

The Exchange requested authorization from the Texas Department of Insurance (TDI) to refund Subscriber Deposits for individuals who are no longer active policyholders. TDI has authorized partial pro-rata

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NOTES TO FINANCIAL STATEMENTS (Continued)

AS OF DECEMBER 31, 2005 AND 2004, AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

distributions of subscriber deposits to former subscribers and the Exchange s Board of Directors elected to authorize maximum refunds of $200,000 and $250,000 for 2005 and 2004, respectively. The Board of Directors may elect to continue to refund up to $200,000 per year in the future contingent on specific TDI requirements. The TDI has authorized the Exchange to return full subscriber deposits to active policyholders upon death, disability, or retirement. Total refunds made in 2005, 2004, and 2003 were $324,900, $245,100, and $53,800, respectively.

Beginning in 1991, physicians who were previously members of the Exchange and subsequently return are allowed to apply their current refundable deposits against current premiums and to satisfy any current and future subscriber deposit requirements. The Exchange continues to allow existing subscribers to convert their refundable deposits in this manner. The amounts of such conversions were $108,800, $215,100, and $62,700 during 2005, 2004, and 2003, respectively.

9. MANAGEMENT AGREEMENTS

FMI serves as the attorney-in-fact for the Exchange. In accordance with the terms of a management agreement, FMI performs the administrative functions related to the operations of the Exchange. FMI receives a management fee from the Exchange for providing these services. The management fee, which is calculated as a percentage of the direct gross earned premiums and statutory net income including contingent management fees of the Exchange, were $11,038,400, $10,608,800, and $7,275,800 in 2005, 2004, and 2003, respectively. Contingent management fees are based upon the financial performance of the Exchange. The Exchange recorded amounts payable to affiliates of $2,723,200 and $1,667,200 as of December 31, 2005 and 2004, respectively, and are included in other liabilities in the balance sheets. Management fees were allocated as follows in the accompanying statements (in thousands):

Allocation of Management Fees	2005	2004	2003
Loss and loss adjustment expense	$ 4,592	$ 5,029	$ 3,354
Underwriting expenses	4,063	3,973	2,774
General and administrative expenses	1,978	1,442	1,029
Investment expenses	405	165	119
Total management fees	$ 11,038	$ 10,609	$ 7,276

10. TRANSACTIONS WITH AFFILIATES AND RELATED PARTIES

The Exchange s management contract with its attorney-in-fact, FMI, is treated as an affiliated transaction. However, there is no ownership between the two entities. They have separate boards of directors and their duties to each other are based on the management contract. Transactions with parties related to FMI are also treated as affiliated transactions. American Physicians Insurance Agency, Inc. (APIA), and APS Financial Corporation (APS) are considered affiliates of FMI through common ownership.

In addition to the management fees paid to FMI described in Note 9, the Exchange received reimbursement of commission expenses from FMI in the amount of $375,000 in 2005, 2004, and 2003, respectively.

APS manages the bond portfolio within the investment guidelines established by the Board of Directors, provides advisory services on key investment decisions and manages investment accounting services for the Exchange. The Exchange pays APS standard markup fees on trades of bonds. Fees paid to APS for services were $654,900, $656,500, and $776,620 for 2005, 2004, and 2003, respectively.

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

NOTES TO FINANCIAL STATEMENTS (Continued)

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11. INCOME TAXES

The components of the income tax expense (benefit) reported in the statements of operations at December 31, 2005, 2004, and 2003, are summarized as follows (in thousands):

	2005	2004	2003
Current	$ 4,309	$ 3,624	$ 1,765
Deferred	(121)	(203)	(554)
Total taxes incurred	$ 4,188	$ 3,421	$ 1,211

The income tax expense (benefit) and the deferred income tax expense (benefit) incurred for the years ended December 31, 2005, 2004, and 2003 differs from the amount computed by applying the federal statutory rate of 34% to income before income tax as follows (in thousands):

	2005	2004	2003
Computed expected expense	$ 4,495	$ 3,141	$ 647
Dividends received deduction	(13)	(14)	(10)
Adjustments to prior years taxes	(55)		
Section 835 election expense (recovery)	(248)	248	580
Other income tax adjustments	9	46	(6)
Total income tax expense	$ 4,188	$ 3,421	$ 1,211

The Exchange filed its 2005 tax return with an 835 election which allowed it to consolidate its tax return with its attorney-in fact management company (FMI). This election had an unfavorable impact in 2003 on the Exchange s income. The Exchange petitioned the Internal Revenue Service to discontinue the 835 election and was granted permission to do so in 2005 and was effective for the 2004 and future tax years.

The main components of deferred tax assets and deferred tax liabilities at December 31, 2005 and 2004, are as follows (in thousands):

	2005	2004
Deferred tax assets:		
Reserve for losses and loss adjustment expenses	$ 1,486	$ 1,368
Unearned premiums and maintenance fees	2,337	2,244
Net unrealized losses on investments	695	
Total deferred tax assets	4,518	3,612
Deferred tax liabilities:		
Net unrealized gains on investments		175
Bond discount accumulated	50	23

Structured annuity contract	395	365
Deferred acquisition costs	852	819
Total deferred tax liabilities	1,297	1,382
Net deferred tax asset	$ 3,221	$ 2,230

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AMERICAN PHYSICIANS INSURANCE EXCHANGE

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At December 31, 2005, the Exchange did not have any unused operating loss carryforward to offset future taxable income. The Exchange has recorded income tax expense that will be available for recovery in the event of future net losses. The amount of federal income taxes incurred in the current and prior years that will be available for recovery in the event of future net losses is $4,611,800, $3,327,800, and $1,760,000 from 2005, 2004, and 2003, respectively.

The Exchange is required to establish a valuation allowance for any portion of the deferred tax asset that management believes will not be realized. In the opinion of management, it is more likely than not that the Exchange will have sufficient taxable income or carry-back potential plus feasible tax strategies to realize the net deferred tax asset and, therefore, no such valuation allowance has been established.

12. CONTINGENCIES

Various lawsuits against the Exchange have arisen in the normal course of the Exchange s business. It is management s opinion that liabilities, if any, arising from these claims will not have a significant adverse effect on the financial position, results of operations or cash flows of the Exchange.

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ANNEX A

MERGER AGREEMENT AND PLAN OF MERGER

by and among

American Physicians Service Group, Inc.,

APSG ACQCO, INC.

and

American Physicians Insurance Exchange

Dated: June 1, 2006

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ATTACHMENTS

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Merger Agreement and Plan of Merger

This Merger Agreement and Plan of Merger (this ***Agreement***) dated as of June 1, 2006, is by and among (i) American Physicians Service Group, Inc., a Texas corporation (***APSG Parent***), (ii) APSG ACQCO, INC., a Texas corporation and a wholly-owned subsidiary of APSG Parent (***APSG Merger Sub***, and together with APSG Parent the ***APSG Parties***), and (iii) American Physicians Insurance Exchange, a reciprocal and inter-insurance exchange (the ***Insurance Company***). The Insurance Company together with the APSG Parties are sometimes referred to as the ***Parties***.

RECITALS:

A. Contemporaneously with the execution of this Agreement, the Insurance Company adopted that certain Plan of Conversion attached as *Exhibit A* to this Agreement (as subsequently amended, the ***Plan of Conversion***) pursuant to which, among other things (and subject to obtaining all necessary Consents of Governmental Bodies), (i) the Insurance Company will be converted (the ***Conversion***) into a Texas stock insurance company, (ii) the Persons who are Subscribers under the governing documents of the Insurance Company (the ***Subscribers***) and certain other insureds of the Insurance Company (as more particularly set forth in the Plan of Conversion) will receive shares of the $1.00 par value common stock of Insurance Company (the ***Insurance Company Common Stock***), and (iii) the Persons who hold rights to repayment of Refundable Deposits will receive shares of the $1.00 par value mandatorily redeemable preferred stock of the Insurance Company (the ***Insurance Company Preferred Stock***).

B. Each Party s Board of Directors believes it is in its and its respective owners best interests that immediately following the Conversion, APSG Parent acquire the Insurance Company through the statutory merger of APSG Merger Sub with and into the Insurance Company (the ***Merger***) and, in furtherance thereof, have approved the Merger.

C. Pursuant to the Merger, all of Insurance Company Common Stock will be converted into the right to receive shares of APSG Parent s common stock, par value $0.10 per share (***APSG Parent Common Shares***) and all of Insurance Company Preferred Stock will be converted into the right to receive shares of APSG Parent s mandatorily redeemable preferred stock, par value $1.00 per share (***APSG Parent Preferred Shares***).

D. The Parties desire to make certain representations and warranties and other agreements in connection with the Conversion and the Merger.

E. As required pursuant to Chapter 942 of the Texas Insurance Code, substantially all of the Insurance Company s day-to-day operations have been, and at all time prior to the Conversion will be, managed by an attorney-in-fact (the ***Attorney-in-Fact***).

F. For federal income tax purposes, the Parties intend to adopt a plan of reorganization within the meaning of, and to cause the Conversion and the Merger to qualify as a reorganization under Section 368(a) of the Internal Revenue Code of 1986 (the **Code**).

AGREEMENT:

NOW, THEREFORE, in consideration of the premises and the mutual promises herein made, and in consideration of the representations, warranties, and covenants contained herein, each APSG Party and the Insurance Company agrees as follows:

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ARTICLE 1.

DEFINITIONS

180-Day Lock Up means the 180 day period of time commencing on the Closing Date during which the APSG Parent Common Shares and the APSG Parent Preferred Shares issued in the Merger will be held in escrow or subject to a similar arrangement such that the Shares cannot be traded.

Action means any action, appeal, petition, plea, charge, complaint, claim, suit, demand, litigation, arbitration, mediation, hearing, inquiry, investigation or similar event, occurrence, or proceeding.

Affiliate means a Person that, directly or indirectly, through one or more intermediaries, controls or is controlled by, or is under common control with, such specified Person. For this definition, control (and its derivatives) means the possession, directly or indirectly, or as trustee or executor, of the power to direct or cause the direction of the management and policies of a Person, whether through ownership of voting Equity Interests, as trustee or executor, by contract or credit arrangements or otherwise.

Agreement is defined in the preamble to this Agreement.

Ancillary Agreements means the Plan of Conversion, the Amended and Restated Bylaws of the Insurance Company, the Certificate of Formation of the Insurance Company and the Advisory Services Agreement.

Announcement Exchange Ratio is defined in *Section 2.8(d)*.

Announcement Market Price is defined in *Section 2.8(d)*.

APSG Merger Sub is defined in the preamble to this Agreement.

APSG Parent is defined in the preamble to this Agreement.

APSG Parent Common Shares is defined in the recitals to this Agreement.

APSG Parent Preferred Shares is defined in the recitals to this Agreement.

APSG Parties is defined in the preamble to this Agreement.

AID means the Arkansas Insurance Department.

Attorney-in-Fact is defined in the recitals to this Agreement.

Basis means any past or current fact, situation, circumstance, status, condition, activity, practice, plan, occurrence, event, incident, action, failure to act, or transaction about which the relevant Person has Knowledge that forms or could form the basis for any specified consequence.

Best Efforts means the efforts, time, and costs that a prudent Person desirous of achieving a result would use, expend, or incur in similar circumstances to ensure that such result is achieved as expeditiously as possible; provided, however, that no such use, expenditure, or incurrence will be required if it would have a Material Adverse Effect on such Person calculated immediately prior to the Closing Date.

Breach means (a) any breach, inaccuracy, failure to perform, failure to comply, conflict with, failure to notify, default, or violation or (b) any other act, omission, event, occurrence or condition the existence of which would (i) permit any Person to accelerate any obligation or terminate, cancel, or modify any right or obligation or (ii) require the payment of money or other consideration.

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Closing is defined in *Section 2.3*.

Closing Date is defined in *Section 2.3*.

Closing Exchange Ratio is defined in *Section 2.8(d)*.

Closing Market Price is defined in *Section 2.8(d)*.

Code is defined in the recitals to this Agreement.

Commitment means (a) options, warrants, convertible securities, exchangeable securities, subscription rights, conversion rights, exchange rights, or other Contracts that could require a Person to issue any of its Equity Interests or to sell any Equity Interests it owns in another Person; (b) any other securities convertible into, exchangeable or exercisable for, or representing the right to subscribe for any Equity Interest of a Person or owned by a Person; (c) statutory pre-emptive rights or pre-emptive rights granted under a Person s Organizational Documents; and (d) stock appreciation rights, phantom stock, profit participation, or other similar rights with respect to a Person.

Confidential Information means any confidential information concerning the businesses and affairs of any Party.

Consent means any consent, approval, notification, waiver, or other similar action that is necessary or convenient.

Contract means any contract, agreement, arrangement, commitment, letter of intent, memorandum of understanding, heads of agreement, promise, obligation, right, instrument, document, or other similar understanding, whether written or oral.

Conversion is defined in the recitals to this Agreement.

Conversion Record Date means June 1, 2006.

Corporate Laws means Chapter 10 of the Texas Business Organizations Code and applicable provisions of the Texas Insurance Code.

Damages means all damages (including incidental and consequential damages), losses (including any diminution in value), Liabilities, payments, amounts paid in settlement, obligations, fines, penalties, expenses, costs of burdens associated with performing injunctive relief, and other costs (including reasonable fees and expenses of attorneys, accountants and other professional advisors, and of expert witnesses and other costs (including the allocable portion of the relevant Person s internal costs) of investigation, preparation and litigation in connection with any Action) of any kind or nature whatsoever, whether known or unknown, contingent or vested, or matured or unmatured.

Dissenting Shareholder is defined in *Section 2.12*.

Effective Time is defined in *Section 2.4*.

Encumbrance means any Order, Security Interest, Contract, easement, covenant, community property interest, equitable interest, right of first refusal, or restriction of any kind, including any restriction on use, voting, transfer, receipt of income, or exercise of any other attribute of ownership.

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Enforceable a Contract is Enforceable if it is the legal, valid, and binding obligation of the applicable Person enforceable against such Person in accordance with its terms, except as such enforceability may be subject to the effects of bankruptcy, insolvency, reorganization, moratorium, or other Laws relating to or affecting the rights of creditors, and general principles of equity.

Equity Interest means (a) with respect to a corporation, any and all shares of capital stock and any Commitments with respect thereto, (b) with respect to a partnership, limited liability company, trust, or similar Person, any and all units, interests or other partnership/limited liability company interests, and any Commitments with respect thereto, and (c) any other direct or indirect equity ownership or participation in a Person.

ERISA means the Employee Retirement Income Security Act of 1974.

Exchange Ratio is defined in *Section 2.8(d)*.

Expiration Date means December 31, 2006.

Financial Statements is defined in *Section 4.8*.

GAAP means United States generally accepted accounting principles as in effect from time to time.

Governmental Body means any legislature, agency, bureau, branch, department, division, commission, court, tribunal, magistrate, justice, multi-national organization, quasi- governmental body, or other similar recognized organization or body of any federal, state, county, municipal, local, or foreign government or other similar recognized organization or body exercising similar powers or authority.

HSR Act means the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

Insurance Company is defined in the preamble to this Agreement.

Insurance Company Common Stock is defined in the recitals to this Agreement.

Insurance Company Common Equity is defined in *Section 2.8(d)*.

Insurance Company Preferred Stock is defined in the recitals to this Agreement.

Intellectual Property means any rights, licenses, liens, security interests, charges, encumbrances, equities and other claims that any Person may have to claim ownership, authorship or invention, to use, to object to or prevent the modification of, to withdraw from circulation or control the publication or distribution of any: (a) copyrights in both published works and unpublished works, (b) fictitious business names, trading names, corporate names, registered and unregistered trademarks, service marks, and applications, (c) any (i) patents and patent applications, and (ii) business methods, inventions, and discoveries that may be patentable, (d) computer software or middleware, and (e) know-how, trade secrets, confidential information, customer lists, software (source code and object code), technical information, data, process technology, plans, drawings, and blue prints.

Interim Financial Statements is defined in *Section 4.8(b)*.

IRS means the Internal Revenue Service.

Knowledge an individual will be deemed to have Knowledge of a particular fact or other matter if such individual is actually aware of such fact or other matter. A Person other than an individual will be deemed to have Knowledge of a particular fact or other matter only if any individual who is serving as an officer of such Person or a Subsidiary of such Person (or in each case any similar capacity) has, or at any time had, Knowledge of such fact or other matter. The Insurance Company will be deemed to have Knowledge of a particular fact or other matter only if a current Insurance Company Director has, or at any time had, Knowledge of such fact or other matter.

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Law means any law (statutory, common, or otherwise), constitution, treaty, convention, ordinance, equitable principle, code, rule, regulation, executive order, or other similar authority enacted, adopted, promulgated, or applied by any Governmental Body, each as amended and now in effect.

Liability or ***Liable*** means any liability or obligation, whether known or unknown, asserted or unasserted, absolute or contingent, matured or unmatured, conditional or unconditional, latent or patent, accrued or unaccrued, liquidated or unliquidated, or due or to become due.

Advisory Services Agreement means that certain Advisory Services Agreement between API Advisors, LLC, a Texas limited liability company and the Surviving Corporation in the form attached hereto as *Exhibit I*.

Material Adverse Change (or Effect) means a change (or effect) in the condition (financial or otherwise), properties, assets, Liabilities, rights, obligations, operations, business, or prospects which change (or effect), individually or in the aggregate, could reasonably be expected to be materially adverse to such condition, properties, assets, Liabilities, rights, obligations, operations, business, or prospects.

Merger is defined in the recitals to this Agreement.

Merger Certificate is defined in *Section 2.4*.

Merger Consideration is defined in *Section 2.8(b)*.

Most Recent Year End is defined in *Section 4.8(a)*.

Order means any order, ruling, decision, verdict, decree, writ, subpoena, mandate, precept, command, directive, consent, approval, award, judgment, injunction, or other similar determination or finding by, before, or under the supervision of any Governmental Body, arbitrator, or mediator.

Ordinary Course of Business means the ordinary course of business consistent with past custom and practice (including with respect to quantity, quality, and frequency) of the relevant Person.

Organizational Documents means the articles of incorporation, certificate of formation, certificate of incorporation, charter, bylaws, articles of formation, regulations, operating agreement, certificate of limited partnership, partnership agreement, and all other similar documents, instruments or certificates executed, adopted, or filed in connection with the creation, formation, or organization of a Person, including any amendments thereto.

Parties is defined in the preamble to this Agreement.

Permit means any permit, license, certificate, approval, consent, notice, waiver, franchise, registration, filing, accreditation, or other similar authorization required by any Law, Governmental Body, or Contract.

Person means any individual, partnership, limited liability company, corporation, association, joint stock company, trust, entity, joint venture, labor organization, unincorporated organization, or Governmental Body.

Plan of Conversion is defined in the recitals to this Agreement and attached as *Exhibit A*.

Present Value of the Redemption Obligation is defined in *Section 2.8(d)*.

Purchase Price is defined in *Section 2.8(d)*.

Receivables means all receivables of the Insurance Company, including all Contracts in transit, manufacturers warranty receivables, notes receivable, accounts receivable, trade account receivables, and insurance proceeds receivable.

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Refundable Deposit means the obligation of the Insurance Company to refund those refundable surplus deposits contributed by subscribers in accordance with all orders of TDI in effect as of the Closing.

Schedules means the Schedules to this Agreement.

SEC means the U. S. Securities and Exchange Commission.

SEC No-Action Letter is defined in *Section 5.2(e)*.

Security Interest means any security interest, deed of trust, mortgage, pledge, lien, charge, claim, or other similar interest or right, except for (i) liens for taxes, assessments, governmental charges, or claims that are being contested in good faith by appropriate Actions promptly instituted and diligently conducted and only to the extent that a reserve or other appropriate provision, if any, has been made on the face of the Financial Statements in an amount equal to the Liability for which the lien is asserted, (ii) statutory liens of landlords and warehousemen s, carriers , mechanics , suppliers , materialmen s, repairmen s, or other like liens (including Contractual landlords liens) arising in the Ordinary Course of Business and with respect to amounts not yet delinquent and being contested in good faith by appropriate proceedings, only to the extent that a reserve or other appropriate provision, if any, has been made on the face of the Financial Statements in an amount equal to the Liability for which the lien is asserted; and (iii) liens incurred or deposits made in the Ordinary Course of Business in connection with workers compensation, unemployment insurance and other similar types of social security.

Shareholders means the record holders of the Insurance Company Common Stock as they may be constituted from time-to-time.

statutory accounting is defined in *Section 4.8*.

Subscribers is defined in the recitals to this Agreement.

Subsidiary means, with respect to any Person: (a) any corporation of which more than 50% of the total voting power of all classes of the Equity Interests entitled (without regard to the occurrence of any contingency) to vote in the election of directors is owned by such Person directly or through one or more other Subsidiaries of such Person and (b) any Person other than a corporation of which at least a majority of the Equity Interest (however designated) entitled (without regard to the occurrence of any contingency) to vote in the election of the governing body, partners, managers or others that will control the management of such entity is owned by such Person directly or through one or more other Subsidiaries of such Person.

Superior Proposal is defined in *Section 7.1(f)*.

Surviving Corporation is defined in *Section 2.2*.

Tax means any federal, state, local, or foreign income, gross receipts, license, payroll, employment, excise, severance, stamp, occupation, premium, windfall profits, environmental (including taxes under Code Section 59A), customs, ad valorem, duties, capital stock, franchise, profits, withholding, social security, unemployment, disability, real property, personal property, sales, use, transfer, registration, value added, alternative or add-on minimum, estimated, or other tax of any kind whatsoever, including any interest, penalty, or addition thereto, whether disputed or not.

TDI means the Texas Department of Insurance.

TDI Refundable Deposit Order means TDI Consent Order No. 04-0856, effective September 3, 2004, as amended by Amended Consent Order No. 05-0874, effective October 12, 2005.

Termination Date means the earlier to occur of (a) the Expiration Date and (b) the date on which this Agreement is terminated pursuant to *Section 7.1* (other than *Section 7.1(b)*).

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Threatened means a demand or statement has been made (orally or in writing) or a notice has been given (orally or in writing), or any other event has occurred or any other circumstances exist that would lead a prudent Person to conclude that a cause of Action or other matter is likely to be asserted, commenced, taken, or otherwise initiated.

Transaction Documents means this Agreement and the Ancillary Agreements.

Transactions means all of the transactions contemplated by this Agreement, including: (a) the Conversion, the filing of the Plan of Conversion, the issuance by the Insurance Company of Insurance Company Common Stock to the Subscribers and certain other insureds, and the issuance of Insurance Company Preferred Stock to Persons entitled to repayment of the Refundable Deposits; (b) the Merger, the filing of the Merger Certificate, and APSG Parent s delivery of the Merger Consideration hereunder; (c) the 180-Day Lock Up; (d) the execution, delivery, and performance of all of the documents, instruments and agreements to be executed, delivered, and performed in connection herewith, including each Ancillary Agreement; and (e) the performance by the APSG Parties, the Insurance Company, and the Shareholders of their respective covenants and obligations (pre- and post-Closing) under this Agreement.

ARTICLE 2.

THE MERGER

2.1 The Conversion.

Prior to the Effective Time, the Insurance Company will exercise its Best Efforts to effect the Conversion in accordance with the Plan of Conversion.

2.2 The Merger.

At the Effective Time, subject to this Agreement and the Corporate Laws, APSG Merger Sub will be merged with and into the Insurance Company, the separate corporate existence of APSG Merger Sub will cease, and the Insurance Company will continue as the surviving corporation and a wholly-owned Subsidiary of APSG Parent. The Insurance Company as the surviving corporation after the Merger is sometimes referred to as the ***Surviving Corporation***.

2.3 Closing.

The closing of the Merger (the ***Closing***) will take place at the offices of Akin, Gump, Strauss, Hauer & Feld, L.L.P. in Austin, Texas, commencing 10:00 am local time on the second business day following the satisfaction or waiver of all conditions to consummate the Merger (other than conditions with respect to actions the respective Parties will take at the Closing itself) or such other date as APSG Parent and the Insurance Company may mutually determine (the ***Closing Date***).

2.4 Actions and Deliveries at Closing.

On the Closing Date, the Parties will cause the Merger to be consummated by filing a Certificate of Merger with the Secretary of State of Texas and, if necessary, with TDI and AID, substantially in the form of *Exhibit B* (the ***Merger Certificate***), in accordance with the applicable Corporate Law. The date and time the Merger becomes effective as specified in the Merger Certificate or as otherwise provided in accordance with the applicable Corporate Law is referred to as the ***Effective Time***. In addition, at the Closing,

(a) The Insurance Company will deliver to APSG Parent:

(i) A closing certificate certified by the secretary and chairman of the Insurance Company, substantially in the form of *Exhibit C*, duly executed on behalf of the Insurance Company, as to whether each condition specified in *Sections 6.1(a) (d)* has been satisfied in all respects.

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(b) APSG Parent will deliver to the Insurance Company:

(i) An Officers certificate, substantially in the form of *Exhibit D*, duly executed on behalf of the APSG Parties, as to whether each condition specified in *Sections 6.2(a) (c)* has been satisfied in all respects.

(ii) A Secretary s certificate, substantially in the form of *Exhibit E*, duly executed on on behalf of the APSG Parties.

2.5 Effect of the Merger.

At the Effective Time, the effect of the Merger will be as provided in the applicable Corporate Law. At the Effective Time all the property, rights, privileges, powers, and franchises of APSG Merger Sub will vest in the Surviving Corporation, and all debts, liabilities, obligations, and duties of APSG Merger Sub, including the rights and obligations under the agreements, if any, of APSG Merger Sub, will become the Surviving Corporation s debts, liabilities, obligations, and duties. Notwithstanding anything to the contrary contained herein, the Merger will not affect the policy coverage of any policy of insurance issued by the Insurance Company. Additionally, all policies and obligations, if any, of APSG Merger Sub shall be assumed by the Surviving Corporation on the same terms as if such policies and obligations were still being carried by APSG Merger Sub.

2.6 Charter and Bylaws.

At the Effective Time, the Certificate of Formation of the Insurance Company in the form attached to this Agreement as *Exhibit F* will be the Surviving Corporation s Certificate of Formation until thereafter amended as provided by Law and such Certificate of Formation, and the Amended and Restated Bylaws of the Insurance Company in the form attached as *Exhibit G* to this Agreement, will be the bylaws of the Surviving Corporation until thereafter amended.

2.7 Directors and Officers.

(a) The individuals listed on *Schedule 2.7(a)* will be the initial director(s) and officers of the Surviving Corporation.

(b) At the Effective Time, the individuals listed on *Schedule 2.7(b)* will be elected by the Board of Directors of APSG Parent to serve on the Board of Directors of APSG Parent until the next annual meeting of shareholders of APSG Parent.

2.8 Effect on Capital Stock.

At the Effective Time, because of the Merger and without any action on the part of APSG Parent, APSG Merger Sub or the Insurance Company:

(a) **Conversion of Insurance Company Preferred Stock**. Each share of Insurance Company Preferred Stock issued pursuant to the Conversion and outstanding immediately prior to the Effective Time will be converted into a like number of shares of APSG Parent Preferred Shares. The APSG Parent Preferred Shares will have the same redemption provisions as the Insurance Company Preferred Stock. All Insurance Company Preferred Stock, when so converted, shall automatically be cancelled and shall cease to exist. There will not be any certificates issued to represent the outstanding Insurance Company Preferred Stock in the Conversion, and the holders of Insurance Company Preferred Stock, at the Effective Time of the Merger, will cease to have any rights with respect to the Insurance Company Preferred Stock except the right to receive APSG Parent Preferred Shares.

(b) **Conversion of Insurance Company Common Stock**. Subject to *Sections 2.10* and *2.12*, each share of Insurance Company Common Stock issued pursuant to the Conversion and outstanding immediately

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prior to the Effective Time will be converted into the number of APSG Parent Common Shares equal to the Exchange Ratio. All Insurance Company Common Stock, when so converted, will no longer be outstanding and will automatically be canceled and retired and will cease to exist. There will not be any certificates issued to represent the outstanding Insurance Company Common Stock in the Conversion, and the holders of Insurance Company Common Stock, at the Effective Time of the Merger, will cease to have any rights with respect to the Insurance Company Common Stock except the right to receive: (i) the APSG Parent Common Shares as determined herein and (ii) cash in lieu of fractional APSG Parent Common Shares under *Section 2.10*, in each case without interest (together with the APSG Parent Preferred Shares, collectively, the ***Merger Consideration***).

(c) **Rights Associated with Insurance Company Common Stock and Insurance Company Preferred Stock**. Since there will not be any certificates issued to represent the outstanding Insurance Company Common Stock or Insurance Company Preferred Stock, the holders of Insurance Company Common Stock and Insurance Company Preferred Stock will have only the right to receive their respective Merger Consideration.

(d) **Certain Additional Definitions**. For this Agreement the following terms will have the indicated meanings:

Announcement Exchange Ratio means (a) the quotient of (i) the Purchase Price divided by (ii) the Announcement Market Price; divided by (b) the Insurance Company Common Equity. For instance, and purely by way of example, if the Present Value of the Redemption Obligation is $7 million (making the Purchase Price $26 million), the Announcement Market Price is $13 per share, and the Insurance Company Common Equity resulting from the Conversion is 10 million shares, then the Announcement Exchange Ratio would be:

$$\left(\frac{\$26{,}000{,}000}{\$13}\right) \div 10{,}000{,}000 = \frac{1}{5}$$

Therefore, five (5) shares of Insurance Company Common Stock issued in the Conversion would be exchanged for one (1) APSG Parent Common Share.

Announcement Market Price means the average closing market prices of APSG Parent Common Shares on the National Association of Securities Dealers Automated Quotation System, as reported in The Wall Street Journal, for the twenty (20) consecutive trading days immediately prior to the close of the full business day immediately prior to the date this Agreement is fully executed by all of the Parties and announced to the public by appropriate SEC filings and the issuance of the mutually agreed upon press release.

Closing Exchange Ratio means the Announcement Exchange Ratio; provided, however, that in the event the Closing Market Price is more than 115% of the Announcement Market Price or is less than 85% of the Announcement Market Price, the Closing Exchange Ratio shall equal:

(i) if the Closing Market Price is more than 115% of the Announcement Market Price, the Closing Exchange Ratio shall equal (A) the quotient of (i) the Purchase Price multiplied by 115% divided by (ii) the Closing Market Price; divided by (B) the Insurance Company Common Equity. For instance, and purely by way of example, if the Present Value of the Redemption Obligation is $7 million (making the Purchase Price $26 million), the Announcement Market Price is $10 per share, the Closing Market Price is $12 per share and the Insurance Company Common Equity resulting from the Conversion is 10 million shares, then the Closing Exchange Ratio would be:

$$\left(\frac{\$26{,}000{,}000 \times 115\%}{\$12}\right) \div 10{,}000{,}000 = \frac{1}{4}$$

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Therefore, four (4) shares of Insurance Company Common Stock issued in the Conversion would be exchanged for one (1) APSG Parent Common Share.

(ii) if the Closing Market Price is less than 85% of the Announcement Market Price, the Closing Exchange Ratio shall equal (A) the quotient of (i) the Purchase Price multiplied by 85% divided by (ii) the Closing Market Price; divided by (B) the Insurance Company Common Equity. For instance, and purely by way of example, if the Present Value of the Redemption Obligation is $7 million (making the Purchase Price $26 million), the Announcement Market Price is $10 per share, the Closing Market Price is $8 per share and the Insurance Company Common Equity resulting from the Conversion is 10 million shares, then the Closing Exchange Ratio would be:

$$\left(\frac{\$26{,}000{,}000 \times 85\%}{\$8} \right) \div 10{,}000{,}000 = \frac{1}{3.6}$$

Therefore, slightly more than three and one-half (3 1/2) shares of Insurance Company Common Stock issued in the Conversion would be exchanged for one (1) APSG Parent Common Share.

Closing Market Price means the average closing market prices of APSG Parent Common Shares on the National Association of Securities Dealers Automated Quotation System, as reported in The Wall Street Journal, for the twenty (20) consecutive trading days immediately prior to the close of the full business day immediately prior to the Closing Date.

Insurance Company Common Equity means the aggregate number of shares of Insurance Company Common Stock that the Subscribers and certain policyholders of the Insurance Company become entitled to receive in the Conversion.

Present Value of the Redemption Obligation means the net present value of the stream of payments authorized by TDI (as of the Closing) that must be made by the Insurance Company to comply with the mandatory redemption features of the Insurance Company Preferred Stock issued in the Conversion in full satisfaction of the Refundable Deposit determined on the basis of a constant discount rate of 5.35%.

Purchase Price means $33 million, less the Present Value of the Redemption Obligation.

2.9 Surrender of Insurance Company Common Stock.

(a) **Exchange Procedures**. As soon as practicable after Closing, (i) the holders of Insurance Company Common Stock and Insurance Company Preferred Stock shall be deemed to have surrendered such interests to APSG Parent (or, if applicable, APSG Parent s designated exchange agent), (ii) upon surrender of Insurance Company Common Stock and Insurance Company Preferred Stock the holder thereof will be entitled to receive, subject to the 180-Day Lock Up, the applicable Merger Consideration, and (iii) the Insurance Company Common Stock and Insurance Company Preferred Stock so surrendered will forthwith be canceled.

(b) **Transfers of Ownership**. APSG Parent will not issue any APSG Parent Common Shares or other Merger Consideration in any name other than the name of a holder of Insurance Company Common Stock. APSG Parent will not issue any APSG Parent Preferred Shares or other Merger Consideration in any name other than the name of a holder of Insurance Company Preferred Stock.

(c) **No Further Ownership Rights in Insurance Company Common Stock**. All Merger Consideration will be deemed to have been issued in full satisfaction of all rights pertaining to the Insurance Company Common Stock and Insurance Company Preferred Stock.

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2.10 No Fractional Common Shares.

No fractional APSG Parent Common Shares will be issued in the Merger and fractional share interests will not entitle the owner thereof to vote or to any rights of an APSG Parent shareholder. All Shareholders that would be entitled to receive fractional APSG Parent Common Shares will be entitled to receive, in lieu thereof, an amount in cash determined by multiplying the fraction of an APSG Parent Common Share to which such holder would otherwise have been entitled by the Announcement Market Price or the Closing Market Price, as applicable.

2.11 Tax Treatment.

The Parties intend that the Conversion and the Merger will constitute a tax free reorganization under Code Section 368(a).

2.12 Shares of Dissenting Shareholders.

Any Insurance Company Common Stock or Insurance Company Preferred Stock held by a Person properly exercising its dissent or appraisal rights under the Corporate Law (a ***Dissenting Shareholder***) will be converted into the right to receive such consideration as may be determined to be due to such Dissenting Shareholder under the Corporate Law; except that Insurance Company Common Stock or Insurance Company Preferred Stock outstanding at the Effective Time that a Dissenting Shareholder holds for which, after the Effective Time, such Dissenting Shareholder withdraws its demand to exercise dissenters or appraisal rights or loses its right to exercise dissenters or appraisal rights as provided in the Corporate Law, will be deemed to be converted, as of the Effective Time, into the right to receive the Merger Consideration. The Insurance Company will give APSG Parent (a) prompt notice of any written demands for the exercise of dissenters or appraisal rights, withdrawals of demands for the exercise of dissenters or appraisal rights and any other instruments served under the Corporate Law, and (b) the opportunity to direct all negotiations and proceedings with respect to demands for exercise of dissenters or appraisal rights under the Corporate Law. The Insurance Company will not voluntarily make any payment with respect to any purchase demands and will not, except with APSG Parent s prior written consent, settle or offer to settle any such demands.

2.13 Taking of Necessary Action; Further Action.

If, at any time after the Effective Time, any such further action is necessary or desirable to carry out the purposes of this Agreement and to vest the Surviving Corporation with full right, title and possession to all assets, property, rights, privileges, powers, and franchises of the Insurance Company, the officers and directors of the Insurance Company and APSG Parent are fully authorized in the name of their respective corporations or otherwise to take, and the Insurance Company and APSG Parent will cause them to take, all such lawful and necessary action.

ARTICLE 3.

REPRESENTATIONS AND WARRANTIES

CONCERNING THE APSG PARTIES

Each APSG Party represents and warrants to the Insurance Company that the statements contained in this *ARTICLE 3* are correct and complete as of the date of this Agreement and will be correct and complete as of the Closing Date (as though made then and, except as expressly provided in a representation or warranty, as though the Closing Date were substituted for the date of this Agreement throughout this *ARTICLE 3*).

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3.1 Entity Status.

Each APSG Party is an entity duly created, formed or organized, validly existing and in good standing under the Laws of the jurisdiction of its creation, formation or organization. APSG Parent has the requisite power and authority to own or lease its properties and to carry on its business as currently conducted. There is no pending or Threatened Action (or Basis therefor) for the dissolution, liquidation, insolvency, or rehabilitation of any APSG Party.

3.2 Power and Authority; Enforceability.

Each APSG Party has the relevant entity power and authority to execute and deliver each Transaction Document to which it is party, and to perform and consummate the Transactions. Each APSG Party has taken all action necessary to authorize the execution and delivery of each Transaction Document to which it is party, the performance of its obligations thereunder, and the consummation of the Transactions, including but not limited to obtaining the necessary Consents by the shareholders and the Board of Directors of the APSG Parent, pursuant to *Section 5.2*. Each Transaction Document to which an APSG Party is party has been duly authorized, executed and delivered by, and is Enforceable against, such APSG Party.

3.3 No Violation.

Except as listed on *Schedule 3.3*, the execution and delivery of the Transaction Documents to which an APSG Party is party by such APSG Party and the performance and consummation of the Transactions by each APSG Party will not (i) Breach any Law or Order to which such APSG Party is subject or any provision of its Organizational Documents; (ii) Breach any Contract, Order, or Permit to which such APSG Party is a party or by which it is bound or to which any of its assets is subject; (iii) require any Consent, except (A) any applicable filings required under the HSR Act, (B) any SEC, TDI, AID and other filings required to be made by any APSG Party, and (C) any other notifications or filings to or consent from relevant state or federal regulatory agencies.

3.4 Brokers Fees.

No APSG Party has Liability to pay any compensation to any broker, finder, or agent with respect to the Transactions for which any Shareholder could become Liable.

3.5 APSG Merger Sub.

APSG Merger Sub has been formed for the sole purpose of effecting the Merger and, except as contemplated by this Agreement, APSG Merger Sub has not conducted any business activities and does not have any material Liabilities.

3.6 Capitalization.

(a) APSG Parent s authorized capital stock consists of 20,000,000 APSG Parent Common Shares, of which 2,751,672 shares were issued and outstanding as of May 15, 2006 and zero (0) shares were held in treasury. All of the issued and outstanding APSG Parent Common Shares (i) have been duly authorized, are validly issued, fully paid, and nonassessable, (ii) were issued in compliance with all applicable state and federal securities Laws, and (iii) were not issued in Breach of any Commitments. APSG Parent participates in a previously announced stock repurchase plan through which the APSG Parent can repurchase APSG Parent Common Shares from time to time. Except as otherwise set forth herein and described in APSG Parent s Form 10-K for the year ended December 31, 2005 filed with the SEC and as issued in the ordinary course of APSG Parent s business since the date thereof and more particularly set forth in *Schedule 3.6(a)*, no Commitments exist with respect to any APSG Parent Common Shares and no such Commitments will arise in connection with the Transactions. There are no Contracts with respect to the voting or transfer of APSG Parent s capital stock. APSG Parent is not obligated to redeem or otherwise acquire any of its outstanding capital stock.

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(b) The APSG Parent Common Shares and the APSG Parent Preferred Shares to be issued pursuant to this Agreement will be duly authorized, validly issued, fully paid, and nonassessable and will be issued in compliance with all applicable federal and state securities Laws and in accordance with an effective registration statement filed with the SEC such that all of such shares shall be fully registered shares subject only to the 180-Day Lock Up.

3.7 SEC Filings.

APSG Parent has timely filed with the SEC any and all reports and other filings required to be filed under the federal securities Laws, and all such reports and other filings required to be filed were made in compliance with the federal securities Laws, were complete and accurate as of the date of such filing with the SEC and, subject to any further filings thereafter made with the SEC, remain complete and accurate.

3.8 Representations Complete.

Except as and to the extent set forth in this Agreement, no APSG Party makes any representations or warranties whatsoever, and each of them hereby disclaims all Liability and responsibility for any representation, warranty, statement, or information not included herein that was made, communicated, or furnished (orally or in writing) to the Insurance Company or any Shareholder or their representatives (including any opinion, information, projection, or advice that may have been or may be provided to the Insurance Company or any Shareholder by any director, officer, employee, agent, consultant, or representative of any APSG Party or Affiliate thereof).

ARTICLE 4.

REPRESENTATIONS AND WARRANTIES

CONCERNING THE INSURANCE COMPANY

The Insurance Company represents and warrants to APSG Parent that the statements contained in this *ARTICLE 4* are correct and complete as of the date of this Agreement and will be correct and complete as of the Closing Date (as though made then and, except as expressly provided in a representation or warranty, as though the Closing Date were substituted for the date of this Agreement throughout this *ARTICLE 4*), except as set forth in the Schedules the Insurance Company has delivered to APSG Parent on the date hereof.

4.1 Entity Status.

The Insurance Company is an entity duly created, formed or organized, validly existing, and in good standing under the Laws of the jurisdiction of its creation, formation, or organization. The Insurance Company is duly authorized to conduct its business and is in good standing under the laws of each jurisdiction where such qualification is required, and has the requisite power and authority necessary to own or lease its properties and to carry on its businesses as currently conducted and any businesses in which it currently proposes to engage. *Schedule 4.1* lists the directors and officers of the Insurance Company. The Insurance Company has delivered to APSG Parent correct and complete copies of its Organizational Documents, as amended to date. The Insurance Company is not in Breach of any provision of its Organizational Documents. There is no pending or Threatened Action (or Basis therefor) for the dissolution, liquidation, insolvency, or rehabilitation of the Insurance Company.

4.2 Power and Authority; Enforceability.

The Insurance Company has the relevant entity power and authority necessary to execute and deliver each Transaction Document to which it is a party and to perform and consummate the Transactions. The Board of Directors of the Insurance Company has taken all action necessary to authorize the execution and delivery of each Transaction Document to which it is a party, the performance of the Insurance Company s obligations thereunder, and the consummation of the Transactions, and shall prior to the Closing Date undertake Best Efforts

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to obtain all necessary approvals of the Transactions by TDI, ADI and Subscribers of the Insurance Company, pursuant to *Section 5.2*. Each Transaction Document to which the Insurance Company is a party has been duly authorized, executed, and delivered by, and is Enforceable against, the Insurance Company.

4.3 No Violation.

Except as listed on *Schedule 4.3*, the execution and the delivery of the applicable Transaction Documents by the Insurance Company and the performance of its obligations hereunder and thereunder, and consummation of the Transactions by the Insurance Company will not (a) Breach any Law or Order to which the Insurance Company is subject or any provision of the Organizational Documents of the Insurance Company; (b) Breach any Contract, Order, or Permit to which the Insurance Company is a party or by which it is bound or to which any of its assets is subject (or result in the imposition of any Encumbrance upon any of its assets); (c) require any Consent, except (i) any applicable filings required under the HSR Act and (ii) any notifications to, filings with, or consent by TDI, AID, and the SEC; or (d) trigger any rights of first refusal, preferential purchase, or similar rights.

4.4 Brokers Fees.

The Insurance Company does not have any Liability to pay any compensation to any broker, finder, or agent with respect to the Transactions for which APSG Parent, APSG Merger Sub, or the Insurance Company could become directly or indirectly Liable.

4.5 Subscriber Information.

No one other than the current Subscribers has any voting rights in the Insurance Company of any type or nature whatsoever. Notwithstanding the foregoing, the parties acknowledge that certain policyholders and former Subscribers may obtain interests in the Insurance Company as provided in the Plan of Conversion.

4.6 No Dividends or Distributions.

No dividends or other distributions have been or will be declared or made to the holders of the Insurance Company Common Stock or Insurance Company Preferred Stock, other than payment of the applicable Merger Consideration.

4.7 Records.

The copies of the Insurance Company s Organizational Documents that were provided to APSG Parent are accurate and complete and reflect all amendments made through the date hereof. The Insurance Company s minute books and other records made available to APSG Parent for review were correct and complete as of the date of such review, no further entries have been made through the date of this Agreement, such minute books and records contain the true signatures of the persons purporting to have signed them, and such minute books and records contain an accurate record of all actions of the Subscribers, directors, members, managers, or other such representatives of the Insurance Company taken by written consent, at a meeting, or otherwise since formation.

4.8 Financial Statements.

Set forth on *Schedule 4.8* are the following financial statements (collectively the ***Financial Statements***):

(a) audited statutory financial statements of the Insurance Company as of and for the fiscal years ended December 31, 2005 (the ***Most Recent Year End***), 2004, 2003, 2002 and 2001 prepared in accordance with the statutory accounting principles prescribed by TDI;

(b) unaudited quarterly statutory financial statements (the ***Interim Financial Statements***) filed with TDI for each quarter ended prior to the Closing.

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The Financial Statements have been prepared in conformity with insurance accounting (***statutory accounting***) practices prescribed or permitted by TDI. Statutory accounting principles are designed primarily to reflect the Insurance Company s ability to meet obligations to policyholders. The State of Texas has adopted the National Association of Insurance Commissioners statutory accounting practices as the basis of its statutory accounting practices except that it has retained certain prescribed practices.

The Financial Statements have been prepared in accordance with statutory accounting principles prescribed by TDI, as specified above, applied on a consistent basis throughout the periods covered thereby, present fairly the financial condition of the Insurance Company as of such dates and the results of operations for such periods, are correct and complete, and are consistent with the books and records of the Insurance Company; provided, however, that the Interim Financial Statements are subject to normal year-end adjustments (which will not be material individually or in the aggregate) and lack footnotes and other presentation items. Since the Most Recent Year End, the Insurance Company has not effected any change in any method of accounting or accounting practice, except for any such change required because of a concurrent change in the statutory accounting principles prescribed by TDI.

4.9 Subsequent Events.

Except as set forth in *Schedule 4.9*, since the Most Recent Year End the Insurance Company has operated in the Ordinary Course of Business and, as of the date hereof there have been no events, series of events or the lack of occurrence thereof which, singularly or in the aggregate could reasonably be expected to have a Material Adverse Effect on the Insurance Company. Without limiting the foregoing, since that date, and except as set forth on *Schedule 4.9*, none of the following has occurred:

(a) The Insurance Company has not sold, leased, transferred, or assigned any assets other than for a fair consideration in the Ordinary Course of Business and sales of assets not exceeding $10,000 singularly or $25,000 in the aggregate.

(b) The Insurance Company has not entered into any Contract (or series of related Contracts) either involving more than $10,000, except for Contracts for the sale of insurance in the Ordinary Course of Business, or outside the Ordinary Course of Business.

(c) No Encumbrance has been imposed upon any assets of the Insurance Company.

(d) The Insurance Company has not made any capital expenditure (or series of related capital expenditures) involving more than $10,000 individually, $25,000 in the aggregate, or outside the Ordinary Course of Business.

(e) The Insurance Company has not made any capital investment in, any loan to, or any acquisition of the securities or assets of, any other Person involving more than $10,000 singularly, $25,000 in the aggregate, or outside the Ordinary Course of Business.

(f) The Insurance Company has not issued any note, bond, or other debt security or created, incurred, assumed, or guaranteed any Liability for borrowed money or capitalized lease Contract either involving more than $10,000 individually or $25,000 in the aggregate.

(g) The Insurance Company has not delayed or postponed the payment of accounts payable or other Liabilities either involving more than $10,000 (individually or in the aggregate) or outside the Ordinary Course of Business.

(h) The Insurance Company has not canceled, compromised, waived, or released any Action (or series of related Actions) either involving more than $100,000 or outside the Ordinary Course of Business.

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(i) The Insurance Company has not granted any Contracts or any rights under or with respect to any Intellectual Property.

(j) There has been no change made or authorized to be made to the Organizational Documents of the Insurance Company, other than as contemplated by the Transactions.

(k) The Insurance Company has not declared, set aside, or paid any dividend or made any distribution with respect to its Equity Interests (whether in cash or in kind) or redeemed, purchased, or otherwise acquired any of its Equity Interests.

(l) The Insurance Company has not experienced any damage, destruction, or loss (whether or not covered by insurance) to its tangible properties.

(m) The Insurance Company has not made any loan to, or entered into any other transaction with, any of its directors, officers, or employees.

(n) The Insurance Company has not entered into any employment, collective bargaining, or similar Contract or modified the terms of any existing such Contract.

(o) The Insurance Company has not committed to pay any bonus or granted any increase in the base compensation (i) of any director or officer, or an employee who is also a Subscriber or an Affiliate of a Subscriber, or (ii) outside of the Ordinary Course of Business, of any of its other employees.

(p) The Insurance Company has not adopted, amended, modified, or terminated any bonus, profit-sharing, incentive, severance, or similar Contract for the benefit of any of its directors, officers, or employees (or taken any such action with respect to any other Employee Benefit Plan).

(q) The Insurance Company has not made any other change in employment terms for (i) any officer or employee thereof that is a Subscriber or an Affiliate thereof, or (ii) outside of the Ordinary Course of Business, any of its other directors, officers, or employees.

(r) The Insurance Company has not made or pledged to make any charitable or other capital contribution either involving more than $10,000 (individually or in the aggregate) or outside the Ordinary Course of Business.

(s) There has not been any other occurrence, event, incident, action, failure to act, or transaction with respect to the Insurance Company either involving more than $10,000 (individually or in the aggregate) or outside the Ordinary Course of Business.

(t) The Insurance Company has not committed to any of the foregoing.

4.10 Liabilities.

To the Insurance Company s Knowledge, the Insurance Company does not have any Liability (and there is no Basis for any present or future Action or Order against it giving rise to any Liability), except for (a) Liabilities quantified on the face of the Interim Financial Statements (rather than in any notes thereto) and not heretofore paid or discharged, and (b) Liabilities that have arisen after the Balance Sheet Date in the Ordinary Course of Business which, individually or in the aggregate, are not material and are of the same character and nature as the Liabilities quantified on the face of the Interim Financial Statements (rather than any notes thereto) none of which results from or relates to any Breach of Contract, Breach of warranty, tort, infringement, or Breach of Law, or arose out of any Action or Order.

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4.11 Legal Compliance.

The Insurance Company and its predecessors and Affiliates have complied with all applicable Laws, and no Action is pending or Threatened (and there is no Basis therefor) against it alleging any failure to so comply. No material expenditures are, or based on applicable Law, will be required of the Insurance Company for it and its business and operations to remain in compliance with applicable Law.

4.12 Tax Matters.

Except as set forth in *Schedule 4.12*, the Insurance Company is not subject to any Liabilities for Taxes, including Taxes relating to prior periods, other than those set forth or adequately reserved against in the Interim Financial Statements or those incurred since the Balance Sheet Date in the Ordinary Course of Business. The Insurance Company has duly filed when due all Tax reports and returns in connection with and in respect of its business, assets, and employees, and has timely paid and discharged all amounts shown as due thereon. The Insurance Company has made available to APSG Parent accurate and complete copies of all of its Tax reports and returns for all periods, except those periods for which returns are not yet due. The Insurance Company has not received any notice of any Tax deficiency outstanding, proposed or assessed against or allocable to it, and has not executed any waiver of any statute of limitations on the assessment or collection of any Tax or executed or filed with any Governmental Body any Contract now in effect extending the period for assessment or collection of any Taxes against it. There are no Encumbrances for Taxes upon, pending against or Threatened against, any asset of the Insurance Company. The Insurance Company is not subject to any Tax allocation or sharing Contract.

4.13 Title to and Condition of Assets.

The Insurance Company has no tangible assets of any material amount.

4.14 Intellectual Property.

Except as set forth in *Schedule 4.14*, the Insurance Company owns, or possesses adequate rights to use, all Intellectual Property used in its business as currently, or as currently proposed to be, conducted. No Consent of any Person is required for the Insurance Company s interest in such Intellectual Property to continue to be Enforceable by the Insurance Company following the Transactions. The Insurance Company s use of such Intellectual Property in its business as currently conducted (and the operation of its business) does not and the use of such Intellectual Property by the Insurance Company and its Affiliates after Closing will not, infringe upon any rights any other Person owns or holds.

4.15 Contracts.

Except as otherwise disclosed in *Schedule 4.14*, *Schedule 4.15* lists the following Contracts to which the Insurance Company is a party, as of the date hereof:

(a) Any Contract (or group of related Contracts) for the lease of personal property to or from any Person providing for lease payments in excess of $10,000 per annum.

(b) Any Contract (or group of related Contracts) for the purchase or sale of raw materials, commodities, supplies, products, or other personal property, or for the furnishing or receipt of services, the performance of which will extend over a period of more than one year, result in a material loss to the Insurance Company, or involve consideration in excess of $10,000.

(c) Any Contract concerning a limited liability company, partnership, joint venture, or similar arrangement.

(d) Any Contract (or group of related Contracts) under which the Insurance Company has created, incurred, assumed, or guaranteed any Liability for borrowed money or any capitalized lease in excess of $10,000,

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or under which the Contract has imposed or the Insurance Company has suffered to exist an Encumbrance on any of its assets, except for Contracts related to the Refundable Deposit as described under the terms of the TDI Refundable Deposit Order attached hereto as *Exhibit H*.

(e) Any Contract concerning confidentiality or noncompetition.

(f) Any Contract with any Subscriber or any Affiliates of any Subscriber, other than the Insurance Company.

(g) Any profit sharing, stock option, stock purchase, stock appreciation, deferred compensation, severance, or other similar Contract for the benefit of its current or former directors, officers, and employees.

(h) Any Contract for the employment of any individual on a full-time, part-time, consulting, or other basis providing annual compensation in excess of $100,000 or providing severance benefits.

(i) Any Contract under which it has advanced or loaned any amount to any of its directors or officers or any Subscriber or, outside the Ordinary Course of Business, to its employees that are not Subscribers or Affiliates of any Subscriber.

(j) Any other Contract (or group of related Contracts) the performance of which involves receipt or payment of consideration in excess of $50,000.

The Insurance Company has delivered to APSG Parent a correct and complete copy of each written Contract (as amended to date) listed in *Schedule 4.15* and a written summary setting forth the terms and conditions of each oral Contract referred to in *Schedule 4.15*. To the Insurance Company s Knowledge, with respect to each such Contract:

(i) the Contract is Enforceable;

(ii) the Contract will continue to be Enforceable on identical terms following the consummation of the Transactions;

(iii) Neither the Insurance Company nor, to the Insurance Company s Knowledge any counter-party, is in Breach of such Contract, and no event has occurred that with notice or lapse of time would constitute a Breach under the Contract; and

(iv) no party to the Contract has repudiated any provision thereof.

4.16 Receivables.

To the Insurance Company s Knowledge, all of the Receivables are Enforceable, represent bona fide transactions, arose in the Ordinary Course of Business of the Insurance Company, and are reflected properly in their books and records; all of the Receivables are good and collectible receivables, are current, and will be collected in accordance with past practice and the terms of such Receivables (and in any event within six months following the Closing Date), without set off or counterclaims; and no customer or supplier of the Insurance Company has any Basis to believe that it has or would be entitled to any payment terms other than terms in the Ordinary Course of Business, including any prior course of conduct.

4.17 Powers of Attorney.

There are no outstanding powers of attorney executed on behalf of the Insurance Company, except for the Attorney-in-Fact.

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4.18 Insurance.

The Insurance Company has a Directors and Officers Policy with limits of $1,000,000 with retention of $100,000 on certain types of claims. The policy is in force for calendar year 2006. In 1990 the Insurance Company established an Indemnification Trust which provides additional funds in the event of a claim against a Director. Frost Bank serves as trustee and the value of the Trust as of December 31, 2005 was $168,262.

4.19 Litigation.

Schedule 4.19 sets forth each instance in which the Insurance Company (a) is subject to any outstanding Order or (b) is a party, the subject of, or is Threatened to be made a party or the subject of any Action, except for litigation related to professional medical liability in the Ordinary Course of Business. No Action required to be set forth in *Schedule 4.19* questions the Enforceability of this Agreement or the Transactions, or could result in any Material Adverse Change with respect to the Insurance Company, and the Insurance Company has no Basis to believe that any such Action may be brought against the Insurance Company.

4.20 Labor; Employees.

The Insurance Company has two (2) employees, neither of whom are a party to or are bound by any collective bargaining Contract or employment agreement.

4.21 Employee Benefits.

There are no employee benefit plans or arrangements of any type (including plans described in Section 3(3) of ERISA) under which the Insurance Company has or in the future could have directly, or indirectly through a commonly controlled entity (within the meaning of Sections 414(b), (c), (m) and (o) of the Code), any Liability with respect to the Insurance Company s or commonly controlled entity s current or former employees.

4.22 Subscribers and Other Insureds.

The APSG Parties have been provided a complete list of all Subscribers and the other Persons covered by insurance policies issued by the Insurance Company as of April 30, 2006.

4.23 Permits.

The Insurance Company possesses all Permits required to be obtained for its businesses and operations. *Schedule 4.23* sets forth a list of all such Permits. Except as set forth in *Schedule 4.23*, with respect to each such Permit:

(a) it is valid, subsisting and in full force and effect;

(b) there are no violations of such Permit that would result in a termination of such Permit; and

(c) the Insurance Company has not received notice that such Permit will not be renewed; and

(d) the Transactions will not adversely affect the validity of such Permit or cause a cancellation of or otherwise adversely affect such Permit.

4.24 TDI Refundable Deposit Order.

The TDI Refundable Deposit Order, attached hereto as *Exhibit I*, is in full force and effect and has not been changed or modified from the form attached and will not be changed or modified prior to Closing except pursuant to the Conversion. The Insurance Company is in full compliance with the TDI Refundable Deposit Order.

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4.25 Certain Business Relationships with the Insurance Company.

Except insurance policies issued by the Insurance Company in the Ordinary Course of Business, any Subscriber s Agreement and Power of Attorney (or similar agreements), service as a member of the Board of Directors or Medical Director of the Insurance Company, or as provided on the list provided to the APSG Parties referred to in *Section 4.22*, no Subscriber or any of its Affiliates has been involved in any business arrangement or relationship with the Insurance Company within the past 12 months, and no Subscriber or any of its Affiliates owns any asset that is used in the Insurance Company s business.

4.26 Real Property.

The Insurance Company does not own or lease any real property.

4.27 Accuracy of Information Furnished.

No representation, statement, or information contained in this Agreement (including the Schedules) or any Contract or document executed in connection herewith or delivered pursuant hereto or thereto or made available or furnished to APSG Parent or its representatives by the Insurance Company contains or will contain any untrue statement of a material fact or omits or will omit any material fact necessary to make the information contained therein not misleading. The Insurance Company has provided APSG Parent with correct and complete copies of all documents listed or described in the Schedules.

4.28 Representations Complete.

Except as and to the extent expressly set forth in this Agreement, neither the Insurance Company nor any Subscriber or other insureds makes any representations or warranties whatsoever (INCLUDING, ANY IMPLIED OR EXPRESS WARRANTY OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, OR CONFORMITY TO MODELS OR SAMPLES OF MATERIALS) to any APSG Party and each of them hereby disclaims all Liability and responsibility for any representation, warranty, statement, or information not included herein that was made, communicated, or furnished (orally or in writing) to any APSG Party or its representatives (including any opinion, information, projection, or advice that may have been or may be provided to any APSG Party by any director, officer, employee, agent, consultant, or representative of the Insurance Company or Subscriber).

ARTICLE 5.

PRE-CLOSING COVENANTS

The Parties agree as follows with respect to the period between the execution of this Agreement and the earlier of the Closing and the Termination Date:

5.1 General.

Each Party will use its Best Efforts to take all actions and to do all things necessary, proper, or advisable to consummate, make effective, and comply with all of the terms of this Agreement and the Transactions applicable to it (including satisfaction, but not waiver, of the Closing conditions for which it is responsible or otherwise in control, as set forth in *ARTICLE 6*).

5.2 Notices and Consents.

(a) The Insurance Company will obtain a written Consent or certified resolutions by the Board of Directors of the Insurance Company approving of the Merger and the Transactions as set forth herein.

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(b) The APSG Parent will obtain a Consent by the Board of Directors of the APSG Parent approving of the Merger and the Transactions as set forth herein.

(c) The Insurance Company will (subject to SEC approval of any proxy or joint proxy information that may be used in connection with such a meeting or submission to a vote) call and hold a meeting of its Subscribers as soon as practicable after the date hereof, at which meeting the Board of Directors of the Insurance Company will submit and recommend the Agreement and the Transactions described herein to its Subscribers, and, if the requisite approval is obtained, will undertake promptly to consummate the Merger and the Transactions as set forth herein.

(d) The APSG Parent will (subject to SEC approval of any proxy or joint proxy information that may be used in connection with such a meeting or submission to a vote) call and hold a meeting of its shareholders as soon as practicable after the date hereof, at which meeting the Board of Directors of such APSG Party will, subject to its fiduciary obligations to shareholders, submit and recommend the Agreement and the Transactions described herein to its shareholders, and, if the requisite approval is obtained, will undertake promptly to consummate the Merger and the Transactions as set forth herein.

(e) The Insurance Company will make the necessary notifications to or filings with TDI, AID, the SEC and any other relevant state or federal regulatory agencies, including but not limited to obtaining a No-Action Letter from the SEC stating that the Insurance Company Common Stock and Insurance Company Preferred Stock, issued pursuant to the Conversion, are exempt from registration with the SEC (the ***SEC No-Action Letter***) and will use its Best Efforts to provide the APSG Parties with all the information needed to make the necessary notifications and filings with the SEC.

(f) Each APSG Party will make notifications to or filings with TDI, AID, the SEC, and any other relevant state or federal regulatory agencies, which are required to be made by any APSG Party in order to consummate the Merger and the Transactions as set forth herein.

(g) The Insurance Company will give any notices to third parties, and will use its Best Efforts to obtain any third party Consents listed on *Schedule 4.3*, or that APSG Parent reasonably may otherwise request in connection with the matters referred to in *Section 4.3*.

(h) Each APSG Party will give any notices to third parties, and will use its Best Efforts to obtain any third party Consents listed on *Schedule 3.3*, or that the Insurance Company reasonably may otherwise request in connection with the matters referred to in *Section 3.3*.

(i) Each Party will cooperate and use its Best Efforts to agree jointly on a method to overcome any objections by any Governmental Body to the Transactions. Without limiting the foregoing, each Party (i) will file any notification and report forms and related material that such Party may be required to file under the HSR Act, (ii) if requested by APSG Parent, will use their Best Efforts to obtain an early termination of the applicable waiting period, and (iii) will make any further filings pursuant thereto that may be necessary, proper, or advisable in connection therewith. APSG Parent and the Insurance Company will bear the cost of the HSR Act filing fee equally. No Party shall be obligated to file a suit or to appeal from any adverse ruling by the Commissioner of TDI or the Commissioner of AID, and neither the APSG Parent nor the Insurance Company shall be obligated to make any material changes in any lawful, good faith management policy in order to gain such approval.

(j) Nothing in this *Section 5.2* will require that (i) APSG Parent or its Affiliates divest, sell, or hold separately any of its assets or properties, or (ii) APSG Parent, its Affiliates, or the Insurance Company (the determination with respect to which APSG Parent will make) take any actions that could affect the normal and regular operations of APSG Parent, its Affiliates, or the Insurance Company after the Closing.

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5.3 Refundable Deposit.

The Insurance Company s Refundable Deposit that remains an obligation of the Insurance Company as of April 30, 2006 is equal to the amount set forth on *Schedule 5.3*. To the Insurance Company s Knowledge, the annual partial pro rata distributions of the Refundable Deposit are not to exceed $200,000, in accordance with the TDI Refundable Deposit Order, and there has been no further approval by the Commissioner of TDI to change this amount. The Insurance Company has met and will continue to meet the conditions set out in the Exhibit A attached to the TDI Refundable Deposit Order regarding the Insurance Company s plan to make annual partial pro rata distributions of the Refundable Deposit until the TDI Refundable Deposit Order is eliminated or modified in the Conversion.

5.4 Operation of Business.

Except as necessary to consummate the Transactions, the Insurance Company will not engage in any practice, take any action, or enter into any transaction outside the Ordinary Course of Business or engage in any practice, take any action, or enter into any transaction of the sort described in *Section 4.9*. Subject to compliance with applicable Law, from the date hereof until the earlier to occur of the Closing or the Termination Date, the Insurance Company will confer on a regular and frequent basis with one or more representatives of APSG Parent to report on operational matters and the general status of the Insurance Company s ongoing business, operations and finances and will promptly provide to APSG Parent or its representatives copies of all material filings they make with any Governmental Body during such period.

5.5 No Shop.

The Insurance Company agrees that it has not and will not, directly or indirectly, enter into any agreements, understandings or negotiations with, or solicit, initiate or encourage any inquiries, proposals or offers from, any Person other than the APSG Parties relating to (a) any acquisition or purchase of any assets of the Insurance Company (other than in the ordinary course) or (b) any merger, consolidation or business combination involving the Insurance Company. The Insurance Company will notify the APSG Parent immediately if any Person makes any written proposal, offer, inquiry, or contact with respect to any of the foregoing and the terms of any such proposal, offer, inquiry, or contact.

5.6 Preservation of Business.

The Insurance Company will keep its business and properties substantially intact, including its present operations, physical facilities, and working conditions, and relationships with lessors, licensors, suppliers, customers, and employees.

5.7 Full Access.

The Insurance Company will permit representatives of APSG Parent (including financing providers) to have full access to all premises, properties, personnel, books, records, Contracts, and documents pertaining to the Insurance Company and will furnish copies of all such books, records, Contracts, and documents and all financial, operating and other data, and other information as APSG Parent may reasonably request; provided, however, that no investigation pursuant to this *Section 5.7* will effect any representations or warranties made herein or the conditions of the Parties obligations to consummate the Transactions.

5.8 Notice of Developments.

The Insurance Company will give prompt written notice to APSG Parent of any development occurring after the date of this Agreement, or any item about which the Insurance Company did not have Knowledge on the date of this Agreement, which causes or reasonably could be expected to cause a Breach of any of the representations and warranties in *ARTICLE 4*. The Parties acknowledge that the Insurance Company intends to amend its bylaws

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shortly after the execution of this Agreement and the Insurance Company agrees to promptly deliver such amended bylaws to APSG Parent. APSG Parent will give prompt written notice to the Insurance Company of any development occurring after the date of this Agreement, or any item about which such APSG Party did not have Knowledge on the date of this Agreement, which causes or reasonably could be expected to cause a Breach of any of the representations and warranties in *ARTICLE 3*. No disclosure by any Party pursuant to this *Section 5.8* will be deemed to amend or supplement the Schedules or to prevent or cure any misrepresentation or Breach of any representation, warranty, or covenant.

5.9 Confidentiality; Publicity.

Except as may be required by Law, stock exchange or regulation or as otherwise expressly contemplated herein, no Party or their respective Affiliates, employees, agents and representatives will disclose to any Person the existence of this Agreement, the subject matter or terms hereof or any Confidential Information concerning the business or affairs of any other Party that it may have acquired from such Party in the course of pursuing the Transactions without the prior written consent of the Insurance Company or APSG Parent, as the case may be; provided, however, any Party may disclose any such Confidential Information as follows: (a) to such Party s Affiliates and its or its Affiliates employees, lenders, counsel, or accountants, the actions for which the applicable Party will be responsible; (b) to comply with any applicable Law or Order, provided that prior to making any such disclosure the Party making the disclosure notifies the other Party of any Action of which it is aware which may result in disclosure and uses its Best Efforts to limit or prevent such disclosure; (c) to the extent that the Confidential Information is or becomes generally available to the public through no fault of the Party or its Affiliates making such disclosure; (d) to the extent that the same information is in the possession (on a non-confidential basis) of the Party making such disclosure prior to receipt of such Confidential Information; (e) to the extent that the Party that received the Confidential Information independently develops the same information without in any way relying on any Confidential Information; or (f) to the extent that the same information becomes available to the Party making such disclosure on a nonconfidential basis from a source other than a Party or its Affiliates, which source, to the disclosing Party s Knowledge, is not prohibited from disclosing such information by a legal, Contractual, or fiduciary obligation to the other Party. Notwithstanding the foregoing, APSG Parent may make such public disclosure of the existence of this Agreement, the principal economic terms thereof, and the status with respect to achieving the Closing as it desires; provided, that APSG Parent will consult with the Insurance Company prior to releasing any such public disclosure so that the Insurance Company may notify the Insurance Company s employees of the Transactions. Neither the Insurance Company nor any of its Affiliates will issue any press release or other public announcement related to this Agreement or the Transactions without APSG Parent s prior written approval.

5.10 Financial Statements.

On or before June 30, 2006, the Insurance Company will deliver to APSG Parent the following financial statements:

(a) audited balance sheets as of December 31, 2005 and 2004 and the related statements of operations, changes in members equity, and cash flows of the Insurance Company for the each of the three year periods ending 2005, 2004 and 2003, prepared in accordance with GAAP;

(b) unaudited balance sheets as of December 31, 2003, 2002 and 2001 and the related statements of operations, changes in member s equity, and cash flows of the Insurance Company for the each of the periods ending 2002 and 2001, prepared in accordance with GAAP; and

(c) unaudited balance sheets and statements of operations, changes in member s equity, and cash flows of the Insurance Company for each quarter ended prior to the Closing Date with comparative preceding year financial statements, prepared in accordance with GAAP.

Each of the above have been prepared in accordance with GAAP, applied on a consistent basis throughout the periods covered thereby, present fairly the financial condition of the Insurance Company as of such dates and

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the results of operations for such periods, are correct and complete, and are consistent with the books and records of the Insurance Company; provided, however, that the *Section 5.10(c)* financial statements are subject to normal year-end adjustments (which will not be material individually or in the aggregate) and lack footnotes and other presentation items. Since the Most Recent Year End, the Insurance Company has not effected any change in any method of accounting or accounting practice, except for any such change required because of a concurrent change in the statutory accounting principles prescribed by TDI.

ARTICLE 6.

CLOSING CONDITIONS

6.1 Conditions Precedent to Obligation of the APSG Parties.

The APSG Parties obligation to effect the Merger and consummate the other Transactions contemplated to occur in connection with the Closing and thereafter is subject to the satisfaction of each condition precedent listed below. Unless expressly waived pursuant to this Agreement, no representation, warranty, covenant, right, or remedy available to an APSG Party in connection with the Transactions will be deemed waived by any of the following actions or inactions by or on behalf of an APSG Party (regardless of whether the Insurance Company is given notice of any such matter): (i) consummation by the APSG Parties of the Transactions, (ii) any inspection or investigation, if any, of the Insurance Company, (iii) the awareness of any fact or matter acquired (or capable or reasonably capable of being acquired) with respect to the Insurance Company, or (iv) any other action, in each case at any time, whether before, on, or after the Closing Date.

(a) **Accuracy of Representations and Warranties.** Each representation and warranty set forth in *ARTICLE 4* and *Section 5.10* must have been accurate and complete in all material respects (except with respect to any provisions including the word material or words of similar import, and except with respect to materiality, as reflected under statutory accounting principles, for purposes of *Section 4.8*, and under GAAP, with respect to *Section 5.10*, with respect to which such representations and warranties must have been accurate and complete) as of the date of this Agreement, and must be accurate and complete in all material respects (except with respect to any provisions including the word material or words of similar import and except with respect to materiality, as reflected under statutory accounting principles, for purposes of *Section 4.8*, and under GAAP, with respect to *Section 5.10*, with respect to which such representations and warranties must have been accurate and complete) as of the Closing Date, as if made on the Closing Date, without giving effect to any supplements to the Schedules.

(b) **Compliance with Obligations.** The Insurance Company must have performed and complied with all of its covenants to be performed or complied with at or prior to Closing (singularly and in the aggregate) in all material respects.

(c) **No Material Adverse Change or Destruction of Property.** Since the date hereof there must have been no event, series of events or the lack of occurrence thereof which, singularly or in the aggregate, could reasonably be expected to have a Material Adverse Effect on the Insurance Company. Without limiting the foregoing, (i) there must have been no Material Adverse Change to the Insurance Company, (ii) there must not have been any action or inaction by a Governmental Body, arbitrator, or mediator which could reasonably be expected to cause a Material Adverse Change to the Insurance Company, and (iii) there must not have been any fire, flood, casualty, act of God or the public enemy or other cause (regardless of insurance coverage for such damage) which event could reasonably be expected to have a Material Adverse Effect on the Insurance Company.

(d) **No Adverse Litigation.** There must not be pending or Threatened any Action by or before any Governmental Body, arbitrator, or mediator which will seek to restrain, prohibit, invalidate, or collect Damages arising out of the Transactions, or which, in the judgment of APSG Parent, makes it inadvisable to proceed with the Transactions.

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(e) **Consents.** The Insurance Company and APSG Parent must have received Consents to the Transactions and waivers of rights to terminate or modify any rights or obligations of the Insurance Company from any Person (i) from whom such Consent is required, including under any Contract listed or required to be listed in *Schedules 4.14 and 4.15*, under the HSR Act or other Law, from AID and TDI, including obtaining all necessary approvals of the Plan of Conversion and from the SEC, including obtaining the SEC No-Action Letter, and **obtaining all necessary shareholder approvals, as applicable,** or (ii) who as a result of the Transactions, would have such rights to terminate or modify such Contracts, either by their terms or as a matter of Law.

(f) **Dissenting Shares**. The holders of no more than two percent (2%) of either the Insurance Company Common Stock or the Insurance Company Preferred Shares may have exercised their right to dissent from the Merger under the applicable Corporate Law.

(g) **Advisory Services Agreement**. The Advisory Services Agreement must have been fully executed as of the Closing Date and be in full force and effect.

(h) **Tax Assurances**. The Insurance Company and APSG Parent must have received reasonable assurances from their tax advisors that, for federal income tax purposes, the Conversion and the Merger qualify as a tax-free reorganization under Section 368(a) of the Code.

6.2 Conditions Precedent to Obligation of the Insurance Company.

The Insurance Company s obligation to effect the Merger and consummate the other Transactions contemplated to occur in connection with the Closing and thereafter is subject to the satisfaction of each condition precedent listed below. Unless expressly waived pursuant to this Agreement, no representation, warranty, covenant, right, or remedy available to any Shareholder in connection with the Transactions will be deemed waived by any of the following actions or inactions by or on behalf of any Shareholder or the Insurance Company (regardless of whether APSG Parent is given notice of any such matter): (i) consummation by the Insurance Company of the Transactions, (ii) any inspection or investigation, if any, of APSG Parent, (iii) the awareness of any fact or matter acquired (or capable or reasonably capable of being acquired) with respect to APSG Parent, or (iv) any other action, in each case at any time, whether before, on, or after the Closing Date.

(a) **Accuracy of Representations and Warranties.** Each representation and warranty set forth in *ARTICLE 3* must have been accurate and complete in all material respects (except with respect to any provisions including the word material or words of similar import, with respect to which such representations and warranties must have been accurate and complete) as of the date of this Agreement, and must be accurate and complete in all material respects (except with respect to any provisions including the word material or words of similar import, with respect to which such representations and warranties must have been accurate and complete) as of the Closing Date, as if made on the Closing Date.

(b) **Compliance with Obligations.** Each APSG Party must have performed and complied with all its covenants and obligations required by this Agreement to be performed or complied with at or prior to Closing (singularly and in the aggregate) in all material respects.

(c) **No Order or Injunction.** There must not be issued and in effect any Order restraining or prohibiting the Transactions.

(d) **Consents; HSR Act Waiting Period.** The Insurance Company must have received Consents to the Transactions and waivers of rights to terminate or modify any rights or obligations of the Insurance Company from any Person (i) from whom such Consent is required under the HSR Act or other Law, from AID and TDI, including obtaining all necessary approvals of the Plan of Conversion and from the SEC, including obtaining the SEC No-Action Letter, and **obtaining all necessary Subscriber approvals** or (ii) who as a result of the Transactions, would have such rights to terminate or modify such Contracts, either by their terms or as a matter of Law.

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(e) The Insurance Company must have received the required Consents to the Transactions from TDI, AID, and the SEC, and any applicable waiting period under the HSR Act must have expired or been terminated.

(f) **Advisory Services Agreement**. The Advisory Services Agreement must have been fully executed as of the Closing Date and be in full force and effect.

(g) **Organizational Documents.** The Organizational Documents of APSG Merger Sub must be in place and have been completed, executed and filed as applicable.

(h) **Elections of Directors**. APSG Parent must have elected the directors to the Board of Directors of the APSG Parent as set forth in *Section 2.7*.

(i) **Tax Assurances**. The Insurance Company and APSG Parent must have received reasonable assurances from their tax advisors that, for federal income tax purposes, the Conversion and the Merger qualify as a tax-free reorganization under Section 368(a) of the Code.

ARTICLE 7.

TERMINATION

7.1 Termination of Agreement.

The Parties may terminate this Agreement as provided below:

(a) APSG Parent and the Insurance Company may terminate this Agreement as to all Parties by mutual written consent at any time prior to the Closing.

(b) APSG Parent or the Insurance Company may terminate this Agreement upon delivery of notice if the Closing has not occurred prior to the Expiration Date, provided that the Party delivering such notice will not have caused such failure to close.

(c) APSG Parent may terminate this Agreement by giving written notice to the Insurance Company at any time prior to the Closing if the Insurance Company has Breached any representation, warranty, or covenant contained in this Agreement in any material respect (except with respect to materiality for any provisions including the word material or words of similar import and *Section 4.8*, in which case such termination rights will arise upon any Breach), which breach has not been cured by the Insurance Company within ten (10) days following written notice to the Insurance Company.

(d) The Insurance Company may terminate this Agreement by giving notice to APSG Parent at any time prior to the Closing if any APSG Party has Breached any representation, warranty, or covenant contained in this Agreement in any material respect (except with respect to materiality for any provisions including the word material or words of similar import, in which case such termination rights will arise upon any Breach), which breach has not been cured by APSG Parent within ten (10) days following written notice to APSG Parent.

(e) Either APSG Parent or the Insurance Company may terminate if the Closing Market Price is more than 25% greater than or less than the Announcement Market Price.

(f) Either APSG Parent or, in the event the Insurance Company has not breached *Section 5.5* of this Agreement, the Insurance Company, may terminate this Agreement prior to the approval of this Agreement by the shareholders of APSG Parent if (1) the Board of Directors of such Party authorizes such Party to enter into a binding written agreement concerning a transaction that constitutes a Superior Proposal and such Party notifies the other Party in writing that it intends to enter into such an agreement, attaching the most current version of such agreement to such notice, (2) the other Party does not make, within three business days of receipt of such

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written notification of the intention to enter into a binding written agreement concerning a transaction that constitutes a Superior Proposal, an offer that the Board of Directors of such Party determines, in its good faith judgment is at least as favorable to the Party s shareholders (or in the case of the Insurance Company, the Subscribers) from a financial point of view as the Superior Proposal, and (3) the terminating Party prior to such termination pays to the other Party in immediately available funds (A) a termination fee of $1,500,000 and (B) an amount equal to all actual out-of-pocket fees and expenses incurred by the non-terminating Party (including, without limitation, the fees and expenses of its counsel, financial advisor, accountants, and financing sources) in connection with this Agreement and the transactions contemplated hereby. The term ***Superior Proposal*** means any bona fide written proposal to effect a merger, consolidation, reorganization, share exchange, recapitalization, acquisition, liquidation, direct or indirect business combination, or other similar transaction as a result of which the shareholders of the Party (or in the case of the Insurance Company, the Subscribers) cease to own at least 50% of the voting ownership interests of the ultimate parent entity resulting from such transaction or sale of all or substantially all of the assets of such Party, which in any such case, is on terms that the Board of Directors of such Party determines in its good faith judgment, taking into account all relevant factors, including any conditions to such proposal, the timing of the closing thereof, the risk of non-consummation, the ability of the Person making the proposal to finance the transaction contemplated thereby, any required governmental or other consents, filings and approvals, (A) would, if consummated, result in a transaction that is more favorable to such Party s shareholders (or in the case of the Insurance Company, the Subscribers) from a financial point of view than the transactions contemplated by this Agreement (including the terms of any proposal by the other Party to modify the terms of the transactions contemplated by this Agreement) and (B) is reasonably likely to be financed and otherwise completed without undue delay.

(g) This Agreement will automatically terminate on the Expiration Date.

7.2 Effect of Termination.

Except for the obligations under *Section 5.9*, this *ARTICLE 7*, and *ARTICLE 9*, if this Agreement is terminated under *Section 7.1*, then, except as provided in this *Section 7.2*, all further obligations (excluding specifically any remaining obligation to pay any termination fee and reimburse expenses as provided in *Section 7.1(f)* above) of the Parties under this Agreement will terminate. Notwithstanding any provision of this Agreement to the contrary, the Parties acknowledge and agree that the rights of termination pursuant to *Sections 7.1(c)* or *7.1(d)* shall be the sole and exclusive remedies of any Party in the event of a Breach of any representation, warranty, or covenant contained in this Agreement, and no Party shall pursue any legal remedies for Damages in such an event.

ARTICLE 8.

EFFECT OF REPRESENTATIONS AND WARRANTIES

APSG Parent and the Insurance Company acknowledge and agree that the only right resulting from a breach of any of the representations and warranties contained in *ARTICLE 3* or *ARTICLE 4* is the right of the non-breaching party not to close, as set forth in *Sections 6.1(a)* and *6.2(a)*. Without limiting the foregoing, APSG Parent and the Insurance Company acknowledge and agree that no Party to this Agreement and no party by or through any Party to this Agreement shall have the right to assert any Action whatsoever as a result of a breach of any of the representations and warranties contained in this Agreement, whether arising at law or equity. All of the representations and warranties will expire at the time of the Closing and have no further force or effect.

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ARTICLE 9.

MISCELLANEOUS

9.1 Schedules.

(a) The disclosures in the Schedules, and those in any supplement thereto, relate only to the representations and warranties in the Section or paragraph of the Agreement to which they expressly relate and not to any other representation or warranty in this Agreement.

(b) If there is any inconsistency between the statements in the body of this Agreement and those in the Schedules (other than an exception expressly set forth in the Schedules with respect to a specifically identified representation or warranty), the statements in the body of this Agreement will control.

(c) Nothing in the Schedules will be deemed adequate to disclose an exception to a representation or warranty made herein, unless the Schedules identify the exception with reasonable particularity and describes the relevant facts in reasonable detail.

(d) The mere listing (or inclusion of a copy) of a document or other item in a Schedule will not be deemed adequate to disclose an exception to a representation or warranty made in this Agreement (unless the representation or warranty pertains to the existence of the document or other item itself).

9.2 Entire Agreement.

This Agreement, together with the Exhibits and Schedules hereto and the certificates, documents, instruments and writings that are delivered pursuant hereto, constitutes the entire agreement and understanding of the Parties in respect of its subject matter and supersedes all prior understandings, agreements, or representations by or among the Parties, written or oral, to the extent they relate in any way to the subject matter hereof or the Transactions. There are no third party beneficiaries having rights under or with respect to this Agreement.

9.3 Successors.

All of the terms, agreements, covenants, representations, warranties, and conditions of this Agreement are binding upon, and inure to the benefit of and are enforceable by, the Parties and their respective successors. No person or entity not a signatory hereto shall have any rights or claim to any cause of action except as contemplated by this Agreement or the Transactions hereby.

9.4 Assignments.

No Party may assign either this Agreement or any of its rights, interests, or obligations hereunder without the prior written approval of APSG Parent and (i) before the Closing, the Insurance Company, and (ii) after the Closing, a majority in interest of the Shareholders; provided, however, that APSG Parent may (a) assign any or all of its rights and interests hereunder to one or more of its Affiliates and (b) designate one or more of its Affiliates to perform its obligations hereunder (in any or all of which cases APSG Parent nonetheless will remain responsible for the performance of all of its obligations hereunder).

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9.5 Notices.

All notices, requests, demands, claims and other communications hereunder will be in writing. Any notice, request, demand, claim or other communication hereunder will be deemed duly given if (and then three business days after) it is sent by registered or certified mail, return receipt requested, postage prepaid, and addressed to the intended recipient as set forth below:

If to APSG Parent and after Closing to the Insurance Company:

Attn: Mr. Kenneth Shifrin

1301 Capital of Texas Highway

Austin, TX 78746

Tel: (512) 328-0888

Fax: (512) 314-4398

Copy to (which will not constitute notice):

Akin, Gump, Strauss, Hauer & Feld, L.L.P.

Attn: Tim LaFrey

300 West Sixth Street, Suite 2100

Austin, TX 78703

Tel: (512) 499-6296

Fax: (512) 703-1111

If to the Subscribers and before Closing to the Insurance Company:

Attn: Sharon Stripling

21729 Forest Waters Circle

San Antonio, TX 78266

Tel: (210) 651-9358

Fax: (210) 651- 9374

Copy to (which will not constitute notice):

Graves, Dougherty, Hearon & Moody, P.C.

Attn: Clarke Heidrick

401 Congress Avenue, Suite 2200

Austin, TX 78701

Tel: (512) 480-5600

Fax: (512) 480-5836

Any Party may send any notice, request, demand, claim, or other communication hereunder to the intended recipient at the address set forth above using any other means (including personal delivery, expedited courier, messenger service, telecopy, telex, ordinary mail, or electronic mail), but no such notice, request, demand, claim, or other communication will be deemed to have been duly given unless and until it actually is received by the intended recipient. Any Party may change the address to which notices, requests, demands, claims, and other communications hereunder are to be delivered by giving the other Parties notice in the manner herein set forth.

9.6 Specific Performance.

Each Party acknowledges and agrees that the other Parties would be damaged irreparably if any provision of this Agreement is not performed in accordance with its specific terms or is otherwise Breached. Accordingly, each Party agrees that the other Parties will be entitled to an injunction or injunctions to prevent Beaches of the provisions of this Agreement and to enforce specifically this Agreement and its terms and provisions in any Action instituted in any court of the United States or any state thereof having jurisdiction over the Parties and the

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matter, subject to *Sections 9.7* and *9.11*, in addition to any other remedy to which they may be entitled, at Law or in equity.

9.7 Submission to Jurisdiction; No Jury Trial.

(a) **Submission to Jurisdiction.** Each Party submits to the jurisdiction of any state or federal court sitting in Austin, Texas, in any Action arising out of or relating to this Agreement and agrees that all claims in respect of the Action may be heard and determined in any such court. Each Party also agrees not to bring any Action arising out of or relating to this Agreement in any other court. Each Party agrees that a final judgment in any Action so brought will be conclusive and may be enforced by Action on the judgment or in any other manner provided at Law or in equity. Each Party waives any defense of inconvenient forum to the maintenance of any Action so brought and waives any bond, surety, or other security that might be required of any other Party with respect thereto.

(b) **Waiver of Jury Trial.** THE PARTIES EACH HEREBY AGREE TO WAIVE THEIR RESPECTIVE RIGHTS TO JURY TRIAL OF ANY DISPUTE BASED UPON OR ARISING OUT OF THIS AGREEMENT OR ANY OTHER AGREEMENTS RELATING HERETO OR ANY DEALINGS AMONG THEM RELATING TO THE TRANSACTIONS. The scope of this waiver is intended to be all encompassing of any and all Actions that may be filed in any court and that relate to the subject matter of the Transactions, including, Contract claims, tort claims, breach of duty claims, and all other common Law and statutory claims. The Parties each acknowledge that this waiver is a material inducement to enter into a business relationship and that they will continue to rely on the waiver in their related future dealings. Each Party further represents and warrants that it has reviewed this waiver with its legal counsel, and that each knowingly and voluntarily waives its jury trial rights following consultation with legal counsel. NOTWITHSTANDING ANYTHING TO THE CONTRARY HEREIN, THIS WAIVER IS IRREVOCABLE, MEANING THAT IT MAY NOT BE MODIFIED ORALLY OR IN WRITING, AND THE WAIVER WILL APPLY TO ANY AMENDMENTS, RENEWALS, SUPPLEMENTS OR MODIFICATIONS TO THIS AGREEMENT OR TO ANY OTHER DOCUMENTS OR AGREEMENTS RELATING HERETO. In the event of an Action, this Agreement may be filed as a written consent to trial by a court.

9.8 Time.

Time is of the essence in the performance of this Agreement.

9.9 Counterparts.

This Agreement may be executed in two or more counterparts, each of which will be deemed an original but all of which together will constitute one and the same instrument.

9.10 Headings.

The article and section headings contained in this Agreement are inserted for convenience only and will not affect in any way the meaning or interpretation of this Agreement.

9.11 Governing Law.

This Agreement and the performance of the Transactions and obligations of the Parties hereunder will be governed by and construed in accordance with the laws of the State of Texas, without giving effect to any choice of Law principles.

9.12 Amendments.

The Parties may amend this Agreement by action taken by or on behalf of the respective Boards of Directors of APSG Parent and the Insurance Company at any time prior to the Effective Time. Notwithstanding the

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foregoing, after the Subscribers approve and adopt this Agreement and the Transactions, no amendment to this Agreement may be made that would reduce the amount of or change the Merger Consideration or otherwise would require the Subscribers to approve such amendment under the Corporate Law, unless the Subscribers approve such amendment in accordance with the applicable Corporate Law. Amendments to this Agreement must be in writing that the Insurance Company and APSG Parties have signed.

9.13 Extensions; Waiver.

(a) At any time prior to the Effective Time, the APSG Parties, on the one hand, and the Insurance Company, on the other, to the extent legally allowed, may (i) extend the time for the performance of any of the obligations of the other Party, (ii) waive any inaccuracies in the representations and warranties made to such Party contained herein or in any document delivered pursuant hereto, and (iii) waive compliance with any of the agreements or conditions for the benefit of such Party contained herein. Any agreement on the part of a Party to any such extension or waiver will be valid only if set forth in an instrument in writing signed on behalf of such Party.

(b) No waiver by any Party of any default, misrepresentation, or breach of warranty or covenant hereunder, whether intentional or not, may be deemed to extend to any prior or subsequent default, misrepresentation, or Breach of warranty or covenant hereunder or affect in any way any rights arising because of any prior or subsequent such occurrence.

9.14 Severability.

The provisions of this Agreement will be deemed severable and the invalidity or unenforceability of any provision will not affect the validity or enforceability of the other provisions hereof; provided that if any provision of this Agreement, as applied to any Party or to any circumstance, is adjudged by a Governmental Body, arbitrator, or mediator not to be enforceable in accordance with its terms, the Parties agree that the Governmental Body, arbitrator, or mediator making such determination will have the power to modify the provision in a manner consistent with its objectives such that it is enforceable, and/or to delete specific words or phrases, and in its reduced form, such provision will then be enforceable and will be enforced.

9.15 Expenses.

Except as otherwise expressly provided in this Agreement, each Party will bear its own costs and expenses incurred in connection with the preparation, execution and performance of this Agreement and the Transactions including all fees and expenses of agents, representatives, financial advisors, legal counsel and accountants.

9.16 Construction.

The Parties have participated jointly in the negotiation and drafting of this Agreement. If an ambiguity or question of intent or interpretation arises, this Agreement will be construed as if drafted jointly by the Parties and no presumption or burden of proof will arise favoring or disfavoring any Party because of the authorship of any provision of this Agreement. Any reference to any federal, state, local, or foreign Law will be deemed also to refer to Law as amended and all rules and regulations promulgated thereunder, unless the context requires otherwise. The words include, includes, and including will be deemed to be followed by without limitation. Pronouns in masculine, feminine, and neuter genders will be construed to include any other gender, and words in the singular form will be construed to include the plural and vice versa, unless the context otherwise requires. The words this Agreement, herein, hereof, hereby, hereunder, and words of similar import refer to this Agreement as a whole and not to any particular subdivision unless expressly so limited. The Parties intend that each representation, warranty, and covenant contained herein will have independent significance. If any Party has breached any representation, warranty, or covenant contained herein in any respect, the fact that there exists another representation, warranty or covenant relating to the same subject matter (regardless of the

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relative levels of specificity) which the Party has not breached will not detract from or mitigate the fact that the Party is in breach of the first representation, warranty, or covenant.

9.17 Incorporation of Exhibits, Annexes, and Schedules.

The Exhibits, Annexes, Schedules, and other attachments identified in this Agreement are incorporated herein by reference and made a part hereof.

9.18 Remedies.

Except as expressly provided herein, the rights, obligations and remedies created by this Agreement are cumulative and in addition to any other rights, obligations or remedies otherwise available at Law or in equity. Except as expressly provided herein, nothing herein will be considered an election of remedies.

9.19 Electronic Signatures.

(a) Notwithstanding the Electronic Signatures in Global and National Commerce Act (15 U.S.C. Sec. 7001 *et.seq.*), the Uniform Electronic Transactions Act, or any other Law relating to or enabling the creation, execution, delivery, or recordation of any Contract or signature by electronic means, and notwithstanding any course of conduct engaged in by the Parties, no Party will be deemed to have executed a Transaction Document or other document contemplated thereby (including any amendment or other change thereto) unless and until such Party shall have executed such Transaction Document or other document on paper by a handwritten original signature or any other symbol executed or adopted by a Party with current intention to authenticate such Transaction Document or such other document contemplated.

(b) Delivery of a copy of a Transaction Document or such other document bearing an original signature by facsimile transmission (whether directly from one facsimile device to another by means of a dial-up connection or whether mediated by the worldwide web), by electronic mail in portable document format (.pdf) form, or by any other electronic means intended to preserve the original graphic and pictorial appearance of a document, will have the same effect as physical delivery of the paper document bearing the original signature. Originally signed or original signature means or refers to a signature that has not been mechanically or electronically reproduced.

[*signature page follows*]

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IN WITNESS WHEREOF, the Parties have executed this Agreement as of the date first above written.

American Physicians Service Group, Inc.

By: /s/ Kenneth S. Shifrin

Name: Kenneth S. Shifrin

Title: CEO and President

APSG ACQCO, INC.

By: /s/ Kenneth S. Shifrin

Name: Kenneth S. Shifrin

Title: CEO and President

American Physicians Insurance Exchange

By: /s/ Norris C. Knight, MD

Name: Norris C. Knight, MD

Title: Chairman

Signature Page to the Merger Agreement and Plan of Merger

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EXHIBIT A

PLAN OF CONVERSION

SEE ANNEX B TO THE JOINT PROXY STATEMENT/PROSPECTUS

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EXHIBIT B

FORM OF MERGER CERTIFICATE

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CERTIFICATE OF MERGER

OF

APSG ACQCO, INC., a Texas corporation

WITH AND INTO

[AMERICAN PHYSICIANS INSURANCE COMPANY], A TEXAS STOCK INSURANCE COMPANY

Pursuant to the provisions of Chapter 10 of the Texas Business Organizations Code and Chapter 824 of the Texas Insurance Code, APSG ACQCO, Inc. a Texas corporation (***APSG ACQCO***), and [American Physicians Insurance Company], a Texas stock insurance company (***APIC***), hereby execute and adopt the following Articles of Merger this day of , 2006 and certify that:

FIRST: The name and jurisdiction of incorporation of each of the constituent corporations of the merger are:

(a) APSG ACQCO, Inc., a Texas corporation; and

(b) [American Physicians Insurance Company], a Texas stock insurance company; and

SECOND: A plan of merger has been approved, adopted, certified, executed and acknowledged by each of the constituent corporations in accordance with the requirements of the laws of the State of Texas and by all action required under the laws of the State of Texas.

THIRD: The name of the surviving corporation is [American Physicians Insurance Company], a Texas stock insurance company.

FOURTH: The Certificate of Formation of APIC will be the Certificate of Formation of the surviving corporation, except that [all references to preferred stock] is to be amended and deleted in its entirety.

FIFTH: The executed plan of merger is on file at 1301 South Capital of Texas Highway, Suite C300, Austin, TX 78746, the address of the principal place of business of the surviving corporation.

SIXTH: A copy of the plan of merger will be furnished by the surviving corporation, on request and without cost, to any stockholder of the constituent corporations.

SEVENTH: The plan of merger has been approved by each of the undersigned corporation in the manner required by the laws of the State of Texas and by the respective Certificate of Formation and Bylaws of each corporation.

EIGHTH: The merger is to become effective on [, 2006]/[on the date that these Articles of Merger are issued by the Texas Department of Insurance.

NINTH: The surviving company will be responsible for the payment of all fees and franchise and/or premium taxes and will be obligated to pay such fees and franchise and/or premium taxes if they are not timely paid.

TENTH: The surviving company will be responsible and liable for all the liabilities and obligations, including the rights and obligations under the agreements of the merged corporation.

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IN WITNESS WHEREOF, the parties hereto have caused these Articles of Merger to be executed as of the day and year first written above.

[American Physicians Insurance Company]

By: _____

Name: _____

Title: _____

By: _____

Name: _____

Title: _____

APSG ACQCO, INC.

By: _____

Name: _____

Title: _____

By: _____

Name: _____

Title: _____

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EXHIBIT C

FORM OF THE INSURANCE COMPANY S CLOSING CERTIFICATE

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APIE CLOSING CERTIFICATE

We certify that we are the duly elected, qualified, and acting Secretary and Chairman, respectively, of American Physicians Insurance Exchange, a Texas reciprocal and inter-insurance exchange (***APIE***), and that, as such, we are familiar with the facts herein certified and are duly authorized to certify the same and do hereby certify, on behalf of APIE, subject to the fact that, as required pursuant to Chapter 942 of the Texas Insurance Code, substantially all of APIE s day-to-day operations have been, and at all time prior to the Conversion will be, managed by an attorney-in-fact, as follows:

1. Attached as *Exhibit A* is a true, correct, and complete copy of APIE s Bylaws, as amended, which are in full force and effect as of today.

2. Attached as *Exhibit B* is a true, correct, and complete copy of the resolutions of APIE s Board of Directors approving the Transactions. Such resolutions have not been rescinded or modified in any way, and are in full force and effect on the date hereof.

3. Attached as *Exhibit C* is a true, correct, and complete copy of the certificate of authority for APIE, issued by the Texas Department of Insurance.

4. Attached as *Exhibit D* is a true, correct, and complete copy of a certificate of good standing for APIE regarding APIE s tax account status, issued by the Texas Comptroller of Public Accounts.

5. We have carefully reviewed the Merger Agreement and Plan of Merger dated as of June , 2006, by and among American Physicians Services Group, Inc., a Texas corporation, and APSG ACQCO, INC., a Texas corporation and a wholly-owned subsidiary of APSG, and APIE (the ***Merger Agreement***), and the schedules and exhibits thereto.

6. To our knowledge, each representation and warranty set forth in *Article 4* and *Section 5.10* of the Merger Agreement was accurate and complete in all material respects (except with respect to any provisions including the word material or words of similar import, with respect to which such representations and warranties were accurate and complete) as of the date of the Merger Agreement, and is accurate and complete in all material respects (except with respect to any provisions including the word material or words of similar import, with respect to which such representations and warranties are accurate and complete) as of the date hereof, as if made on the date hereof.

7. To our knowledge, APIE has performed and complied with all of its covenants to be performed or complied with at or prior to Closing (singularly and in the aggregate) in all material respects.

8. To our knowledge, since the date of the Merger Agreement there has been no event, series of events, or the lack of occurrence thereof which, singularly or in the aggregate, could reasonably be expected to have a Material Adverse Effect on APIE. Without limiting the foregoing, (i) there has not been any Material Adverse Change to APIE, (ii) there has not been any action or inaction by a Governmental Body, arbitrator or mediator which could reasonably be expected to cause a Material Adverse Change to APIE, and (iii) there has not been any fire, flood, casualty, act of God or the public enemy or other cause (regardless of insurance coverage for damage resulting therefrom) which event could reasonably be expected to have a Material Adverse Effect on APIE.

9. To our knowledge, there is no pending or Threatened Action by or before any Governmental Body, arbitrator, or mediator which seeks to restrain, prohibit, invalidate, or collect Damages arising out of the Transactions.

10. The Secretary of APIE has examined the signatures of APSG s chairman signing the Merger Agreement, and the exhibits and other documents delivered in connection therewith, and such signatures are his true signature. As of the date hereof (and the date of such signatures), the chairman is (was) the duly elected, qualified and acting chairman of APIE, holding the office specified beside his name.

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11. This Certificate is being delivered on APIE s behalf pursuant to the Merger Agreement.

12. Undefined capitalized terms herein are defined in the Merger Agreement.

[signature page follows]

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IN WITNESS WHEREOF, I have executed this certificate on June , 2006.

By: _____

Printed Name: _____

Title: Secretary

By: _____

Printed Name: _____

Title: Chairman

Signature Page to the APIE Certificate

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EXHIBIT D

FORM OF THE APSG PARTIES OFFICERS CERTIFICATE

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APSG OFFICERS CERTIFICATE

We certify that we are the duly elected, qualified, and acting President and Chief Executive Officer and Secretary and Chief Financial Officer, respectively, of American Physicians Service Group, Inc., a Texas corporation (***APSG***), and that, as such, we are familiar with the facts herein certified and are duly authorized to certify the same and do hereby certify, on behalf of APSG and APSG ACQCO, INC., a Texas corporation and a wholly-owned subsidiary of APSG (***APSG Merger Sub***), as follows:

1. Each of us has carefully reviewed the Merger Agreement and Plan of Merger dated as of June , 2006, by and among APSG, APSG Merger Sub and American Physicians Insurance Exchange, a Texas reciprocal and inter-insurance exchange (the ***Merger Agreement***), and the schedules and exhibits thereto.

2. Each representation and warranty set forth in *Article 3* of the Merger Agreement was accurate and complete in all material respects (except with respect to any provisions including the word material or words of similar import, with respect to which such representations and warranties were accurate and complete) as of the date of the Merger Agreement, and is accurate and complete in all material respects (except with respect to any provisions including the word material or words of similar import, with respect to which such representations and warranties are accurate and complete) as of the date hereof, as if made on the date hereof.

3. APSG has performed and complied with all of its covenants to be performed or complied with at or prior to Closing (singularly and in the aggregate) in all material respects.

4. There is no Order issued and in effect restraining or prohibiting the Transactions.

5. This Certificate is being delivered on APSG s behalf pursuant to the Merger Agreement.

6. Undefined capitalized terms herein are defined in the Merger Agreement.

IN WITNESS WHEREOF, we have executed this certificate on , 2006.

By: _____

Printed Name: Kenneth S. Shifrin

Title: President and Chief Executive Officer

By: _____

Printed Name: William H. Hayes

Title: Secretary and Chief Financial Officer

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EXHIBIT E

FORM OF THE APSG PARTIES SECRETARY S CERTIFICATE

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APSG SECRETARY S CERTIFICATE

I certify that I am the duly elected, qualified, and acting Secretary of American Physicians Service Group, Inc., a Texas corporation (***APSG***), and that, as such, I am familiar with the facts herein certified and am duly authorized to certify the same and do hereby certify, on behalf of APSG and APSG ACQCO, INC., a Texas corporation and a wholly-owned subsidiary of APSG (***APSG Merger Sub***), as follows:

1. Attached as *Exhibit A* is a true, correct, and complete copy of APSG s Articles of Incorporation, certified by the Secretary of State of Texas, which are in full force and effect as of today.

2. Attached as *Exhibit B* is a true, correct, and complete copy of APSG s Bylaws, as amended, which are in full force and effect as of today.

3. Attached as *Exhibit C* is a true, correct, and complete copy of the resolutions of APSG s Board of Directors approving the Transactions. Such resolutions have not been rescinded or modified in any way, and are in full force and effect on the date hereof.

4. Attached as *Exhibit D* is a true, correct, and complete copy of a recent certificate of existence and good standing for APSG, issued by the Secretary of State of Texas.

5. I have examined the signatures of APSG s officers signing the Merger Agreement and Plan of Merger dated as of June , 2006, by and among APSG, APSG Merger Sub and American Physicians Insurance Exchange, a Texas reciprocal and inter-insurance exchange (the ***Merger Agreement***), and the exhibits and other documents delivered in connection therewith, and such signatures are their true signatures. As of the date hereof (and the date of such signatures), such officers are (were) duly elected, qualified and acting officers of APSG, holding the office specified beside their names.

6. This Certificate is being delivered on APSG s behalf pursuant to the Merger Agreement.

7. Undefined capitalized terms herein are defined in the Merger Agreement.

IN WITNESS WHEREOF, I have executed this certificate on , 2006.

By: _____

Printed Name: William H. Hayes
Title: Secretary and Chief Financial Officer

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EXHIBIT F

[REPLACED BY EXHIBIT F TO

THE AMENDMENT TO MERGER AGREEMENT AND PLAN OF MERGER]

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EXHIBIT G

[REPLACED BY EXHIBIT G TO

THE AMENDMENT TO MERGER AGREEMENT AND PLAN OF MERGER]

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EXHIBIT H

TDI REFUNDABLE DEPOSIT ORDER

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Texas Department of Insurance

General Counsel and Chief Clerk, Mail Code 113-2A

333 Guadalupe P. O. Box 149104, Austin, Texas 78714-9104

STATE OF TEXAS §
§
COUNTY OF TRAVIS §

The Commissioner of Insurance, as the chief administrative and executive officer and custodian of records of the Texas Department of Insurance has delegated to the undersigned the authority to certify the authenticity of documents filed with or maintained by or within the custodial authority of the Office of the General Counsel and Chief Clerk of the Texas Department of Insurance.

Therefore, I hereby certify that the attached document is a true and correct copy of the document described below. I further certify that the document described below is filed with or maintained by or within the custodial authority of the Office of the General Counsel and Chief Clerk of the Texas Department of Insurance.

The certified document consists of complete copy of:

Official Order No. 05-0874 of the Commissioner of Insurance of the State of Texas, dated October 11, 2005 consisting of nine (9) pages;

Subject considered:

Application for Authorization to Return Subscriber Deposits

AMERICAN PHYSICIANS INSURANCE EXCHANGE

Austin, Texas

AMENDED ORDER

APPROVING PLAN TO DISTRIBUTE SUBSCRIBER DEPOSITS

This certification does not include records relevant to an inquiry, if any, by the Texas Department of Insurance s Insurance Fraud Unit which are confidential pursuant to Tex. Ins. Code art. §701.151, §5(a) and an Op. Tex. Att y Gen. No. OR95-1536 (1995).

IN TESTIMONY WHEREOF, witness my hand and seal of office at Austin, Texas, this

12th day of October A.D. 2005

MIKE GEESLIN

COMMISSIONER OF INSURANCE

By /s/ Judy Woolley
Judy Woolley
Deputy Chief Clerk
Texas Department of Insurance

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OFFICIAL ORDER

OF THE

COMMISSIONER OF INSURANCE

of the

STATE OF TEXAS

AUSTIN, TEXAS

Date: OCT 11 2005

Subject Considered:

Application for Authorization to Return Subscriber Deposits.

AMERICAN PHYSICIANS INSURANCE EXCHANGE Austin, Texas

AMENDED ORDER APPROVING PLAN TO DISTRIBUTE SUBSCRIBER DEPOSITS

General remarks and official action taken:

On this day, the Commissioner of Insurance considered the application of AMERICAN PHYSICIANS INSURANCE EXCHANGE, Austin, Texas, (AMERICAN PHYSICIANS), for approval to make a partial distribution of subscriber deposits in an amount not to exceed $250,000 and for approval of its plan to make annual pro rata partial distributions of subscriber deposits.

Jurisdiction

The Commissioner of Insurance has jurisdiction over this matter, pursuant to TEX. INS. CODE ANN. § 942.155 (formerly art. 19.06), which provides that an exchange shall maintain at all times an unencumbered surplus over and above all liabilities that is at least equal to the minimum capital stock and surplus required of a stock insurance company engaged in the same kinds of business and that such exchange shall maintain at all times the reserves required by the laws of this state or by rules adopted by the Commissioner of Insurance (including 28 TEX. ADMIN. CODE § 7.410, Minimum Risk-Based Capital and Surplus Requirements for Property/Casualty Insurers), as well as TEX. INS. CODE ANN. arts. 1.32 and 21.28-A. The Commissioner has authority to dispose of these matters as set forth in TEX. INS. CODE ANN. § 36.104, TEX. Gov t CODE ANN. § 2001.56, and 28 TEX. ADMIN. CODE § 1.47.

Waiver

AMERICAN PHYSICIANS acknowledges the existence of certain procedural rights related to the issuance of this Consent Order, including issuance and service of notice of hearing, a public hearing, a proposal for decision, rehearing by the Commissioner of Insurance, review by the Texas Department of Insurance, and judicial review, as provided for in TEX. INS. CODE ANN. Ch. 36, and TEX. Gov t CODE ANN. Ch. 2001. And, by the signature of its authorized representative on this Order, AMERICAN PHYSICIANS expressly acknowledges the Commissioner s jurisdiction in this matter and waives each and every one of these procedural rights. AMERICAN PHYSICIANS elects to informally settle this matter under TEX. INS. CODE ANN. § 36.104, TEX. Gov t CODE ANN. § 2001.056, and 28 TEX. ADMIN. CODE § 1.47, stipulates to the Findings of Fact and Conclusions of Law contained in this Order, and agrees to the entry of this Order.

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Findings of Fact

Based on information provided by AMERICAN PHYSICIANS, and with AMERICAN PHYSICIANS agreement, the Commissioner makes the following Findings of Fact:

1. AMERICAN PHYSICIANS is a reciprocal exchange holding a license under TEX. INS. CODE ANN. Ch. 942, authorizing the Company to engage in the business of insurance in the State of Texas;

2. AMERICAN PHYSICIANS is not currently in hazardous financial condition, as contemplated by TEX. INS. CODE ANN. § 1.32 or § 21.28-A;

3. AMERICAN PHYSICIANS requires each subscriber to sign a subscriber s agreement before being eligible to purchase insurance;

4. between 1976 and 1993, the subscriber deposit agreement required each subscriber to make a refundable deposit to AMERICAN PHYSICIANS; AMERICAN PHYSICIANS provided a subscriber s certificate that detailed each subscriber s right to a refund and set out the following conditions;

    a. the subscriber cannot be an active policyholder;

    b. there must be a minimum period of 24 months from the date of deposit;

    c. AMERICAN PHYSICIANS must have minimum surplus as approved by its board of director and in excess of amounts specified in agreements reached with respective departments of insurance in which AMERICAN PHYSICIANS is licensed; and

    d. the refundable interest shall be calculated at annualized simple rates with interest compounded annually;

5. between 1993 and 2003, the subscriber deposit agreement required a non-refundable deposit; the current subscriber agreement does not require a deposit;

6. as of September 30, 2003, AMERICAN PHYSICIANS reported $11,468,727 in refundable subscriber deposits;

7. if AMERICAN PHYSICIANS were required to refund subscriber deposits immediately and in full, it would no longer comply with the financial requirements set out in the Texas Insurance Code and Title 28 of the Texas Administrative Code;

8. in 1989, AMERICAN PHYSICIANS developed and presented a plan for partial refunds eligible subscriber deposits, establishing minimum surplus requirements before refunds could be made. The Commissioner signed off on the plan indicating his approval. In 1990, the Commissioner extended approval of the plan for partial refunds and provided that AMERICAN PHYSICIANS could make no refund that would reduce surplus below $5,000,000. AMERICAN PHYSICIANS sought and received the Commissioner s approval to make partial pro rata distributions to eligible subscribers in 1989, 1990, 1995, and 1999, and made these distributions in

accordance with the Commissioner s approval; AMERICAN PHYSICIANS sought but did not receive the Commissioner s approval in 1992, and, therefore, did not make a distribution in 1992;

9. In 2004, AMERICAN PHYSICIANS submitted a request to make an additional partial pro rata distribution not to exceed a total of $250,000 in 2004 and also submitted an up-dated plan seeking approval to make partial pro rata distributions each year after 2004, which the Commissioner approved;

10. The Commissioner entered Official Order No. 04-0856, Consent Order Approving Partial Pro Rata Distribution and Approving Plan to Distribute Subscriber Deposits; and

11. AMERICAN PHYSICIANS has submitted an application to issue or reissue previously approved refunds or partial refunds that were inadvertently omitted or sent to the wrong address and an up-dated plan seeking approval to expand its authority to make partial pro rata distributions each year; the up-dated plan is attached to this Order as Exhibit A and incorporated herein by reference as if fully set out.

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Conclusions of Law

Based upon the foregoing Findings of Fact, the Commissioner makes the following Conclusions of Law:

1. the Commissioner has jurisdiction over this matter under TEX. INS. CODE ANN. §§ 942.155, 942.156, 822.203, 822.210, and 36.104, TEX. ADMIN. CODE § 7.410, and TEX. Gov t CODE ANN. § 2001.056; and

2. the Commissioner has authority to informally dispose of this matter under TEX. INS. CODE ANN. § 36.104, TEX. GOV T CODE ANN. § 2001.056, and 28 TEX. ADMIN. CODE § 1.47.

Based upon the Findings of Fact and Conclusions of Law, the Department recommends approval of AMERICAN PHYSICIANS application to make annual partial pro rata distributions not to exceed $200,000 without further approval of the Commissioner, provided AMERICAN PHYSICIANS meets the conditions set out in the attached Exhibit A.

The Commissioner, THEREFORE, ORDERS that AMERICAN PHYSICIANS application to issue or reissue previously approved refunds or partial refunds that were inadvertently omitted or sent to the wrong address be, and is, approved.

The Commissioner FURTHER ORDERS that AMERICAN PHYSICIANS application for approval of its up-dated plan to make annual partial pro rata distributions, as described in the attached Exhibit A be, and is, approved.

The Commissioner FURTHER ORDERS that AMERICAN PHYSICIANS apply for and obtain the Commissioner s approval before making any distribution of subscriber deposits that does not comply with the terms of this Order.

The approval is effective on and after the date of this Order.

MIKE GEESLIN

COMMISSIONER OF INSURANCE

By: /s/ Betty Patterson
Betty Patterson, CPA, CFE

Senior Associate Commissioner

The Financial Program

Commissioner s Order No. 01-0665

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Recommended by:

/s/ Edward P. Roush
Edward P. Roush, Analyst

Financial Analysis and Examinations

Reviewed by:

/s/ Angel Garrett
Angel Garrett, Supervising Analyst

Financial Analysis and Examinations

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Agreed and consented to by American Physicians Insurance Exchange on October 6 2005:

By: /s/ Maury L. Magids
Maury L. Magids

President,

APMC Insurance Services, Inc.

Attorney-In-Fact for

American Physicians Insurance Exchange

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APIE PLAN FOR PARTIAL AND FULL REFUND OF SUBSCRIBER DEPOSITS

A. ***Partial Refund Program:***

1. All former subscribers with refundable deposits will participate in the partial refund program on a consistent and prorata basis.

2. All partial refunds of subscriber deposits from the exchange shall be subject to the Commissioner s prior written approval and the approval of the APIE Board of Directors.

3. APIE can make partial refunds in the aggregate amount of $200,000 in each year without prior approval of the Commissioner if the following criteria are met:

   a. The refund is approved by the APIE Board of Directors.

   b. APIE would be in compliance with all applicable law, before and after the refund is issued, including risk-based capital requirements.

   c. The refund is made only from earned surplus of APIE.

   d. The amount to be distributed must not cause a significant reduction in APIE s total adjusted capital for risk-based capital purposes.

   e. All former subscribers with a refundable deposit would have the right to participate in the refund.

4. APIE will distribute a minimum of $50.00 to each subscriber. APIE will also calculate an additional pro rata amount to add to each subscriber s distribution. This additional amount will be based on the difference between $200,000 and the total of all minimum $50.00 distributions to former subscribers eligible to receive a partial refund.

5. APIE may seek the Commissioner s approval to make total distributions in excess of $200,000, if the conditions set out in paragraph A(3) above are met:

6. If the death of a former subscriber occurs after termination of the policy, APIE will offer the estate a one-time settlement of the deposit account of 50% of the remaining refundable deposit or allow the estate to participate in partial refunds until the full deposit has been paid through partial refunds.

B. ***Full Refund Program:***

1. APIE will make a full refund of refundable deposits on-hand only to an individual who is a current subscriber/insured at the time coverage is terminated and only when the first four criteria listed under paragraph A(3) above are met. To qualify for a full refund, the reason for termination must be based on one of the following conditions:

   a. The subscriber/insured is retiring completely from the practice of medicine at the time of termination; or

   b. The reason for termination of the insured s policy is the death of the subscriber/insured; or,

   c. The reason for termination of the insured s policy is the total disability of the subscriber/insured.

2. For all subscriber/insureds who have refundable deposits on-hand with APIE at the time of termination but do not meet one of the criteria above, then the partial refund program will apply.

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STATE OF TEXAS §
§
COUNTY OF TRAVIS §

Maury L. Magids personally appear before me, the undersigned notary public, and stated the following after being sworn:

1. My name is Maury L. Magids. I am of sound mind, am capable of making this statement, and am personally acquainted with the facts stated herein.

2. I am the President of American Physicians Insurance Exchange, which is licensed in the State of Texas. As an officer and Attorney-In-Fact, I am authorized to make this statement, and I agree to and execute this Consent Order on behalf of American Physicians Insurance Exchange.

3. American Physicians Insurance Exchange agrees with and consents to the issuance and service of the foregoing Consent Order by the Texas Commissioner of Insurance.

/s/ Maury L. Magids

Maury L. Magids

SWORN TO AND SUBSCRIBED before me, the undersigned authority, by Maury L. Magids, the President of American Physicians Insurance Exchange on this 6th day of October 2005.

/s/ Georgia Lynn Porcher

Signature of Notary Public

Georgia Lynn Porcher

Printed Name of Notary Public

Notary Public in and for the State of Texas

My Commission Expires:8-26-2006

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Texas Department of Insurance

General Counsel and Chief Clerk, Mail CODE 113-2A

333 Guadalupe P.O. Box 149104, Austin, Texas 78714-9104

STATE OF TEXAS §
§
COUNTY OF TRAVIS §

The Commissioner of Insurance, as the chief administrative and executive officer and custodian of records of the Texas Department of Insurance has delegated to the undersigned the authority to certify the authenticity of documents filed with or maintained by or within the custodial authority of the Office of the Chief Clerk of the Texas Department of Insurance, excluding records relevant to an inquiry, if any, by the Texas Department of Insurance s Insurance Fraud Unit.

Therefore, I hereby certify that the attached document is a true and correct copy of the document described below. I further certify that the document described below is filed with or maintained by or within the custodial authority of the Office of the Chief Clerk of the Texas Department of Insurance.

The certified document consists of complete copy of:

Official Order No. 04-0856 of the Commissioner of Insurance

of the State of Texas, September 3, 2004

consisting of five (5) pages;

Subject considered:

Application for Authorization to Return Subscriber Deposits

AMERICAN PHYSICIANS INSURANCE EXCHANGE

Austin, Texas

CONSENT ORDER APPROVING PARTIAL PRO RATA DISTRIBUTION AND

APPROVING PLAN TO DISTRIBUTE SUBSCRIBER DEPOSITS

This certification does not include records relevant to an inquiry, if any, by the Texas Department of Insurance s Insurance Fraud Unit, which are confidential pursuant to TEX. Ins. CODE art. 1.10D, §5(a) and an Op. TEX. Att y Gen. No. OR95-1536 (1995).

IN TESTIMONY WHEREOF, witness my hand and seal of office at Austin, Texas, this

29th day of October A.D. 2004

JOSE MONTEMAYOR

COMMISSIONER OF INSURANCE

By **/s/ Judy Woolley**
Judy Woolley

Deputy Chief Clerk

Texas Department of Insurance

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OFFICIAL ORDER

of the

COMMISSIONER OF INSURANCE

of the

STATE OF TEXAS

AUSTIN, TEXAS

Date: SEP 03 2004

Subject Considered:

Application for Authorization to Return Subscriber Deposits

AMERICAN PHYSICIANS INSURANCE EXCHANGE

Austin, Texas

CONSENT ORDER APPROVING PARTIAL PRO RATA DISTRIBUTION AND

APPROVING PLAN TO DISTRIBUTE SUBSCRIBER DEPOSITS.

General remarks and official action taken:

On this day, the Commissioner of Insurance considered the application of AMERICAN PHYSICIANS INSURANCE EXCHANGE, Austin, Texas, (American Physicians), for approval to make a partial distribution of subscriber deposits in an amount not to exceed $250,000 and for approval of its plan to make annual pro rata partial distributions of subscriber deposits.

Jurisdiction

The Commissioner of Insurance has jurisdiction over this matter, pursuant to TEX. INS. CODE ANN. § 942.155 (formerly art. 19.06), which provides that an exchange shall maintain at all times an unencumbered surplus over and above all liabilities that is at least equal to the minimum capital stock and surplus required of a stock insurance company engaged in the same kinds of business and that such exchange shall maintain at all times the reserves required by the laws of this state or by rules adopted by the Commissioner of Insurance (including 28 Tex. Admin. Code § 7.410, Minimum Risk-Based Capital and Surplus Requirements for Property/Casualty Insurers), as well as Tex. Ins. Code Ann. arts. 1.32 and 21.28-A. The Commissioner has authority to dispose of these matters as set forth in Tex. Ins. Code Ann. § 36.104, Tex. Gov t Code Ann. § 2001.56, and 28 Tex. Admin. Code § 1.47.

Waiver

American Physicians acknowledges the existence of certain procedural rights related to the issuance of this Consent Order, including issuance and service of notice of hearing, a public hearing, a proposal for decision, rehearing by the Commissioner of Insurance, review by the Texas Department of Insurance, and judicial review, as provided for in Tex. Ins. Code Ann. Ch. 36, and Tex. Gov t Code Ann. Ch. 2001. And, by the signature of its authorized representative on this Order, American Physicians expressly acknowledges the Commissioner s jurisdiction in this matter and waives each and every one of these procedural rights. American Physicians elects to informally settle this matter under Tex. Ins. Code Ann. § 36.104, Tex. Gov t Code Ann. § 2001.056, and 28 Tex. Admin. Code § 1.47, stipulates to the Findings of Fact and Conclusions of Law contained in this Order, and agrees to the entry of this Order.

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Findings of Fact

Based on information provided by AMERICAN PHYSICIANS, and with AMERICAN PHYSICIANS agreement, the Commissioner makes the following Findings of Fact:

1. AMERICAN PHYSICIANS is a reciprocal exchange holding a license under TEX. INS. CODE ANN. Ch. 942, authorizing the Company to engage in the business of insurance in the State of Texas;

2. AMERICAN PHYSICIANS is not currently in hazardous financial condition, as contemplated by TEX. INS. CODE ANN. § 1.32 or § 21.28-A;

3. AMERICAN PHYSICIANS requires each subscriber to sign a subscriber s agreement before being eligible to purchase insurance;

4. between 1976 and 1993, the subscriber deposit agreement required each subscriber to make a refundable deposit to AMERICAN PHYSICIANS; AMERICAN PHYSICIANS provided a subscriber s certificate that detailed each subscriber s right to a refund and set out the following conditions:

   a. the subscriber cannot be an active policyholder;

   b. there must be a minimum period of 24 months from the date of deposit;

   c. AMERICAN PHYSICIANS must have minimum surplus as approved by its board of directors and in excess of amounts specified in agreements reached with respective departments of insurance in which AMERICAN PHYSICIANS is licensed; and

   d. the refundable interest shall be calculated at annualized simple rates with interest compounded annually;

5. between 1993 and 2003, the subscriber deposit agreement required a non-refundable deposit; the current subscriber agreement does not require a deposit;

6. as of September 30, 2003, AMERICAN PHYSICIANS reported $11,468,727 in refundable subscriber deposits;

7. if AMERICAN PHYSICIANS were required to refund subscriber deposits immediately and in full, it would no longer comply with the financial requirements set out in the Texas Insurance Code and Title 28 of the Texas Administrative Code;

8. in 1989, AMERICAN PHYSICIANS developed and presented a plan for partial refunds eligible subscriber deposits, establishing minimum surplus requirements before refunds could be made. The Commissioner signed off on the plan indicating his approval. In 1990, the Commissioner extended approval of the plan for partial refunds and provided that AMERICAN PHYSICIANS could make no refund that would reduce surplus below $5,000,000. AMERICAN PHYSICIANS sought and received the Commissioner s approval to make partial pro rata distributions to eligible subscribers in 1989, 1990, 1995, and 1999, and made these distributions in accordance with the Commissioner s approval; AMERICAN PHYSICIANS sought but did not receive the Commissioner s approval in 1992, and, therefore, did not make a distribution in 1992;

9. AMERICAN PHYSICIANS has submitted a request to make an additional partial pro rata distribution not to exceed a total of $250,000 in 2004;

10. AMERICAN PHYSICIANS would still be in compliance with TEX. INS. CODE ANN. 942.155 after making the proposed partial pro rata distribution not to exceed $250,000 in 2004; and

11. AMERICAN PHYSICIANS has also submitted an up-dated plan seeking approval to make partial pro rata distributions each year after 2004; the up-dated plan is attached to this Order as Exhibit A and incorporated herein by reference as if fully set out.

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Conclusions of Law

Based upon the foregoing Findings of Fact, the Commissioner makes the following Conclusions of Law:

1. the Commissioner has jurisdiction over this matter under TEX. INS. CODE ANN. §§ 942.155, 942.156, 822.203, 822.210, and 36.104, TEX. ADMIN. CODE § 7.410, and TEX. GOV T CODE ANN. § 2001.056; and

2. the Commissioner has authority to informally dispose of this matter under TEX. INS. CODE ANN. § 36.104, TEX. GOV T CODE ANN. § 2001.056, and 28 TEX. ADMIN. CODE § 1.47.

Based upon the Findings of Fact and Conclusions of Law, the Department recommends approval of AMERICAN PHYSICIANS application to make a partial pro rata distribution not to exceed $250,000 in 2004 as well as AMERICAN PHYSICIANS application to make annual partial pro rata distributions not to exceed $200,000 without further approval of the Commissioner, provided AMERICAN PHYSICIANS meets the conditions set out in the attached Exhibit A.

The Commissioner, THEREFORE, ORDERS that AMERICAN PHYSICIAN S application for approval to make a partial distribution of subscriber deposits not to exceed $250,000 in 2004 be, and is, approved.

The Commissioner FURTHER ORDERS that AMERICAN PHYSICIANS application for approval of its up-dated plan to make annual partial pro rata distributions, as described in the attached Exhibit A be, and is, approved.

The Commissioner FURTHER ORDERS that AMERICAN PHYSICIANS apply for and obtain the Commissioner S approval before making any distribution of subscriber deposits that does not comply with the terms of this Order.

The approval is effective on and after the date of this Order.

JOSE MONTEMAYOR

COMMISSIONER OF INSURANCE

By: /s/ BETTY PATTERSON
BETTY PATTERSON
SENIOR ASSOCIATE COMMISSIONER
FINANCIAL PROGRAM
COMMISSIONER S ORDER NO. 01-0665

RECOMMENDED BY:

/s/ EDWARD P. ROUSH

EDWARD P. ROUSH, ANALYST
FINANCIAL ANALYSIS AND EXAMINATIONS

REVIEWED BY:

/s/ ANGEL GARRETT

ANGEL GARRETT, SUPERVISING ANALYST
FINANCIAL ANALYSIS AND EXAMINATIONS

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APIE PLAN FOR PARTIAL AND FULL

REFUND OF SUBSCRIBER DEPOSITS

A. ***Partial Refund Program:***

1. All former subscribers with refundable deposits will participate in the partial refund program on a consistent and prorata basis.

2. All partial refunds of subscriber deposits from the exchange shall be subject to the Commissioner s prior written approval and the approval of the APIE Board of Directors.

3. APIE can make partial refunds in the aggregate amount of $200,000 in each year without prior approval of the Commissioner if the following criteria are met:

   a. The refund is approved by the APIE Board of Directors.

   b. APIE would be in compliance with all applicable law, before and after the refund is issued, including risk-based capital requirements.

   c. The refund is made only from earned surplus of APIE.

   d. The amount to be distributed must not cause a significant reduction in APIE s total adjusted capital for risk-based capital purposes.

   e. All former subscribers with a refundable deposit would have the right to participate in the refund.

4. APIE will distribute a minimum of $50.00 to each subscriber. APIE will also calculate an additional pro rata amount to add to each subscriber s distribution. This additional amount will be based on the difference between $200,000 and the total of all minimum $50.00 distributions to former subscribers eligible to receive a partial refund.

5. APIE may seek the Commissioner s approval to make total distributions in excess of $200,000, if the conditions set out in paragraph A(3) above are met.

6. If the death of a former subscriber occurs after approval of this Plan, APIE will offer the estate a one-time settlement of the deposit account of 50% of the remaining refundable deposit or allow the estate to participate in partial refunds until the full deposit has been paid through partial refunds.

B. ***Full Refund Program:***

1. APIE will make a full refund of refundable deposits on-hand only to an individual who is a current subscriber/insured at the time coverage is terminated and only when the first four criteria listed under paragraph A(3) above are met. To qualify for a full refund, the reason for termination must be based on one of the following conditions:

   a. The subscriber/insured is retiring completely from the practice of medicine at the time of termination; or

   b. The reason for termination of the insured s policy is the death of the subscriber/insured; or

   c. The reason for termination of the insured s policy is the total disability of the subscriber/insured.

2. For all subscriber/insureds who have refundable deposits on-hand with APIE at the time of termination but do not meet one of the criteria above, then the partial refund program will apply.

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EXHIBIT I

ADVISORY SERVICES AGREEMENT

SEE ANNEX E TO THE JOINT PROXY STATEMENT/PROSPECTUS

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AMENDMENT TO MERGER AGREEMENT

AND

PLAN OF MERGER

This Amendment to Merger Agreement and Plan of Merger (this ***Amendment***) amends that certain Merger Agreement and Plan of Merger (the ***Merger Agreement***) by and among American Physicians Service Group, Inc., APSG ACQCO, Inc. and American Physicians Insurance Exchange dated June 1, 2006.

R E C I T A L S:

Each parties Board of Directors believes it is in its and its prospective owners best interests to amend the Merger Agreement as set forth in this Amendment.

A G R E E M E N T:

NOW, THEREFORE, in consideration of the premises and the mutual promises herein made each APSG Party and the Insurance Company agree as follows:

1. *Definitions*.

A. Unless otherwise specifically defined in this Amendment, capitalized terms shall have the definitions set forth in the Merger Agreement.

B. The definition of ***Expiration Date*** in *Article I* of the Merger Agreement is hereby amended to mean March 31, 2007.

2. *Charter and Bylaws*. The Certificate of Formation of the Insurance Company attached to the Merger Agreement as *Exhibit F* is hereby deleted and replaced in its entirety with the Certificate of Formation attached as *Exhibit F* to this Amendment. Furthermore, the Amended and Restated Bylaws of the Insurance Company attached to the Merger Agreement as *Exhibit G* are hereby deleted and replaced in their entirety with the Amended and Restated Bylaws attached as *Exhibit G* to this Amendment. Except for the substitution of these exhibits, *Section 2.6* of the Merger Agreement shall remain in full force and effect in accordance with its terms.

3. *Effect on Capital Stock*. *Section 2.8* of the Merger Agreement is hereby deleted in its entirety and replaced with the following:

2.8 **Effect on Capital Stock.**

At the Effective Time, because of the Merger and without any action on the part of APSG Parent, APSG Merger Sub or the Insurance Company:

(a) **Conversion of Insurance Company Preferred Stock**. Each share of Insurance Company Preferred Stock issued pursuant to the Conversion and outstanding immediately prior to the Effective Time will be converted into, and exchanged for, a like number of shares of APSG Parent Preferred Shares. The APSG Parent Preferred Shares will have the same redemption and dividend provisions as the Insurance Company Preferred Stock. There will not be any certificates issued to represent the outstanding Insurance Company Preferred Stock in the Conversion, and the holders of Insurance Company Preferred Stock, at the Effective Time of the Merger, will cease to have any rights with respect to the Insurance Company Preferred Stock except the right to receive APSG Parent Preferred Shares. Immediately following the Effective Time, APSG will be the holder of all of the issued and outstanding Insurance Company Preferred Stock.

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(b) **Conversion of Insurance Company Common Stock**. Subject to *Sections 2.10* and *2.12*, each share of Insurance Company Common Stock issued pursuant to the Conversion and outstanding immediately prior to the Effective Time will be converted into, and exchanged for, the number of APSG Parent Common Shares equal to the Exchange Ratio. There will not be any certificates issued to represent the outstanding Insurance Company Common Stock in the Conversion, and the holders of Insurance Company Common Stock, at the Effective Time of the Merger, will cease to have any rights with respect to the Insurance Company Common Stock except the right to receive: (i) the APSG Parent Common Shares as determined herein and (ii) cash in lieu of fractional APSG Parent Common Shares under *Section 2.10*, in each case without interest (together with the APSG Parent Preferred Shares, collectively, the ***Merger Consideration***). Immediately following the Effective Time, APSG will be the holder of all of the issued and outstanding Insurance Company Common Stock.

(c) **Rights Associated with Insurance Company Common Stock and Insurance Company Preferred Stock**. Since there will not be any certificates issued to represent the outstanding Insurance Company Common Stock or Insurance Company Preferred Stock, the holders of Insurance Company Common Stock and Insurance Company Preferred Stock will have only the right to receive their respective Merger Consideration.

(d) **Certain Additional Definitions**. For this Agreement the following terms will have the indicated meanings:

Announcement Exchange Ratio means (a) the quotient of (i) the Purchase Price divided by (ii) the Announcement Market Price; divided by (b) the Insurance Company Common Equity. For instance, and purely by way of example, if the Present Value of the Redemption Obligation is $9 million (making the Purchase Price $30 million), the Announcement Market Price is $14.28 per share, and the Insurance Company Common Equity resulting from the Conversion is 10 million shares, then the Announcement Exchange Ratio would be 0.210 APSG Parent Common Shares for every share of Insurance Company Common Stock issued in the Conversion, as follows:

$$\left(\frac{\$30,000,000}{\$14.28} \right) \div 10,000,000 = 0.210$$

Announcement Market Price means the average closing market prices of APSG Parent Common Shares on the National Association of Securities Dealers Automated Quotation System, as reported in The Wall Street Journal, for the twenty (20) consecutive trading days immediately prior to the close of the full business day immediately prior to the date this Agreement is fully executed by all of the Parties and announced to the public by appropriate SEC filings and the issuance of the mutually agreed upon press release, which price is $14.28 per share.

Closing Exchange Ratio means the Announcement Exchange Ratio; provided, however, that in the event the Closing Market Price is more than 115% of the Announcement Market Price or is less than 85% of the Announcement Market Price, the Closing Exchange Ratio shall equal:

(i) if the Closing Market Price is more than 115% of the Announcement Market Price, the Closing Exchange Ratio shall equal (A) the quotient of (i) the Purchase Price multiplied by 115% divided by (ii) the Closing Market Price; divided by (B) the Insurance Company Common Equity. For instance, and purely by way of example, if the Present Value of the Redemption Obligation is $9 million (making the Purchase Price $30 million), the Announcement Market Price is $14.28 per share, the Closing Market Price is $17.14 per share and the Insurance Company Common Equity resulting from the Conversion is 10 million shares, then the Closing Exchange Ratio would be 0.201 APSG Parent Common Shares for every share of Insurance Company Common Stock issued in the Conversion, as follows:

$$\left(\frac{\$30,000,000 \times 115\%}{\$17.14} \right) \div 10,000,000 = 0.201$$

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(ii) if the Closing Market Price is less than 85% of the Announcement Market Price, the Closing Exchange Ratio shall equal (A) the quotient of (i) the Purchase Price multiplied by 85% divided by (ii) the Closing Market Price; divided by (B) the Insurance Company Common Equity. For instance, and purely by way of example, if the Present Value of the Redemption Obligation is $9 million (making the Purchase Price $30 million), the Announcement Market Price is $14.28 per share, the Closing Market Price is $11.42 per share and the Insurance Company Common Equity resulting from the Conversion is 10 million shares, then the Closing Exchange Ratio would be 0.223 APSG Parent Common Shares for every share of Insurance Company Common Stock issued in the Conversion, as follows:

$$\left(\frac{\$30{,}000{,}000 \times 85\%}{\$11.42} \right) \div 10{,}000{,}000 = 0.223$$

Closing Market Price means the average closing market prices of APSG Parent Common Shares on the National Association of Securities Dealers Automated Quotation System, as reported in The Wall Street Journal, for the twenty (20) consecutive trading days immediately prior to the close of the full business day immediately prior to the Closing Date.

Insurance Company Common Equity means the aggregate number of shares of Insurance Company Common Stock that the Subscribers and certain policyholders of the Insurance Company become entitled to receive in the Conversion.

Present Value of the Redemption Obligation means the net present value of the stream of payments authorized by TDI (as of the Closing) that must be made by the Insurance Company to comply with the mandatory redemption features of the Insurance Company Preferred Stock issued in the Conversion in full satisfaction of the Refundable Deposit determined on the basis of a constant discount rate of 5.35%.

Purchase Price means $39 million, less the Present Value of the Redemption Obligation.

4. *Due Authorization*. Each of the Parties represents and warrants to the other Parties that it has the relevant entity power and authority to execute and deliver this Amendment and has taken all necessary action to authorize the execution and delivery of this Amendment.

5. *Merger Agreement*. Except as specifically amended hereby, the Merger Agreement shall remain binding and enforceable in accordance with its terms.

[signature page follows]

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IN WITNESS WHEREOF, the Parties have executed this Amendment as of the 25th day of August, 2006.

American Physicians Service Group, Inc.

By: /s/ Kenneth S. Shifrin
Name: Kenneth S. Shifrin

Title: CEO and President

APSG ACQCO, INC.

By: /s/ Kenneth S. Shifrin
Name: Kenneth S. Shifrin

Title: CEO and President

American Physicians Insurance Exchange

By: /s/ Norris C. Knight MD
Name: Norris C. Knight MD

Title: Chairman of the Board

Signature Page to the Amendment to Merger Agreement and Plan of Merger

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EXHIBIT F

CERTIFICATE OF FORMATION OF APIC

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EXHIBIT F

ARTICLES OF INCORPORATION

OF

AMERICAN PHYSICIANS INSURANCE COMPANY

In connection with the conversion (the ***Conversion***) of American Physicians Insurance Exchange (the ***Corporation***) from a Texas reciprocal and inter-insurance exchange to a Texas stock property and casualty insurance company, the Corporation (i) has elected to adopt the Business Organizations Code of the State of Texas (the ***TBOC***), in accordance with Section 402.003 thereof and, (ii) hereby, files this Articles of Incorporation of the Corporation (this ***Articles***) in accordance with the applicable provisions of the Texas Insurance Code (the ***Insurance Code***).

ARTICLE I

NAME AND TYPE OF ENTITY

The name of the entity is American Physicians Insurance Company. The Corporation is a Texas stock property and casualty insurance company.

ARTICLE II

CONVERSION

By converting from a reciprocal and inter-insurance exchange to a stock property and casualty insurance company and by duly executing and filing these Articles, the Corporation ceases to be organized as a reciprocal and inter-insurance exchange under the applicable provisions of the Insurance Code and is, as of the date hereof and hereafter, organized as a stock property and casualty insurance company under the applicable provisions of the Insurance Code.

ARTICLE III

PURPOSE

The purpose of the Corporation shall be (i) to write fire, allied lines coverages, hail (growing crops only), rain, inland marine, ocean marine, aircraft liability, aircraft physical damage, workers compensation and employer s liability, employer s liability, auto liability, auto physical damage, liability lines other than automobile, fidelity and surety, glass, burglary and theft, forgery, boiler and machinery, credit, livestock, and any and all other forms of insurance against hazards or risks of every kind and description which may lawfully be the subject of insurance except life insurance, accident and health insurance, endowment insurance, and contracts for the payment of annuities; (ii) to accept and to cede reinsurance of any such risks or hazards; and (iii) to engage in any lawful act or activity for which corporations may be organized under the Texas Insurance Code and the Texas Business Organizations Code.

ARTICLE IV

CAPITALIZATION

Section 4.1 *Authorized Shares*. The Corporation shall be authorized to issue Ten Million and Twenty-Five Thousand (10,025,000) shares of stock, consisting of (i) Ten Million and Ten Thousand (10,010,000) Common Shares with a par value of One Dollar ($1.00) each (the ***Common Shares***), and (ii) Fifteen Thousand (15,000) Preferred Shares with a par value of One Dollar ($1.00) each (the ***Preferred Shares***), amounting in the aggregate to Ten Million and Twenty-Five Thousand Dollars ($10,025,000), of which shares there shall always be issued, outstanding, and fully paid at least fifty percent (50%) of the aggregate par value of the shares authorized to be issued. The Corporation shall also have at all times at least One Million Dollars ($1,000,000) in capital and One Million Dollars ($1,000,000) in surplus, as required by Section 822.054 of the Texas Insurance Code.

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Section 4.2 *Common Shares*.

(a) The holders of Common Shares shall be entitled to one vote for each such share on each matter properly submitted to the shareholders on which the holders of Common Shares are entitled to vote. Except as otherwise provided by law or these Articles, at any annual or special meeting of the shareholders the Common Shares shall have the exclusive right to vote for the election of directors and on all other matters properly submitted to a vote of the shareholders.

(b) Subject to the rights of the holders of Preferred Shares, the holders of Common Shares shall be entitled to receive such dividends and other distributions when, as and if declared thereon by the Board of Directors (the ***Board***) from time to time out of any assets or funds of the Corporation legally available therefor.

(c) In the event of any voluntary or involuntary winding-up or termination of the Corporation, after payment or provision for payment of the debts, liabilities and obligations of the Corporation and subject to the rights of the holders of Preferred Shares in respect thereof, the holders of Common Shares shall be entitled to receive all the remaining assets of the Corporation available for distribution to its shareholders, ratably in proportion to the number of Common Shares held by them.

Section 4.3 *Preferred Shares*.

(a) *General*.

The Preferred Shares shall consist of a series designated as the Series A Redeemable Preferred Stock (hereinafter referred to as the ***Series A Redeemable Preferred Stock***). Each share of Series A Redeemable Preferred Stock shall be identical in all respects with the other shares of the Series A Redeemable Preferred Stock subject to the provisions of *Sections 4.3(e)(v) and 4.3(e)(vi)*.

The number of authorized shares of the Series A Redeemable Preferred Stock shall initially be Fifteen Thousand (15,000) which number may from time to time be increased (but not above the total number of authorized Preferred Shares) or decreased (but not below the number of shares of the Series A Redeemable Preferred Stock then outstanding) by resolution of the Board. Series A Redeemable Preferred Stock may be issued in fractions of a share. Shares of Series A Redeemable Preferred Stock redeemed or purchased by the Corporation shall be cancelled and shall revert to authorized but unissued Preferred Shares, undesignated as to series.

Shares of Series A Redeemable Preferred Stock shall be non-certificated shares. The record holders of the shares of the Series A Redeemable Preferred Stock, the number of shares of the Series A Redeemable Preferred Stock held thereby, and the total number of outstanding shares of the Series A Redeemable Preferred Stock shall be recorded in the stock books of the Corporation.

Shares of Series A Redeemable Preferred Stock may not be sold or transferred to, or encumbered by, any person, but shall be subject to redemption in accordance with these Articles.

(b) *Dividends; No Preemptive Rights*.

The shareholders in whose name such Series A Redeemable Preferred Stock is registered in the stock books of the Corporation (the ***holders***) shall be entitled to receive, out of funds legally available for such purpose, dividends which shall accrue at the rate of 3.00% per annum of the Redemption Price of such stock and shall compound annually, payable upon: (i) liquidation as provided in *Section 4.3(c)(i)* or (ii) a redemption pursuant to *Section 4.3(d)(i)* or *Section 4.3(d)(ii)*. Dividends shall be payable in cash to the holders entitled to the Liquidation Payment or Redemption payment, as the case may be. Dividends in arrears for any past dividend periods may be declared and paid at any time, without reference to any regular dividend payment date, to holders

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of record on a date not more than sixty (60) nor less then ten (10) days preceding the payment date thereof, as may be fixed by the Board. No interest, or sum of money in lieu of interest, shall be payable in respect of any dividend payment on the Series A Redeemable Preferred Stock which may be in arrears. Dividends on each share of Series A Redeemable Preferred Stock shall be cumulative and shall accrue beginning the third (3rd) calendar day following the date of issuance. The date on which the Corporation initially issues any share of Series A Redeemable Preferred Stock shall be its issue date, regardless of the number of times transfer of such shares is made on the stock records maintained by or for the Corporation and regardless of the number of certificates that may be issued to evidence such shares. No dividends may be paid with respect to any shares of Corporation Common Shares unless all accrued dividends have been paid at some point within the last twelve (12) months with respect to all shares of Series A Redeemable Preferred Stock.

The holders of shares of the Series A Redeemable Preferred Stock shall not be entitled to any preemptive or subscription right in respect of any securities of the Corporation.

(c) *Liquidation*.

In the event of any liquidation (complete or partial), dissolution or winding up of the affairs of the Corporation, whether voluntary or involuntary, after payment or provision for payment of the debts and other liabilities of the Corporation, each holder of Series A Redeemable Preferred Stock shall be entitled to receive an amount in cash equal to the Redemption Price of the shares of the Series A Redeemable Preferred Stock owned of record by such holder, plus accrued dividends (the ***Liquidation Payment***) before any distribution is made to holders of Common Shares (and any other class or series of shares of the Corporation hereafter authorized over which the Series A Redeemable Preferred Stock has preference or priority in the distribution of assets on any liquidation (complete or partial), dissolution or winding up of the affairs of the Corporation) upon any such liquidation (complete or partial), dissolution or winding up of the affairs of the Corporation. If, upon any liquidation (complete or partial), dissolution or winding up of the affairs of the Corporation, whether voluntary or involuntary, the assets of the Corporation, or proceeds thereof, distributable among the holders of the then outstanding shares of the Series A Redeemable Preferred Stock and the holders of any shares of capital stock ranking on a parity with the Series A Redeemable Preferred Stock with respect to any distribution of assets upon liquidation (complete or partial), dissolution or winding up of the affairs of the Corporation, whether voluntary or involuntary, are insufficient to pay in full all such preferential amounts payable to such holders, then all such assets and proceeds of the Corporation thus distributable shall be distributed among the holders of Series A Redeemable Preferred Stock and the holders of such capital stock so ranking on a parity with the Series A Redeemable Preferred Stock ratably in proportion to the respective aggregate amounts otherwise payable with respect thereto.

For the purposes of this *Section 4.3(c)*, neither the voluntary sale, lease, conveyance, exchange or transfer of all or substantially all the property or assets of the Corporation (whether for cash, shares of stock, securities or other consideration), nor the consolidation or merger of the Corporation with one or more other entities, shall be deemed to be a liquidation (complete or partial), dissolution or winding up of the affairs of the Corporation, unless such voluntary sale, lease, conveyance, exchange or transfer shall be in connection with a plan of liquidation (complete or partial), dissolution or winding up of the affairs of the Corporation.

After the payment in cash to the holders of shares of the Series A Redeemable Preferred Stock of the full amount of the Liquidation Payment with respect to outstanding shares of the Series A Redeemable Preferred Stock, (1) the holders of such shares shall cease to be shareholders with respect to such shares, (2) such shares shall no longer be deemed to be outstanding on the books of the Corporation and (3) such holders shall have no interest in or claim against the Corporation or any of the remaining assets of the Corporation.

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(d) *Redemption*.

Subject to *Section 4.3(e)(v)*, at any time, the Corporation, at its option, may redeem outstanding shares of the Series A Redeemable Preferred Stock, in whole or in part, in accordance with *Section 4.3(e)* (each, an ***Optional Redemption***).

Subject to *Section 4.3(e)*, the Corporation shall redeem, by the end of each fiscal year of the Corporation during which there are shares of the Series A Redeemable Preferred Stock outstanding, a number of shares of the Series A Redeemable Preferred Stock outstanding on such redemption date with an aggregate Redemption Price equal to $1 million (each, a ***Mandatory Redemption***), in accordance with *Section 4.3(e)*. Notwithstanding the foregoing, the Corporation shall redeem all remaining outstanding shares of Series A Redeemable Preferred Stock on or before December 31, 2016. The Corporation s obligations under this *Section 4.3(d)* shall not be affected by any Optional Redemption.

The Series A Redeemable Preferred Stock shall not be redeemable except as set forth in *Sections 4.3(d)(i)* or *4.3(d)(ii)* above.

(e) *Terms of Redemption*. Any Optional Redemption or Mandatory Redemption (each, a ***Redemption***) shall be effected in the manner and with the effect set forth in this *Section 4.3(e)*.

The redemption price (the ***Redemption Price***) payable in respect of Series A Redeemable Preferred Stock redeemed pursuant to a Redemption shall be $1,000 per share, adjusted accordingly for fractions of a share.

The redemption price for any Redemption shall be paid in cash.

The Corporation shall give notice of any Optional Redemption by mail, postage prepaid, not less than twenty (20) days nor more than sixty (60) days prior to the date fixed for such redemption, to each holder of record of the shares of the Series A Redeemable Preferred Stock to be redeemed appearing on the stock books of the Corporation as of the date of such notice at the address of said holder shown therein. Such notice to any holder shall state the redemption date; the number of shares to be redeemed and, if less than all outstanding shares are to be redeemed, the number (and the identification) of shares to be redeemed from such holder; the Redemption Price; and the procedure for receiving payment of the Redemption Price therefor (including, the place at which the shareholders may obtain payment of the Redemption Price). Any notice that is mailed in the manner herein provided shall be conclusively presumed to have been duly given, whether or not the shareholder receives such notice, and failure duly to give such notice by mail, or any defect in such notice, to any holder of shares of the Series A Redeemable Preferred Stock to be redeemed shall not affect the validity of the proceedings for the redemption of any other shares of the Series A Redeemable Preferred Stock.

If notice of Redemption of shares of the Series A Redeemable Preferred Stock to be redeemed on a redemption date shall have been duly given, then upon such redemption date (if on or before such redemption date all funds in cash necessary for redemption of such shares shall have been set aside by the Corporation, separate and apart from its other funds, in trust for the pro rata benefit of the holders of such shares, so as to be and continue to be available therefor), (1) the holders of such shares shall cease to be shareholders with respect to such shares, (2) such shares shall no longer be deemed to be outstanding on the books of the Corporation, and (3) such holders shall have no interest in or claim against the Corporation with respect to such shares except only the right to receive from the Corporation the amount payable on redemption thereof, without interest (or, in the case of such deposit, from such bank or trust company the funds so deposited, without interest). Any funds so deposited in a bank or trust company and unclaimed at the end of two (2) years from the date fixed for redemption shall, to the extent permitted by law, be repaid to the Corporation upon its request, after which the holders of such shares shall look only to the Corporation for payment thereof.

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Any Redemption shall be affected only out of funds legally available for such purpose. If on any date the Corporation is required to redeem any shares of the Series A Redeemable Preferred Stock pursuant to a Mandatory Redemption and does not have sufficient funds legally available to redeem all such shares on such date, the Corporation shall use any funds that are legally available to redeem such portion of all such shares pro rata (as nearly as may be) on such redemption date as such funds are sufficient therefor and shall redeem the remaining shares of the Series A Redeemable Preferred Stock (required to be redeemed pursuant to such Mandatory Redemption) on the earliest practicable date(s) next following the day on which the Corporation shall first have funds legally available for the redemption of such shares.

If less than all of the outstanding shares of the Series A Redeemable Preferred Stock are to be redeemed pursuant to any Optional Redemption or Mandatory Redemption, the shares of the Series A Redeemable Preferred Stock to be redeemed shall be determined pro rata (as nearly as may be, with adjustments to equalize for any prior Redemption that was not precisely pro rata) among all holders of Series A Redeemable Preferred Stock, according to the respective number of shares of the Series A Redeemable Preferred Stock held by such holders.

Upon any Redemption of shares of the Series A Redeemable Preferred Stock, the shares of the Series A Redeemable Preferred Stock so redeemed shall be cancelled and shall revert to authorized but unissued Preferred Shares, undesignated as to series, and the number of Preferred Shares that the Corporation shall have authority to issue shall not be decreased by such Redemption.

In any case where any redemption date shall not be a business day, then (notwithstanding any other provision of these Articles) payment of redemption price need not be made on such date, but may be made on the next succeeding Business Day with the same force and effect as if made on the redemption date; *provided*, *however*, that no interest shall accrue on such amount of redemption price for the period from and after such redemption date.

If on any date any Mandatory Redemption required to be effected on or prior to such date by *Section 4.3(d)(ii)* or *Section 4.3(d)(iii)*, respectively, (without giving effect to *Section 4.3(e)(v)*) shall not have been effected, the Corporation shall not on such date, directly or indirectly, redeem, purchase, or otherwise acquire for value, or set apart money for any discharge, any sinking or other similar fund for the redemption or purchase of, any shares of any class or series of stock of the Corporation ranking on a parity with Series A Redeemable Preferred Stock upon liquidation (complete or partial), dissolution or winding up of the affairs of the Corporation (except for shares of the Series A Redeemable Preferred Stock redeemed pursuant to the second sentence of *Section 4.3(e)(v)*).

(f) *Voting*. The holders of shares of the Series A Redeemable Preferred Stock shall not be entitled to vote on any matters, including without limitation, any matters described in Articles 4.03 or 5.01 5.20 of the Texas Business Corporation Act (**TBCA**) or any matters which are a fundamental action or a fundamental business transaction under the TBOC, as either may hereafter be amended from time to time.

(g) *No Other Rights*. The shares of the Series A Redeemable Preferred Stock shall not have any powers, designations, preferences or relative, participating, optional, or other special rights, nor shall there be any qualifications, limitations or restrictions of any powers, designations, preferences or rights of such shares, other than as set forth herein or as may be provided by law.

ARTICLE V

PRINCIPAL PLACE OF BUSINESS

The principal place of business of this Corporation is in the City of Austin, Travis County, Texas. All of the Corporation s accounts and records shall be maintained at its principal place of business or at such other location determined by its Board, with the prior approval of the Texas Department of Insurance.

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ARTICLE VI

DIRECTORS

The number of directors constituting the Board shall be no less than seven (7), and the names and addresses of the persons who are to serve as directors until the first annual meeting of shareholders or until their successors are duly elected and qualified are as follows:

Name	Address
Freddie L. Contreras, M.D.	1002 Texas Blvd., Suite 406 Texarkana, Texas 75501
Thomas Eades, M.D.	1303 McCullough, #300 San Antonio, Texas 78212
Gregory M. Jackson, M.D.	5307 Broadway San Antonio, Texas 78209
Norris C. Knight, Jr., M.D.	1002 Texas Boulevard, Suite 407 Texarkana, Texas 75501
William J. Peche, M.D.	311 Camden, Suite 403 San Antonio, Texas 78215
Lawrence S. Pierce, M.D.	1105 Central Expressway North, #380 Allen, Texas 75013
Richard S. Shoberg, Jr., M.D.	3705 Medical Parkway, Suite 570 Austin, Texas 78705
Duane K. Boyd, Jr.	8700 Silver Hill Lane Austin, Texas 78759
Michael L. Green, Jr., M.D.	119 Weston Lane Southlake, Texas 76092

ARTICLE VII

ACTIONS BY SHAREHOLDERS WITHOUT A MEETING

Any action required to be taken at any annual or special meeting of shareholders, and any action which may be taken at any annual or special meeting of shareholders, may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing, setting forth the action so taken, shall have been signed by the holder or holders of shares having not less than the minimum number of votes that would be necessary to take such action at a meeting at which holders of all shares entitled to vote on the action were present and voted.

ARTICLE VIII

LIMITED LIABILITY; INDEMNIFICATION

Section 8.1 *Limitation of Liability*. No person who is or was a director of the Corporation shall be personally liable to the Corporation or any of its shareholders for monetary damages for an act or omission in such person s capacity as a director of the Corporation, except to the extent such limitation or elimination of liability is not permitted by applicable law, as the same exists or hereafter may be changed. If applicable law is hereafter

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changed to authorize corporate action further limiting or eliminating the liability of directors, then the liability of a director to the Corporation or its shareholders shall be limited or eliminated to the fullest extent permitted by applicable law, as so changed. Any repeal or amendment of this *Section 8.1* by the shareholders of the Corporation or by changes in law, or the adoption of any other provision of these Articles inconsistent with this *Section 8.1* will, unless otherwise required by law, be prospective only (except to the extent such amendment or change in law permits the Corporation to further limit or eliminate the liability of directors) and shall not adversely affect any right or protection of a director of the Corporation existing at the time of such repeal or amendment or adoption of such inconsistent provision with respect to acts or omissions occurring prior to such repeal or amendment or adoption of such inconsistent provision.

Section 8.2 *Indemnification*.

(a) Each person who was or is a respondent or defendant, or is threatened to be made a respondent or defendant, or testifies or otherwise participates, in any threatened, pending, or completed action, suit or proceeding, whether civil, criminal, administrative, arbitrative or investigative, any appeal in such an action, suit or proceeding, and any inquiry or investigation that could lead to such an action, suit, or proceeding (any of the foregoing hereinafter called a ***proceeding***), whether or not by or in the right of the Corporation, because such person is or was a director of the Corporation or, while a director of the Corporation, is or was serving at the request of the Corporation as a director, officer, partner, venturer, proprietor, trustee, employee, administrator, agent or similar functionary of another foreign or domestic corporation, limited or general partnership, limited liability company, business trust, real estate investment trust, joint venture, joint stock company, cooperative, association, bank, insurance company, credit union, association, proprietorship, trust, employee benefit plan, other enterprise or other organization (hereinafter a ***Covered Person***) shall be indemnified by the Corporation to the fullest extent authorized or permitted by applicable law, as the same exists or may hereafter be changed, against all judgments (including arbitration awards), court costs, penalties, excise and similar taxes, fines, settlements, reasonable attorneys fees and other expenses (all of the foregoing hereinafter called ***expenses***) actually incurred by such person in connection with such proceeding, and such right to indemnification shall continue as to a person who has ceased to be a director, officer, partner, venturer, proprietor, trustee, employee, administrator, agent or similar functionary and shall inure to the benefit of his or her heirs, executors and administrators. The right to indemnification conferred by this *Section 8.2* shall be a contract right and shall include the right to be paid or reimbursed by the Corporation the reasonable expenses incurred in defending or otherwise participating in any such proceeding in advance of its final disposition upon receipt by the Corporation of a written affirmation by the Covered Person of the Covered Person s good faith belief that the person has met the standard of conduct necessary for indemnification under the TBOC or the TBCA and a written undertaking by or on behalf of the person to repay all amounts so advanced if it shall be ultimately determined by final judicial decision from which there is no further right to appeal that the Covered Person has not met that standard or that indemnification of the Covered Person against expenses incurred by such person in connection with that proceeding is prohibited by the TBOC or the TBCA.

(b) The rights conferred on any Covered Person by this *Section 8.2* shall not be exclusive of any other rights which any Covered Person may have or hereafter acquire under law, these Articles, the bylaws of the Corporation, an agreement, vote of shareholders or disinterested directors, or otherwise.

(c) Any repeal or amendment of this *Section 8.2* by the shareholders of the Corporation or by changes in law, or the adoption of any other provision of these Articles inconsistent with this *Section 8.2*, will, unless otherwise required by law, be prospective only (except to the extent such amendment, change in law or adoption permits the Corporation to provide broader indemnification rights on a retroactive basis than permitted prior thereto), and will not in any way diminish or adversely affect any right or protection existing at the time of such repeal or amendment or adoption of such inconsistent provision in respect of any act or omission occurring prior to such repeal or amendment or adoption of such inconsistent provision.

(d) This *Section 8.2* shall not limit the right of the Corporation, to the extent and in the manner authorized or permitted by law, to indemnify and to advance expenses to persons other than Covered Persons.

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ARTICLE IX

SHAREHOLDER VOTE ON CERTAIN MATTERS

Except as otherwise provided in these Articles, the vote of shareholders required for approval of any action for which the TBOC or the TBCA requires a shareholder vote, shall, if a greater vote of shareholders is provided for by the TBOC or TBCA, instead be the affirmative vote of the holders of a majority of the outstanding shares entitled to vote thereon, unless any class or series of shares is entitled to vote as a class thereon, in which event the vote required shall be the affirmative vote of the holders of a majority of the outstanding shares within each class or series of shares entitled to vote thereon as a class and a majority of the outstanding shares otherwise entitled to vote thereon. Notwithstanding the foregoing, the holders of share of the Series A Redeemable Preferred Stock shall not be entitled to vote on any matters, including without limitation, any matters described in Articles 4.03 or 5.01 5.20 of the TBCA or any matters which are a fundamental action or a fundamental business transaction under the TBOC, as either may hereafter be amended from time to time.

ARTICLE X

BYLAWS; AMENDMENT OF ARTICLES

Section 10.1 Bylaws. The Board is authorized to adopt the Amended and Restated Bylaws of the Corporation (the ***Bylaws***), to amend or repeal the Bylaws or to adopt new Bylaws, subject to any limitations that may be contained in such Bylaws.

Section 10.2 Amendment of Articles. To the maximum extent permitted by the Section 21.155 of the TBOC or Article 2.13 of the TBCA, the Board is vested with the authority to amend these Articles, including without limitation the authority to establish series of unissued shares of any class by fixing and determining the designations, preferences, limitations, and relative rights, including voting rights, of the shares of any series so established to the same extent that such designations, preferences, limitations, and relative rights could be stated if fully set forth in these Articles.

ARTICLE XI

COMMENCEMENT OF BUSINESS

The Corporation will not commence doing business until it has received for the issuance of its shares consideration of at least One Million Dollars ($1,000,000) in capital and One Million Dollars ($1,000,000) in surplus, paid in cash, with not less than fifty percent of the authorized shares being fully subscribed and paid for.

ARTICLE XII

TERM

This Corporation shall exist for a term which shall be perpetual.

ARTICLE XII

REGISTERED AGENT AND REGISTERED ADDRESS

The address of the registered office of the Corporation is 1021 Main Street, Suite 1150, Houston, Texas, 77002, and the name of the initial registered agent at such address is CT Corporation System.

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IN WITNESS WHEREOF, the Corporation has caused these Articles of Incorporation to be executed by its , , on the day of , 2006.

AMERICAN PHYSICIANS INSURANCE COMPANY

By: _____

Name: _____

Title: _____

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EXHIBIT G

AMENDED AND RESTATED BYLAWS OF APIC

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EXHIBIT G

AMENDED AND RESTATED BYLAWS

AMERICAN PHYSICIANS INSURANCE COMPANY

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AMENDED AND RESTATED BYLAWS

AMERICAN PHYSICIANS INSURANCE COMPANY

A Texas Insurance Corporation

PREAMBLE

These bylaws are subject to, and governed by, Chapter 822 of the Texas Insurance Code, the Texas Business Organizations Code and the Articles of Incorporation of American Physicians Insurance Company (the Corporation). In the event of a direct conflict between the provisions of these bylaws and the mandatory provisions of the Texas Insurance Code or the provisions of the Articles of Incorporation of the Corporation, such provisions of the Texas Insurance Code or the Articles of Incorporation of the Corporation, as the case may be, will be controlling.

ARTICLE ONE: OFFICES

1.01 *Registered Office and Agent*. The registered office of the Corporation within the State of Texas will be located at either (a) the principal place of business of the Corporation in the State of Texas or (b) the office of the corporation or individual acting as the Corporation s registered agent in Texas.

1.02 *Other Offices*. The Corporation may, in addition to its registered office in the State of Texas, have such other offices and places of business, both within and without the State of Texas, as the board of directors of the Corporation may from time to time determine or as the business and affairs of the Corporation may require. The principal place of business of this Corporation shall be in the City of Austin, Travis County, Texas. All of the Corporation s books and records shall be maintained at its principal place of business in the City of Austin, Travis County, Texas, or at such other location determined by the board of directors; provided, however, if the Corporation s books and records are moved out-of-state, prior notice to the Texas Department of Insurance is required.

ARTICLE TWO: SHAREHOLDERS

2.01 *Annual Meetings*. An annual meeting of shareholders of the Corporation shall be held on or before April 30th during each calendar year at such time as shall be designated by the board of directors and stated in the notice of the meeting, if not a legal holiday in the place where the meeting is to be held, and, if a legal holiday in such place, then on the next business day following, at the time specified in the notice of the meeting. At such meeting, the shareholders shall elect directors and transact such other business as may properly be brought before the meeting.

2.02 *Special Meetings*. A special meeting of the shareholders may be called at any time by the president, the board of directors, or the holders of not less than ten percent of all shares entitled to vote at such meeting. Only business within the purpose or purposes described in the notice of special meeting may be conducted at such special meeting.

2.03 *Place of Meetings*. The annual meeting of shareholders may be held at any place within or without the State of Texas designated by the board of directors. Special meetings of shareholders may be held at any place within or without the State of Texas designated by the person or persons calling such special meeting as provided in Section 2.02 above. Meetings of shareholders shall be held at the principal office of the Corporation unless another place is designated for meetings in the manner provided herein.

2.04 *Notice*. Except as otherwise provided by law, written or printed notice stating the place, day, and hour of each meeting of the shareholders and, in case of a special meeting, the purpose or purposes for which the meeting is called, shall be delivered not less than ten (10) nor more than sixty (60) days before the date of the meeting by or at the direction of the president, the secretary, or the person calling the meeting, to each shareholder of record entitled to vote at such meeting.

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2.05 *Voting List*. At least ten days before each meeting of shareholders, the secretary shall prepare a complete list of shareholders entitled to vote at such meeting, arranged in alphabetical order, including the address of each shareholder and the number of voting shares held by each shareholder. For a period of ten days prior to such meeting, such list shall be kept on file at the registered office of the Corporation and shall be subject to inspection by any shareholder during usual business hours. Such list shall be produced at such meeting, and at all times during such meeting shall be subject to inspection by any shareholder. The original stock transfer books shall be prima facie evidence as to who are the shareholders entitled to examine such list.

2.06 *Voting of Shares*. Treasury shares, shares of the Corporation s own stock owned by another corporation the majority of the voting stock of which is owned or controlled by the Corporation, and shares of the Corporation s own Stock held by the Corporation in a fiduciary capacity shall not be shares entitled to vote or to be counted in determining the total number of outstanding shares. Shares standing in the name of another domestic or foreign corporation of any type or kind may be voted by such officer, agent, or proxy as the bylaws of such corporation may authorize or, in the absence of such authorization, as the board of directors of such corporation may determine. Shares held by an administrator, executor, guardian, or conservator may be voted by him, either in person or by proxy, without transfer of such shares into his name so long as such shares form a part of the estate served by him and are in the possession of such estate. Shares held by a trustee may be voted by him, either in person or by proxy, only after the shares have been transferred into his name as trustee. Shares standing in the name of a receiver may be voted by such receiver, and shares held by or under the control of a receiver may be voted by such receiver without transfer of such shares into his name if authority to do so is contained in the court order by which such receiver was appointed. A shareholder whose shares are pledged shall be entitled to vote such shares until they have been transferred into the name of the pledgee, and thereafter, the pledgee shall be entitled to vote such shares. The holders of shares of the Corporation s Series A Redeemable Preferred Stock shall not be entitled to vote on any matters, including without limitation, any matters described in Articles 4.03 or 5.01 through 5.20 of the Texas Business Corporation Act, or any matters which are a fundamental action or a fundamental business transaction under the Texas Business Organizations Code, as either may hereinafter be amended from time to time.

2.07 *Quorum*. The holders of at least fifty-one percent (51%) of the outstanding shares entitled to vote, present in person or represented by proxy, shall constitute a quorum at any meeting of shareholders, except as otherwise provided by law, the Articles of Incorporation, or these bylaws. If a quorum shall not be present or represented at any meeting of shareholders, a majority of the shareholders entitled to vote at the meeting, who are present in person or represented by proxy, may adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum shall be present or represented. At any reconvening of an adjourned meeting at which a quorum shall be present or represented by proxy, any business may be transacted which could have been transacted at the original meeting, if a quorum had been present or represented.

2.08 *Majority Vote; Withdrawal of Quorum*. If a quorum is present in person or represented by proxy at any meeting, the vote of the holders of a majority of the outstanding shares entitled to vote, present in person or represented by proxy, shall decide any question brought before such meeting, unless the question is one on which, by express provision of the Texas Insurance Code, the Articles of Incorporation, or these bylaws, a different vote is required, in which event such express provision shall govern and control the decision of such question. The shareholders present at a duly convened meeting may continue to transact business until adjournment, notwithstanding any withdrawal of shareholders which may leave less than a quorum remaining.

2.09 *Method of Voting; Proxies*. Every shareholder of record shall be entitled at every meeting of shareholders to one vote on each matter submitted to a vote, for every share standing in his name on the original stock transfer books of the Corporation except, (a) to the extent that the voting rights of the shares of any class or classes are limited or denied by the Articles of Incorporation, or (b) if, and to the extent, the Articles of Incorporation of the Corporation provide for the holders of one or more classes of shares of stock of the Corporation to vote or consent as a class with respect to any particular matter or to have other special voting or consent rights. Such stock transfer books shall be prima facie evidence as to the identity of shareholders entitled to vote. At any meeting of shareholders, every shareholder having the right to vote may vote either in person or

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by a proxy executed in writing by the shareholder or by his duly authorized attorney-in-fact. Each such proxy shall be filed with the secretary of the Corporation before, or at the time of, the meeting. No proxy shall be valid after eleven months from the date of its execution, unless otherwise provided in the proxy. If no date is stated on a proxy, such proxy shall be presumed to have been executed on the date of the meeting at which it is to be voted. Each proxy shall be revocable unless the proxy form conspicuously states that the proxy is irrevocable and the proxy is coupled with an interest.

2.10 *Closing of Transfer Books; Record Date*. For the purpose of determining shareholders entitled to notice of, or to vote at, any meeting of shareholders or any reconvening thereof, or entitled to receive a distribution (other than a distribution involving a purchase or redemption by the Corporation of any of its own shares) or a share dividend, or in order to make a determination of shareholders for any other proper purpose, the board of directors may provide that the stock transfer books of the Corporation shall be closed for a stated period but not to exceed in any event sixty days. If the stock transfer books are closed for the purpose of determining shareholders entitled to notice of, or to vote at, a meeting of shareholders, such books shall be closed for at least ten days immediately preceding such meeting. In lieu of closing the stock transfer books, the board of directors may fix in advance a date as the record date for any such determination of shareholders, such date in any case to be not more than sixty days and, in case of a meeting of shareholders, not less than ten days prior to the date on which the particular action requiring such determination of shareholders is to be taken. If the stock transfer books are not closed and if no record date is fixed for the determination of shareholders entitled to notice of, or to vote at, a meeting of shareholders or entitled to receive a distribution (other than a distribution involving a purchase or redemption by the Corporation of any of its own shares) or a share dividend, the date on which the notice of the meeting is mailed or the date on which the resolution of the board of directors declaring such distribution or share dividend is adopted, as the case may be, shall be the record date for such determination of shareholders.

2.11 *Officers Duties at Meetings*. The Chairman of the Board shall preside at, and the secretary shall prepare minutes of, each meeting of shareholders, and in the absence of either such officer, his duties shall be performed by some person or persons elected by the vote of the holders of a majority of the outstanding shares entitled to vote, present in person or represented by proxy.

ARTICLE THREE: DIRECTORS

3.01 *Management*. The business and property of the Corporation shall be managed by the board of directors, and subject to the restrictions imposed by law, the Articles of Incorporation, or these bylaws, the board of directors may exercise all the powers of the Corporation.

3.02 *Number; Election; Term; Qualification*. The number of directors which shall constitute the board of directors shall be not more than eleven (11) and shall never be less than seven (7). The number of directors which shall constitute the entire board of directors shall be as provided in the Articles of Incorporation, or, in absence of applicable provisions in the Articles of Incorporation, as determined by resolution of the board of directors at any meeting thereof or by the shareholders at any meeting thereof, but shall never be less than one. At each annual meeting of shareholders, directors shall be elected to hold office until the next annual meeting of shareholders and until their successors are elected and qualified. No director need be a shareholder, a resident of the State of Texas, or a citizen of the United States.

3.03 *Changes in Number*. No decrease in the number of directors constituting the entire board of directors shall have the effect of shortening the term of any incumbent director. Any directorship to be filled by reason of an increase in the number of directors may be filled by (i) the shareholders at any annual or special meeting of shareholders called for that purpose or (ii) the board of directors for a term of office continuing only until the next election of one or more directors by the shareholders; provided that the board of directors may not fill more than two such directorships during the period between any two successive annual meetings of shareholders.

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Notwithstanding the foregoing, whenever the holders of any class or series of shares are entitled to elect one or more directors by the provisions of the Articles of Incorporation, any newly created directorship(s) of such class or series to be filled by reason of an increase in the number of such directors may be filled by the affirmative vote of a majority of the directors elected by such class or series then in office or by a sole remaining director so elected or by the vote of the holders of the outstanding shares of such class or series, and such directorship(s) shall not in any case be filled by the vote of the remaining directors or by the holders of the outstanding shares of the Corporation as a whole unless otherwise provided in the Articles of Incorporation.

3.04 *Removal*. At any meeting of shareholders called expressly for that purpose, any director or the entire board of directors may be removed, with or without cause, by a vote of the holders of a majority of the shares then entitled to vote on the election of such director.

3.05 *Vacancies*. Any vacancy occurring in the board of directors may be filled by (i) the shareholders at any annual or special meeting of shareholders called for that purpose or (ii) the affirmative vote of a majority of the remaining directors though less than a quorum of the board of directors. A director elected to fill a vacancy shall be elected to serve for the unexpired term of his predecessor in office. Notwithstanding the foregoing, whenever the holders of any class or series of shares are entitled to elect one or more directors by the provisions of the Articles of Incorporation, any vacancies in such directorship(s) may be filled by the affirmative vote of a majority of the directors elected by such class or series then in office or by a sole remaining director so elected or by the vote of the holders of the outstanding shares of such class or series, and such directorship(s) shall not in any case be filled by the vote of the remaining directors or the holders of the outstanding shares of the Corporation as a whole unless otherwise provided in the Articles of Incorporation.

3.06 *Place of Meetings*. The board of directors may hold its meetings and may have an office and keep the books of the Corporation, except as otherwise provided by law, in such place or places within or without the State of Texas as the board of directors may from time to time determine.

3.07 *First Meeting*. Each newly elected board of directors may hold its first meeting for the purpose of organization and the transaction of business, if a quorum is present, immediately after and at the same place as the annual meeting of shareholders, and notice of such meeting shall not be necessary.

3.08 *Regular Meetings*. Regular meetings of the board of directors may be held without notice at such times and places as may be designated from time to time by resolution of the board of directors and communicated to all directors.

3.09 *Special Meetings; Notice*. Special meetings of the board of directors shall be held whenever called by the president or by the chairman of the board, if any. The person calling any special meeting shall cause notice of such special meeting, including therein the time and place of such special meeting, to be given to each director at least two days before such special meeting. Neither the business to be transacted at, nor the purpose of, any special meeting of the board of directors need be specified in the notice or waiver of notice of any special meeting.

3.10 *Quorum; Majority Vote*. At all meetings of the board of directors, a majority of the directors, fixed in the manner provided in these bylaws, shall constitute a quorum for the transaction of business. If a quorum is not present at a meeting, a majority of the directors present may adjourn the meeting from time to time, without notice other than an announcement at the meeting, until a quorum is present. The act of a majority of the directors present at a meeting at which a quorum is in attendance shall be the act of the board of directors, unless the act of a greater number is required by law, the Articles of Incorporation, or these bylaws.

3.11 *Procedure; Minutes*. At meetings of the board of directors, business shall be transacted in such order as the board of directors may determine from time to time. The board of directors shall appoint at each meeting a

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person to preside at the meeting and a person to act as secretary of the meeting. The secretary of the meeting shall prepare minutes of the meeting which shall be delivered to the secretary of the Corporation for placement in the minute books of the Corporation.

3.12 *Presumption of Assent*. A director of the Corporation who is present at any meeting of the board of directors at which action on any matter is taken shall be presumed to have assented to the action unless his dissent shall be entered in the minutes of the meeting or unless he shall file his written dissent to such action with the person acting as secretary of the meeting before the adjournment thereof or shall forward any dissent by certified or registered mail to the secretary of the Corporation immediately after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action.

3.13 *Compensation*. Directors, in their capacity as directors, may receive, by resolution of the board of directors, a fixed sum and expenses of attendance, if any, for attending meetings of the board of directors or a stated salary. No director shall be precluded from serving the Corporation in any other capacity or receiving compensation therefor.

ARTICLE FOUR: COMMITTEES

4.01 *Designation*. The board of directors may, by resolution adopted by a majority of the entire board of directors, designate or dissolve one or more committees, including the executive and other committees, each committee to consist of one or more directors and may include non-voting advisory members.

4.02 *Number; Qualification; Term*. Each committee shall consist of one or more directors appointed by resolution adopted by a majority of the entire board of directors. The number of committee members may be increased or decreased from time to time by resolution adopted by a majority of the entire board of directors. Each committee member shall serve as such until the earliest of (i) the expiration of his term as director, (ii) his resignation as a committee member or as a director, or (iii) his removal, as a committee member or as a director.

4.03 *Authority*. Each committee, to the extent expressly provided in the resolution establishing such committee, shall have and may exercise all of the authority of the board of directors in the management of the business and property of the Corporation, including, without limitation, the power and authority to declare a dividend and to authorize the issuance of shares of the Corporation. Notwithstanding the foregoing, however, no committee shall have the authority of the board of directors in reference to:

(a) amending the Articles of Incorporation;

(b) approving a plan of merger or consolidation;

(c) recommending to the shareholders the sale, lease, or exchange of all or substantially all of the property and assets of the Corporation otherwise than in the usual and regular course of its business;

(d) recommending to the shareholders a voluntary dissolution of the Corporation or a revocation thereof;

(e) amending, altering, or repealing these bylaws or adopting new bylaws;

(f) filling vacancies in the board of directors or of any committee;

(g) filling any directorship to be filled by reason of an increase in the number of directors;

(h) electing or removing officers or committee members;

(i) fixing the compensation of any committee member; or

(j) altering or repealing any resolution of the board of directors which by its terms provides that it shall not be amendable or repealable.

4.04 *Committee Changes; Removal*. Except as set forth in the Articles of Incorporation, the board of directors shall have the power at any time to fill vacancies in, to change the membership of, and to discharge any

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committee. However, a committee member may be removed by the board of directors, only if, (a) in the judgment of the board of directors, the best interests of the Corporation will be served thereby, and (b) such removal is not inconsistent with the Articles of Incorporation.

4.05 *Regular Meetings*. Regular meetings of any committee may be held without notice at such time and place as may be designated from time to time by the committee and communicated to all members thereof.

4.06 *Special Meetings*. Special meetings of any committee may be held whenever called by any committee member. The committee member calling any special meeting shall cause notice of such special meeting, including therein the time and place of such special meeting, to be given to each committee member at least two days before such special meeting. Neither the business to be transacted at, nor the purpose of, any special meeting of any committee need be specified in the notice or waiver of notice of any special meeting.

4.07 *Quorum; Majority Vote*. At meetings of any committee, a majority of the number of members designated by the board of directors shall constitute a quorum for the transaction of business. If a quorum is not present at a meeting of any committee, a majority of the members present may adjourn the meeting from time to time, without notice other than an announcement at the meeting, until a quorum is present. The act of a majority of the members present at any meeting at which a quorum is in attendance shall be the act of a committee, unless the act of a greater number is required by law, the Articles of Incorporation, or these bylaws.

4.08 *Minutes*. Each committee shall cause minutes of its proceedings to be prepared and shall report the same to the board of directors upon the request of the board of directors. The minutes of the proceedings of each committee shall be delivered to the secretary of the Corporation for placement in the minute books of the Corporation.

4.09 *Executive Committee*. During the intervals between meetings of the board of directors, and subject to such limitations as may be required by law or by resolution of the board of directors, the Executive Committee shall have and may exercise all of the authority of the board of directors.

4.10 *Ethics and Internal Affairs*. The Ethics and Internal Affairs Committee shall review and advise the Board regarding internal matters involving the Advisory Directors.

4.11 *Underwriting*. The Underwriting Committee shall review and advise the Board with respect to all rate changes for insurance policies issued by the Corporation and advise management on marketing and underwriting of such policies.

4.12 *Claims*. The Claims Committee shall review, analyze and consult with the Corporation regarding insured claims presented to the committee by the Claims Department, and such other matters as may be designated from time to time by the Board.

4.13 *Finance*. The Finance Committee shall review and monitor the financial status of the Corporation for the purpose of optimizing the Corporation s use of accounting, actuarial, regulatory and investment analysis to enhance and accelerate the decision-making process in response to financial trends.

4.14 *Political Affairs*. The Political Affairs Committee monitor tort reform issues and other legislative matters affecting the Corporation and physician policyholders.

4.15 *Physician Liaison*. The Physician Liaison Committee shall provide insured physicians with the opportunity to meet directly with the Board Members and/or Advisory Board Members regarding applications for insurance, policy renewals, premiums and any other underwriting concerns.

4.16 *Responsibility*. The designation of any committee and the delegation of authority to it shall not operate to relieve the board of directors or any director of any responsibility imposed upon it or such director by law.

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ARTICLE FIVE: GENERAL PROVISIONS RELATING TO MEETINGS

5.01 *Notice*. Whenever by law, the Articles of Incorporation, or these bylaws, notice is required to be given to any committee member, director, or shareholder and no provision is made as to how such notice shall be given, it shall be construed to mean that any such notice may be given (a) in person, (b) in writing, by mail, postage prepaid, addressed to such committee member, director, or shareholder at his address as it appears on the books of the Corporation or, in the case of a shareholder, the stock transfer records of the Corporation, or (c) by any other method permitted by law. Any notice required or permitted to be given by mail shall be deemed to be delivered and given at the time when the same is deposited in the United States mail, postage prepaid, and addressed as aforesaid. Any notice required or permitted to be given by telegram, telex, cable, telecopy, or similar means shall be deemed to be delivered and given at the time transmitted with ail charges prepaid and addressed as aforesaid.

5.02 *Waiver of Notice*. Whenever by law, the Articles of Incorporation, or these bylaws, any notice is required to be given to any committee member, shareholder, or director of the Corporation, a waiver thereof in writing signed by the person or persons entitled to such notice, whether before or after the time notice should have been given, shall be equivalent to the giving of such notice. Attendance of a committee member, shareholder, or director at a meeting shall constitute a waiver of notice of such meeting, except where such person attends for the express purpose of objecting to the transaction of any business on the ground that the meeting is not lawfully called or convened.

5.03 *Telephone and Similar Meetings*. Shareholders, directors, or committee members may participate in and hold a meeting by means of a conference telephone or similar communications equipment by means of which persons participating in the meeting can hear each other. Participation in such a meeting shall constitute presence in person at such meeting, except where a person participates in the meeting for the express purpose of objecting to the transaction of any business on the ground that the meeting is not lawfully called or convened.

5.04 *Action Without Meeting*.

(a) Any action which may be taken, or is required by law, the Articles of Incorporation, or these bylaws to be taken, at a meeting of the directors, or any committee members may be taken without a meeting if a consent in writing, setting forth the action so taken, shall be signed by all of the directors, or committee members, as the case may be, entitled to vote with respect to the subject matter thereof, and such consent shall have the same force and effect, as of the date stated therein, as a unanimous vote of such directors, or committee members, as the case may be, and may be stated as such in any document filed with the Secretary of State of Texas or in any certificate or other document delivered to any person. The consent may be in one or more counterparts so long as each director or committee member signs one of the counterparts. The signed consent shall be placed in the minute books of the Corporation.

(b) Any action which may be taken, or which is required by law or the Articles of Incorporation or bylaws of the Corporation to be taken, at any annual or special meeting of shareholders may be taken without a meeting, without prior notice, and without a vote, if a consent or consents in writing, setting forth the action so taken, shall have been signed by the holder or holders of shares having not less than the minimum number of votes that would be necessary to take such action at a meeting at which the holders of all shares entitled to vote on the action were present and voted.

ARTICLE SIX: OFFICERS AND OTHER AGENTS

6.01 *Number; Titles; Election; Term; Qualification*. The officers of the Corporation shall be a president and secretary, and if the board of directors determines appropriate, one or more vice presidents (and, in the case of each vice president, with such descriptive tire, if any, as the board of directors shall determine), and a treasurer.

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The Corporation may also have a chairman of the board, one or more assistant treasurers, one or more assistant secretaries, and such other officers and such agents as the board of directors may from time to time elect or appoint. The board of directors shall elect a president and secretary and such other officers as it deems appropriate at its first meeting at which a quorum shall be present after the annual meeting of shareholders or whenever a vacancy exists. The board of directors then, or from time to time, may also elect or appoint one or more other officers or agents as it shall deem advisable. Each officer and agent shall hold office for the term for which he is elected or appointed and until his successor has been elected or appointed and qualified. Any person may hold any number of offices. Except as provided in Section 6.07, no officer or agent need be a shareholder, a director, a resident of the State of Texas, or a citizen of the United States.

6.02 *Removal*. Any officer or agent elected or appointed by the board of directors may be removed by the board of directors whenever in its judgment the best interest of the Corporation will be served thereby, but such removal shall be without prejudice to the contract rights, if any, of the person so removed. Election or appointment of an officer or agent shall not of itself create contract rights.

6.03 *Vacancies*. Any vacancy occurring in any office of the Corporation may be filled by the board of directors.

6.04 *Authority*. Officers shall have such authority and perform such duties in the management of the Corporation as are provided in these bylaws or as may be determined by resolution of the board of directors not inconsistent with these bylaws.

6.05 *Compensation*. The compensation, if any, of officers and agents shall be fixed from time to time by the board of directors; provided, that the board of directors may by resolution delegate to any one or more officers of the Corporation the authority to fix such compensation.

6.06 *Chairman of the Board*. The chairman of the board shall have such powers and duties as may be prescribed by the board of directors.

6.07 *President*. Unless and to the extent that such powers and duties are expressly delegated to a chairman of the board by the board of directors, the president shall be the chief executive officer of the Corporation and, subject to the supervision of the board of directors, shall have general management and control of the business and property of the Corporation in the ordinary course of its business with all such powers with respect to such general management and control as may be reasonably incident to such responsibilities, including, but not limited to, the power to employ, discharge, or suspend employees and agents of the Corporation, to fix the compensation of employees and agents, and to suspend, with or without cause, any officer of the Corporation pending final action by the board of directors with respect to continued suspension, removal, or reinstatement of such officer. The president may, without limitation, agree upon and execute all division and transfer orders, bonds, contracts, and other obligations in the name of the Corporation. To the extent required by law, the president shall be a non-voting member of the Board of Directors.

6.08 *Vice Presidents*. Each vice president shall have such powers and duties as may be prescribed by the board of directors or as may be delegated from time to time by the president and (in the order as designated by the board of directors, or in the absence of such designation, as determined by the length of time each has held the office of vice president continuously) shall exercise the powers of the president during that officer s absence or inability to act. As between the Corporation and third parties, any action taken by a vice president in the performance of the duties of the president shall be conclusive evidence of the absence or inability to act of the president at the time such action was taken.

6.09 *Treasurer*. The treasurer shall have custody of the Corporation s funds and securities, shall keep full and accurate accounts of receipts and disbursements, and shall deposit all moneys and valuable effects in the name and to the credit of the Corporation in such depository or depositories as may be designated by the board of

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directors. The treasurer shall audit all payrolls and vouchers of the Corporation, receive, audit, and consolidate all operating and financial statements of the Corporation and its various departments, shall supervise the accounting and auditing practices of the Corporation, and shall have charge of matters relating to taxation. Additionally, the treasurer shall have the power to endorse for deposit, collection, or otherwise all checks, drafts, notes, bills of exchange, and other commercial paper payable to the Corporation and to give proper receipts and discharges for all payments to the Corporation. The treasurer shall perform such other duties as may be prescribed by the board of directors or as may be delegated from time to time by the president.

6.10 *Assistant Treasurers*. Each assistant treasurer shall have such powers and duties as may be prescribed by the board of directors or as may be delegated from time to time by the president. The assistant treasurers (in the order as designated by the board of directors or, in the absence of such designation, as determined by the length of time each has held the office of assistant treasurer continuously) shall exercise the powers of the treasurer during that officer s absence or inability to act. As between the Corporation and third parties, any action taken by an assistant treasurer in the performance of the duties of the treasurer shall be conclusive evidence of the absence or inability to act of the treasurer at the time such action was taken.

6.11 *Secretary*. The secretary shall maintain minutes of all meetings of the board of directors, of any committee, and of the shareholders or consents in lieu of such minutes in the Corporation s minute books, and shall cause notice of such meetings to be given when requested by any person authorized to call such meetings. The secretary may sign with the president, in the name of the Corporation, all contracts of the Corporation and affix the seal of the Corporation thereto. The secretary shall have charge of the certificate books, stock transfer books, stock ledgers, and such other stock books and papers as the board of directors may direct, all of which shall at all reasonable times be open to inspection by any director at the office of the Corporation during business hours. The secretary shall perform such other duties as may be prescribed by the board of directors or as may be delegated from time to time by the president.

6.12 *Assistant Secretaries*. Each assistant secretary shall have such powers and duties as may be prescribed by the board of directors or as may be delegated from time to time by the president. The assistant secretaries (in the order designated by the board of directors or, in the absence of such designation, as determined by the length of time each has held the office of .assistant secretary continuously) shall exercise the powers of the secretary during that officer s absence or inability to act. As between the Corporation and third parties, any action taken by an assistant secretary in the performance of the duties of the secretary shall be conclusive evidence of the absence or inability to act of the secretary at the time such action was taken.

ARTICLE SEVEN: CERTIFICATES AND SHAREHOLDERS

7.01 *Certificated and Uncertificated Shares*. The shares of the Corporation may be either certificated shares or uncertificated shares. As used herein, the term certificated shares means shares represented by instruments in bearer or registered form, and the term uncertificated shares means shares not represented by instruments and the transfers of which are registered upon books maintained for that purpose by or on behalf of the Corporation.

7.02 *Certificates for Certificated Shares*. The certificates representing certificated shares of stock of the Corporation shall be in such form as shall be approved by the board of directors in conformity with law. The certificates shall be consecutively numbered, shall be entered as they are issued in the books of the Corporation or in the records of the Corporation s designated transfer agent, if any, and shall state upon the face thereof: (a) that the Corporation is organized under the laws of the State of Texas; (b) the name of the person to whom issued; (c) the number and class of shares and the designation of the series, if any, which such certificate represents; (d) the par value of each share represented by such certificate, or a statement that the shares are without par value; and (e) such other matters as may be required by law. The certificates shall be signed by the president or any vice president and also by the secretary, an assistant secretary, or any other officer; however, the

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signatures of any of such officers may be facsimiles. The certificates may be sealed with the seal of the Corporation or a facsimile thereof.

7.03 *Issuance*. Shares with par value of at least $1.00 may be issued for such consideration and to such persons as the board of directors may from time to time determine, except in the case of shares with par value the consideration must be at least equal to the par value of such shares. Shares may not be issued until the full amount of the consideration has been paid. After the issuance of uncertificated shares, the Corporation or the transfer agent of the Corporation shall send to the registered owner of such uncertificated shares a written notice containing the information required to be stated on certificates representing shares of stock as set forth in Section 7.02 above and such additional information as may be required by the Texas Uniform Commercial Code as currently in effect and as the same may be amended from time to time hereafter.

7.04 *Consideration for Shares*. The consideration for the issuance of shares shall consist of money paid, labor done (including services actually performed for the Corporation), or property (tangible or intangible) actually received. Neither promissory notes nor the promise of future services shall constitute payment or part payment for the issuance of shares. In the absence of fraud in the transaction, the judgment of the board of directors as to the value of consideration received shall be conclusive. When consideration, fixed as provided by law, has been paid, the shares shall be deemed to have been issued and shall be considered fully paid and nonassessable. The consideration received for shares shall be allocated by the board of directors, in accordance with law, between stated capital and capital surplus accounts.

7.05 *Lost, Stolen, or Destroyed Certificates*. The Corporation shall issue a new certificate or certificates in place of any certificate representing shares previously issued if the registered owner of the certificate:

(a) *Claim*. Makes proof by affidavit, in form and substance satisfactory to the board of directors, that a previously issued certificate representing shares has been lost, destroyed, or stolen;

(b) *Timely Request*. Requests the issuance of a new certificate before the Corporation has notice that the certificate has been acquired by a purchaser for value in good faith and without notice of an adverse claim;

(c) *Bond*. Delivers to the Corporation a bond in such form, with such surety or sureties, and with such fixed or open penalty, as the board of directors may direct, in its discretion, to indemnify the Corporation (and its transfer agent and registrar, if any) against any claim that may be made on account of the alleged loss, destruction, or theft of the certificate; and

(d) *Other Requirements*. Satisfies any other reasonable requirements imposed by the board of directors.

7.06 *Transfer of Shares*. Shares of stock of the Corporation shall be transferable only on the books of the Corporation by the shareholders thereof in person or by their duly authorized attorneys or legal representatives. With respect to certificated shares, upon surrender to the Corporation or the transfer agent of the Corporation for transfer of a certificate representing shares duly endorsed and accompanied by any reasonable assurances that such endorsements are genuine and effective as the Corporation may require and after compliance with any applicable law relating to the collection of taxes, the Corporation or its transfer agent shall, if it has no notice of an adverse claim or if it has discharged any duty with respect to any adverse claim, issue one or more new certificates to the person entitled thereto, cancel the old certificate, and record the transaction upon its books. With respect to uncertificated shares, upon delivery to the Corporation or the transfer agent of the Corporation of an instruction originated by an appropriate person (as prescribed by the Texas Uniform Commercial Code as currently in effect and as the same may be amended from time to time hereafter) and accompanied by any reasonable assurances that such instruction is genuine and effective as the, Corporation may require and after compliance with any applicable law relating to the collection of taxes, the Corporation or its transfer agent shall, if it has no notice of an adverse claim or has discharged any duty with respect to any adverse claim, record the transaction upon its books, and shall send to the new registered owner of such uncertificated shares, and, if the shares have been transferred subject to a registered pledge, to the registered pledgee, a written notice containing

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the information required to be stated on certificates representing shares of stock set forth in Section 7.02 above and such additional information as may be required by the Texas Uniform Commercial Code as currently in effect and as the same may be amended from time to time hereafter.

7.07 *Registered Shareholders*. The Corporation shall be entitled to treat the shareholder of record as the shareholder in fact of any shares and, accordingly, shall not be bound to recognize any equitable or other claim to or interest in such shares on the part of any other person, whether or not it shall have actual or other notice thereof, except as otherwise provided by law.

7.08 *Legends*. The board of directors shall cause an appropriate legend to be placed on certificates representing shares of stock as may be deemed necessary or desirable by the board of directors in order for the Corporation to comply with applicable federal or state securities or other laws.

7.09 *Regulations*. The board of directors shall have the power and authority to make all such roles and regulations as it may deem expedient concerning the issue, transfer, registration, or replacement of certificates representing shares of stock of the Corporation.

ARTICLE EIGHT: MISCELLANEOUS PROVISIONS

8.01 *Dividends*. Subject to provisions of applicable statutes and the Articles of Incorporation, dividends may be declared by and at the discretion of the board of directors at any meeting and may be paid in cash, in property, or in shares of stock of the Corporation.

8.02 *Reserves*. The board of directors may create out of funds of the Corporation legally available therefor such reserve or reserves out of the Corporation s surplus as the board of directors from time to time, in its discretion, considers proper to provide for contingencies, to equalize dividends, to repair or maintain any property of the Corporation, or for such other purpose as the board of directors shall consider beneficial to the Corporation. The board of directors may modify or abolish any such reserve.

8.03 *Books and Records*. The Corporation shall keep correct and complete books and records of account, shall keep minutes of the proceedings of its shareholders, board of directors, and any committee, and shall keep at its registered office or principal place of business, or at the office of its transfer agent or registrar, a record of its shareholders, giving the names and addresses of all shareholders and the number and class of the shares held by each shareholder. The board of directors shall keep a full and complete record of all of its transactions.

8.04 *Fiscal Year*. The fiscal year of the Corporation shall be the calendar year.

8.05 *Seal*. The seal, if any, of the Corporation shall be in such form as may be approved from time to time by the board of directors. If the board of directors approves a seal, the affixation of such seal shall not be required to create a valid and binding obligation against the Corporation.

8.06 *Attestation by the Secretary*. With respect to any deed, deed of trust, mortgage, or other instrument executed by the Corporation through its duly authorized officer or officers, the attestation to such execution by the secretary of the Corporation shall not be necessary to constitute such deed, deed of trust, mortgage, or other instrument a valid and binding obligation against the Corporation unless the resolutions, if any, of the board of directors authorizing such execution expressly state that such attestation is necessary.

8.07 *Resignation*. Any director, committee member, officer, or agent may resign by so stating at any meeting of the board of directors or by giving written notice to the board of directors, the president, or the secretary. Such resignation shall take effect at the time specified in the statement at the board of directors meeting or in the written notice, but in no event may the effective time of such resignation be prior to the time such statement is made or such notice is given. If no effective time is specified in the resignation, the resignation

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shall be effective immediately. Unless a resignation specifies otherwise, it shall be effective without being accepted.

8.08 *Securities of Other Corporations*. The president or any vice president of the Corporation shall have the power and authority to transfer, endorse for transfer, vote, consent, or take any other action with respect to any securities of another issuer which may be held or owned by the Corporation and to make, execute, and deliver any waiver, proxy, or consent with respect to any such securities.

8.09 *Amendment of Bylaws*. The power to amend or repeal these bylaws or to adopt new bylaws is vested in the board of directors, but is subject to the right of the shareholders to amend or repeal these bylaws or to adopt new bylaws.

8.10 *Invalid Provisions*. If any part of these bylaws is held invalid or inoperative for any reason, the remaining parts, so far as is possible and reasonable, shall remain valid and operative.

8.11 *Headings*. The headings used in these bylaws are for convenience only and do not constitute matter to be construed in the interpretation of these bylaws.

8.12 *Indemnification*. The Corporation shall indemnify any person who was, is, or is threatened to be made a named defendant or respondent in a proceeding (as hereinafter defined) because the person (i) is or was a director or officer of the Corporation or (ii) while a director or officer of the Corporation, is or was serving at the request of the Corporation as a director, officer, partner, venturer, proprietor, trustee, employee, agent, or similar functionary of another foreign or domestic corporation, partnership, joint venture, sole proprietorship, trust, employee benefit plan, or other enterprise, to the fullest extent that a corporation may grant indemnification to a director under the Texas Business Organizations Code, as the same exists or may hereafter be amended. Such right shall be a contract right and as such shall run to the benefit of any director or officer who is elected and accepts the position of director or officer of the Corporation or elects to continue to serve as a director or officer of the Corporation while this Section 8.12 is in effect. Any repeal or amendment of this Section 8.12 shall be prospective only and shall not limit the rights of any such director or officer or the obligations of the Corporation with respect to any claim arising from or related to the services of such director or officer in any of the foregoing capacities prior to any such repeal or amendment of this Section 8.12. Such right shall include the right to be paid or reimbursed by the Corporation for expenses incurred in defending any such proceeding in advance of its final disposition to the maximum extent permitted under the Texas Business Organizations Code, as the same exists or may hereafter be amended. If a claim for indemnification or advancement of expenses hereunder is not paid in full by the Corporation within 90 days after a written claim has been received by the Corporation, the claimant may at any time thereafter bring suit against the Corporation to recover the unpaid amount of the claim, and if successful in whole or in part, the claimant shall be entitled to be paid also the expenses of prosecuting such claim. It shall be a defense to any such action that such indemnification or advancement of costs of defense are not permitted under the Texas Business Organizations Code, but the burden of proving such defense shall be on the Corporation. Neither the failure of the Corporation (including its Board of Directors or any committee thereof, special legal counsel, or shareholders) to have made its determination prior to the commencement of such action that indemnification of, or advancement of costs of defense to, the claimant is permissible in the circumstances nor an actual determination by the Corporation (including its Board of Directors or any committee thereof, special legal counsel, or shareholders) that such indemnification or advancement is not permissible, shall be a defense to the action or create a presumption that such indemnification or advancement is not permissible. In the event of the death of any person having a right of indemnification under the foregoing provisions, such right shall inure to the benefit of his heirs, executors, administrators, and personal representatives. The rights conferred above shall not be exclusive of any other right which any person may have or hereafter acquire under any statute, bylaw, resolution of shareholders or directors, agreement, or otherwise.

The Corporation may additionally indemnify any person covered by the grant of mandatory indemnification contained above to such further extent as is permitted by law and may indemnify any other person to the fullest

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extent permitted by law. To the extent permitted by then applicable law, the grant of mandatory indemnification to any person pursuant to this Section 8.12 shall extend to proceedings involving the negligence of such person.

As used herein, the term proceeding means any threatened; pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, arbitrative, or investigative, any appeal in such an action, suit, or proceeding, and any inquiry or investigation that could lead to such an action, suit, or proceeding.

8.13 *Other Indemnification*. In addition to the indemnification provided for in Section 8.12 of these Bylaws and in the Articles of Incorporation, the Corporation may enter into agreements relating to indemnification with any person who is an officer or director of the Corporation, and any such agreement shall not be restricted, limited or impaired by any of the provisions of Section 8.12, and shall be enforceable against, and binding upon, the Corporation to the maximum extent permitted by law.

8.14 *Advisory Directors*. The Advisory Board to the Corporation shall meet concurrently with the Board of Directors. The Advisory Board shall not have any right to vote on matters before the Board, but the Advisory Board shall have the right to review information provided to the Board of Directors and to provide the Board with advice and counsel regarding such matters.

The undersigned, the Secretary of the Corporation, hereby certifies that the foregoing bylaws were adopted by the board of directors of the Corporation as of , 2006.

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ANNEX B

PLAN OF CONVERSION

OF

AMERICAN PHYSICIANS INSURANCE EXCHANGE

Under Chapters 942 and 822 of the Texas Insurance Code

and Chapter 10 of the Texas Business Organizations Code

PREAMBLE

WHEREAS, American Physicians Insurance Exchange (the Company) is a Texas reciprocal exchange organized under Chapter 942 of the Texas Insurance Code (formerly Chapter 19 of the Texas Insurance Code of 1951) and has no authorized capital stock; and

WHEREAS, the Company proposes to convert to a stock insurance company (the Insurance Company) under Chapter 822 (as defined below) by (i) adopting the provisions of Chapter 822 of the Texas Insurance Code; (ii) adopting its Certificate of Formation pursuant to the Texas Insurance Code, among other things, to authorize the issuance of capital stock and change its corporate name to *American Physicians Insurance Company* ; and (iii) taking such other actions as are provided for in this Plan of Conversion (collectively, the Conversion); and

WHEREAS, past surplus contributions from subscribers have not been fully refunded and constitute a significant portion of the surplus of the Company in the form of outstanding Subscriber s Deposit Certificates (the Surplus Certificates); and

WHEREAS, the Conversion will allow the Company to compete more effectively in the medical professional liability business of the Company; and

WHEREAS, the Conversion will give the Company the ability to grow by enabling access to capital for the development of additional capacity, new products and services, and possible acquisitions; and

WHEREAS, the Conversion will allow the Company to obtain and achieve long-term stability as well as achieve financial ratings in the financial markets and allow comparison with similar insurers by financial analysts; and

WHEREAS, the Conversion will continue the corporate existence of the Company without interruption under the name *American Physicians Insurance Company* ; and

WHEREAS, at the Effective Time of the Conversion (defined below), shares of the $1.00 par value voting common stock of the Insurance Company (the Insurance Company Common Stock) will be issued to the Eligible Policyholders (as defined below) in exchange for their Subscriber Interests (as defined below) on the basis of the Conversion Formula (as defined below); and

WHEREAS, at the Effective Time of the Conversion, shares of $1.00 par value non-voting preferred stock of the Insurance Company, and having such rights, privileges, preferences and limitations as are set forth in the Certificate of Formation of the Insurance Company (the Insurance Company Preferred Stock) will be issued to Surplus Certificate Holders (as defined below) in exchange for their Surplus Certificates; and

WHEREAS, every Policy (as defined below) of the Company that is in force at the Effective Time of the Conversion shall continue as a Policy of the Insurance Company and all policy and contract rights of such Policies, except the related Subscriber Interests, shall remain as they exist at the Effective Time of the Conversion; and

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WHEREAS, at the Effective Time of the Conversion, all Subscriber Interests shall be extinguished; and

WHEREAS, at the Effective Time of the Conversion, each Surplus Certificate shall be extinguished; and

WHEREAS, immediately following the Effective Time of the Conversion, APSG ACQCO, INC., a Texas corporation (Merger Sub), a wholly-owned subsidiary of American Physicians Service Group, Inc., a Texas corporation (APSG), shall merge with and into the Insurance Company, with the Insurance Company as the surviving company (the Merger); and

WHEREAS, the Company, APSG, and Merger Sub are parties to that certain Agreement and Plan of Merger dated June 1, 2006 (the Merger Agreement) which shall govern the terms and conditions of the Merger; and

WHEREAS, pursuant to the Merger Agreement, APSG will issue shares of its fully registered $.10 par value common stock (the APSG Common Stock) to the holders of the Insurance Company Common Stock on the terms provided in the Merger Agreement in exchange for, and extinguishment of, their shares of Insurance Company Common Stock; and

WHEREAS, pursuant to the Merger Agreement, APSG will issue shares of its unregistered no par value preferred stock (the APSG Preferred Stock) to the holders of the Insurance Company Preferred Stock on the terms provided in the Merger Agreement in exchange for, and extinguishment of, the shares of Insurance Company Preferred Stock; and

WHEREAS, the Board of Directors of the Company believes the Conversion to be in the best interests of the Company and to be fair and equitable to its Subscribers, Policyholders and holders of Surplus Certificates and, at a meeting duly called and held on June 1, 2006 (the Adoption Date), unanimously approved the Conversion, adopted this Plan of Conversion and authorized and directed the execution of this Plan of Conversion subject to the terms and conditions more particularly set forth in this Plan of Conversion; and

WHEREAS, the Board of Directors of the Company has directed that an Application to Convert to Insurance Company (the Application) be submitted to the Commissioner of Insurance of the State of Texas (the Commissioner) for approval as provided by law; and

WHEREAS, the Board of Directors of the Company has directed that the Plan of Conversion be submitted to the Eligible Subscribers for approval as provided by law and by the Company s Bylaws.

NOW, THEREFORE, this Plan of Conversion is hereby adopted by the Company, all as more particularly provided below.

ARTICLE I

DEFINITIONS

As used in this Plan of Conversion and in the Preamble hereto, the following words or phrases have the following meanings and the following definitions shall be equally applicable to both the singular and plural forms of any of the terms herein defined:

Adoption Date has the meaning specified in the Preamble.

Amended and Restated Bylaws has the meaning specified in Section 2.2.

APSG Stock has the meaning specified in the Preamble.

Certificate of Formation has the meaning set forth in Section 2.2.

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Chapter 822 means Chapter 822 of the Texas Insurance Code, as amended from time to time.

Conversion is defined in the Preamble.

Conversion Formula means the method of allocation (set forth below) for determining that portion of the Total Common Shares to be received by each Eligible Policyholder:

Thirty percent (30%) of the Total Common Shares shall be divided equally among all of the Eligible Subscribers on a per Eligible Subscriber basis; and

Seventy percent (70%) of the Total Common Shares shall be divided among the Eligible Policyholders based upon the Attributable Earned Premium of each Eligible Policyholder during the three year period beginning June 1, 2003 and ending on the May 31, 2006 in relation to the Attributable Earned Premium of all Eligible Policyholder over such period of time. Attributable Earned Premium means earned premium attributable to such Eligible Policyholders under a Policy issued by the Company, but excluding maintenance fees and legal defense premiums.

Effective Time has the meaning specified in Section 3.4.

Eligible Policyholders means the Eligible Subscribers and the Other Eligible Insureds, collectively.

Eligible Subscriber means each Subscriber under an In Force Policy (as defined below) on the Record Date who does not voluntarily terminate his or her Policy by cancellation prior to the Effective Time. A Subsequent Policyholder shall not be an Eligible Subscriber.

Insurance Company has the meaning specified in the Preamble.

Other Eligible Insured means each health care provider who is not a Subscriber, but who is (a) an insured under a Policy in force on the Record Date, such as certified registered nurse anesthetists, nurse midwives, and similar insureds who do not voluntarily terminate his or her Policy coverage by cancellation prior to the Effective Time, (b) a former Subscriber who paid a premium within the three (3) years preceding the Record Date to purchase an extended reporting endorsement (tail coverage), or (c) a former Subscriber who within the three (3) years preceding the Record Date earned an extended reporting endorsement (tail coverage).

Person means an individual, corporation, joint venture, partnership, association, trust, trustee, unincorporated entity, organization or government or any department or agency thereof. A person who is the holder of Policies in more than one legal capacity (e.g., a trustee under separate trusts) shall be deemed to be a separate Person in each such capacity.

Plan of Conversion means this Plan of Conversion (including all Exhibits and Schedules hereto), as it may be amended from time to time in accordance with Section 5.5.

Policy has the meaning specified in Section 4.1.

Policyholder means a Person who is an insured under a Policy in force at the Effective Time.

Policy Rights means any contractual rights of a Policyholder under the Policy but specifically excluding any rights in, to, or regarding the Company otherwise arising as a result of its existence and status as a reciprocal exchange such as any right to vote on any matter affecting the Company and the right to receive dividends.

Record Date means June 1, 2006

SEC means the Securities and Exchange Commission.

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Subsequent Policyholder has the meaning specified in Section 4.4(a).

Subscriber means a Person who has signed a Subscriber Agreement and Power of Attorney with the Company as a subscriber.

Subscriber Interests means the rights of a Subscriber of the Company to vote as provided for in the bylaws of the Company and under the Subscriber Agreement and Power of Attorney executed by such Person, along with such other rights as are provided by law, but shall not include any contractual rights as an insured expressly conferred by any Policy.

Subscriber Meeting has the meaning specified in Section 3.3(a).

Surplus Certificate Holders means the holders of the Surplus Certificates at the Effective Time.

TBOC means the Texas Business Organization Code.

Total Common Shares means Ten Million (10,000,000) shares of Insurance Company Common Stock.

ARTICLE II

CONVERSION

2.1 *The Conversion*. At the Effective Time and in accordance with the terms of this Plan of Conversion and the applicable provisions of the TBOC, the Company shall convert into a stock insurance company, and continue the existence of the Company as a stock insurance company without interruption.

2.2 *Conversion into the Insurance Company*.

(a) *Conversion*. At the Effective Time, the Company shall, without further act or deed, adopt the provisions of Chapter 822 of the Texas Insurance Code, convert into a stock property and casualty insurance company and adopt Certificate of Formation pursuant to the provisions of Section 822.052 of the Texas Insurance Code to become a stock property and casualty insurance company authorized to issue capital stock; and shall change its corporate name to *American Physicians Insurance Company.* All of the shares of Insurance Company Common Stock and Insurance Company Preferred Stock shall be uncertificated shares and shall be issued in exchange for the Subscriber Interests of the Eligible Policyholders and the Surplus Certificates, which shall be the sole consideration for the issuance of such shares.

(b) *Continuation of Corporate Existence*. At the Effective Time and thereafter:

(i) The corporate existence of the Company shall continue in the Insurance Company without interruption from June 26, 1975, its initial date of formation, and all of its rights, privileges, powers, permits and licenses and all of its duties, liabilities and obligations shall be, remain and continue unaffected.

(ii) All assets, rights, franchises, and interests of the Company in and to property, real, personal, or mixed, and any accompanying things in action, shall be vested in the Insurance Company, without a deed or transfer, and the Insurance Company shall assume all the obligations and liabilities of the Company.

(iii) The Insurance Company shall have all of the rights and privileges and shall be subject to all of the requirements and regulations imposed on stock property and casualty insurance companies formed under Chapter 822 of the Texas Insurance Code and any other laws of the State of Texas relating to the regulation and supervision of stock property and casualty insurance companies

but shall not exercise rights or privileges that other stock property and casualty insurance companies may not exercise.

(c) *Adopted Certificate of Formation and Amended and Restated Bylaws of the Insurance Company*. At the Effective Time of the Conversion, the Certificate of Formation of the Insurance Company shall, without further act or deed, be adopted substantially as set forth in the Certificate of Formation filed as *Exhibit A* to the Application (the Certificate of Formation). At the Effective Time, the bylaws of the Insurance Company shall, without further act or deed, be amended and restated substantially as set forth in the Amended and Restated Bylaws filed as *Exhibit B* to the Application (the Amended and Restated Bylaws).

2.3 *Issuance of Insurance Company Common Stock in Exchange for Subscriber Interests and All Other Rights*. At the Effective Time of the Conversion and immediately after the Company converts to the Insurance Company pursuant to *Section 2.2* hereof, the Insurance Company shall issue the Total Common Shares as provided herein. Each Eligible Policyholder shall receive the number of shares of Insurance Company Common Stock as provided under the Conversion Formula. Upon such issuance, all Subscriber Interests and all other rights of all Policyholders (except for the Policy Rights of such Policyholders) in the Company shall be extinguished.

2.4 *Issuance of Insurance Company Preferred Stock to Surplus Certificate Holders*. At the Effective Time of the Conversion, the Insurance Company shall issue to each of the Surplus Certificate Holders that number of shares or fractions of a share of Insurance Company Preferred Stock as are equal to the number of dollars of unreturned surplus evidenced by the Surplus Certificate held by such Surplus Certificate Holder as of the Effective Time, divided by one thousand (1,000). Upon such issuance, all rights of each Surplus Certificate Holder under and with respect to each Surplus Certificate, including, without limitation, all rights to any additional payments by the Insurance Company with respect to the same, shall be fully extinguished and entirely replaced by the Insurance Company Preferred Stock issued in consideration of such extinguishment.

2.5 *Exchange of Shares of APSG Common Stock for Shares of Insurance Company Common Stock*. At the Effective Time of the Merger (as defined in the Merger Agreement), each outstanding share of Insurance Company Common Stock shall be cancelled in consideration of the issuance by APSG of APSG Common Stock as more particularly provided in the Merger Agreement.

2.6 *Exchange of Shares of APSG Preferred Stock for Shares of Insurance Company Preferred Stock*. At the Effective Time of the Merger (as defined in the Merger Agreement), each outstanding share of Insurance Company Preferred Stock shall be cancelled in consideration of the issuance by APSG of APSG Preferred Stock as more particularly provided in the Merger Agreement.

2.7 *Continuation of Policies*. Each Policy that is in force at the Effective Time shall remain in effect as a Policy of the Insurance Company and, except as provided herein, all Policy Rights shall be and remain as they exist at the Effective Time. All rights with respect to the Subscriber Interests shall be extinguished at the Effective Time including, but not limited to, (a) any voting rights of Policyholders or Subscribers, and (b) any right to share in the surplus or profits of the Company or to receive dividends.

ARTICLE III

APPROVAL, CONDITIONS AND EFFECTIVE TIME OF CONVERSION

3.1 *Filing with Commissioner*. The Company has filed an application with the Commissioner for approval of the Plan of Conversion. Such application includes all documents and information required by Chapter 822. The Plan of Conversion is subject to approval by the Commissioner, and a public hearing will be held in accordance with the provisions of Chapter 823.

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3.2 *Notice to Eligible Policyholders and Surplus Certificate Holders*. The Company has sent to each Eligible Policyholder and Surplus Certificate Holder a notice advising such Persons of the adoption and filing with the Commissioner of the initial Plan of Conversion and such Person s right to provide to the Commissioner and the Company comments on the Plan of Conversion. Such notice to Eligible Policyholders and Surplus Certificate Holders is substantially in the form filed as *Exhibit C* to the Application. The Company will promptly provide the Commissioner a copy of any written comments received from Eligible Policyholders or Surplus Certificate Holders.

3.3 *Approval by Eligible Subscribers*.

(a) *Subscriber Meeting*. The Plan of Conversion is subject to approval by the Eligible Subscribers. The Company shall hold a meeting of Eligible Subscribers (the Subscriber Meeting). At such Subscriber Meeting, the Eligible Subscribers shall be entitled to vote on the proposal to approve the Plan of Conversion, and the proposal to approve the Certificate of Formation. Each Eligible Subscriber shall be entitled to one vote. The adoption of the Plan of Conversion and the Certificate of Formation shall be approved by the Eligible Subscribers if at least two-thirds of the Eligible Subscribers cast votes FOR the Plan of Conversion and the Certificate of Formation.

(b) *Notice of Eligible Subscriber Meeting*. Notice by the Company of the time and place of the Subscriber Meeting, in form satisfactory to the Commissioner, shall be mailed to all Eligible Subscribers by first class mail to the last known address of each Eligible Subscriber as it appears on the records of the Company within 60 days after the Commissioner s approval of the Plan of Conversion and not less than 30 days prior to the Subscriber Meeting.

(c) *Form of Notice*. The notice of the Subscriber Meeting shall be substantially in the form filed as *Exhibit D* to the Application.

3.4 *Conditions and Effective Time*. Upon satisfaction of all conditions as provided in Subsections (a), (b), (c), (d) and (e) of this Section 3.4, the Company shall file the Certificate of Formation, the Amended and Restated Bylaws and the minutes of the Subscriber Meeting with the Commissioner. This Plan of Conversion shall take effect when the Certificate of Formation as approved by the Eligible Subscribers is filed with the Commissioner (the Effective Time).

(a) *Regulatory Approvals*. The Conversion shall not become effective unless:

(i) As provided in Section 3.1 hereof, the Plan of Conversion shall have been filed with the Commissioner, the Commissioner shall have held a public hearing on the Plan of Conversion, and the Commissioner shall have approved the Plan of Conversion.

(ii) The Articles shall have been filed and approved by the Commissioner as part of the Plan of Conversion.

(b) *Subscriber Approval*. The Conversion shall not become effective unless the Plan of Conversion and the Articles shall have been approved by the Eligible Subscribers as provided in Section 3.3.

(c) *Tax Considerations*. The Conversion shall not become effective unless on or prior to the Effective Time the Company shall have obtained rulings from the Internal Revenue Service or obtained an opinion of tax counsel satisfactory to the Company with respect to certain tax aspects of the Conversion and of the Merger.

(d) *Securities Considerations*. The Conversion shall not become effective unless on or prior to the Effective Time the Company shall have (i) obtained a no-action letter from the SEC in form and substance

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satisfactory to the Company relating to matters pertaining to applicable federal securities laws and/or (ii) received an opinion of independent legal counsel in form and substance satisfactory to the Company with respect to federal and state securities law matters.

(e) *Merger Considerations*. The Conversion shall not become effective unless on or prior to the Effective Time all conditions precedent (exclusive of the Conversion) to the closing of the Merger shall have been satisfied or waived by the parties to the Merger Agreement.

ARTICLE IV

POLICY OWNERSHIP AND IN FORCE DATES

4.1 *Policies*.

(a) Each insurance policy that has been bound or issued by the Company is deemed to be a Policy for purposes of this Plan of Conversion.

(b) For the purposes of this Plan of Conversion, any insurance policy assumed by the Company, as a reinsurer on an indemnity reinsurance basis, shall not constitute a Policy.

4.2 *Determination of Eligible Policyholders*. Unless otherwise stated herein, the Eligible Policyholder under any Policy as of a given date shall be determined on the basis of the Company s records as of such date in accordance with the following provisions:

(a) The Eligible Policyholder shall be as shown as an insured under an active policy on the Company s records.

(b) Except as otherwise set forth in this Article IV, the identity of the Eligible Policyholder shall be determined without giving effect to any interest of any other Person in such Policy.

(c) In any situation not expressly covered by the foregoing provisions of this Section 4.2, the subscribers under a Policy, as reflected on the records of, and as determined in good faith by, the Company, shall conclusively be presumed to be the Eligible Subscriber(s) under such Policy for purposes of this Section 4.2, and the Company shall not be required to examine or consider any other facts or circumstances.

(d) The mailing address of an Eligible Policyholder as of any date for purposes of the Plan of Conversion shall be the Eligible Policyholder s last known address as shown on the records of the Company as of such date.

4.3 *In Force*.

(a) A Policy shall be deemed to be in force as of a given date if, as shown on the Company s records, both paragraphs (i) and (ii) are met:

(i) coverage has been bound or a policy has been issued as of such date; and

(ii) such Policy has not expired, cancelled, non-renewed or otherwise terminated, provided that a Policy shall be deemed to be in force after lapse for nonpayment of premiums until expiration of any applicable grace period (or other similar period however designated in such Policy) during which the Policy is in full force for its basic benefits.

(b) The date of the expiration, cancellation or termination of a Policy shall be as shown on the Company s records.

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4.4 *Subsequent Policyholders*.

(a) On issuance of a Policy that becomes effective after the Adoption Date but before the Effective Time, the Company shall send to the policyholder to whom the Policy is issued (the Subsequent Policyholder) a written notice regarding the Plan of Conversion, substantially in the form attached as *Exhibit E* to the Application.

(b) Except as otherwise provided by law, each Subsequent Policyholder is entitled to receive the notice described by Section 4.4(a) and shall be advised of such Subsequent Policyholder s right to (i) cancel the Policy, and (ii) receive a pro rata refund of unearned premiums.

ARTICLE V

ADDITIONAL PROVISIONS

5.1 *No Transfer or Exchange*. The Conversion shall not be construed to result in any reinsurance or in any real or constructive issuance or exchange of any insurance policy or contract or any other transfer of any assets, rights or obligations of the Company, nor shall the Conversion be construed to result in a liquidation of the Company.

5.2 *Directors and Officers*. The directors and officers of the Company serving at the Effective Time shall serve as the initial directors and officers of the Insurance Company, at and after the Effective Time, until such time as their successors are duly elected and qualified, or until their earlier death, resignation or removal pursuant to the Certificate of Formation and Amended and Restated Bylaws of the Insurance Company.

5.3 *Compensation of Officers, Directors and Employees*.

(a) No officer, director or employee of the Company shall receive any fee, commission or other consideration, other than their usual salary and other compensation, for aiding, promoting, or assisting in the Conversion, except as provided in this Plan of Conversion. This Section 5.3 shall not (i) prohibit the payment of reasonable fees and compensation to an attorney, accountant, or actuary for professional services performed by that person, even if the attorney, accountant, or actuary is also a director or officer of the Company, or (ii) prohibit the issuance of capital stock pursuant to the Plan of Conversion to any officer, director or employee of the Company in such Person s capacity as an Eligible Policyholder or Surplus Certificate Holder.

(b) Notwithstanding the foregoing, the Company Directors shall receive stock options issued by APSG as partial consideration for their willingness to serve as advisory directors of the Insurance Company following the Conversion and Merger. The stock options issued to the Company Directors shall have such the terms and shall be in such amounts as set forth on *Exhibit F* to the Application.

5.4 *Notices*. If the Company complies substantially and in good faith with the notice requirements of the Texas Insurance Code, the TBOC or the terms of the Plan of Conversion, its failure in any case to give notice to any person or persons entitled thereto shall not impair the validity of the actions and proceedings taken under the Texas Insurance Code, the TBOC, or the Plan of Conversion or entitle such person to any damages, or injunctive or other equitable relief with respect thereto.

5.5 *Revocation of Power of Attorney with Attorney-in-Fact*. At the Effective Time, the power of attorney vested in the Company s Attorney-in-Fact shall be revoked pursuant to the terms of the revocation letter in the form attached hereto as *Exhibit G*.

5.6 *Amendment of Plan of Conversion*. At any time prior to the Effective Time, the Company, by the affirmative vote of not less than two-thirds of the members of the Board of Directors of the Company, may amend the Plan of Conversion (including the amendment, deletion or addition of Exhibits and Schedules hereto). No amendment made after approval by the Commissioner pursuant to Section 3.1 hereof and approval at the

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Subscriber Meeting may change the Plan of Conversion in a manner that the Commissioner determines is materially adverse to the interests of Eligible Subscribers, Surplus Certificate Holders or Policyholders unless approved by the Commissioner. Except as otherwise required by the Commissioner, the Plan of Conversion as amended need not be submitted for reconsideration by Eligible Subscribers if the amendment is made after this Plan of Conversion has been approved at the Subscriber Meeting.

5.7 *Withdrawal of Plan of Conversion*. The Board of Directors of the Company, by the affirmative vote of not less than two-thirds of its members, may withdraw the Plan of Conversion at any time prior to the Effective Time notwithstanding prior approval by the Commissioner or the Eligible Subscribers at the Subscriber Meeting. No person shall have any rights or claims against the Company or its Board of Directors based on a withdrawal of the Plan of Conversion.

5.8 *Corrections*. The Company may, until the Effective Time, by an instrument executed by its Chairman, Vice Chairman, Chief Executive Officer, President or any Executive Vice President, attested by its Secretary or Assistant Secretary under the Company s corporate seal and submitted to the Commissioner, make such modifications as are appropriate to correct errors, clarify existing items or make additions to correct manifest omissions in the Plan of Conversion (including the amendment, deletion or addition of Exhibits and Schedules). The Company may in the same manner also make such modifications as may be required by the Commissioner as a condition to approval of the Conversion. The Board of Directors of the Company, by the affirmative vote of not less than two-thirds of its members, may interpret the application and implementation of any provisions of the Plan of Conversion consistent with any requirements of the Insurance Code and any such interpretation by the Board of Directors shall be final and binding.

5.9 *GOVERNING LAW*. THE TERMS OF THE PLAN OF CONVERSION SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAW OF THE STATE OF TEXAS.

5.10 *Headings*. Article and section headings contained in the Plan of Conversion are for convenience only and shall not be considered in construing or interpreting any of the provisions hereof.

5.11 *Preamble*. The Preamble is a general expression of the concepts of the Plan of Conversion. It is not, and shall not be construed to be, a substantive part of the Plan of Conversion except for definitions included therein.

5.12 *Time Periods*. Unless otherwise expressly stated, all references herein to numbers of days shall refer to calendar days.

[THE REMAINDER OF THIS PAGE HAS BEEN INTENTIONALLY LEFT BLANK]

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IN WITNESS WHEREOF, American Physicians Insurance Exchange, by authority of its Board of Directors, has caused this Plan of Conversion to be signed by its Chairman and its Chief Executive Officer and its corporate seal to be affixed hereto attested by its Secretary on , 2006.

AMERICAN PHYSICIANS INSURANCE EXCHANGE

By: /s/ Norris C. Knight
Name:Norris Knight, M.D.

Title:Chairman of the Board

ATTEST:

/s/ Greg Jackson

Name:Greg Jackson, M.D.
Title:Secretary

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EXHIBIT A

[REPLACED BY EXHIBIT A TO

THE AMENDMENT TO PLAN OF CONVERSION]

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EXHIBIT B

[REPLACED BY EXHIBIT B TO

THE AMENDMENT TO PLAN OF CONVERSION]

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EXHIBIT C

NOTICE

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June 22, 2006

Dear Policyholder:

I am pleased and excited to announce that the Board of Directors of American Physicians Insurance Exchange (the Exchange) has adopted a plan of conversion (the Plan of Conversion) providing for the conversion of the Exchange from a reciprocal exchange to a Texas stock insurance company (the Conversion). In addition, the Board of Directors of the Exchange has also adopted a Merger Agreement (the Plan of Merger) in which the newly converted Texas stock insurance company will merge (the Merger) with a wholly owned subsidiary of American Physicians Service Group, Inc. (APSG), a publicly traded Texas corporation. The Conversion along with the Merger is collectively referred to as the Plan . I have included the press release announcing the Merger with this letter for your review.

The Exchange has filed the Plan and required documentation for review and approval by the Commissioner of Insurance of the State of Texas (the Commissioner). The Plan is available for review on our web site at www.apie.us, but terms of the Plan may change as a result of the Commissioner s review. If the Commissioner approves the Plan, the Exchange will then submit the Plan for approval by the Exchange s Eligible Subscribers[1] as defined in the Plan of Conversion.

If you were a subscriber with an in force policy with the Exchange on June 1, 2006 (the Adoption Date) and if the Plan is approved, you will be an Eligible Subscriber[2] entitled to vote on the Plan at a special meeting of the Exchange s Subscribers. However, in order to receive consideration in the Merger you must hold an in force policy with the Exchange at the closing date. If the Commissioner approves the Plan, the Exchange will send you a copy of the Plan as approved by the Commissioner along with other information and notify you of the date, time and place of a special meeting of the Subscribers to vote on the Plan.

In addition, as an Eligible Subscriber you are entitled to provide comments regarding the Plan while it is being reviewed by the Texas Department of Insurance.

Any comments you wish to make should be in writing. Comments may be submitted to the Exchange at the following:

American Physicians Insurance Exchange

1301 S. Capital of Texas Hwy, Suite-C300

Attn: Sharon Stripling, Executive Secretary

Austin, Texas 78746

Email: sstripling@amph.com

Fax: 512-314-4398

The Exchange will promptly provide the Texas Department of Insurance with a copy of any written comments received by the Exchange. If you want to send comments directly to the Texas Department of Insurance, those comments can be sent to the following:

Texas Department of Insurance

P.O. Box 149104

Mail Code MC 305-2C

Austin, Texas 78714-9104

Attn: Mr. Jeff Hunt

Email: jeff.hunt@tdi.state.tx.us

Fax: 512-322-3550

[1] Eligible Subscribers are those policyholders who have a signed Subscribers Agreement & Power of Attorney providing rights in the Exchange including the right to vote on this Plan and are under an in force policy on the Adoption Date.

[2] Other Eligible Insureds as defined in the Plan of Conversion are also included in this mailing, but are not entitled to vote for the Conversion since this group of insureds does not have an executed Subscribers Agreement and Power of Attorney giving them the right to vote. However, Other Eligible Insureds will receive consideration in the transaction. Other Eligible Insureds include those former subscribers that either earned (Death, Disability or Retirement) or paid for extended reporting endorsement (tail) during the last three years and Physician Extenders (CRNAs, Nurse Practitioners, etc) that are currently paying premium to the Exchange.

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The Commissioner may hold a public hearing. If a hearing is held, the Exchange will provide you with no less than 30 days notice of the date, time, and location.

This letter provides you with background information regarding some of the reasons that the Board of Directors of the Exchange chose to pursue the Plan and a summary of the key provisions of the Plan that was approved by the Board.

BACKGROUND AND REASONS FOR THE PLAN

American Physicians Insurance Exchange (APIE or the Exchange) is a reciprocal exchange. The Exchange was organized in the State of Texas on November 23, 1975 and commenced operations on June 1, 1976. It is licensed as a multiple-line insurer under the provisions of the Texas Insurance Code. A reciprocal exchange is an organization under which policyholders (subscribers) effectively exchange insurance contracts and thereby insure each other and become members of the Exchange. As required by Chapter 942 of the Texas Insurance Code, the Exchange is managed by its attorney-in-fact, APS Facilities Management, Inc. (FMI), a wholly owned subsidiary of APSG, and is subject to the supervision of the Exchange s Board of Directors.

APIE writes professional liability insurance coverage for physician groups, individual physicians and other healthcare providers in the states of Texas and Arkansas. Most of the Exchange s coverage is written on a claims-made and reported basis. The coverage is provided only for claims that are first reported to the Exchange during the coverage period and that arise from occurrences during the coverage period. The Exchange also provides extended or tail coverage available for purchase in order to cover claims that arise from occurrences during the coverage period, but that are first reported to the Exchange after the coverage period and during the term of the applicable tail coverage.

The Exchange has provided medical malpractice insurance to physicians for 30 years and has demonstrated the ability to sustain and grow through the many cycles of the market. During this period of time, there have been numerous medical professional liability crises whereby carriers have entered the market only to quickly leave or raise rates substantially leaving physicians scrambling for coverage. The Exchange has consistently provided stability and dependability of coverage for the markets it serves.

The Board has spent considerable time and effort in carefully researching and exploring alternatives for growth to continue to strengthen the Exchange and continue to provide stability to marketplace, as in years past. As a reciprocal exchange, the Exchange cannot access capital through stock offerings. The Board believes that the Plan will allow the Exchange to continue to prosper through its ability to access capital through public markets and that the policyholders will benefit from outside capital, in addition to what is being generated by its stand-alone financial performance.

Several medical malpractice companies operating in other states have converted to stock companies for the purpose to access capital to support growth and provide financial stability. The Board views access to capital as a component for the Exchange to grow and to compete in a changing marketplace. Additional capital will only further strengthen the Exchange and provide a platform for growth by increasing market capacity. Furthermore, the Board anticipates that the Plan, if approved, will allow the Exchange to pursue and eventually achieve meaningful ratings with A.M. Best and other rating agencies. The Exchange believes the ability to achieve a meaningful A.M. Best rating will further enhance the converted company to write insurance for more medical professionals that may be required to purchase insurance from a Best rated carrier.

While the Exchange intends to convert to a Texas stock insurance company, it does not intend to change the overall philosophy of how services are provided to policyholders. The current physician members of the Exchange s Board of Directors will continue to be very involved in all areas of the insurance business including

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claims, underwriting, and risk management. Under the Plan as approved by the Board, insured physicians will continue to have the opportunity to meet with the physician members of the Board of Directors through a Physician Liaison Committee.

The Board believes that approval of this Plan will enhance the ability of the Exchange to continue as a reliable, stable insurance market for physicians. The Exchange will also continue to maintain the high quality of services and insurance products for physicians. The Exchange is committed to maintaining its philosophy Physicians for Physicians within the fabric of the company.

CONCLUSION

This letter constitutes notice of (i) the adoption of the Plan by the Board of Directors of the Exchange, (ii) filing of the Plan for review and approval by the Commissioner, and (iii) your right to provide comments regarding the Plan to the Exchange and the Commissioner.

Please note that you are not being requested to vote on the Plan at this time. If the Plan is approved by the Commissioner, the Exchange will send you a copy of the Plan as approved by the Commissioner along with other information and notify you of the date, time and place of a special meeting to vote on the Plan.

We look forward to receiving any comments you may have on the Plan. It is requested that comments be provided within thirty (30) days of receipt of this letter.

Should you have any additional questions for the Exchange with regard to the Plan, please feel free to contact the Exchange at (800)252-3628.

Very truly yours,

AMERICAN PHYSICIANS INSURANCE EXCHANGE

By:
Norris C. Knight, Jr., MD

Chairman of the Board

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EXHIBIT D

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EXHIBIT E

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EXHIBIT F

STOCK OPTIONS

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EXHIBIT F

Stock Options

Name	# Options
Duane Kenneth Boyd, Jr.	2,000
Freddie Lee Contreras, MD	5,000
Thomas William Eades, MD	27,000
Michael Lewis Green, Jr. MD	2,000
Gregory Mann Jackson, MD	16,000
Norris Crockett Knight, Jr., MD	22,000
William Joseph Peche, MD	29,000
Lawrence Scott Pierce, MD	17,000
Richard Samuel Shoberg, Jr., MD	28,000
	148,000

The terms of the above stock options include, but are not limited to:

The exercise price is the day before the announcement market price

The term of the exercise of the option is five years except for the following:

The term of the exercise shall be 3 months after the date of which the Advisory or Director relationship is terminated for any other reason other than death or permanent and total disability

The term of the exercise of the option shall be 12 months after the date of which the Advisory or Director relationship is terminated by reason of the permanent and total disability

In the event of the death while serving as an Advisory Director or Director of the Company, the executors or administrators for the above individuals may exercise the option within12 months following the date of death

Immediate vesting

The Options are granted for future service as either Advisory Directors or Directors of American Physicians Insurance Company based on years of experience and knowledge serving as Company Directors

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EXHIBIT G

REVOCATION OF ATTORNEY-IN-FACT

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REVOCATION OF AUTHORITY OF ATTORNEY-IN-FACT

WHEREAS, American Physicians Insurance Exchange (APIE) and APS Facilities Management, Inc. (APSFM), as successor to American Physicians Service Corporation, n/k/a American Physicians Service Group, Inc. (APSG), are parties to that certain Management Agreement of Attorney-in-Fact for American Physicians Insurance Exchange, as amended from time to time (the Agreement); and

WHEREAS, APIE, APSG and APSG ACQCO, Inc. are parties to that certain Merger Agreement and Plan of Merger, dated June 1, 2006, pursuant to which APIE intends to convert to a Texas stock insurance company; and

WHEREAS, upon conversion of APIE to a Texas stock insurance company pursuant to the Plan of Conversion filed with the Texas Department of Insurance, APIE will no longer be managed by an attorney-in-fact; and

WHEREAS, APIE and APSFM wish to revoke the attorney-in-fact powers delegated to APSFM upon the effective time of the conversion of APIE;

NOW, THEREFORE, it is agreed by and between the parties:

1. Upon the effective time of the conversion of APIE from a Texas reciprocal insurance exchange into a Texas stock insurance company, all authority of the APSFM under and pursuant to such Agreement shall be revoked by APIE without further action by APIE.

Executed this day of , 2006.

APS Facilities Management, Inc.

By: _____

Name: _____

Title: _____

American Physicians Insurance Exchange

By: _____

Name: _____

Title: _____

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AMENDMENT TO PLAN OF CONVERSION

This Amendment to The Plan of Conversion (this ***Amendment***) amends that certain Plan of Conversion (the ***Plan of Conversion***) adopted and approved by the Board of Directors of American Physicians Insurance Exchange dated June 1, 2006.

R E C I T A L S:

WHEREAS, on or about June 1, 2006, the Board of Directors of American Physicians Insurance Exchange adopted a Plan of Conversion to convert to a stock insurance company pursuant to the terms of the Plan of Conversion; and

WHEREAS, the Board of Directors believes it is in its and its prospective owners best interests to amend the Plan of Conversion as set forth in this Amendment.

A G R E E M E N T:

NOW, THEREFORE, the Plan of Conversion is amended as follows:

1. *Certificate of Formation and Bylaws*. The Certificate of Formation of the Insurance Company attached to the Plan of Conversion as *Exhibit A* is hereby deleted and replaced in their entirety with the Articles of Incorporation attached as *Exhibit A* to this Amendment. Furthermore, the Amended and Restated Bylaws of the Insurance Company attached to the Plan of Conversion as *Exhibit B* are hereby deleted and replaced in their entirety with the Amended and Restated Bylaws attached as *Exhibit B* to this Amendment. Except for the substitution of these exhibits, *Section 2.2(c)* of the Plan of Conversion shall remain in full force and effect in accordance with its terms.

2. Except as specifically amended hereby, the Plan of Conversion shall remain adopted and approved by the Board of Directors in accordance with its terms.

IN WITNESS WHEREOF, American Physicians Insurance Exchange, by authority of its Board of Directors, has caused this Plan of Conversion to be signed by its Chairman and its Chief Executive Officer and its corporate seal to be affixed hereto attested by its Secretary on August 25, 2006.

AMERICAN PHYSICIANS INSURANCE EXCHANGE

By: /s/ Norris C. Knight
Name:Norris Knight, M.D.

Title:Chairman of the Board

ATTEST:

/s/ Gregory M. Jackson, M.D.

Name:Gregory M. Jackson, M.D.

Title:Secretary

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EXHIBIT A

CERTIFICATE OF FORMATION OF APIC

[SEE EXHIBIT F TO AMENDED MERGER AGREEMENT AND PLAN OF MERGER]

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EXHIBIT B

AMENDED AND RESTATED BYLAWS OF APIC

[SEE EXHIBIT G TO AMENDED MERGER AGREEMENT AND PLAN OF MERGER]

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ANNEX C

November 17, 2006

Dr. Norris C. Knight

Chairman of the Board

American Physicians Insurance Exchange

1301 S. Capital of Texas Hwy., Suite C-300

Austin, Texas 78746

Re: APIE Conversion and Acquisition

Dear Dr. Knight:

This letter is in response to your request for the opinion of Deloitte Tax LLP (Deloitte Tax), set forth below, regarding certain U.S. federal income tax consequences resulting from (i) the conversion of American Physicians Insurance Exchange (APIE) into a stock insurance company to be named American Physicians Insurance Company (APIC) (the Conversion) and (ii) the subsequent acquisition of APIC by American Physician Service Group, Inc. (APSG) through the merger of APSG s wholly owned subsidiary with and into APIC in exchange for APSG stock. (the Merger, and together with the Conversion, the Transactions).

This tax opinion letter (the Opinion) is limited to the specific U.S. federal income tax issues addressed herein. Additional tax issues may exist that could affect the U.S. federal tax treatment of the transactions that are the subject of this Opinion, and this Opinion does not consider or provide a conclusion with respect to any additional tax issues. This Opinion was not written, and cannot be used by the taxpayer, for the purposes of avoiding penalties with respect to any significant U.S. federal tax issues outside the limited scope of this Opinion (see section of this letter entitled ISSUES PRESENTED).

The conclusions expressed herein are based on our understanding of the facts, assumptions, documents, and representations described in this letter, as well as the current tax laws and tax authorities in effect as of the date of this letter. If any of these items are incorrect or change after the date of this letter, or if the tax law changes, the conclusions likewise would be subject to change. Deloitte Tax assumes no obligation to update this letter for any future changes in the tax law, regulations, or other authoritative interpretations, and does not intend to, unless it is specifically requested to do so.

In preparing this Opinion, we have (with your permission) reviewed and relied upon the following documents and the attachments thereto:

1. Representation Letter, dated November 17, 2006, and executed by APSG;

2. Representation Letter, dated November 17, 2006, and executed by APIE;

3. The Form of Plan of Conversion, dated June 1, 2006, as amended on August 25, 2006 and adopted by APIE (the Plan);

4. The Form of Merger Agreement and Plan of Merger, dated June 1, 2006 as amended on August 25, 2006, and executed by and among APSG, APSG ACQCO, Inc. (ACQCO), and APIE (the Agreement);

5. The Form of Advisory Services Agreement, to be executed by and among API Advisory, LLC (Advisor) and APIC (the Advisory Services Agreement);

6. The Form of Articles of Incorporation of APIC, to be filed with Texas Department of Insurance (Certificate of Formation);

7. The Form of Certificate of Designation executed by APSG pursuant to Article 2.13 of the Texas Business Corporation Act (the TBCA);

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8. The Form of Stock Option Agreement (Non-Qualified) to be executed by APSG and certain directors of APIE;

9. The United States Securities and Exchange Commission (the SEC) Amendment No. 2 Form S-4 registration statement under the Securities Act of 1933 (the Securities Act) filed by APSG on November 17, 2006, (the Registration Statement[1]); and

10. APSG s SEC Form 10-K Annual Report for the fiscal year ended December 31, 2005.

I. FACTS

The following is a summary of the facts upon which we have based the conclusions in this Opinion.

1. CORPORATE STRUCTURE APSG

A. APSG

APSG, a Texas corporation with its principal place of business in Austin, Texas, is a management and financial services firm whose subsidiaries and affiliates provide: (i) brokerage and investment services to institutions and individuals; and (ii) management services to APIE. APSG was organized in October 1974 and began trading on the NASDAQ Market under the symbol AMPH in 1983.

As of December 31, 2005, APSG had 20,000,000 authorized shares of $.10 par value common stock, with 2,784,120 shares issued and outstanding (with 139,107 treasury shares purchased and retired), and 1,000,000 authorized shares of $1.00 par value preferred stock, none of which had been issued. In addition, 483,000 shares of APSG common stock were subject to outstanding options. The average closing price of APSG common stock for the twenty consecutive trading days ending June 6, 2006 was $14.28 per share.

B. ACQCO

ACQCO, a Texas corporation, is a wholly owned subsidiary of APSG. ACQCO was formed and organized for the purpose of merging with and into APIC as part of the Transactions. ACQCO engages in no business activities and it has no material assets or liabilities, other than those assets and liabilities incident to its formation and those liabilities to be incurred in connection with the Merger.

C. The Advisor

Advisor, a Texas limited liability company to be owned by members of APIE s current Board of Directors, will be formed in connection with the Transactions and organized for the purpose of providing the APIC Board of Directors (the APIC Board) with advisory and consulting services under the Advisory Services Agreement. The obligations of APIC under the Advisory Services Agreement will be guaranteed by APSG.

APIC will establish an Advisory Board of Directors (the Advisory Board), with no more than nine members, with such members to be provided by Advisor. Under the Advisory Services Agreement, the Advisory Board will participate in APIC Board discussions, but in no event will the Advisory Board members have any right to vote on matters brought before the APIC Board. Advisor will retain the sole right to remove, appoint, or substitute persons to serve as members of the Advisory Board as it deems necessary to fulfill its obligations under the Advisory Services Agreement.

The APIC Board will be elected by its shareholders. However, APIC may, in its sole discretion, appoint one or more members of the Advisory board to serve on the APIC Board. The members of the Advisory Board (and any member of the Advisory Board appointed to the APIC Board) provided by the Advisor will be compensated directly by APIC for their services as a member of the Advisory Board and/or the APIC Board.

[1].

References to the Registration Statement also include prior registration statements filed in connection with the Merger, including the original registration statement filed on August 31, 2006 and subsequent amendments.

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In addition to appointing members of the Advisory Board, the Advisor will also be responsible for appointing Advisory Board members to serve on certain operating committees of APIC. Each APIC operating committee will consist of one or more members of the APIC Board appointed by an APIC Board resolution, and certain of these committees will include Advisory Board members appointed by the Advisor. Each committee, to the extent expressly provided in the APIC Board resolution establishing such committee, will have and may exercise all of the authority of the APIC Board in the management of the business and property of APIC, including the power and authority to declare a dividend and to authorize the issuance of shares of the Corporation, but will not have and may not exercise the authority of the APIC Board in certain other areas.[2] Under the Advisory Services Agreement, the Advisory Board members appointed to serve on operating committees of APIC will participate in APIC operating committee discussions, but in no event will such Advisory Board members have any right to vote on matters brought before the APIC operating committees.

The APIC Board will have the power at any time to fill vacancies in, to change the membership of, and to discharge any APIC committee. However, a committee member may be removed by the APIC, only if, (a) in the judgment of the board of directors, the best interests of the APIC will be served thereby, and (b) such removal is not inconsistent with the APIC Certificate of Formation.

Further, the Advisor will be responsible for retaining on behalf of APIC the services of a Medical Director and an Executive Secretary, both of which will be subject to the operational authority of the chief executive officer of APIC and the APIC Board. Although APIC will advance the compensation of the Medical Director and the Executive Secretary, such compensation will be the responsibility of the Advisor.

2. CORPORATE STRUCTURE APIE

A. APIE

APIE is a Texas reciprocal insurance exchange organized under Chapter 942 of the Texas Insurance Code. The purpose of APIE is to provide its policyholders with liability and other insurance coverage. A reciprocal insurance exchange is an organization under which insurance policyholders effectively exchange insurance contracts and thereby insure each other by becoming subscribers of the insurance exchange. APIE s insurance policyholders include (i) physicians who hold medical professional liability insurance contracts underwritten by APIE (the Subscribers) and (ii) non-Subscribers who are either (a) former Subscribers who have purchased or earned an extended reporting endorsement (tail coverage) within the last three years or (b) non-physician health care providers who hold professional liability insurance contracts underwritten by APIE (Other Eligible Insureds) (collectively, Subscribers and Other Eligible Insureds are referred to herein as Policyholders). APIE has no shareholders or any authorized capital stock. The APIE by-laws provide that the Subscribers hold certain rights in APIE (the Subscriber Interests), including the rights to select and terminate members of the APIE Board of Directors, as well as the exclusive rights to amend the APIE by-laws as it relates to the rights of Subscribers. Thus, the Subscribers hold proprietary interests in APIE. Although the Other Eligible Insureds are not entitled to vote for members of the APIE Board of Directors or on any other matter, APIE s bylaws provide that such insureds hold a non-voting proprietary interest in APIE (collectively, the Subscriber Interests and interests in APIE held by Other Eligible Insureds are referred to herein as Policyholder Interests).

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[2] No APIC committee will have the authority of the APIC Board in reference to: (i) amending the Certificate of Formation of APIC; (ii) approving a plan of merger or consolidation; (iii) recommending to APIC shareholders the sale, lease, or exchange of all or substantially all of the property and assets of APIC otherwise than in the usual and regular course of its business; (iv) recommending to the APIC shareholders a voluntary dissolution of the APIC or a revocation thereof; (v) amending, altering, or repealing the APIC bylaws or adopting new bylaws; (vi) filling vacancies in the APIC Board or of any APIC committee; (vii) filling any directorship to be filled by reason of an increase in the number of directors; (viii) electing or removing officers or committee members; (ix) fixing the compensation of any committee member; or (x) altering or repealing any resolution of the APIC Board which by its terms provides that it shall not be amendable or repealable.

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APIE only has two employees, and is managed through an attorney-in-fact contract discussed below. The Subscribers have the power to approve and terminate the attorney-in-fact under the APIE bylaws.

APIE is authorized to do business in Texas and Arkansas, and specializes in writing medical professional liability insurance for healthcare providers. It writes insurance in Texas primarily through purchasing groups and is not fully subject to certain rate and policy form regulations issued by the Texas Department of Insurance. It reviews applicants for insurance coverage based on the nature of their practices, prior claims records, and other underwriting criteria. APIE is one of the largest medical professional liability insurance companies in Texas and is the only such company that is wholly owned by its Subscribers.

Generally, medical professional liability insurance is offered on either a claims made basis or an occurrence basis. Claims made policies insure physicians only against claims that are reported during the period covered by the policy. Occurrence policies insure physicians against claims based on occurrences during the policy period regardless of when they are reported. APIE offers only a claims made policy in Texas and Arkansas, but provides for an extended reporting option upon termination of the policy. APIE reinsures 100 percent of all Texas and Arkansas coverage risk between $250,000 and $1,000,000 per medical incident, primarily through certain domestic and international insurance companies. In addition, APIE provides medical professional liability insurance policies with liability limits up to $1,000,000 per occurrence for nurses, nurse assistants, physician assistants, physical therapist, nurse midwives and moonlighters or medical residents who choose to practice medicine outside of their training program.

APIE is managed by its attorney-in-fact, APS Facilities Management, Inc., d.b.a. APMC Insurance Services (APMC), a wholly owned subsidiary of APSG, subject to the direction of APIE s Board of Directors. For these services, APIE pays APMC a management fee in an amount that is based on a percentage of the combination of statutory earned premiums of APIE and a percentage of APIE s statutory profits, subject to a ceiling limitation based on premium levels. APMC s assets are not subject to any insurance claims by the insureds of APIE.

APMC has been APIE s exclusive attorney-in-fact since APIE s inception in 1975. The management agreement between APMC and APIE provides for full management by APMC of the day-to-day operations of APIE under the direction of APIE s physician Board of Directors. Subject to the direction of the APIE Board, APMC sells and issues policies, investigates, settles, and defends claims on behalf of APIE, and otherwise manages APIE s affairs. APMC pays salaries, personnel-related expenses, rent, office operations costs, information technology costs, and many other operating expenses of APIE. APIE is responsible for the payment of all claims, claims expenses, peer review expenses, directors fees and expenses, legal, actuarial and auditing expenses, its taxes, outside agent commissions, and certain other specific expenses. Under the management agreement, APMC s authority to act as attorney-in-fact of APIE is automatically renewed each year unless a majority of the Subscribers of APIE elect to terminate the management agreement by reason of an adjudication that APMC has been grossly negligent, has acted in bad faith or with fraudulent intent, or has committed willful misfeasance in its management activities.

Due to APIE s unique structure, APIE has limited access to capital markets and can build surplus only through earnings or Subscriber deposits (Deposits). APIE was initially capitalized through refundable Deposits and has historically utilized Deposits to offset significant underwriting losses. From APIE s inception through March 1992 (the date of the Board decided it would no longer utilize refundable Deposits), as periodically determined and approved by the APIE Board of Directors, eligible physicians desiring to purchase insurance through APIE were required to make a refundable Deposit in exchange for a Deposit certificate (collectively, the Deposit Certificates). The amount of a refundable Deposit varied during this period based on the physician s medical specialty and the surplus requirements of APIE.

APIE s balance sheet currently identifies Deposits made by current and former Subscribers as refundable surplus deposits. Historically, for statutory insurance purposes, these Deposits have been recorded on its financial statements as a component of surplus similar to a surplus debenture. Past Deposits from Subscribers have not been fully refunded and constitute a significant portion of APIE s surplus.

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By Consent Order No. 04-0856, effective September 3, 2004 (the Order) the Texas Department of Insurance (the TDI) approved on a prospective basis a partial pro-rata refund of Deposits to former Subscribers and full refunds of Deposits to current Subscribers upon their death, disability, or retirement. By Amended Consent Order No. 05-0874 (the Amended Order), the TDI allowed APIE to refund such Deposits retrospectively and not just prospectively.

As of December 31, 2005, the total balance of Deposits was $10,567,520 of which (i) $488,558 is attributable to 95 current Subscribers and (ii) $10,078,961 is attributable to 2,292 former Subscribers who are no longer insured with APIE. Pursuant to the Amended Order, such former Subscribers may receive partial refunds in the aggregate amount of $200,000 per year provided the conditions in the Amended Order are met. Pursuant to the terms of the Amended Order, upon the death of a former Subscriber, the estate of such former Subscribers may request a refund of 50 percent of the outstanding balance of the Deposit. Pursuant to the Amended Order, current Subscribers may receive a full refund of their Deposits upon their death, disability, or retirement. No interest has accrued to Deposit holders since 1989.

Only Deposit holders (both current and former Subscribers) who provided a Deposit to APIE while insured by the company and who still have a balance owed to them by APIE should be holding a Deposit Certificate. Each Deposit Certificate on its face highlights the terms of refund, the interest rate, the rights of the Subscriber to vote, payments in the event of liquidation, and the lack of rights in APIE upon cancellation of his or her insurance policy.

3. THE TRANSACTIONS

A. General Summary

On the effective date of the Transactions, APIE will convert pursuant to the Texas Insurance Code (TIC) and the Texas Business Organization Code (TBOC) into a stock insurance company, change its name to APIC, and continue its corporate existence as a stock insurance company without interruption.

In the Conversion, the proprietary interests of the Policyholders will be exchanged for shares of APIC voting common stock, and the Deposit Certificates will be cancelled in exchange for shares of non-voting, mandatorily redeemable APIC preferred stock. Except for the common and preferred shares of APIC stock, no other consideration will be offered in the Conversion to the Policyholders or holders of Deposit Certificates.

Following the Conversion, provided that certain conditions are satisfied, APSG, ACQCO, and APIC will effect the Merger. Pursuant to the Merger, ACQCO will merge with and into APIC with APIC surviving. Although the Boards of Directors of both APSG and APIE have approved the Merger, completion of the Merger is subject to: (i) approval by the TDI; (ii) necessary filings with the SEC; (iii) approval of the shareholders of APSG and the APIE Subscribers; and (iv) the execution of the Advisory Services Agreement. Upon consummation of the Merger, APIC will become a wholly owned subsidiary of APSG.

In the Merger, each outstanding share of APIC common stock will be converted into, and exchanged for, APSG common stock. Likewise, each outstanding share of APIC preferred stock will be converted into, and exchanged for, APSG preferred stock. After the Merger, ACQCO will cease to exist, and APSG will be the holder of all of the issued and outstanding APIC voting common stock and APIC preferred stock. Each APIE insurance policy in force prior to the Transactions will remain in effect after the Merger.

B. Reason for the Transactions

With post-merger consolidated assets expected to exceed $180 million, consolidated equity exceeding $50 million, and consolidated revenues exceeding $80 million, the management of APSG and APIE believe the Transactions will allow APSG and APIE to build an organization that is positioned for growth and financial success.

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The management of APIE believes that the Transactions will allow APIE access to capital not previously available to it as a reciprocal insurance exchange. Additional capital will strengthen APIE, provide a platform for growth by increasing APIE s market capacity, and provide the opportunity for APIE to obtain a favorable A.M. Best rating. APIE s Policyholders will benefit directly from this new strength, as well as from the liquidity and opportunity of being shareholders of APSG. The Transactions should not result in any changes in coverage or other contractual obligations in existing insurance policies. In addition, APIE has structured the Transactions to retain the involvement of its physician insureds (through the Advisor) in the insurance operations.

C. The Conversion

(i) General Terms

The Conversion will take effect pursuant to the Plan when a Certificate of Formation of a stock insurance company as approved by the APIE s Subscribers is filed with the Commissioner of Insurance of the State of Texas (the Commissioner) (the Effective Time of the Conversion). Without further act or deed, APIE will: (i) adopt the provisions of Chapter 822 of the Texas Insurance Code (TIC); (ii) adopt a Certificate of Formation pursuant to the provisions of Section 822.052 of the TIC to become a stock property and casualty insurance company authorized to issue capital stock; and (iii) change its corporate name to APIC. All of the shares of APIC common stock and APIC preferred stock will be uncertificated shares and will be issued in exchange for the proprietary interests of eligible Policyholders and for the cancellation of the Deposit Certificates, respectively, which will be the sole consideration for the issuance of such shares.[3]

The legal existence of APIE will continue as a stock insurance company without interruption from June 26, 1975. Thus, all of APIE s assets, rights, franchises, privileges, powers, permits, licenses, and interests in and to property, real, personal, or mixed, and any accompanying things in action, will be vested in APIC, without a deed or transfer. In addition, all of APIE s obligations and liabilities will become obligations and liabilities of APIC.

At the Effective Time of the Conversion, each eligible Subscriber and Other Eligible Insured will receive the number of shares of APIC common stock as provided below:

(I) Thirty percent of the 10 million shares of $1.00 par value APIC common stock will be divided equally among all of the eligible Subscribers on a per eligible Subscriber basis; and

(II) Seventy percent of the 10 million shares of $1.00 par value APIC common stock will be divided among the eligible Subscribers and Other Eligible Insureds based upon the Attributable Earned Premium of each eligible Subscriber and Other Eligible Insured during the three year period beginning June 1, 2003 and ending on the May 31, 2006 in relation to the Attributable Earned Premium of all eligible Subscribers and Other Eligible Insureds over such period of time. Attributable Earned Premium for this purpose means earned premium attributable to such eligible Subscribers and Other Eligible Insureds under a Policy issued by APIE, but excluding maintenance fees and legal defense premiums.

Upon such issuance, all Policyholder Interests and all other rights of all Policyholders (except for the rights of Policyholders arising under their insurance policies) in APIE will be extinguished.

In addition, APIE Deposit Certificates will be converted into and exchanged for a number of shares or fractional shares of $1.00 par value mandatorily redeemable APIC non-voting preferred stock equal to the number of dollars of unreturned Deposits evidenced by the outstanding balance on APIE s books at the time of the Conversion, divided by one thousand (1,000). Upon the Conversion, all rights of each Deposit Certificate holder under and with respect to each Deposit Certificate, including, without limitation, all rights to any additional payments by APIC will be fully extinguished and entirely replaced by the shares of APIC redeemable preferred stock issued in consideration of such exchange. The APIC redeemable preferred stock will provide for

[3] Subscribers and Other Eligible Insureds will be eligible to participate in the Conversion if they maintained an insurance policy on June 1, 2006 and did not voluntarily terminate their insurance policy by cancellation prior to the Effective Time of the Conversion.

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cumulative dividends thereon at the rate of three percent (3%) per annum payable on the redemption value per share, in priority to the payments of dividends on the common shares. The terms of the APIC redeemable preferred stock will provide that APIC shall redeem, by the end of each fiscal year of APIC during which there are shares of such preferred stock outstanding, a number of shares of such preferred stock outstanding on such redemption date with an aggregate redemption price equal to $1 million. Notwithstanding the foregoing, APIC (i) shall redeem all remaining outstanding shares of the APIC redeemable preferred stock on or before December 31, 2016, and (ii) shall not be required to make the initial redemption prior to twelve (12) months after the Effective Time of the Conversion. Furthermore, the terms of the APIC redeemable preferred stock will provide that APIC shall have an optional right to redeem outstanding shares of the APIC redeemable preferred stock, in whole or in part, at any time.

(ii) Conditions to the Conversion

The Plan provides that the Conversion will not become effective until certain conditions are met, including:

(I) The Plan is approved by the Commissioner, and a public hearing is held in accordance with the provisions of Chapter 823 of the TIC.

(II) APIE has sent to each Policyholder and each holder of a Deposit Certificate a notice advising such persons of the adoption and filing with the Commissioner of the initial Plan and such person s right to provide to the Commissioner and APIE comments on the Plan.

(III) Approval of the Plan by the eligible Subscribers at a meeting of eligible Subscribers.

(IV) APIE has obtained rulings from the IRS or obtained an opinion from its tax advisors satisfactory to APIE with respect to certain tax aspects of the Conversion and of the Merger.

(V) APIE has (i) obtained a no-action letter from the SEC in form and substance satisfactory to APIE relating to matters pertaining to applicable federal securities laws, and/or (ii) received an opinion of independent legal counsel in form and substance satisfactory to APIE with respect to federal and state securities law matters.

(VI) All conditions precedent (exclusive of the Conversion) to the closing of the Merger have been satisfied or waived by the parties to the Agreement.

D. The Merger

(i) General Terms

Following the Conversion, and in accordance with the terms of the Agreement, ACQCO will merge with and into APIC, with APIC surviving. The closing of the Merger (the Closing) will be effected by filing a Certificate of Merger with the Secretary of State of Texas and, if necessary, with the TDI and the Arkansas Insurance Department (AID), in accordance with the applicable provisions of the TBCA and the TBOC. The Closing will take place after the satisfaction or waiver of the conditions set forth in the Agreement.

On the effective date of the Merger (the Merger Effective Date), all of the property, rights, privileges, powers, and franchises of ACQCO will vest in APIC, and all debts, liabilities, obligations, and duties of ACQCO, including the rights and obligations under the agreements, if any, of ACQCO, will become APIC s debts, liabilities, obligations, and duties. The Merger will not affect the policy coverage of any policy of insurance issued by APIC and all policies and obligations, if any, of ACQCO will be assumed by APIC.

In the Merger, each share of APIC common stock will be converted into, and exchanged for, the number of shares of APSG common stock, par value $0.10 per share, equal to the Exchange Ratio. There will not be any certificates issued to represent the outstanding APIC common stock received in the Conversion, and the holders of APIC common stock, on the Merger Effective Date, will cease to have any rights with respect to the APIC common stock except the right to receive: (i) the APSG common stock determined under the Agreement and (ii) cash in lieu of fractional shares of APSG common stock, in each case without interest. Immediately following the Merger Effective Date, APSG will be the holder of all of the issued and outstanding APIC common stock.

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In the Merger, each share of APIC preferred stock will be converted into, and exchanged for, a like number of shares of APSG mandatorily redeemable voting preferred stock, par value $1.00 per share. The APSG preferred shares will have the same redemption and dividend provisions as the APIC preferred stock. There will not be any certificates issued to represent the outstanding APIC preferred stock received in the Conversion, and the holders of APIC preferred stock, on the Merger Effective Date, will cease to have any rights with respect to the APIC preferred stock except the right to receive APSG preferred stock. Immediately following the Merger Effective Date, APSG will be the holder of all of the issued and outstanding APIC common stock.

ACQCO will cease to exist on the Merger Effective Date. The aggregate APSG common stock, the aggregate APSG preferred stock, and cash in lieu of fractional APSG common stock, in each case without interest, will be collectively referred to as the Merger Consideration.

In connection with the Merger, APIC will enter into the Advisory Services Agreement with Advisor, which will be owned at the time of the Merger by current members of APIE s Board of Directors, all but one of which are also APIC shareholders. The fair market value of the payments to be made by APIC, and guaranteed by APSG, under the Advisory Services Agreement will be commensurate with the value of the services to be provided to APIC by Advisor.

Finally, pursuant to separate agreements to be executed between APSG and former APIE Directors (each of these agreements referred to as a Stock Option Agreement), APSG will issue to former APIE Directors in connection with their future service to APSG 148,000 stock options to purchase APSG common stock, par value $0.10 per share, at an agreed upon price of $13.94. Generally, each option holder will have five (5) years from the date of its Stock Option Agreement to exercise the options.[4] The options will be issued by APSG in accordance with APSG s current incentive and non-qualified stock option plan. Such options will have terms substantially identical to the options APSG grants to its existing employees and will be commensurate with the value of the services to be provided to APSG by the former APIE Directors.

(ii) The Exchange Ratio

Each share of APIC common stock received in the Conversion will be exchanged for a number of APSG common shares equal to the Exchange Ratio. The Exchange Ratio will equal: (a) $39 million, less the discounted value of the future payments to holders of redeemable APIC preferred stock (the Purchase Price), divided by the average NASDAQ market closing price of APSG common shares for the twenty trading days immediately prior to the date the Agreement is fully executed and announced in an SEC filing (the Announcement Market Price); divided by (b) the aggregate number of shares of APIC common stock entitled to be received in the Conversion.

However, if the average NASDAQ market closing price of APSG common stock for the twenty-day period prior to the closing of the Merger (the Closing Market Price) is more than 115 percent of the Announcement Market Price; or is less than 85 percent of the Announcement Market Price, the Exchange Ratio will be modified. In addition, the Agreement may be terminated if the Closing Market Price is more than 25 percent greater than or less than the Announcement Market Price.

(iii) No Fractional Shares of APSG Common Stock

No fractional shares of APSG common stock will be issued in the Merger and fractional share interests will not entitle the owner thereof to vote or to any rights of an APSG shareholder. All Shareholders that would be entitled to receive fractional APSG common stock will be entitled to receive, in lieu thereof, an amount in cash determined by multiplying the fraction of a share of APSG common stock to which such holder would otherwise have been entitled by the Announcement Market Price or the Closing Market Price, as applicable.

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[4] The 5-year period is subject to termination provisions in Section 4 of the Stock Option Agreement that terminate the option period due to the complete separation of option holder from APSG or its direct and indirect subsidiaries for any reason, including death and disability.

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(iv) Dissenting Shareholders

In the Merger, there will be no dissenters rights for either preferred or common shareholders of APIC.

(v) Conditions to the Merger

The Agreement provides that the Merger will not become effective until certain conditions are met, including:

(I) The representations and warranties of APIE and APSG contained in the Agreement are true and correct, or APIE and APSG have performed all of its obligations required by the Agreement;

(II) The Advisory Services Agreement must have been fully executed as of the Merger Effective Date and be in full force and effect;

(III) APIC and APSG must have received reasonable assurances from their tax advisors that, for federal income tax purposes, the Conversion and the Merger should qualify as a tax-free reorganization under section 368(a) of the Code; and

(IV) There were no legal or regulatory injunctions or impediments to completing the Conversion or the Merger.

II. ISSUES PRESENTED

1. Whether the Conversion should qualify as a reorganization under section 368(a)(1)(E).

2. Whether APIE, APIC, the Subscribers, the Other Eligible Insureds, or holders of Deposit Certificates should recognize gain or loss in the Conversion.

3. Whether the Merger should qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

4. Whether APSG, APIC, or the APIC common and preferred shareholders that receive APSG shares in the Merger should recognize gain or loss in the Merger.

III. CONCLUSIONS

1. The Conversion should qualify as a reorganization under section 368(a)(1)(E).

2. Neither APIE nor APIC, should recognize gain or loss in the Conversion.

3. Subscribers and Other Eligible Insureds should not recognize gain or loss if they only receive APIC common stock in the Conversion. However, Subscribers who also are holders of Deposit Certificates should recognize gain, but not loss, to the extent they receive APIC preferred stock in the Conversion. Holders of Deposit Certificates that only receive APIC preferred stock should recognize gain or loss in the Conversion.

4. The Merger should qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

5. APSG, APIC, and the APIC common and preferred shareholders that receive APSG shares in the Merger should not recognize gain or loss in the Merger.

IV. LAW AND ANALYSIS

1. The Conversion should qualify as a reorganization under section 368(a)(1)(E).

To qualify as a reorganization under section 368(a), a transaction must generally: (a) satisfy at least one of the statutory definitions contained in section 368(a)(1); (b) occur pursuant to a plan of reorganization; (c) be consummated for a valid business purpose; (d) satisfy the continuity of business enterprise (COBE) requirement; and (e) satisfy the continuity of interest (COI) requirement.

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A. Statutory Definition

Section 368(a)(1)(E) provides that the term reorganization includes a recapitalization (an E reorganization). For purposes of section 368(a)(1)(E), a recapitalization has been defined by the U.S. Supreme Court as a reshuffling of a capital structure within the framework of an existing corporation.[5] Rev. Rul. 2003-19 illustrates three such reshufflings in the context of mutual companies converting to stock companies under state law, each of which qualified as a recapitalization, and therefore a reorganization under section 368(a)(1)(E).[6]

Situation 1 in Rev. Rul. 2003-19 involved Mutual Company, a State Y mutual insurance company whose members had both membership interests in Mutual Company and contractual rights under either insurance policies or annuity contracts. The Mutual Company members received their membership interest in Mutual Company as a result of the purchase of a life insurance or an annuity contract that was inextricably tied to the contract from the time of purchase. A membership interest in Mutual Company entitled the member to vote for the board of directors and to receive assets or other consideration in the event of the demutualization, dissolution, or liquidation of Mutual Company. The rights inherent in each membership interest were created by operation of State Y law solely as a result of the policyholder s acquisition of the underlying contract from Mutual Company and could not be transferred separately from that contract. Further, if the contract was surrendered by the policyholder or, in the event the contract was otherwise terminated by payment of benefits to the contract beneficiary, these membership interests would cease to exist, having no continuing value.

Pursuant to a plan to convert Mutual Company from a mutual insurance company to a stock insurance company, Mutual Company amended and restated its articles of incorporation and bylaws to authorize the issuance of capital stock and changed its name to Stock Company. Pursuant to State Y law, members of Mutual Company surrendered their membership interests in Mutual Company to Stock Company in exchange for all of Stock Company s voting common stock.

Because Stock Company was the same corporation as Mutual Company under State Y law, the Internal Revenue Service (the IRS or the Service) concluded that the conversion from a mutual insurance company to a stock insurance company was an E reorganization, and that the exchange by members of their Mutual Company membership interests for stock in Stock Company was pursuant to that reorganization.

In Situations 2 and 3, following the conversion of Mutual Company to a Stock Company, the shareholders of the Stock Company immediately exchanged their Stock Company shares for stock of another company that acquired control of Stock Company. The Service determined that its conclusion that the conversion of Mutual Company to Stock Company qualified as a reorganization under section 368(a)(1)(E) was not altered by the fact that there is a subsequent change in the direct ownership of the converted company.[7]

Similar to Rev. Rul. 2003-19, the Conversion will result in a reshuffling of the capital structure of APIE. Here, APIC will be the same legal entity as APIE under Texas law. The Conversion will also involve Policyholders exchanging their proprietary interests in APIE for APIC common stock, and Deposit Certificate holders exchanging their Deposit Certificates for preferred stock in APIC. Accordingly, the Conversion should satisfy the definition of a recapitalization, thus meeting the statutory definition of a reorganization under section 368(a)(1)(E).

B. Plan of Reorganization

In order for a transaction to qualify as a reorganization under section 368(a), it must be effected pursuant to a plan of reorganization. A plan of reorganization must contemplate the execution of a transaction specifically described in section 368(a) and the *bona fide* consummation of each requisite act under which non-recognition

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5 *See Helvering v. Southwest Consolidated Corp*., 315 U.S. 194 (1942).

6 2003-1 C.B. 468.

7 2003-1 C.B. 468 (citing Treas. Reg. § 1.368-1 (e) (1); Rev. Rul. 96-29, 1996-1 C.B. 50; Rev. Rul. 77-415, 1977-2 C.B. 311).

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of gain is claimed.[8] In addition, any plan of reorganization must appear in the official records of a party to the reorganization, and each party to the reorganization must file a copy of the plan of reorganization, together with a reorganization statement, as part of its U.S. federal income tax return for the year in which the transaction occurs.[9]

The Conversion will be effected pursuant to the Plan adopted by APIE and referenced in the Agreement. Both the Plan and the Agreement contemplate the execution of a reshuffling of APIE s corporate structure intended to qualify as a reorganization described in section 368(a)(1)(E). In fact, the Agreement requires that the Plan be executed and approved by the Commissioner prior to the Closing of the Merger. Further, APIE has represented that it will attach a copy of the Plan to its U.S. federal income tax return for the taxable year in which the Conversion is effected. Therefore, based on the representations and the facts and analysis above, the plan of reorganization requirement should be satisfied.

C. Business Purpose

In addition to meeting one of the specific definitions contained in section 368(a), a reorganization must also be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization.[10] If the transaction or series of transactions has no business or corporate purpose, then the transactions will not constitute a reorganization under section 368(a).

APIE has represented that the Conversion will be undertaken for bona fide business purposes unrelated to U.S. federal income taxes. APIE management believes that the Conversion and the subsequent Merger will allow APIE access to capital not previously available to it as a reciprocal insurance exchange. This additional capital will strengthen APIE, provide a platform for growth by increasing APIE s market capacity, and provide the opportunity for APIE to obtain a favorable A.M. Best rating. For these reasons, the Conversion should satisfy the business purpose requirement.

D. COBE and COI Not Required

As noted above, for most transactions to qualify as a reorganization under section 368(a), the transaction must satisfy the continuity of business enterprise (COBE) requirement and the continuity of interest (COI) requirement under Treas. Reg. § 1.368-1(d) and (e). Both the COBE and COI requirements are intended to determine whether a transaction involves an otherwise taxable transfer of stock or assets of one corporation to another corporation, as distinguished from a tax-free reorganization, which assumes only a readjustment of continuing interests under a modified corporate form.[11] However, a recapitalization does not involve a transfer from one corporation to another; rather a recapitalization entails the restructuring of capital within a single corporation.[12] Accordingly, Treas. Reg. § 1.368-1(b) provides that COI and COBE are not required for a transaction to qualify as an E reorganization. Thus, the Conversion should not need to satisfy the COI or COBE requirements to qualify as a reorganization under section 368(a)(1)(E).

E. The Conversion should be a Reorganization under section 368(a)(1)(E).

Because the Conversion should (a) satisfy the statutory definition of a reorganization under section 368(a)(1)(E), (b) occur pursuant to a plan of reorganization; and (c) be consummated for a valid business purpose, the Conversion should qualify as a reorganization under section 368(a)(1)(E) for U.S. federal income tax purposes.

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8 Treas. Reg. § 1.368-1(c).

9 Treas. Reg. § 1.368-3.

10 Treas. Reg. § 1.368-2(g).

11 Treas. Reg. § 1.368-1(b).

12 *See* Reg-106889-04, 69 Fed. Reg. 49836 (August 12, 2004), in the preamble to the proposed regulations, the Treasury Department cited earlier revenue rulings in which the Service determined that the COI and COBE requirements are necessary in an acquisitive reorganization (to ensure that the transaction does not involve an otherwise taxable transfer of stock or assets), but that they are not necessary when the transaction involves only a single corporation.

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2. Tax Consequences of a reorganization under section 368(a)(1)(E)

A. APIC should be a party to a reorganization

Section 368(b)(1) provides that the term a party to a reorganization includes a corporation resulting from a reorganization. Accordingly, with respect to the Conversion APIC should be a party to a reorganization.

B. APIC should recognize no gain or loss in the Conversion

Section 1032(a) provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation. Accordingly, no gain or loss should be recognized by APIC on the receipt of the APIE Policyholder Interests and the cancellation of the Deposit Certificates in exchange for newly issued APIC common and preferred stock in the Conversion.

Notwithstanding section 1032, section 61(a)(12) provides that income from discharge of indebtedness (COD income) constitutes an item of gross income. Section 108(e)(8) further provides that for purposes of determining COD income, if a debtor corporation transfers stock to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. The issuing corporation realizes COD income if and to the extent that the amount of debt exceeds the value of the stock and other consideration transferred in the exchange. However, if an interest in the issuing corporation does not constitute indebtedness, then its discounted discharge does not constitute COD income under section 61(a)(12) or section 108(e)(8).

Regardless of whether or not an obligation constitutes indebtedness, no COD income should arise for the obligor from the discharge of an obligation where the obligor does not realize an accession to wealth. Courts have routinely endorsed this principle and reasoned that the amount of the income with respect to the discharged obligation is only equal to the offsetting increase to the obligor s assets that occurs by virtue of the discharge.[13]

The Deposit Certificates should not constitute indebtedness. In *Policyholder s National Life Insurance Company v. Commissioner*, the U.S. Board of Tax Appeals (the BTA) held that obligatory payments made on founder s certificates by a mutual insurance company did not constitute deductible interest because the instruments did not constitute indebtedness for federal income tax purposes.[14] In *Policyholder s*, the policyholders of a mutual insurance company were required to purchase in addition to their policy an endowment feature that was repayable in full after six years, or upon the election of the insured, convertible to a founder s certificate at that time. Each founder s certificate was to be treated as a distinct and separate liability of the insurance company that would be exchanged for corporate stock upon the conversion of the mutual company to a stock company. Until the conditions necessary for conversion to a stock company were obtained, the company s board of directors were authorized to make interest payments on the founder s certificates not to exceed 6 percent per annum if, in their judgment, the financial condition of the company warranted such payment. The BTA found that that the holders of the founder s certificates had a proprietary interest in the company because the company did not obligate itself to pay interest on the Founders Certificates. Furthermore, although the company was obligated to convert to a stock company and issue stock to the certificate holders when a company fund reached a certain dollar amount, such fund was always at the risk of the business like any other surplus of the company. Accordingly, the BTA held that any payments made on the founder s certificates were voluntary distributions of the company s profits and not deductible interest.

In *Commissioner v. Union Mutual Insurance Company of Providence*, the U.S. Tax Court held and the U.S. Court of Appeals for the First Circuit affirmed that guaranty certificates issued by a mutual insurance company

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13 *See United States v. Kirby Lumber,* 284 U.S. 1 (1931); *Fashion Park, Inc. v. Comm r,* 21 T.C. 600 (1954), *nonacq.*, 1955-1 C.B.; *United States v. U.S. Steel Corp.*, 848 F.2d 1232 (Fed. Cir. 1988), *rev g* 11 Cl. Ct. 375 (1986).

14 37 B.T.A. 60 (1938).

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constituted indebtedness for federal income tax purposes.[15] In *Union Mutual*, a mutual insurance company had issued guaranty fund certificates to provide a reserve that would enable it under state law to write policies free of any contingent liability on the part of its policyholders. The guaranty fund certificates were issued for a fixed amount, provided for semi-annual interest payments of not more than 5 percent nor less than 3 1/2 percent, and were transferable. The company made semi-annual payments for every year, including loss years, on the guaranty fund certificates. However, such payments were permitted to be made only from surplus funds above the company s required reserves. In addition, the guaranty certificates provided holders the right to elect some members of the company s board of directors.

In arriving at its decision, the First Circuit distinguished the certificates issued in *Union Mutual* from those at issue in *Policyholder s.* Regular payments on the guaranty fund certificates in *Union Mutual* were contingent on the company having excess capital above state mandated levels, whereas the payments in *Policyholder s* were wholly contingent on the judgment of the company s board of directors that the company was financially able to make such payments.[16]

In Rev. Rul. 68-515, the Service stated that it would follow the First Circuit s decision in *Union Mutual* by treating guaranty fund certificates similar to those issued by the taxpayer in *Union Mutual* as debt so that payments made on such certificates are deductible as interest expense for federal income tax purposes.[17]

Here, some of the Deposit Certificates are non-interest bearing, while others bear interest at a rate determined by the APIE Board of Directors. However, this interest rate was set at zero in 1989 and has not been changed, such that no Deposit Certificate has accrued interest since 1989. Therefore, similar to the distinguishing feature in *Policyholder s,* the APIE Board of Directors is under no obligation to make interest payments on the Deposit Certificates. In addition, under the terms of the Deposit Certificate, refund of the Deposit is conditional on the existence of a minimum surplus in APIE as specified and approved by the APIE Board of Directors. Thus, unlike the facts of *Union Mutual,* refund of the Deposit Certificate is wholly contingent on the specification and approval of the APIE Board of Directors. Accordingly, because both interest payments and refunds of the Deposit Certificates are wholly contingent on the discretion of the APIE Board of Directors, the Deposit Certificates are distinguishable from those in *Union Mutual* and, under *Policyholder s*, should not constitute indebtedness of APIE.

Moreover, the issuance of the APIC preferred stock by APIC to the Deposit Certificate holders in exchange for the cancellation of their Deposit Certificates should not result in an accession to the wealth of APIC. As noted above, the Deposit Certificates have not accrued interest since 1989 (in fact, Deposit Certificates issued since 1987 have been non-interest bearing). There is no fixed maturity date on the Deposit Certificates. The APIC preferred stock that will be issued to the Deposit Certificate holders will be equal to the number of dollars of unreturned Deposits evidenced by the outstanding balance on APIE s books at the time of the Conversion. Additionally, the APIC preferred stock will have redemption features more favorable than the contingent and indefinite refund features of the Deposit Certificates. The APIC preferred stock will be mandatorily redeemable at $1 million per year, with all such stock to be redeemed by APIC by December 31, 2016. Also, unlike holders of the APIE Deposit Certificates, holders of APIC redeemable preferred stock will be entitled to cumulative dividends thereon at the rate of three percent (3%) per annum payable on the redemption value per share, in

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15 386 F.2d 974 (1st Cir. 1967). *See also Jones v. U.S.*, 659 F.2d 618 (5th Cir. 1981) (surplus capital notes issued by a mutual insurance company that provided for fixed payments and fixed maturity dates that were both contingent upon the company having funds in excess of the state imposed minimum capital requirements constituted hybrid instruments that should be afforded debt treatment for federal income tax purposes); *Anchor National Life Insurance Company v. Commissioner*, 93 T.C. 382 (1989) (payments made on certificates of contribution issued by a stock insurance company to its sole shareholder that were contingent upon maintaining capital reserves at state imposed levels constituted deductible interest because certificates constituted debt for federal income tax purposes).

16 386 F.2d at 977-978.

17 1968-2 C.B. 297.

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priority to the payments of dividends on the APIC common shares. Accordingly, the increase to APIC s assets by virtue of the cancellation of the Deposit Certificates should be no greater than the amount of the Deposit Certificates cancelled.

Thus, because the Deposit Certificates should not constitute indebtedness, and because the cancellation of the Deposit Certificates should not result in an accession to wealth for APIC, no COD income should be recognized by APIC on the cancellation of the Deposit Certificates in exchange for newly issued APIC preferred stock in the Conversion.

C. Policyholders receiving only APIC common stock, should recognize no gain or loss in the Conversion

Section 1001 generally provides for the recognition of gain or loss upon an exchange of property equal to the difference between the amount of property received and the basis in the property exchanged therefore. Section 354 provides an exception to this general rule. Section 354(a)(1) provides that no gain or loss shall be recognized to a shareholder if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. However, section 354(a)(2)(C) provides that any nonqualified preferred stock (NQPS) received in exchange for stock other than NQPS is not treated as stock or securities exchanged in a reorganization, but as money or other property.

NQPS is defined in section 351(g)(2) as preferred stock having certain rights or obligations associated with it, including an obligation by the issuing corporation to redeem such stock within the 20 year period beginning on the date of issuance. For this purpose, preferred stock is defined as stock that is limited or preferred as to dividends and does not participate in corporate growth to any significant extent.

If a shareholder receives money or other property in addition to stock or securities in a party to the reorganization, section 354 will not apply. Section 356 provides, in part, that if section 354 would apply but for the fact that money or other property is received in addition to property permitted to be received in an exchange to which section 354 would apply, then gain, but not loss, will be recognized to the extent of the fair market value of the money and other property received. That gain generally will constitute capital gain if the property exchanged was held as a capital asset.

As discussed above, with respect to the Conversion, APIC should be a party to a reorganization. In the context of a non-stock corporation, the proprietary interests in the corporation should be treated as voting stock.[18] For this purpose, a proprietary interest in a corporation is an interest that represents a definite and substantial interest in the affairs of a corporation, and possesses three or more of the following characteristics: (i) the only ownership instrument in the corporation; (ii) the right to vote on matters for which the corporation s management must obtain shareholder approval; (iii) the right to receive dividends rather than interest on their interests but no legal right to have a dividend declared or to have a fixed return on their investment; and (iv) the right to a pro rata distribution of any remaining assets after a solvent dissolution.[19] APIE has represented that the Policyholders interests in APIE constitute the only ownership interest in APIE. In addition, the Subscribers interests in APIE possess the right to vote for the APIE Board. Furthermore, all Policyholders have a right to a pro rata distribution of APIE s assets upon a solvent dissolution. Taxpayer has represented the interests in APIE held by the Policyholders constitute proprietary interests in APIE. Accordingly, for U.S. federal income tax purposes, the APIE Policyholder Interests should constitute proprietary interests in APIE and be treated as voting stock.

In the Conversion, the APIE Policyholders will surrender their proprietary interests in APIE for APIC common stock.[20] Thus, such Policyholders Interests should be viewed as surrendered in exchange solely for the

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18 *See* Rev. Rul. 69-3, 1969-1 C.B. 103; Rev. Rul. 2003-19, 2003-1 C.B. 468.

19 *See* Rev. Rul. 78-286, 1978-2 C.B. 145; Rev. Rul. 80-105, 1980-1 C.B. 78.

20 *See*, *e.g,* Rev. Rul. 69-142, 1969-1 C.B. 107; Rev. Rul. 70-41, 1970-1 C.B. 77; Rev. Rul. 78-408, 1978-2 C.B. 203; Rev. Rul. 98-10, 1998-1 C.B. 643, *modifying* Rev. Rul. 69-142, Rev. Rul. 70-41, Rev. Rul. 78-408.

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APIC common stock received in the Conversion. Accordingly no gain or loss should be recognized by such Policyholders because they exchanged their previously held Policyholder Interests solely for APIC common stock.

As detailed above, holders of Deposit Certificates will surrender their Deposit Certificates solely in exchange for redeemable APIC preferred stock. Pursuant to the terms of the preferred stock, APIC shall redeem, by the end of each fiscal year of APIC during which there are shares of such preferred stock outstanding, a number of shares having a fair market value of $1 million per year, and in any event, APIC shall redeem all remaining outstanding shares of the APIC redeemable preferred stock on or before December 31, 2016. In addition, APIC will not be required to redeem any APIC preferred stock until twelve months after the Effective Time of the Conversion. Furthermore, APIC shall have an optional right to redeem outstanding shares of the APIC redeemable preferred stock, in whole or in part, at anytime after the Conversion.

Because the APIC preferred stock will be limited and preferred as to dividends, and APIC will have the exclusive right to redeem the APIC preferred stock at anytime, the APIC preferred stock should constitute NQPS for purposes of section 354(a)(2)(C). Thus, the APIC preferred stock should not be treated as stock or securities for purposes of section 354, but as money or other property.

If a Policyholder holds a Deposit Certificate in addition to a Policyholder Interest, and thereby receives APIC preferred stock as well as APIC common stock, section 354 should not apply to provide non-recognition treatment to such Policyholder in the Conversion. Rather, under section 356, a Policyholder that receives both APIC common stock and APIC preferred stock should recognize gain, but not loss, equal to the lesser of: (i) the gain realized upon the surrender of the Deposit Certificate, or (ii) the fair market value of the APIC preferred stock received in exchange therefore.

If a Deposit Certificate holder is not also a Policyholder, and thus surrenders only a Deposit Certificate in exchange for APIC preferred stock in connection with the Conversion, section 354 should not apply to provide non-recognition treatment to such Policyholder in the Conversion. Section 356 will also not apply because such Policyholder will only receive NQPS in the Conversion. Accordingly, holders of Deposit Certificates that are not also Policyholders that receive APIC common stock in the Conversion should recognize gain or loss under section 1001 upon the exchange of their previously held Deposit Certificates for newly issued shares of APIC preferred stock.

D. Basis in APIC common and preferred stock

Section 358(a)(1) provides that in the case of an exchange to which Section 354 applies, the basis of the property to be received without the recognition of gain or loss shall be the same as that of the property exchanged, decreased by (i) the fair market value of any other property (except money) received by the taxpayer, (ii) the amount of money received by the taxpayer, and (iii) the amount of loss to the taxpayer which was recognized on such exchange, and increased by (i) the amount which was treated as a dividend, and (ii) the amount of gain to the taxpayer which was recognized in such exchange (not including any portion of such gain which was treated as a dividend).

In the Conversion, the Policyholders and Deposit Certificate holders will receive APIC common stock and APIC preferred stock, respectively. Therefore, the basis of the newly issued APIC common stock in the hands of the APIC shareholders should generally be the same as the basis of the APIE Policyholder Interests. However, if such Policyholders also recognize gain upon the receipt of Deposit Certificates, the basis of their APIC common stock should be increased by the amount of such gain. Finally, Deposit Certificate holders that recognize gain or loss on the receipt of APIC preferred stock in the Conversion should hold such stock with a fair market value basis.

E. Holding period in APIC common and preferred stock

Section 1223(1) provides that in determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which the taxpayer held the property exchanged if the

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property has, for the purpose of determining gain or loss from a sale or exchange, the same basis (in whole or in part) in its hands as the property exchanged. In the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange must be a capital asset as defined in Section 1221 or property described in Section 1231.

The basis of the newly issued APIC common stock received by APIE Policyholders in the Conversion should have the same basis as the APIE Policyholder Interests surrendered in exchange therefor. Accordingly, the holding period of APIC common stock received by the APIC shareholders in the Conversion should include the period during which such persons held their respective APIE Policyholder Interests, provided that these interests were held as a capital asset at the Effective Time of the Conversion. The holding period of APIC shareholders that should recognize gain or loss on the receipt of APIC preferred stock should not include any period prior to the Effective Time of the Conversion.

F. APIC should retain APIE tax attributes

Section 381(a) provides generally for the carryover of tax attributes to the acquiring corporation in certain reorganizations specified in section 381(a)(2). However, section 381(a)(2) excludes a reorganization under section 368(a)(1)(E) because there is no acquiring corporation in a recapitalization, and because the recapitalized corporation does not terminate or otherwise cease, dissolve, or merge. Furthermore, in Rev. Rul 54-482,[21] the Service reiterated that a corporation, before and after a recapitalization, is the same corporation for U.S. federal income tax purposes. Thus, the Service concluded that the recapitalized corporation s earnings and profits, and net operating losses sustained before the reorganization, would be available to the reorganized corporation.

As discussed above, the Conversion should qualify as a reorganization under section 368(a)(1)(E). Accordingly, the tax attributes of APIE, including net operating losses incurred prior to the Conversion, if any, should be available for use by APIC following the recapitalization.

3. The Merger should qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E)

To qualify as a reorganization under section 368(a), a merger of one corporation into another must: (a) satisfy at least one of the statutory definitions contained in section 368(a)(1); (b) occur pursuant to a plan of reorganization; (c) satisfy the continuity of business enterprise requirement; (d) satisfy the continuity of interest requirement; and (e) be consummated for a valid business purpose.

A. Statutory Definition

Section 368(a)(1)(A) provides that the term reorganization includes a statutory merger. The regulations under section 368 define a statutory merger as a transaction effected under the statute or statutes necessary to effect the merger, if the operation of such statute or statutes simultaneously transfers all of the assets and liabilities of a transferor corporation to a transferee corporation and ceases the separate legal existence of the transferor corporation for all purposes following the effective time of the transaction.[22]

Section 368(a)(2)(E) further provides that a transaction otherwise qualifying under section 368(a)(1)(A) will not be disqualified by reason of the fact that stock of a corporation (referred to as the controlling corporation), which before the merger was in control (as defined in section 368(c)[23]) of the merged corporation, is used in the transaction if (i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the

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21 1954-2 C.B. 148.

22 Treas. Reg. § 1.368-2(b)(1)(ii).

23 Section 368(c) defines control to mean the ownership of stock possessing at least 80 percent of the total combined voting power of each class of stock entitled to vote and at least 80 percent of the total number of shares of each other class of stock of the corporation.

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transaction); and (ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

The Merger will involve the merger of ACQCO into APIC effected under the TBCA and the TBOC. The specific Texas merger statutes used to effect the Merger should meet the requirements of Treas. Reg. § 1.368-2(b)(1) because the assets and liabilities of ACQCO are automatically transferred to APIC by operation of law. At the time of the Merger, APSG will own 100 percent of the issued and outstanding stock of ACQCO, and thus, should be in control of ACQCO within the meaning of section 368(c). The APIC shareholders will exchange their APIC stock for shares of APSG stock. Accordingly, if the requirements of section 368(a)(2)(E) are satisfied, the Merger should satisfy the statutory definition of a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

i. Substantially All Requirement

The Service has concluded that the test for substantially all will depend upon the facts and circumstances in each case rather than upon any particular percentage. Among the elements of importance that are to be considered in arriving at the conclusion are the nature of the properties retained by the transferor, the purpose of the retention, and the amount thereof.[24] For advance ruling purposes the Service has indicated that the substantially all requirement of section 368(a)(2)(E)(i) is satisfied if there is a transfer (and in the case of a surviving corporation under section 368(a)(2)(E)(i), the retention) of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the corporation immediately prior to the transfer.[25]

For purposes of satisfying the advance ruling requirement of the Service, amounts used by APIC to pay its reorganization expenses, and any redemptions of APIC mandatorily redeemable preferred stock made by APIC immediately preceding the transaction which are part of the transaction will be considered as assets held by APIC immediately prior to the transaction.[26] It has been represented that following the Merger, APIC will hold at least 90 percent of the fair market value of its net assets and at least 70 percent of the fair market value of its gross assets and at least 90 percent of the fair market value of ACQCO s net assets and at least 70 percent of the fair market value of ACQCO s gross assets held immediately prior to the Merger.

Treas. Reg. § 1.368-2(j)(3)(iii) provides that [i]n applying the substantially all test to the merged corporation, assets transferred from the controlling corporation to the merged corporation in pursuance of the plan of reorganization are not taken into account. Therefore, any amounts transferred from APSG to ACQCO in pursuance to the plan of reorganization are not taken into account for purposes of the substantially all test.

Prior to the Merger, APIC intends to redeem no more than eight percent of the APIC preferred stock issued to APIE Deposit Certificate holders in the Conversion. Because APIC will retain at least 90 percent of the fair market value of its net assets and at least 70 percent of the fair market value of its gross assets after the Merger, the substantially all requirement of section 368(a)(2)(E)(i) should be satisfied.

ii. Control Requirement

Based on section 368(a)(2)(E)(ii), Treas. Reg. § 1.368-2(j)(3)(i) provides, in part, that [i]n the transaction, shareholders of the surviving corporation must surrender stock in exchange for voting stock of the controlling corporation. Further, the stock so surrendered must constitute control of the surviving corporation. Control is defined in section 368(c).

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24 Rev. Rul. 57-518, 1957-2 C.B. 253.
25 Section 3.04 of Rev. Proc. 77-37, 1977-2 C.B. 568.
26 *Id.*

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After the Conversion, APIC will have outstanding one class of common stock and one class of redeemable preferred stock. The holders of APIC common stock will be entitled to one vote for each share on each matter properly submitted to the shareholders on which the holders of common stock are entitled to vote. However, holders of the redeemable preferred stock will not be entitled to vote on any matters.

Pursuant to Stock Option Agreements executed between APSG and former APIE Directors, APSG will issue 148,000 stock options for the purchase of APSG common stock as compensation for future employment with APSG. Because these stock options will be issued by APSG in accordance with APSG s current incentive and non-qualified stock option plan, with terms substantially identical to the options APSG grants to its existing employees, and for future services to be performed on behalf of APSG, these options should not be treated as consideration for the APIC stock of these former APIE directors.

In addition, APIC will enter into the Advisory Services Agreement with Advisor, which will be owned at the time of the Merger by members of APIC s Board of Directors, all but one of whom are also APIC shareholders. Because the Advisory Services Agreement will be entered into in connection with the Merger, it is possible that the compensatory rights afforded these APIC shareholders under the Advisory Services Agreement could be viewed as property provided in consideration for APIC shares. However, the fair market value of the payments to be made by APIC, and guaranteed by APSG, under the Advisory Services Agreement will be commensurate with the value of the services to be provided to APIC by Advisor.

In the Merger, APSG will exchange APSG voting common stock and APSG voting preferred stock for APIC voting common stock and APIC non-voting preferred stock, respectively. Thus, APSG will acquire at least 80 percent of the APIC common stock in exchange for APSG voting common stock and at least 80 percent of the APIC preferred stock in exchange for APSG voting preferred stock. Because shares of APIC common and preferred stock representing control (within the meaning of section 368(c)) of APIC, will be exchanged in the Merger solely for APSG voting stock, the requirement in section 368(a)(2)(E)(ii) should be satisfied.

B. Pursuant to a Plan of Reorganization

In order for a transaction to qualify as a reorganization under section 368(a), it must be effected pursuant to a plan of reorganization. A plan of reorganization must contemplate the execution of a transaction specifically described in section 368(a) and the *bona fide* consummation of each requisite act under which non-recognition of gain is claimed.[27] In addition, any plan of reorganization must appear in the official records of a party to the reorganization, and each party to the reorganization must file a copy of the plan of reorganization, together with a reorganization statement, as part of its return for the year in which the transaction occurs.[28]

The Merger will be effected pursuant to the Agreement executed by APSG and APIC and referenced in the Plan. The Agreement contemplates the execution of a transaction intended to qualify as a reorganization described in section 368(a)(1)(A), by reason of section 368(a)(2)(E). Further, APSG and APIE have represented that they will each attach a copy of the Agreement to their U.S. federal income tax return for the taxable year in which the Merger is effected. Therefore, based on the representations and the facts and analysis above, the plan of reorganization requirement should be satisfied.

C. Continuity of Business Enterprise

In order for a reorganization to qualify under section 368(a)(1), there must be a continuity of the target corporation s business enterprise under the modified corporate form.[29] The continuity of business enterprise requirement will be met if an acquiring corporation either continues the acquired corporation s historic business

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27 Treas. Reg. § 1.368-1(c).
28 Treas. Reg. § 1.368-3.
29 Treas. Reg. § 1.368-1(b).

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or uses a significant portion of the acquired corporation s business assets in the operation of a trade or business.[30] In general, a corporation s historic business is the business it has conducted most recently and is not one that the corporation enters into as part of a plan of reorganization. A corporation s historic business assets are assets used in its historic business.

Example 1 of Treas. Reg. § 1.368-1(d)(5) involves a target corporation (T) that conducts three lines of business. The example states that the lines of businesses are approximately equal in value. On July 1, 1981, T sells two of the three business lines to a third party for cash and marketable securities. On December 31, 1981, T transfers all of its assets to P solely for P voting stock. P continues the third business without interruption. The example states that the continuity of business enterprise requirement is met under these facts because [c]ontinuity of business enterprise requires only that P continue one of T s three significant lines of business.[31]

APIC has represented that after the Merger it will continue its insurance services business and will use a significant portion of its historic business assets in a trade or business. APIC has also represented that any property used to redeem the mandatorily redeemable preferred shares or to service the Advisory Services Agreement will constitute less than 2/3 of APIC s historic business assets, and that APIC will continue to own a significant portion of its historic business assets after the Merger. A disposition of less than 2/3 of APIC s historic business assets is less than the amount of assets disposed of prior to the transaction in Example 1 of Treas. Reg. § 1.368-1(d)(5). Thus, the continuity of business enterprise requirement should be met with respect to APIC s assets and business operations, notwithstanding the planned redemptions and the Advisory Services Agreement.

D. Continuity of Interest

A transaction will not qualify as a tax-free reorganization unless the continuity of interest requirement is met.[32] The continuity of interest requirement is met if, in substance, a substantial part of the value of the proprietary interests in the target corporation is preserved in the reorganization.[33]

i. Amount of Continuity

Generally, the proprietary interest in a corporation is measured by reference to the amount of stock (voting or nonvoting) received by the target shareholders as a percentage of the total consideration received in the transaction.[34] In the preamble to recently promulgated final regulations (the COI Regulations), the Treasury Department and the Service affirmed the principle illustrated in examples contained in proposed regulations that the continuity of interest requirement is satisfied if target shareholders receive an amount of acquiring corporation stock equal to at least 40 percent of the value of the target corporation s stock at the time of the transaction.[35] The examples in the COI Regulations specifically illustrate this principle as well.[36]

Here, the APIC shareholders will be receiving voting shares of APSG common and preferred stock in exchange for their APIC common and preferred stock. APSG has represented, and the terms of the Agreement provide, that the aggregate consideration received by APIC shareholders in exchange for their shares of APIC common and preferred stock will consist of at least 80 percent APSG common and preferred stock, inclusive of: (i) payments in redemption of APIC preferred stock; and (ii) cash paid in lieu of fractional shares. Accordingly, sufficient continuity of interest should exist at the time of the Merger.

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30 Treas. Reg. § 1.368-1(d)(2) and (3).
31 Treas. Reg. § 1.368-1(d)(5), Ex. 1.
32 Treas. Reg. § 1.368-1(b).
33 Treas. Reg. § 1.368-1(e)(1)(i).
34 *See Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir 1951).
35 See preamble to T.D. 9225, 70 Fed. Reg. 54631, 54633 (Sept. 16, 2005).
36 Treas. Reg. § 1.368-1(e)(2)(v), Exs. 1 and 6.

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ii. Preservation of Continuity

A proprietary interest in the target corporation generally is preserved if, in a potential reorganization, (1) it is exchanged for a proprietary interest in the acquiring corporation, (2) it is exchanged by the acquiring corporation for a direct interest in the target corporation s enterprise, or (3) it otherwise continues as a proprietary interest in the target corporation. However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, (1) it is acquired by the acquiring corporation for consideration other than stock of the acquiring corporation or (2) stock of the acquiring corporation issued in exchange for a proprietary interest in the target corporation is redeemed or acquired by a related party to the acquirer after a transaction.[37]

For this purpose, two corporations are related if they are members of the same affiliated group as defined in section 1504 (determined without regard to section 1504(b)); or a purchase of the stock of one corporation by another corporation would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to Treas. Reg. § 1.1502-80(b)) because the acquirer or target generally owned 50 percent or more (by vote or value) of a corporation (applying the constructive ownership rules of section 318).[38] For this purpose, a person is considered to own or acquire stock owned or acquired (as the case may be) by a partnership in which such person is a partner in proportion to such person s interest in the partnership.[39] Further, acquisitions of stock of any predecessor or successor of the target by the acquirer (or any predecessor or successor of the acquirer) must be taken into account in determining whether a continuity of proprietary interest in the target corporation is preserved.[40]

Under the terms of the Agreement, and as approved by order of the TDI, APSG must redeem on an annual basis no less than $1 million worth of APSG redeemable preferred. APIC will not be required to redeem any APIC preferred stock until twelve months after the Effective Time of the Conversion. APSG has further represented that except for the required APSG preferred stock redemptions, neither APSG nor any party related to APSG within the meaning of Treas. Reg. § 1.368-1(e)(3) had a present plan or intention to redeem or otherwise reacquire, directly or indirectly, any APSG stock issued in the Merger. Accordingly, there should be sufficient preservation of continuity of interest in APIC to ensure that the Merger should meet the continuity of proprietary interest requirement.

E. Business Purpose

In addition meeting one of the specific definitions contained in section 368(a), a reorganization must also be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization.[41] If the transaction or series of transactions has no business or corporate purpose, then the transactions will not constitute a reorganization under section 368(a).

APSG has represented that the Merger was undertaken for bona fide business purposes unrelated to U.S. federal income taxes. APSG management believes that the integration of APSG and APIC would provide significant beneficial long-term growth prospects for the combined company and would increase shareholder value. With post-merger consolidated assets expected to exceed $180 million, consolidated equity exceeding $50 million and consolidated revenues exceeding $80 million, the management of APSG and APIE believe the Transactions will allow APSG and APIE to build an organization that is poised for growth and financial success. The management of APSG and APIE believe that the Merger is the natural evolution of two companies founded simultaneously with similar purposes. For these reasons, the Merger should satisfy the business purpose requirement.

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37 Treas. Reg. § 1.368-1(e)(i).
38 Treas. Reg. § 1.368-1(e)(4).
39 Treas. Reg. § 1.368-1(e)(5).
40 Treas. Reg. § 1.368-1(e)(6).
41 *See* Treas. Reg. § 1.368-2(g).

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F. The Merger should be a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

Because the Merger should (a) satisfy the statutory definition of a reorganization under section 368(a)(1)(A), by reason of section 368(a)(2)(E), (b) occur pursuant to a plan of reorganization; (c) satisfy the continuity of business enterprise requirement, (d) satisfy the continuity of interest requirement, and (e) be consummated for a valid business purpose, the Merger should be a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E) for U.S. federal income tax purposes.

4. Tax Consequences to APSG, APIC, ACQCO, and APIC shareholders.

A. Tax Consequences to APSG, APIC, and ACQCO.

Based on the discussion above, the Merger should qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E). Because the Merger should satisfy the statutory and nonstatutory requirements of a reorganization under section 368(a)(1)(A), by reason of section 368(a)(2)(E), the tax consequences to the parties involved in the Merger should be determined under the relevant provisions of the Code.

(i) APIC, APSG, and ACQCO should each be a party to a reorganization.

Section 368(b)(2) provides that the term a party to a reorganization includes both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another. In the case of a reorganization qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(E), the term a party to reorganization includes the controlling corporation referred to in section 368(a)(2)(E). Accordingly, APIC, ACQCO, and APSG should each be parties to a reorganization, the Merger.

(ii) APSG, APIC, and ACQCO should recognize no gain or loss in the Merger.

Section 361(a) provides that no gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization. Section 354(a)(1) provides that no gain or loss shall be recognized to a shareholder if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

In the Merger, APIC, APSG, and ACQCO will each be a party to a reorganization and the exchange will be solely for common stock; accordingly, no gain or loss should be recognized to ACQCO on the transfer of its assets to APIC in exchange for APIC common stock under section 361(a), and no gain or loss should be recognized by APSG, the shareholder of ACQCO, upon the exchange of its ACQCO stock solely for APIC common stock under section 354(a)(1).

(iii) APSG should recognize no gain or loss on issuance of its stock.

Under section 1032(a), [n]o gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock . . . of such corporation. APSG issued shares of its stock in the Merger to APIC shareholders in exchange for their APIC common and preferred stock. Therefore, APSG should not recognize gain or loss on the receipt of APIC common and preferred stock in exchange for APSG stock issued to APIC common and preferred shareholders in connection with the Merger.

(iv) APSG s tax basis in APIC stock.

Section 358(a)(1) provides that in the case of an exchange to which section 354 applies, the basis of the property to be received without the recognition of gain or loss shall be the same as that of the property exchanged, decreased by (i) the fair market value of any other property (except money) received by the taxpayer, (ii) the amount of money received by the taxpayer, and (iii) the amount of loss to the taxpayer which was recognized on such exchange, and increased by (i) the amount which was treated as a dividend, and (ii) the amount of gain to the taxpayer which was recognized in such exchange (not including any portion of such gain which was treated as a dividend).

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If a transaction qualifies as both a reverse triangular merger and a stock acquisition under section 368(a)(1)(B), or a section 351 transfer, the acquiring corporation s adjusted basis in the target corporation stock is based either on the target corporation s net asset basis or on the aggregate basis of the target corporation stock surrendered in the transaction (as if the transaction were a reorganization under section 368(a)(1)(B)).[42]

In Rev. Rul. 67-448, the Service held that where, pursuant to a plan of reorganization, a parent corporation (P), issues voting shares to its new subsidiary (S), and S merges into unrelated corporation (Y), with Y surviving and the shareholders of Y receiving from P solely voting shares of P, provided P receives 80 percent or more of the shares of Y, in substance the existence of S is disregarded and the transaction is a tax-free section 368(a)(1)(B) acquisition by P.[43]

In the Merger, APSG, the shareholder of ACQCO, will receive APIC common in exchange for APSG common and preferred stock. Based on the analysis discussed above, the Merger should qualify as a reverse triangular merger under section 368(a)(2)(E). In addition, the Merger may qualify as a stock acquisition under section 368(a)(1)(B). In such event, APSG s basis in its APIC stock should be based either on APIC s net asset basis or on the aggregate basis of the APIC stock surrendered in the transaction (as if the transaction were a reorganization under section 368(a)(1)(B)). The fact that cash will be issued by APSG to the APIC shareholders in lieu of fractional shares, should not affect the characterization of the Merger as a reorganization under section 368(a)(1)(B).[44]

B. Tax Consequences to APIC shareholders as a result of the Merger.

(i) APIC shareholders receiving solely APSG stock should recognize no gain or loss.

Section 354(a)(1) generally provides that no gain or loss will be recognized if stock or securities in a corporation, a party to a reorganization, are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation, a party to the reorganization. For purposes of section 354, the terms reorganization and party to a reorganization mean a reorganization or a party to a reorganization as defined in sections 368(a) and 368(b), respectively. As discussed above, the Merger should qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E). However, section 354(a)(2)(C) provides that any NQPS received in exchange for stock other than NQPS is not treated as stock or securities exchanged in a reorganization.

The holders of APIC common stock will surrender their shares in the Merger in exchange for APSG common stock. Because the APSG preferred stock will be limited and preferred as to dividends, and APSG will have the exclusive right to redeem the APSG preferred stock at anytime, the APSG preferred stock should constitute NQPS for purposes of section 354(a)(2)(C). However, because the APSG preferred stock will be exchanged for APIC preferred stock that is also NQPS, the APSG preferred stock should be treated as stock received in a reorganization for purposes of section 354(a)(1). Accordingly, the holders of APIC preferred stock should be treated as exchanging their APIC preferred stock solely for shares of APSG preferred stock.

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42 Treas. Reg. § 1.358-6(c)(2)(ii). Section 368(a)(1)(B) provides that the term reorganization means the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control (within the meaning of section 368(c)) of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

43 1967-2 C.B. 144.

44 *See* Rev. Rul. 66-365, 1966-2 C.B. 116 (the solely for voting stock requirement of section 368(a)(1)(B) is satisfied where the acquiring corporation pays cash in lieu of issuing fractional shares to shareholders of the acquired corporation provided the cash is not separately bargained-for consideration and merely represents a mechanical rounding-off of the fractions).

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Accordingly, APIC shareholders that received APSG common and preferred stock in exchange for their APIC common and preferred stock surrendered in the Merger should not recognize gain or loss in connection with the Merger, except upon the receipt of cash in lieu of fractional shares as described below.

(ii) Tax basis of APIC shareholders receiving solely APSG stock.

Under section 358(a)(1), the basis of property that is permitted to be received under section 354 without the recognition of gain or loss is the same as that of the property exchanged, decreased by the amount of any money received by the recipient and the amount of loss recognized by the recipient as a result of the exchange and increased by the amount that was treated as a dividend and the amount of other gain recognized by the recipient as a result of the transaction. Under section 358(a)(2), the basis of any other property (except money) received by the taxpayer shall be its fair market value. Accordingly, after the merger, the basis of APIC shareholders in APSG stock received in the Merger should be the same as their basis in the APIC stock surrendered in the Merger.

(iii) Holding period of APIC shareholders receiving only APSG stock.

Section 1223(1) states that in determining the period for which a taxpayer has held property received in an exchange, the period that the taxpayer held the property exchanged is included if the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis as the property exchanged and the property exchanged was a capital asset as defined in section 1221 as of the date of the exchange. Accordingly, the holding period of the APSG stock in the hands of APIC shareholders receiving only APSG stock should include the period that they held the APIC stock surrendered in Merger, provided the APIC stock was held as a capital asset on the date of the exchange.

(iv) Treatment of Fractional Shares.

The Service has ruled that when a company pays cash in lieu of fractional shares, it should generally be treated as issuing the fractional shares to all shareholders exchanging target stock and then redeeming these fractional shares in a separate transaction. The Service applies this deemed issuance-redemption construct when the cash in lieu of fractional shares is merely a mechanical rounding off of the fractions in the exchange, and is not a separately bargained-for consideration.[45] This deemed redemption will be subject to section 302. Any gain or loss recognized generally will constitute capital gain or loss if the common stock was held as a capital asset.

APSG has represented that the cash received by APIC shareholders in lieu of fractional shares was not bargained for with APSG as separate consideration, but is solely for the purpose of avoiding the expense and inconvenience to APSG of issuing fractional shares. The total cash consideration that will be paid in the transaction to the APIC shareholders instead of issuing fractional shares of APSG common and preferred stock will not exceed one percent of the total consideration that will be issued in the Merger to the APIC shareholders in exchange for their shares of APIC stock. The fractional share interest of each APIC shareholder will be aggregated, and no APIC shareholder will receive cash in an amount equal to or greater than the value of one full share of APSG common stock or preferred stock.

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[45] *See* Rev. Rul. 66-365, 1966-2 C.B. 116 (receipt of cash in lieu of fractional shares in a reorganization under section 368(a)(1)(B), or (C) is not treated as boot under section 356, but as a redemption of the fractional shares if not bargained for as separate consideration); *see also* Rev. Proc. 77-41, 1977-2 C.B. 574 (Service will rule that the payment of cash to a shareholder in lieu of issuing fractional shares of acquiring corporation stock is treated as if the fractional shares were issued as part of the reorganization and subsequently reacquired in a redemption subject to section 302); Rev. Rul. 74-515, 1974-2 C.B. 118 (Where shareholders owning both common and preferred stock received cash for the preferred stock and received acquiring common stock for common stock in a reorganization, section 354 applied to shareholders exchanging common stock solely for acquiring common stock, section 302 applied to shareholders only exchanging preferred stock for cash, and section 356 applied to shareholders that exchanged both preferred and common stock).

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Accordingly, cash received by a shareholder of APIC otherwise entitled to receive a fractional share of APSG common stock or preferred stock in exchange for APIC common and preferred stock should be treated as if the fractional shares were distributed as part of the exchange and then were redeemed by APSG. These cash payments should be treated as having been received as distributions in full payment in exchange for the stock redeemed as provided in section 302(a). The receipt of cash should result in gain or loss measured by the difference between the shareholder s basis of such fractional share interest exchanged and the cash received. Such gain or loss should be capital gain or loss to an APIC shareholder, provided the APIC shareholder s stock was a capital asset in the shareholder s hands.

(v) Treatment of Dissenters

In the Merger, there will be no dissenters rights for either preferred or common shareholders of APIC.

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LIMITATIONS ON THE SCOPE OF THIS OPINION

The conclusions expressed herein are based upon our understanding of the facts and representations set forth in this Opinion and the law, as it exists as of the date of this Opinion. Any subsequent change in the law or the facts that have been provided may affect our conclusions expressed herein. We have no obligation to update this Opinion.

This Opinion is limited to specific U.S. federal income tax issues addressed herein.

This Opinion is based solely upon:

1. the representations, information, documents, and facts and assumptions that we have included or referenced in this Opinion;

2. our assumption that all of the representations made by the managements of APIE and APSG used in our analysis and all of the originals, copies, and signatures of documents reviewed by us are accurate, true, and authentic;

3. our assumption that there will be timely execution and delivery of and performance as required by the representations and documents;

4. the understanding that only the specific U.S. federal income tax issues and tax consequences opined upon herein are covered by this Opinion, and no other federal, state, or local taxes of any kind were considered;

5. the law, regulations, cases, rulings, and other tax authorities in effect as of the date of this Opinion. If there are changes in or to the foregoing tax authorities (for which we assume no responsibility to advise you) such changes may result in our opinion being rendered invalid or necessitate (upon your request) a reconsideration of this Opinion;

6. your understanding that this Opinion is not binding on the Service or the courts and should not be considered a representation, warranty, or guarantee that the Service or the courts will concur with our opinion; and

7. your understanding that this Opinion is limited to the described transaction.

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CONSENT OF DELOITTE TAX LLP

We hereby consent to the filing of the opinion regarding certain U.S. federal income tax consequences of the Conversion and Merger to APIE, APIC, APSG, APIE Policyholders, APIE Deposit holders, and APIC shareholders, dated November 17, 2006, as an exhibit to APSG s Amendment No. 2 Form S-4 Registration Statement and to the use of our name in the Registration Statement.

Very truly yours,

/s/ Deloitte Tax LLP

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ANNEX D

August 22, 2006

Board of Directors

American Physicians Insurance Exchange

1301 S. Capital of Texas Highway

Suite C-300

Austin, TX 78746

Members of the Board:

You have requested our opinion as to the fairness, from a financial point of view, of the aggregate consideration to be received by certain policyholders of American Physicians Insurance Exchange (the Company) in connection with a series of transactions whereby (i) the Company is converted from a reciprocal and inter-insurance exchange company under Texas law to a stock insurance company and (ii) a subsidiary of American Physicians Service Group, Inc. (APSG) will immediately thereafter be merged with and into the Company, pursuant and subject to The Plan of Conversion dated June 1, 2006, the draft Amendment to The Plan of Conversion date August 22, 2006 (together with The Plan of Conversion, the Plan), the Merger Agreement and Plan of Merger between the Company and APSG dated June 1, 2006, and the draft Amendment to Merger Agreement and Plan of Merger dated August 22 (together with the Merger Agreement and Plan of Merger, the Agreement), respectively. In exchange for their subscriber interests, Eligible Policyholders (as defined in the Plan) of the Company (the Members) will receive 2,086,024 shares of APSG, subject to adjustment as described in the Agreement, with a market value equal to approximately $28.9 million, as of the close of the markets on August 22, 2006.

In connection with our review of the proposed Plan and Agreement and the preparation of our opinion herein, we have, among other things:

1. reviewed the Plan;

2. reviewed the financial terms and conditions as stated in the Agreement;

3. reviewed the Annual Statements of the Company filed with the Texas Department of Insurance for the years ended December 31, 2004 and 2005;

4. reviewed the Quarterly Statements of the Company filed with the Texas Department of Insurance as of June 30, 2006;

5. reviewed the audited financial statements of the Company prepared in accordance with statutory accounting procedures as of, and for the years ended December 31, 2002, 2003, 2004, and 2005;

6. reviewed the draft audited financial statements of the Company prepared in accordance with generally accepted accounting procedures (GAAP) for the years ended December 31, 2003, 2004, and 3005;

7. reviewed the unaudited financial statements of the Company prepared in accordance with GAAP for the six months ended June 30, 2006;

8. reviewed the management agreement between the Company and its attorney in fact, which is a subsidiary of APSG (the Attorney in Fact);

9. reviewed the reports of the Company s independent actuarial firm, dated April 7, 2006 and August 6, 2006;

10. reviewed certain internal financial analyses and forecasts for the Company prepared by its Attorney in Fact;

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11. reviewed certain internal financial analyses and forecasts for APSG as prepared by the management of APSG;

12. reviewed the business plan and prospects for the Company and APSG, as provided by the Attorney in Fact and APSG, respectively;

13. reviewed APSG s Annual Reports filed on Form 10-K for the years ended 2003, 2004, and 2005;

14. reviewed APSG s quarterly report filed on Form 10-Q for the six months ended June 30, 2006;

15. reviewed other Company and APSG financial and operating information requested from and/or provided by the Company, the Attorney in Fact, and APSG;

16. reviewed certain other publicly available information on the Company and APSG; and

17. discussed with members of the senior management of the Attorney in Fact and APSG, the Company s independent actuarial firm and the Board of Directors of the Company certain information relating to the aforementioned and any other matters which we have deemed relevant to our inquiry.

With your consent, we have assumed and relied upon the accuracy and completeness of all information supplied or otherwise made available to us by the Company, the Attorney in Fact, APSG, or any other party, and we have undertaken no duty or responsibility to verify independently any of such information. We have not made or obtained an independent appraisal of the assets or liabilities (contingent or otherwise) of the Company. With respect to financial forecasts and other information and data provided to or otherwise reviewed by or discussed with us, we have, with your consent, assumed that such forecasts and other information and data have been reasonably prepared in good faith on bases reflecting the best currently available estimates and judgments of the Board of Directors of the Company, the Attorney in Fact, or APSG, and we have relied upon each party to advise us promptly if any information previously provided became inaccurate or was required to be updated during the period of our review. In addition, we have assumed that the final forms of all documents will not differ in any material respect form the drafts of such documents reviewed by us as of the date of this letter.

Our opinion is based upon market, economic, financial and other circumstances and conditions existing and disclosed to us as of August 22, 2006 and any material change in such circumstances and conditions would require a reevaluation of this opinion, which we are under no obligation to undertake.

We express no opinion as to the underlying business decision to effect the Plan or the Agreement, the structure or tax consequences of the Plan or Agreement or the availability or advisability of any alternatives to the Plan and Agreement. We did not structure the Plan or Agreement or negotiate the final terms of the Plan or Agreement. This letter does not express any opinion as to the likely trading range of APSG stock following the merger as contemplated in the Agreement, which may vary depending on numerous factors that generally impact the price of securities or on the financial condition of APSG at that time. Our opinion is limited to the fairness, from a financial point of view, of the aggregate consideration to be received by the Members in connection with the Plan and Agreement. We express no opinion with respect to any other reasons, legal, business, or otherwise, that may support the decision of the Board of Directors to approve or consummate the Plan or Agreement.

We do not express any opinion as to (i) the construction of the class of the Company s policyholders that are to be included among the Members or (ii) the fairness of the consideration to be paid to any individual Member or to any group of Members in connection with the Plan or Agreement. Our opinion does not constitute a recommendation to any Member as to how such Member should vote with respect to the Plan.

In conducting our investigation and analyses and in arriving at our opinion expressed herein, we have taken into account such accepted financial and investment banking procedures and considerations as we have deemed relevant, including the review of (i) historical and projected revenues, operating earnings, net income and capitalization of the Company and certain other publicly held companies in businesses we believe to be comparable to the Company; (ii) the current and projected financial position and results of operations of APSG;

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(iii) financial and operating information concerning selected business combinations which we deemed comparable in whole or in part;
(iv) financial and operating information concerning selected insurance demutualizations which we deemed comparable in whole or in part; and
(v) the general condition of the securities markets.

In arriving at this opinion, Raymond James & Associates, Inc (Raymond James) did not attribute any particular weight to any analysis or factor considered by it, but rather made qualitative judgments as to the significance and relevance of each analysis and factor. Accordingly, Raymond James believes that its analyses must be considered as a whole and that selecting portions of its analyses, without considering all analyses, would create an incomplete view of the process underlying this opinion.

Raymond James is actively engaged in the investment banking business and regularly undertakes the valuation of investment securities in connection with public offerings, private placements, business combinations and similar transactions. Raymond James has been engaged to render financial advisory services to the Company in connection with the proposed Plan and Agreement and will receive a fee upon the delivery of this opinion. In addition, the Company has agreed to indemnify us against certain liabilities arising out of our engagement.

In the ordinary course of our business, Raymond James may trade in the securities of APSG for our own account or for the accounts of our customers and, accordingly, may at any time hold a long or short position in such securities.

It is understood that this letter is for the information of the Board of Directors of the Company in evaluating the proposed Plan and Agreement and does not constitute a recommendation to any Member of the Company regarding how said Member should vote on the proposed Plan or Agreement, nor is this letter intended to confer rights or remedies upon APSG, Members of the Company or other policyholders, or shareholders of APSG. Furthermore, this letter should not be construed as creating any fiduciary duty on the part of Raymond James to any such party. This opinion is not to be quoted or referred to, in whole or in part, without our prior written consent, which will not be unreasonably withheld.

Based upon and subject to the foregoing, it is our opinion that, as of August 22, 2006, the consideration to be received by the Members of the Company pursuant to the Plan and Agreement is fair, from a financial point of view, to the Members.

Very truly yours,

RAYMOND JAMES & ASSOCIATES, INC.

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ANNEX E

ADVISORY SERVICES AGREEMENT

This ADVISORY SERVICES AGREEMENT (hereinafter referred to as this **Agreement**), dated and effective as of , 2006, is made by and between API Advisory, LLC, a Texas limited liability company (hereinafter referred to as the **Advisor**) and **[**American Physicians Insurance Company**]**, a Texas insurance company (hereinafter referred to as **Insurer**).

RECITALS

WHEREAS, the Advisor is able and qualified to provide advisory and consulting services to Insurer as are set forth in this Agreement; and

WHEREAS, Insurer desires to contractually engage the Advisor to provide advisory and consulting services in connection with its operations, as more particularly specified hereinafter in this Agreement; and

WHEREAS, the Advisor desires to perform such advisory and consulting services for Insurer in accordance with the terms and conditions of this Agreement.

NOW, THEREFORE, for and in consideration of the mutual promises, covenants, and agreements hereinafter set forth, the parties hereto agree as follows:

ARTICLE I ADVISORY SERVICES

1.1 ENGAGEMENT OF ADVISOR. Insurer hereby engages the Advisor to provide, with respect to Insurer and its operations, the advisory and consulting services hereinafter specified, and the Advisor hereby accepts such engagement upon the terms and conditions set forth herein and agrees to provide such advisory and consulting services in accordance herewith.

1.2 ADVISORY SERVICES. The Advisor shall provide the following advisory and consulting services to the Insurer as set forth in Article II below, subject, however, to the following:

(a) The Advisor shall perform its responsibilities, duties, and functions in a manner consistent with the policies established by the Articles of Incorporation of Insurer, the Bylaws of Insurer and the Board of Directors of the Insurer (**Board**).

(b) Nothing in this Agreement shall be construed to be a delegation from Insurer to the Advisor of any power or authority required by any applicable statute or regulation to be exercised directly by Insurer.

(c) It is agreed and understood by and between the parties hereto that the Advisor is associated with Insurer, for purposes of this Agreement, only for the purposes and to the extent set forth herein, and that the relationship of the Advisor to Insurer with respect to its duties, functions, and responsibilities under this Agreement shall, during the term hereof, be that of an independent contractor. This Agreement shall not be construed as an agreement of employment, a partnership, or any other form of business entity, or as creating any other type of relationship than the contractual relationship expressly specified herein.

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ARTICLE II DUTIES, AUTHORITIES, AND FUNCTIONS OF THE ADVISOR

2.1 ADVISORY BOARD MEMBERS. The Insurer shall have an Advisory Board of Directors (**Advisory Board**), which Advisory Board shall meet concurrently with the Board and have full access to information as provided to the Board (excluding Board deliberations related to this Agreement). The Advisory Board shall provide advice and counsel to the Board on matters coming before the Board or otherwise specifically requested by the Board. The Board and Advisory Board will meet not less than three (3) times per year. At least one Board meeting per year will be held away from the principal offices of Insurer and last up to three (3) days, and the Advisory Board will meet concurrently at these meetings also, subject to reimbursement of expenses associated therewith by Insurer pursuant to Section 3.2.

(a) The Advisor shall provide persons to serve on the Advisory Board. The Advisor shall determine, subject to the terms of this Agreement, the number of persons, not to exceed nine (9) persons, who shall to serve on the Advisory Board. The Advisory Board shall have the right and opportunity to participate in Board discussions, but in no event shall the Advisory Board members have any right to vote on matters brought before the Board for a vote. The Advisor shall retain the sole right to remove or appoint substitute persons to serve as members of the Advisory Board as it deems necessary to fulfill its obligations under this Agreement.

(b) Insurer may at its sole election, but is not required to, appoint one or more Advisory Board members to serve as a member of the Board, in which event such person shall have the rights and obligations of a member of the Board. Furthermore, upon such an appointment, the number of persons the Advisor shall provide to serve on the Advisory Board pursuant to this Section 2.1 shall be reduced by the number of representatives of Advisor who are then serving as a member of the Board.

(c) The members of the Advisory Board (and any member of the Advisory Board appointed to the Board by the Insurer) provided by the Advisor shall be compensated directly by the Insurer for their service as a member of the Advisory Board. The compensation paid to such Advisory Directors shall initially be $2500 per meeting per day (or $1250 for meetings lasting one-half a day). The per meeting compensation is (i) payable for actual attendance at Advisory Board meetings held concurrently with the Board only and (ii) also applicable for attendance at duly called committee meetings pursuant to Section 2.2. The Advisor may increase the per meeting compensation annually by written notice to Insurer, but in no event shall any such increase exceed an amount (the Annual Increase Cap) equal to the lesser of (x) 10% or (y) the percentage increase in the CPI during the prior year. The **CPI** as used herein shall mean the Consumer Price Index for All Urban Consumers, U.S. City Average (All Items; Base Year 1982 = 100) published by the United States Department of Labor, Bureau of Labor Statistics for the immediately preceding year.

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2.2 COMMITTEE MEMBERS. The Advisor shall further be obligated to provide persons to serve on certain committees of the Insurer, which persons shall be selected by Advisor from among those persons provided by Advisor to serve on the Advisory Board. A person may serve on both the Advisory Board and one or more committees. The committees will meet at such times as shall be determined by Insurer; provided, the Claims Committee will meet at least once per month, unless otherwise agreed by the parties, the Physician Liaison Committee will meet when and only if the Claims Committee meets, and the other committees (excluding the Political Affairs Committee, which meets as needed only) will meet at least once per quarter. The committees of the Insurer and the maximum number of persons to be provided by the Advisor for such committees are as follows:

Claims Committee	up to 9 persons;
Finance Committee	up to 4 persons;
Ethics and Internal Affairs Committee	up to 4 persons;
Underwriting Committee	up to 4 persons;
Physician Liaison Committee	up to 9 persons; and
Political Affairs Committee	1 person.

2.3 MEDICAL DIRECTOR. The Advisor shall retain, compensate and provide to Insurer a person fully qualified to serve as the Medical Director of Insurer. The Advisor shall retain the sole right to remove or appoint substitute persons to serve as the Medical Director as the Advisor, in its sole discretion, deems necessary to fulfill its obligations under this Agreement. Notwithstanding the foregoing, the Medical Director shall be subject to the operational authority of the chief executive officer of Insurer and the Board. Insurer shall reimburse Advisor for all costs of compensation and reasonable benefits incurred by Advisor in connection with the provision of the Medical Director. The parties acknowledge and agree that (i) the aggregate reimbursement due for compensation (excluding insurance and retirement benefits) under this Section for the first year of this Agreement is $185,000, and (ii) the maximum increase for each subsequent year shall not exceed the Annual Increase Cap. Reasonable benefits include reasonable vacation and sick leave (included in the compensation amounts described in the preceding sentence), reasonable health, dental, life and long-term disability insurance and a 401K plan. The Medical Director shall not be entitled to any further compensation under Section 2.1 for attendance at Advisory Board or committee meetings.

2.4 EXECUTIVE SECRETARY. The Advisor shall retain, compensate and provide to Insurer a person fully qualified to serve as the Executive Secretary of Insurer. The Advisor shall retain the sole right to remove or appoint substitute persons to serve as the Executive Secretary as the Advisor, in its sole discretion, deems necessary to fulfill its obligations under this Agreement. Notwithstanding the foregoing, the Executive Secretary shall be subject to the operational authority of the chief executive officer of Insurer and the Board. Insurer shall reimburse Advisor for all costs of compensation and reasonable benefits incurred by Advisor in connection with the provision of the Executive Secretary. The parties acknowledge and agree that (i) the aggregate reimbursement due for compensation (excluding insurance and retirement benefits) under this Section for the first year of this Agreement is $62,500, and (ii) the maximum increase for each subsequent year shall not exceed the Annual Increase Cap. Reasonable benefits include reasonable vacation and sick leave (included in the compensation amounts described in the preceding sentence), reasonable health, dental, life and long-term disability insurance and a 401K plan. The Executive Secretary shall not be entitled to any further compensation under Section 2.1 for attendance at Advisory Board or committee meetings.

2.5 LIMITS TO ADVISOR AUTHORITY. The Advisor agrees that it shall neither have authority to, nor shall it make, invest, or obligate, or commit to make, invest, or obligate on behalf of Insurer any capital expenditure, investment, indebtedness, obligation, cost, or expense except for those reimbursement and compensation obligations of Insurer specifically provided for herein.

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ARTICLE III FEES AND EXPENSES

3.1 PAYMENT OF ADVISORY FEES. Insurer shall pay to Advisor all fees, expenses and other amounts owed to Advisor pursuant to the terms of this Agreement within thirty (30) days after the date of Advisor s invoice. All amounts payable by Insurer hereunder shall be paid in United States dollars at Insurer s address for notice or at such other address as may be specified by Insurer from time to time, without any setoff or deduction. Insurer agrees to pay interest at the rate of one and one-half percent (1.5%) per month, or the maximum legal rate allowed by law, whichever is less, on any outstanding balance due to Advisor for such time as the outstanding balance remains past due.

3.2 ADMINISTRATIVE EXPENSES. Insurer shall bear responsibility for reimbursement of all reasonable out-of-pocket costs and expenses incurred by Advisor in the performance of its obligations under this Agreement, including, without limitation, all reasonable costs incurred by the Advisor for the travel and lodging of the Advisory Board members incurred in connection with the performance of Advisor s duties under this Agreement.

3.3 ADVANCEMENT OF FEES AND EXPENSES. Without limiting the Advisor s right to reimbursement of any amounts as provided in this Agreement, the Advisor shall be entitled to direct Insurer to pay directly any amounts for which reimbursement would otherwise be due hereunder, and Insurer agrees to pay such amounts directly to the extent legally permissible.

ARTICLE IV COVENANTS

4.1 COVENANT REGARDING OWNERSHIP OF MATERIALS. All published reports, documents and materials prepared by the Advisor in connection with its duties, responsibilities and functions under this Agreement shall be the property of Insurer. Insurer will allow the Advisor reasonable access to and use of all documents and materials maintained at its offices necessary for the Advisor to perform its responsibilities, functions and duties required by this Agreement.

4.2 COVENANT REGARDING EMPLOYEES. It is agreed that, while this Agreement is in effect, Insurer and any of its officers, board members and affiliates (other than the Advisor and its affiliates) will not hire or otherwise contract for services with any employee of the Advisor except as provided under this Agreement.

4.3 COVENANT REGARDING SERVICES FOR AFFILIATES OF INSURER. In the event that any Affiliate (defined below) of the Insurer is engaged in the business similar to that of Insurer or offering insurance products of the same business line as those offered by Insurer, then the Advisor shall be required to provide to such affiliate services identical to those provided to Insurer under the terms of this Agreement, but without any additional consideration. For purposes of this Agreement, **Affiliate** means, with respect to any Person, any other Person controlling, controlled by or under common control with such Person. For purposes of this definition and this Agreement, the term **control** (and correlative terms) means the power, whether by contract, equity ownership or otherwise, to direct the policies or management of a Person, and the term **person** means an individual, corporation, partnership, limited liability company, association, trust, unincorporated organization, or other entity.

4.4 NON-INTERFERENCE WITH BUSINESS RELATIONS. Advisor agrees that during the Term (as hereinafter defined) Advisor shall not, directly or indirectly, (a) solicit, advise, persuade or otherwise induce any person to participate in or with any entity or person which provides services comparable to those provided by the Insurer, (b) do anything intentionally to discredit or otherwise injure the reputation or goodwill of the Insurer or any of its affiliates, (c) solicit, induce or attempt to solicit or induce any current or prospective client, customer, company, independent contractor, policyholder, subscriber, or any other business relation of the Insurer (or any

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affiliate) to cease or reduce the level of business between such business relation and the Insurer (or any affiliate), (d) influence, induce, or encourage, or attempt to influence, induce or encourage, any person who is a current or prospective employee of the Insurer to leave the employment of the Insurer, or (e) in any way interfere with the Insurer s (or any affiliates) relationship with any customer, employee, independent contractor, policyholder, subscriber, or any other business relation of the Insurer or affiliate.

4.5 NONDISCLOSURE OF CONFIDENTIAL INFORMATION.

(a) During the Term, Advisor will have access to Confidential Information, including Confidential Information Advisor has not accessed prior to the date of this Agreement. Advisor recognizes that the Insurer s business interests require the fullest practical protection and confidential treatment of the Confidential Information. At all times during the Term and thereafter, Advisor will hold in strictest confidence and will not disclose, use, provide access to, or publish any Confidential Information, except as such disclosure, use or publication may be required in connection with Advisor s services for the Insurer or as required by law or legal process. Advisor agrees that all Confidential Information, whether prepared by Advisor or otherwise coming into Advisor s possession, shall remain the exclusive property of the Insurer during Advisor s employment with the Insurer. Advisor will obtain the Insurer s written approval before publishing or submitting for publication any material (written, oral, or otherwise) that relates to Advisor s work at the Insurer, any Confidential Information and/or any material that incorporates any Confidential Information. Advisor hereby assigns to the Insurer any rights Advisor may have or acquire in such Confidential Information and recognizes that all Confidential Information is the sole property of the Insurer and its assigns.

(b) Confidential Information means all information, not generally known within the relevant trade group or by the public, including all Work Product (as defined below), business plans, training materials, software programs, promotional materials, illustrations, designs, plans, data bases, sources of supply, customer lists, supplier lists, trade secrets, and all other valuable or unique information and techniques acquired, developed or used by the Insurer relating to its business, operations, suppliers, information systems, employees and customers, regardless of whether such information is in writing, on computer disk or disk drive or in any other form. Advisor expressly acknowledges and agrees that Confidential Information constitutes trade secrets and/or confidential and proprietary business information of the Insurer (or its affiliates, customers or suppliers, as the case may be). Confidential Information shall not include information which is or becomes generally available to the public other than through disclosure by Advisor or by any other person or entity under a duty or obligation to maintain the confidentiality thereof.

(c) Advisor understands that violation of any non-disclosure provision of this Agreement shall be a material breach of this Agreement.

4.6 REASONABLENESS OF RESTRICTIONS. Advisor acknowledges and agrees that the restrictions imposed upon Advisor by this Article Iv and the purposes for such restrictions are reasonable and are designed to protect the trade secrets, confidential and proprietary business information and the future success of the Insurer and its affiliates without unduly restricting Advisor. Advisor specifically recognizes and affirms that the restrictive covenants contained in this ARTICLE IV are material and important terms of this Agreement.

4.7 SEVERABILITY. The covenants set forth in this ARTICLE IV each constitute separate agreements independently supported by good and adequate consideration. If a court of competent jurisdiction determines that any restriction in a clause or provision of this ARTICLE IV is void, illegal, or unenforceable, the other clauses and provisions of this ARTICLE IV shall remain in full force and effect.

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4.8 RETURN OF THE INSURER PROPERTY. Upon termination or expiration of this Agreement for any reason, Advisor will promptly (within twenty-four (24) hours) deliver to the Insurer any and all Confidential Information, drawings, notes, memoranda, specifications, devices, formulas and documents, together with all copies thereof and any other material containing or disclosing any works made for hire, or third party information. Advisor further agrees that any property situated on the Insurer s premises and owned by the Insurer including computers, computer disks and computer hard disk drives and other computer storage media, filing cabinets or other work areas, is subject to inspection by the Insurer personnel at anytime with or without notice.

4.9 APPLICABILITY TO REPRESENTATIVES. Advisor acknowledges and agrees it will be responsible for compliance with, and any violation of, a covenant set forth in ARTICLE IV by its employees, officers, members, agents or representatives, including without limitation any person provided by Advisor to serve as a member of the Advisory Board or any committees of Insurer.

ARTICLE V TERMINATION

5.1 TERMINATION OF AGREEMENT. This Agreement shall terminate upon the first to occur of any of the following:

(a) The mutual agreement, in writing, of the parties hereto;

(b) A default in the performance or breach of any material term, condition, covenant, duty, responsibility, or function contained in this Agreement, which default or breach shall continue for a period of ninety (90) days after written notice to the party committing such default or breach by the other party stating the specific nature of such default or breach and requiring it to be remedied; provided, however, if such default cannot be reasonably cured within such 90-day period, the length of such cure period shall be extended for the period reasonably required therefor if the defaulting party commences covering such default within such 90-day period and continues the curing thereof with reasonable diligence and continuity.

(c) The giving of one hundred eighty (180) days written notice of termination by either party to the other (with or without cause) which notice may be given only during the thirty (30) day period that is between two hundred ten (210) and one hundred eighty (180) days prior to expiration of the Initial Term of this Agreement; provided, however, if such notice is given by Insurer, such termination shall be conditioned upon Insurer s satisfaction of the requirements of Section 5.3.

5.2 TERM OF AGREEMENT. The term of this Agreement shall commence on , 2006, and end on December 31, 2011 (the **Initial Term**). Unless terminated as provided by Section 5.1(b) or (c), the term of the Agreement shall extend for a second five-year term, commencing on January 1, 2012 and ending on December 31, 2016 (**Additional Term** and together with the Initial Term, the **Term**).

5.3 NON-COMPETE AGREEMENTS UPON TERMINATION. Upon the termination of the Agreement for any reason other than termination pursuant to Section 5.1(a) or the expiration of the Additional Term without a written agreement between the Advisor and the Insurer to extend this Agreement, then the Advisor shall be required to execute a non-compete agreement in favor of Insurer and shall undertake best efforts to obtain written non-compete agreements in favor of Insurer from each member of the Advisory Board (or representative of Advisor appointed to the Board) serving in such capacity as of the date of termination. Upon receipt of each such written non-compete agreement in substantially the form attached hereto as *Exhibit A*, Insurer shall be obligated to pay the sum of $200,000 (**Non-Compete Payment**) to each member of the Advisory Board who provides such written non-compete agreement to the Insurer. In addition, Insurer shall be obligated to pay a Non-Compete Payment to the Advisor upon the Advisor s delivery of an executed non-compete agreement to Insurer in substantially the form attached hereto as *Exhibit A*.

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ARTICLE VI FURTHER OBLIGATIONS

6.1 INSURANCE. Insurer shall maintain customary officers and directors liability insurance with an endorsement naming the Medical Director and Advisory Directors as additional insureds thereunder.

ARTICLE VII MISCELLANEOUS

7.1 CAPTIONS. The captions and headings used in this Agreement are for convenience only and do not in any way affect, limit, amplify, or modify the terms and provisions hereof, nor shall they be utilized in the construction or interpretation of this Agreement.

7.2 NOTICES. Whenever this Agreement or law requires or permits any consent, approval, notice, request, or demand, from one party to another, such consent, approval, notice, request, or demand must be in writing to be effective, and shall be deemed to have been given on the earlier of (i) receipt, or (ii) the third business day after it is enclosed in an envelope, addressed to the party to be notified at the address stated below (or at such other addresses as may have been designated by written notice in accordance with this Section), properly stamped, sealed and deposited in the United States mail, certified, return receipt requested. The initial address of each party for the purposes of this Agreement is as listed for that party on the signature page hereof.

7.3 INVALID PROVISIONS. If any provision of this Agreement is held to be illegal, invalid, or unenforceable during the term of this Agreement, including any renewal hereof, such provision shall be fully severable from the other provisions hereof. This Agreement shall be construed and enforced as if such illegal, invalid, or unenforceable provision had never comprised part of this Agreement. The remaining provisions of this Agreement shall remain in full force and effect and shall not be affected by the illegal, invalid, or unenforceable provision or by its severance from this Agreement.

7.4 AMENDMENTS. This Agreement may be amended at any time and from time to time in whole or in part by an instrument in writing setting forth the particulars of such amendment duly executed by an authorized officer of each of the parties.

7.5 ASSIGNMENT. Neither this Agreement nor any rights or obligations of any party hereunder may be transferred or assigned by such party without the prior written consent of the other party.

7.6 ENTIRE AGREEMENT. This Agreement (including any instruments, documents, agreements, schedules and exhibits delivered pursuant hereto) constitutes the entire understanding between the parties with respect to the subject matter hereof and supersedes all prior agreements or understandings, if any, relating to the subject matter hereof.

7.7 LAWS GOVERNING. This Agreement shall be construed and interpreted in accordance with the laws of the State of Texas.

7.8 BINDING AGREEMENT. This Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective representatives, successors and assigns.

7.9 WAIVERS AND CONSENTS. One or more waivers of any covenant, term, or provision of this Agreement by any party, shall not be construed as a waiver of any subsequent default or breach of the same covenant, term, or provision, nor shall it be considered as a waiver of any other then existing or subsequent default or breach of a different covenant, term, or provision. The consent or approval by either party to or with respect to any act by the other party requiring such consent or approval shall not be deemed to be a waiver or render unnecessary consent

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to or approval of any subsequent similar act. No custom or practice of either party shall constitute a waiver of either party s rights to insist upon strict compliance with the terms of this Agreement. Pursuit by a party of any remedy provided in this Agreement shall not preclude the pursuit by such party of any of the other remedies provided by law or at equity.

7.10 MULTIPLE COUNTERPARTS. This Agreement shall be executed in a number of identical counterparts, each of which, for all purposes, is deemed to be an original, and all of which constitute, collectively, the Agreement; but in making proof of this Agreement, it shall not be necessary to produce or account for more than one such counterpart.

7.11 GUARANTY OF APSG. American Physician Service Group, Inc. hereby guarantees all obligations of Insurer hereunder and executes this Agreement solely to evidence such guaranty.

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IN WITNESS WHEREOF, this Agreement is effective as of the date first written above.

API ADVISORY, LLC

By:_____

Title:_____

Address for Notice:_____

_____

_____

[AMERICAN PHYSICIANS INSURANCE COMPANY]

By:_____

Title:_____

Address for Notice:_____

_____

_____

[SOLELY FOR THE PURPOSES SPECIFIED IN SECTION 7.11:]

[AMERICAN PHYSICIANS SERVICE GROUP, INC.]

By:_____

Title:_____

Address for Notice:_____

_____

_____

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EXHIBIT A

Form of Non-Compete Agreement

NONCOMPETE AND CONFIDENTIALITY AGREEMENT

THIS NONCOMPETE AND CONFIDENTIALITY AGREEMENT (this Agreement) is entered into effective the day of , by (Advisor), in favor and for the benefit of [American Physicians Insurance Company], a Texas insurance company (Company), and the parties agree as follows:

1. *Recitals*.

(a) This Agreement is executed pursuant to that certain Advisory Services Agreement (the ASA) dated effective , 2006, by and among API Advisory, LLC (API Advisory) and the Company;

(b) Capitalized terms used in this Agreement which are not otherwise defined are used with the same meanings given such terms in the ASA;

(c) Company is in the business of selling and servicing medical malpractice insurance policies to health care providers (the Business);

(d) Prior to the date of this Agreement, Advisor has served as a consultant and advisor to the Company and has been integrally involved in the operation and development of the Business;

(e) It is fair and reasonable for the Company to take steps to protect the goodwill of the Company, and its customers, suppliers and employees, following the termination of the ASA;

(f) Each of Advisor and Company acknowledges that it, she or he has received, good, valuable, present and sufficient consideration to support its or his obligations under this Agreement.

2. *Noncompetition*.

Advisor expressly agrees, confirms, represents and covenants for the benefit of Company, as follows:

(a) For the period set forth below (the Noncompete Period) Advisor shall not engage in competition in the Business with Company, or any of its successors or affiliates, within the Applicable Territory (defined below), and in particular, Advisor shall not, as owner, operator, advisor, employee, consultant, independent contractor, agent, salesperson, officer, director, shareholder, investor, guarantor, partner or member of a joint venture, or otherwise, directly or indirectly, engage in any manner in the Business within the Applicable Territory. For purposes of this Agreement, the term Applicable Territory shall mean and include any state in the United Sates of America in which the Company is doing business as of the date of this Agreement; and,

(b) The Noncompete Period shall begin as the date of this Agreement and end five (5) years following the date of this Agreement; and

(c) During the Noncompete Period, Advisor shall not solicit or encourage any employee, distributor, supplier or customer of the Company to modify or discontinue his, her or its relationship with the Company or the Business; and,

(d) Advisor agrees to return all tangible Confidential Information to the Company at the inception of this Agreement, without retaining any copies, summaries or extracts thereof. During and after the Noncompete Period, Advisor shall not use or divulge to any person or entity any Confidential Information of the Company. Confidential Information means all information, not generally known within the relevant trade group or by the public, including all Work Product (as defined in the ASA), business plans, training materials, software programs, promotional materials, illustrations, designs, plans, data bases, sources of supply, customer lists, supplier lists, trade secrets, and all other valuable or unique information and techniques acquired, developed or

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used by the Insurer relating to its business, operations, suppliers, information systems, employees and customers, regardless of whether such information is in writing, on computer disk or disk drive or in any other form. Advisor expressly acknowledges and agrees that Confidential Information constitutes trade secrets and/or confidential and proprietary business information of the Insurer (or its affiliates, customers or suppliers, as the case may be). Confidential Information shall not include information which is or becomes generally available to the public other than through disclosure by Advisor or by any other person or entity under a duty or obligation to maintain the confidentiality thereof; and

(e) The covenants and agreements of Advisor set forth in this Agreement are ancillary to an otherwise enforceable agreement and supported by independent valuable consideration, and the limitations as to time, geographic area and scope of activity to be restrained are reasonable and acceptable to Advisor, and do not impose any greater restraint than is reasonably necessary to protect the goodwill and other business interests of the Company; and,

(f) If, at some later date, a court of competent jurisdiction determines that any of the provisions set forth in this Agreement do not meet the criteria for enforceability under applicable law, Advisor agrees that this Agreement shall be deemed without further action to be modified to the minimum extent necessary so as to be enforceable to the maximum extent permitted by applicable law, and such court is authorized and requested to reform this Agreement accordingly.

(g) Notwithstanding any term of this Agreement to the contrary, nothing in this Agreement shall in any way restrict the right or ability of Advisor to practice medicine.

3. ***Remedies*****.**

Advisor acknowledges that any breach by her or him of this Agreement will result in irreparable harm to the Company with respect to which no adequate remedy at law shall exist. Accordingly, in addition to any other remedies available to the Company with respect to any actual or threatened breach of this Agreement, Advisor consents to the entry of any temporary and permanent injunctive relief, together with temporary restraining orders ancillary to the same. Advisor waives any requirement for posting of any bond or other security in connection with any enforcement action by the Company.

4. ***Governing Law*****.**

This Agreement shall be interpreted in accordance with the laws of the State of Texas, without regard to its principles of conflicts of law, which state shall have jurisdiction of the subject matter hereof.

5. ***Modification*****.**

The covenants and/or provisions of this Agreement may be modified or waived only by any subsequent written agreement signed by both parties.

6. ***Counterparts*****.**

This Agreement may be executed in two or more counterparts, and each counterpart shall be deemed an original, but all counterparts shall together constitute a single instrument.

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK]

[SIGNATURE PAGE TO FOLLOW]

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ANNEX F

AMENDMENT TO

2005 INCENTIVE AND NON-QUALIFIED STOCK OPTION PLAN

This Amendment to the 2005 Incentive and Non-Qualified Stock Option Plan (this ***Amendment***) amends that certain 2005 Incentive and Non-Qualified Stock Option Plan (the ***2005 Incentive Plan***) adopted by the shareholders of American Physicians Service Group, Inc. (the ***Company***) on June 14, 2005.

R E C I T A L S:

The 2005 Incentive Plan currently provides for the issuance of up to 350,000 shares of common stock of the Company. The Company s Board of Directors has determined that it is advisable, fair and in the best interests of the Company and its shareholders to amend the 2005 Incentive Plan to provide for the issuance of up to an additional 300,000 shares of common stock, in order to continue to provide to the persons who are responsible for the continued growth of the Company s business an opportunity to acquire a proprietary interest in the Company.

The 2005 Incentive Plan currently provides for the Company to be able to, at any time, offer to exchange or buy out any previously granted Option for a payment in cash, common stock of the Company or another stock option under the 2005 Incentive Plan. The Company s Board of Directors has determined that it is advisable, fair and in the best interests of the Company and its shareholders to amend the 2005 Incentive Plan to delete this provision of the 2005 Incentive Plan, in order to better protect shareholders during the remaining life of the 2005 Incentive Plan.

A G R E E M E N T:

NOW, THEREFORE, the 2005 Incentive Plan is amended as follows:

1. *Definitions.*

A. Unless otherwise specifically defined in this Amendment, capitalized terms shall have the definitions set forth in the 2005 Incentive Plan.

2. *Stock Subject to the 2005 Incentive Plan*. *Article IV* of the 2005 Incentive Plan is hereby deleted in its entirety and replaced with the following:

IV. Stock Subject to Plan

The aggregate number of shares of Common Stock that may be issued pursuant to Options granted under this Plan shall not exceed 650,000 shares of Common Stock (subject to adjustment as provided in Article VIII). Such shares may consist of authorized but unissued shares of Common Stock or previously issued shares of Common Stock reacquired by the Corporation. Any of such shares which remain unissued and which are not subject to outstanding Options at the termination of this Plan shall cease to be subject to this Plan, but, until termination of this Plan, the Corporation shall at all times make available a sufficient number of shares to meet the requirements of this Plan. Should any Option hereunder expire or terminate prior to its exercise in full, the shares of Common Stock theretofore subject to such Option may again be subject to an Option granted under this Plan to the extent permitted under Rule 16b-3. The aggregate number of shares which may be issued under this Plan shall be subject to adjustment as provided in Article VIII hereof. Exercise of an Option in any manner pursuant to the terms of this Plan and the related Option Agreement shall result in a decrease in the number of shares of Common Stock which may thereafter be available, for purposes of the Plan, by the

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number of shares as to which the Option is exercised. Separate stock certificates shall be issued by the Corporation for those shares acquired pursuant to the exercise of an Incentive Stock Option and for those shares acquired pursuant to the exercise of any Non-Qualified Stock Options.

3. *Exchange Provisions Deleted.* Article XIII of the 2005 Incentive Plan is hereby deleted in its entirety and replaced with the following:

XIII. Governing Law

This Plan shall be governed by the laws of the State of Texas.

4. *2005 Incentive Plan*. Except as specifically amended hereby, the 2005 Incentive Plan shall remain binding and enforceable in accordance with its terms.

[signature page follows]

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American Physicians Service Group, Inc.

By:
W.H. Hayes

Senior Vice-President Finance

Signature Page to 2005 Incentive Plan Amendment

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PART II.

INFORMATION NOT REQUIRED IN PROSPECTUS

Item 20. Indemnification of Directors and Officers

Article 2.02-1 of the Texas Business Corporation Act, or the TBCA, provides that a Texas corporation shall have the power to indemnify anyone who was, is, or may become a defendant or respondent to any threatened, pending, or completed action, suit or proceeding, whether civil, criminal, administrative, arbitrative, or investigative, or any appeal in such an action, suit or proceeding, and any inquiry or investigation that could lead to such an action, suit, or proceeding, because such person is or was a director of the corporation, provided that (i) such person conducted himself in good faith, (ii) such person reasonably believed (A) that in the case of conduct in his official capacity as a director of the corporation that his conduct was in the corporation s best interests and (B) in all other cases, that his conduct was at least not opposed to the corporation s best interests, and (iii) in the case of a criminal proceeding, such person has no reasonable cause to believe his conduct was unlawful. The termination of a proceeding by judgment, order, settlement, or conviction, or on a plea of nolo contendere or its equivalent, is not of itself determinative that a director is not eligible for indemnification by a corporation. Instead, a person shall be deemed to be liable in respect of any claim, issue or matter only after a court of competent jurisdiction adjudges the person liable and the person has exhausted all available appeals. APSG may not indemnify a director as described above for obligations resulting from a proceeding (i) in which such person is liable on the basis that he improperly received personal benefit, whether or not the benefit resulted from an action taken in his official capacity, or (ii) in which such person is found liable to the corporation (except that in such cases APSG may indemnify such director against reasonable expenses the director actually incurs in connection with the proceeding unless the director s misconduct was willful, in which case APSG may not pay such indemnification).

A corporation may provide indemnification as described above only if a determination of indemnification is made: (i) by a majority vote of a quorum of directors who the proceeding does not name as defendants or respondents at the time of voting, regardless of whether the directors not named defendants or respondents constitute a quorum; (ii) by a majority vote of a committee of the board of directors, if (A) the committee is designated by a majority vote of the directors who at the time of the vote are not named defendants or respondents in the proceeding, regardless of whether the directors not named defendants or respondents constitute a quorum, and (B) the committee consists solely of one or more of the directors not named as defendants or respondents in the proceeding; (iii) by special legal counsel selected by the board of directors or a committee of the board by vote as set forth in (i) and (ii); or (iv) by the shareholders in a vote that excludes the shares held by the directors who are named defendants or respondents in the proceeding. A court may order indemnification even though APSG does not meet certain of these conditions, if the court deems indemnification proper and equitable; provided, however, that if the court determines that the indemnified person is liable to the corporation or that he improperly received a personal benefit, the court-ordered indemnification cannot exceed the reasonable expenses that the indemnified party actually incurred in connection with the proceeding.

A person may be indemnified by a corporation as previously described against judgments, penalties (including excise and similar taxes), fines, settlements, and reasonable expenses actually incurred by the person in connection with the proceeding, provided, that if such a person is found liable to the corporation or is liable on the basis that he or she improperly received a personal benefit, the indemnification shall be limited to reasonable expenses actually incurred by the person in connection with the proceeding and shall not be available in respect of any proceeding in which the person shall have been found liable for willful or intentional misconduct in the performance of his duty to the corporation.

A corporation shall indemnify a director against reasonable expenses incurred by him in connection with the proceeding in which he is a named defendant or respondent because he is or was a director if he has been wholly successful, on the merits or otherwise, in the defense of the proceeding. In addition, if a director sues a corporation to recover indemnification in such a case, the court, upon ordering the corporation to pay

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indemnification, shall also award the director his expenses incurred in securing the indemnification. A corporation may pay, or reimburse a director for, the director s reasonable expenses incurred because he or she was, is, or may become a defendant correspondent in a proceeding, in advance of any final disposition of the proceeding and without any determination that the director is entitled to such payment or reimbursement under the above-described standards after the corporation receives a written affirmation by the director of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification under Article 2.02-1 of the TBCA and a written undertaking by or on behalf of the director (which must be an unlimited general obligation but that need not be secured, and that may be accepted without reference to the director s financial ability to pay) to repay the amount paid or reimbursed if it is ultimately determined that the director has not met that standard or if it is ultimately determined that indemnification of the director against expenses incurred by such director in connection with that proceeding is prohibited under the standards enumerated above. Notwithstanding the above, a corporation may pay or reimburse a director for expenses incurred in connection with the director s appearance as a witness or other participation in a proceeding at a time when the director is not a named defendant or respondent in the proceeding.

Article 2.02-1 of the TBCA permits the purchase and maintenance of insurance or another arrangement on behalf of directors, officers, employees and agents of the corporation against any liability asserted against or incurred by them in any such capacity or arising out of the person s status as such, whether or not the corporation itself would have the power to indemnify any such officer or director against such liability; provided, that if the insurance or other arrangement is with a person or entity that is not regularly engaged in the business of providing insurance coverage, the insurance or arrangement may provide for payment of a liability with respect to which the corporation would not have the power to indemnify the person only if the shareholders of the corporation have approved including coverage for the additional liability.

Any indemnification of, or advance of expenses to, a director must be reported in writing to shareholders with or before the notice or waiver of notice of the next shareholders meeting or before the next submission to shareholders of a consent to action without a meeting, and, in any case, within the 12-month period immediately following such indemnification or advance.

A corporation shall indemnify officers and others who are not officers, employees, or agents of the corporation, but who are serving at the corporation s request as a director, officer, partner, venturer, proprietor, trustee, employee, agent, or similar functionary for another entity, to the same extent that the corporation indemnifies directors. A corporation may indemnify and advance expenses to such officers and other persons to the same extent that it may indemnify, or advance expenses to, directors.

Article IX of APSG s restated articles of incorporation provides that, to the extent permitted by applicable law and by resolution or other proper action of the board of directors of APSG, APSG will indemnify its present and former directors and officers, its employees and agents and any other person serving at the request of APSG as a director, trustee, officer, employee or agent of another corporation, partnership, joint venture, association, trust or other enterprise, against expenses, including attorneys fees, judgments, fines and amounts paid in settlement actually and reasonably incurred in connection with any threatened, pending or completed action, suit or proceeding to which any such person is, or is threatened to be made, a party and which may arise by reason of the fact he is or was a person occupying any such office or position. In addition, APSG currently maintains directors and officers liability insurance.

Article XVI of APSG s restated articles of incorporation provides that APSG directors shall not be liable to APSG or its shareholders for monetary damages for an act or omission in the director s capacity as a director except for liability based upon (i) a breach of duty of loyalty to APSG or its shareholders, (ii) an act or omission not in good faith or that involves intentional misconduct or a knowing violation of law, (iii) a transaction from which a director received an improper benefit, whether or not the benefit resulted from an action taken within the scope of the director s office, or (iv) an act related to an unlawful stock repurchase or payment of a dividend.

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In addition to the indemnifications provided by APSG s restated articles of incorporation, APSG has entered into indemnity agreements with its officers and directors. The agreements generally provide that, to the extent permitted by law, APSG must indemnify each person for judgments, expenses, fines, penalties and amounts paid in settlement of claims that result from the fact that they were was an officer, director or employee of APSG.

The Texas Insurance Code does not contain express provisions providing indemnity to directors, officers or controlling persons of a Texas stock insurance company. However, Section 8.2 of the articles of incorporation of APIC, which have been submitted for approval by the Texas Commissioner of Insurance in the plan of conversion, contain provisions that would allow indemnification of persons who are a party to, testify or otherwise participate in, any pending or threatened proceeding because such person is or was a director of APIC or, while a director of APIC, is or was serving at the request of APIC in a representative capacity for another organization. Such indemnification is provided to the fullest extent authorized or permitted by applicable law and includes the right to be reimbursed by APIC for the reasonable expenses incurred in defending or otherwise participating in any such proceeding in advance of its final disposition. In addition, APIE currently maintains directors and officers liability insurance which will continue to provide coverage for APIC after the conversion.

Furthermore, Section 8.1 of the articles of incorporation of APIC provides that current and former directors of APIC will have no personal liability to APIC or any of its shareholders for monetary damages for any act or omission in such person s capacity as a director of APIC except to the extent such limitation or elimination of liability is not permitted by applicable law.

The preceding discussion of APSG indemnification agreements, APSG s restated articles of incorporation, APIC s articles of incorporation and Section 2.02-1 of the Texas Business Corporation Act is not intended to be exhaustive and is qualified in its entirety by the indemnity agreements, restated articles of incorporation and Section 2.02-1 of the Texas Business Corporation Act.

Item 21. Exhibits and Financial Statement Schedules

(a) Exhibits. A list of exhibits filed with this registration statement is contained in the index to exhibits which is incorporated by reference.

(b) Financial Statement Schedules. No separate financial statement schedules are filed because the required information is not applicable or is included in the consolidated financial statements or related notes included herein.

(c) Item 4(b) Information. Incorporated as Annex C to the joint proxy statement-prospectus, which constitutes a part of this registration statement.

Item 22. Undertakings.

Each undersigned registrant hereby undertakes:

(1) To file, during any period in which offers or sales of its securities are being made, a post-effective amendment to this registration statement to:

(i) Include any prospectus required by Section 10(a)(3) of the Securities Act;

(ii) Reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in

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volume and price represent no more than 20 percent change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement;

(iii) Include any additional or changed material information on the plan of distribution;

(2) That, for the purpose of determining any liability under the Securities Act, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the bona fide offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities that remain unsold at the end of the offering.

(4) That, for purposes of determining any liability under the Securities Act of 1933, each filing of the registrant s annual report pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 (and, where applicable, each filing of an employee benefit plan s annual report pursuant to Section 15(d) of the Securities Exchange Act of 1934) that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(5) That prior to any public reoffering of the securities registered hereunder through use of a prospectus which is part of this registration statement, by any person or party who is deemed to be an underwriter within the meaning of Rule 145(c), the issuer undertakes that such reoffering prospectus will contain the information called for by the applicable registration form with respect to reofferings by persons who may be deemed underwriters, in addition to the information called for by the other Items of the applicable form.

(6) That every prospectus: (i) that is filed pursuant to paragraph 5 immediately preceding, or (ii) that purports to meet the requirements of Section 10(a)(3) of the Act and is used in connection with an offering of securities subject to Rule 415, will be filed as a part of an amendment to the registration statement and will not be used until such amendment is effective, and that, for purposes of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offering therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(7) If the registrant is subject to Rule 430C, each prospectus filed pursuant to Rule 424(b) of the Securities Act of 1933, as amended, as part of a registration statement relating to an offering, other than registration statements relying on Rule 430B or other than prospectuses filed in reliance on Rule 430A, shall be deemed to be part of and included in the registration statement as of the date it is first used after effectiveness. Provided, however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such first use, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such date of first use.

(8) To respond to requests for information that are incorporated by reference into the prospectus pursuant to Item 4, 10(b), 11 or 13 of this Form, within one business day of receipt of such request, and to send the incorporated documents by first class mail or other equally prompt means. This includes information contained in the documents filed subsequent to the effective date of the registration statement through the date of responding to the request.

(9) To supply by means of a post-effective amendment all information concerning a transaction, and the company being acquired involved therein, that was not the subject of and included in the registration statement when it became effective.

(10) To file, promptly upon conversion of American Physicians Insurance Exchange into APIC, a post-effective amendment to this registration statement whereby APIC adopts this registration statement.

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Insofar as indemnification for liabilities arising under the Securities Act may be permitted to directors, officers and controlling persons of the registrants pursuant to the foregoing provisions, or otherwise, the registrants have been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable.

In the event that a claim for indemnification against such liabilities (other than the payment by a registrant of expenses incurred or paid by a director, officer or controlling person of such registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, such registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue.

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SIGNATURES

Pursuant to the requirements of the Securities Act, APSG has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Austin, Texas, on this 17th day of November, 2006.

AMERICAN PHYSICIANS SERVICE GROUP, INC.

By: /s/ KENNETH S. SHIFRIN
Chief Executive Officer

(Principal Executive Officer)

Pursuant to the requirements of the Securities Act, this registration statement and Power of Attorney have been signed by the following persons in the capacity and on the dates indicated.

Signature	Title(s)	Date
/s/ KENNETH S. SHIFRIN **Kenneth S. Shifrin**	Chairman of the Board and Chief Executive Officer (Principal Executive Officer), APSG	November 17, 2006
/s/ W. H. HAYES **W. H. Hayes**	Senior Vice President Finance, Secretary and Chief Financial Officer (Principal Financial Officer) , APSG	November 17, 2006
/s/ THOMAS R. SOLIMINE **Thomas R. Solimine**	Controller (Principal Accounting Officer), APSG	November 17, 2006
/s/ JACKIE MAJORS **Jackie Majors**	Director, APSG	November 17, 2006
/s/ LEW N. LITTLE, JR. **Lew N. Little, Jr.**	Director, APSG	November 17, 2006
/s/ WILLIAM A. SEARLES **William A. Searles**	Director, APSG	November 17, 2006
/s/ CHERYL WILLIAMS **Cheryl Williams**	Director, APSG	November 17, 2006

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SIGNATURES

Pursuant to the requirements of the Securities Act, APIE has duly caused this registration statement to be signed on its behalf, and as predecessor-in-interest to American Physicians Insurance Company upon conversion, by the undersigned, thereunto duly authorized, in the City of Austin, Texas, on this 17th day of November, 2006.

AMERICAN PHYSICIANS INSURANCE EXCHANGE

By: /s/ Norris C. Knight, Jr., M.D.
Chairman of the Board

(Principal Executive Officer)

Pursuant to the requirements of the Securities Act, this registration statement and Power of Attorney have been signed by the following persons in the capacity and on the dates indicated.

Signature	Title(s)	Date
/s/ Norris C. Knight, Jr., M.D. **Norris C. Knight, Jr., M.D.**	Chairman of the Board, APIE	November 17, 2006
/s/ Marc J. Zimmermann **Marc J. Zimmermann**	Chief Financial Officer, APIE (Principal Financial Officer) and Principal Accounting Officer	November 17, 2006
/s/ Gregory M. Jackson, M.D. **Gregory M. Jackson, M.D.**	Secretary and Director, APIE	November 17, 2006
/s/ Duane K. Boyd, Jr. **Duane K. Boyd, Jr.**	Director, APIE	November 17, 2006
/s/ Freddie L. Contreras, M.D. **Freddie L. Contreras, M.D.**	Director, APIE	November 17, 2006
/s/ Thomas Eades, M.D. **Thomas Eades, M.D.**	Director, APIE	November 17, 2006
/s/ Michael L. Green, Jr., M.D. **Michael L. Green, Jr., M.D.**	Director, APIE	November 17, 2006
/s/ William J. Peche, M.D. **William J. Peche, M.D.**	Director, APIE	November 17, 2006

/s/ Lawrence S. Pierce, M.D.	Director, APIE	November 17, 2006
Lawrence S. Pierce, M.D.		
/s/ Richard S. Shoberg, Jr., M.D.	Director, APIE	November 17, 2006
Richard S. Shoberg, Jr., M.D.		

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EXHIBIT INDEX

Exhibit Number	Description
2.1	Merger Agreement and Plan of Merger, dated June 5, 2006, among American Physicians Service Group, Inc., APSG ACQCO, Inc., and American Physicians Insurance Exchange, as amended (included as Annex A to the joint proxy statement/prospectus contained in the Registration Statement).
2.2	Plan of Conversion of American Physicians Insurance Exchange, dated June 1, 2006, as amended (included as Annex B to the joint proxy statement/prospectus contained in the Registration Statement).
3.1	Restated Articles of Incorporation of American Physicians Service Group, Inc. (3)
3.2	Amended and Restated Bylaws of American Physicians Service Group, Inc. (3)
3.3	Bylaws of American Physicians Insurance Exchange. (13)
4.1	Specimen of Common Stock Certificate of American Physicians Service Group, Inc. (1)
4.2	Rights Agreement, dated as of August 15, 2000, between American Physicians Service Group, Inc. and American Stock Transfer & Trust Company, which includes the form of Statement of Resolutions setting forth the terms of the Junior Participating Preferred Stock, Series A, the form of Rights Certificate as Exhibit B and the Summary of Rights to Purchase Preferred Shares as Exhibit C. (7)
5.1	Opinion of Akin Gump Strauss Hauer & Feld LLP regarding legality of securities being registered. (13)
5.2	Opinion of Graves Dougherty Hearon & Moody, P.C. regarding legality of securities being registered. (13)
8.1	Opinion of Deloitte Tax LLP regarding certain federal income tax matters (included as Annex C to the joint proxy statement/prospectus contained in the Registration Statement).
*10.1	1995 Incentive and Non-Qualified Stock Option Plan of American Physicians Service Group, Inc. (4)
*10.2	Form of Stock Option Agreement (ISO). (4)
*10.3	Form of Stock Option Agreement (Non-Qualified). (4)
10.4	Management Agreement of Attorney-in-Fact, dated August 13, 1975, between FMI and American Physicians Insurance Exchange. (1)
*10.5	Profit Sharing Plan and Trust, effective December 1, 1984, of American Physicians Service Group, Inc. (2)
*10.6	First Amendment to 1995 Incentive and Non-Qualified Stock Option Plan of American Physicians Service Group, Inc. Dated December 10, 1997. (5)
*10.7	First Amendment to 1995 Non-Employee Director Stock Option Plan of American Physicians Service Group, Inc. Dated December 10, 1997. (5)
*10.8	2005 Incentive and Non-Qualified Stock Option Plan. (12)
*10.9	Deferred Compensation Master Plan. (12)
*10.10	Contribution and Stock Purchase Agreement dated January 1, 1998 between American Physicians Service Group, Inc., Additional Purchasers, Barton Acquisition, Inc., Barton House, Ltd., Barton House at Oakwell Farms, Ltd., Uncommon Care, Inc., George R. Bouchard, John Trevey and Uncommon Partners, Ltd. (6)

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Exhibit Number	Description
*10.11	Loan Agreement dated January 1, 1998 between American Physicians Service Group, Inc. and Barton Acquisition, Inc. (6)
10.12	Promissory Note (Line of Credit) dated January 1, 1998 between American Physicians Service Group, Inc. and Barton Acquisition, Inc. in the amount of $2,400,000. (6)
10.13	Security Agreement dated January 1, 1998 between American Physicians Service Group, Inc. and Barton Acquisition, Inc. (6)
10.14	Participation Agreement dated March 16, 1998 between American Physicians Service Group, Inc. and Additional Purchasers referred to as Participants. (6)
10.15	Convertible Promissory Note dated April 27, 1999 between American Physicians Service Group, Inc. and Uncommon Care, Inc. (7)
10.16	Replacement Convertible Promissory Note dated September 30, 1999 between American Physicians Service Group, Inc. and Uncommon Care, Inc. (7)
10.17	Liquidity Promissory Note dated September 30, 1999 between American Physicians Service Group, Inc. and Uncommon Care, Inc. (7)
10.18	Replacement Liquidity Note dated October 15, 1999 between American Physicians Service Group, Inc. and Uncommon Care, Inc. (7)
10.19	$1.25 million Promissory Note dated June 1, 2000 between American Physicians Service Group, Inc. and Uncommon Care, Inc. (8)
10.20	$1.20 million Promissory Note dated June 1, 2000 between American Physicians Service Group, Inc. and Uncommon Care, Inc. (8)
10.21	Agreement dated November 22, 2002 transferring and assigning all capital stock of Eco-Systems from American Physicians Service Group, Inc. to the purchaser. (9)
*10.22	Amended 1995 Incentive and Non-Qualified Stock Option Plan. (9)
10.23	Executive Employment Agreement between American Physicians Service Group, Inc. and Kenneth S. Shifrin. (9)
*10.24	Consulting Agreement between American Physicians Service Group, Inc. and William A. Searles. (9)
*10.25	Executive Employment Agreement between American Physicians Service Group, Inc. and William H. Hayes. (9)
10.26	Stock Purchase Agreement dated October 31, 2003 between American Physicians Service Group, Inc. and FPIC Insurance Group, Inc. (9)
10.27	Revolving Promissory Note dated April 15, 2004 between American Physicians Service Group, Inc. and PlainsCapital Bank. (10)
10.28	Commercial Loan Agreement dated April 15, 2004 between American Physicians Service Group, Inc. and PlainsCapital Bank. (10)
10.29	2005 Incentive and Non-Qualified Stock Option Plan. (11)
10.30	American Physician Service Group, Inc. Affiliated Group Deferred Compensation Master Plan. (11)
10.31	Managing General Agency Agreement between American Physicians Insurance Agency, Inc. and American Physicians Insurance Exchange, effective as of May 29, 1996. (13)
10.32	Management Agreement of Attorney-in-Fact for American Physicians Insurance Exchange, effective as of October 1, 1975. (13)

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Exhibit Number	Description
21.1	List of subsidiaries of American Physicians Service Group, Inc. (13)
23.1	Independent Registered Public Accountants Consent of BDO Seidman, LLP. (13)
23.2	Independent Auditors Consent of Deloitte & Touche LLP. (13)
23.3	Consent of Akin Gump Strauss Hauer & Feld LLP (included in Exhibit 5.1 to this Registration Statement).
23.4	Consent of Deloitte Tax LLP (included in Exhibit 8.1 to this Registration Statement).
23.5	Consent of Graves Dougherty Hearon & Moody, P.C. (included in Exhibit 5.2 to this Registration Statement).
99.1	Form of Proxy Card to be used by APSG. (13)
99.2	Form of Proxy Card to be used by APIE. (13)
99.3	Consent of Raymond James and Associates. (13)
99.4	Consent of Norris C. Knight, Jr., M.D. (13)
99.5	Consent of William J. Peche, M.D. (13)
99.6	Consent of Dover Dixon Horne PLLC. (13)
(*)	Executive Compensation plans and arrangements.
(1)	Filed as an Exhibit to the Registration Statement on Form S-1, Registration No. 2-85321, of American Physicians Service Group, Inc., and incorporated herein by reference.
(2)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 1984 and incorporated herein by reference.
(3)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 1990 and incorporated herein by reference.
(4)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 1995 and incorporated herein by reference.
(5)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 1997 and incorporated herein by reference.
(6)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 1998 and incorporated herein by reference.
(7)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 1999 and incorporated herein by reference.
(8)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 2000 and incorporated herein by reference.
(9)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 2003 and incorporated herein by reference.
(10)	Filed as an Exhibit to the Annual Report on Form 10-K of American Physicians Service Group, Inc. for the year ended December 31, 2004.
(11)	Filed as an Exhibit to the Current Report on Form 8-K of American Physicians Service Group, Inc. dated June 17, 2005.
(12)	Filed as an Exhibit to the Registration Statement on Form S-8 filed with the SEC on April 26, 2006.
(13)	Filed herewith.