Zenith National Insurance Corp. and Subsidiaries

Consolidated Financial Statements
as of December 31, 2010 and 2009 and for the three years ended December 31, 2010

Zenith National Insurance Corp. and subsidiaries
Financial Statements

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Report of Independent Auditors

To management of
Zenith National Insurance Corp.:

We have audited the accompanying consolidated balance sheets of Zenith National Insurance Corp. and its subsidiaries (collectively, the "Company") as of December 31, 2010 and December 31, 2009, and the related consolidated statements of operations, cash flows and stockholders' equity and comprehensive income for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2010, and December 31, 2009, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

February 28, 2011

ZENITH NATIONAL INSURANCE CORP. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31,	
(Dollars and shares in thousands)	2010	2009
Assets:		
Investments:		
Fixed maturity securities, at fair value (amortized cost $1,338,136 in 2010 and $1,424,359 in 2009)	$ 1,275,469	$ 1,475,067
Equity securities, at fair value (cost $77,878 in 2010 and $50,875 in 2009)	80,200	55,975
Short-term investments, at fair value (amortized cost $48,555 in 2010 and $416,097 in 2009)	48,555	416,363
Mortgage loan (at unpaid principal balance)	31,595	
Other investments	92,043	55,425
Total investments	1,527,862	2,002,830
Cash	44,945	14,843
Accrued investment income	17,663	20,001
Premiums receivable	6,646	8,901
Reinsurance recoverables	225,013	254,481
Deferred policy acquisition costs	4,287	5,461
Deferred tax asset (see Note 7)		14,425
Income tax receivable	8,160	
Goodwill	20,985	20,985
Other assets	79,092	96,317
Total assets	$ 1,934,653	$ 2,438,244
Liabilities:		
Unpaid losses and loss adjustment expenses	$ 1,169,838	$ 1,191,104
Unearned premiums	31,502	33,994
Policyholders' dividends accrued	7,411	8,633
Long-term debt	38,415	58,363
Income tax payable		1,878
Other liabilities	62,825	85,341
Total liabilities	1,309,991	1,379,313
Commitments and contingencies (see Note 15)		
Stockholders' equity:		
Preferred stock (see Note 2)		
Common stock, $1 par value, authorized shares of 40 in 2010 and 100,000 in 2009; issued and outstanding shares of 38 in 2010 and 37,482 in 2009 (see Note 2)	38	37,482
Additional paid-in capital	398,422	360,464
Retained earnings	218,438	624,537
Accumulated other comprehensive income	7,764	36,448
Total stockholders' equity	624,662	1,058,931
Total liabilities and stockholders' equity	$ 1,934,653	$ 2,438,244

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

ZENITH NATIONAL INSURANCE CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Revenues:			
Net premiums earned	$ 428,166	$ 463,081	$ 607,327
Net investment income	61,203	85,514	94,027
Net realized gains (losses) on investments	101,017	36,252	(18,507)
Change in net unrealized losses on investments (see Note 4)	(72,290)		
Total revenues	518,096	584,847	682,847
Expenses:			
Losses and loss adjustment expenses incurred	358,230	320,001	279,908
Underwriting and other operating expenses:			
Policy acquisition costs	82,294	89,100	111,106
Underwriting and other costs	120,177	118,372	127,353
Policyholders' dividends	8,430	103	12,130
Merger related costs	24,570		
Interest expense	4,523	5,136	5,154
Total expenses	598,224	532,712	535,651
Income (loss) before tax	(80,128)	52,135	147,196
Income tax expense (benefit):			
Current	(5,765)	8,366	42,921
Deferred (see Note 7)	29,870	9,369	8,975
Total income tax expense	24,105	17,735	51,896
Net income (loss)	$ (104,233)	$ 34,400	$ 95,300
Net realized gains (losses) on investments, before tax:			
Other-than-temporary impairment losses:			
Total impairment losses on fixed maturity securities		$ (19,424)	
Non-credit portion of impairment losses on fixed maturity securities recognized in other comprehensive income		8,762	
Other-than-temporary impairment losses on fixed maturity securities		(10,662)	$ (13,224)
Other-than-temporary impairment losses on equity securities		(8,418)	(10,606)
Other net realized gains	$ 101,017	55,332	5,323
Net realized gains (losses) on investments, before tax	$ 101,017	$ 36,252	$ (18,507)

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

ZENITH NATIONAL INSURANCE CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Cash flows from operating activities:			
Premiums collected	$ 439,703	$ 475,515	$ 615,993
Investment income received	70,672	90,557	84,283
Losses and loss adjustment expenses paid	(348,681)	(375,319)	(398,162)
Underwriting and other operating expenses paid	(201,921)	(234,242)	(255,804)
Merger related costs paid	(16,316)		
Interest paid	(4,928)	(5,094)	(5,127)
Income taxes (paid) refunded	(3,400)	26,538	(66,729)
Net cash used in operating activities	(64,871)	(22,045)	(25,546)
Cash flows from investing activities:			
Purchases of investments:			
Fixed maturity securities – available-for-sale	(127,195)	(1,039,551)	(982,269)
Fixed maturity securities – fair value option	(1,902,417)		
Equity securities – available-for-sale	(32,813)	(52,904)	(114,505)
Equity securities – fair value option	(26,008)		
Mortgage loan	(31,675)		
Other investments	(75,202)	(6,147)	(38,090)
Proceeds from maturities and redemptions of investments:			
Fixed maturity securities – available-for-sale	49,941	88,980	95,386
Fixed maturity securities – held-to-maturity			26,000
Fixed maturity securities – fair value option	65		
Mortgage loan	80		
Other investments	7,513	11,582	1,528
Proceeds from sales of investments:			
Fixed maturity securities – available-for-sale	1,304,083	1,245,470	768,957
Fixed maturity securities – fair value option	864,731		
Equity securities – available-for-sale	50,448	48,003	116,270
Equity securities – fair value option	889		
Other investments	1,839		
Net decrease (increase) in short-term investments	367,813	(172,959)	252,842
Capital expenditures and other	(5,610)	(5,356)	(7,043)
Net cash provided by investing activities	446,482	117,118	119,076
Cash flows from financing activities:			
Dividends paid to common stockholders	(320,837)	(90,717)	(90,361)
Repurchase of long-term debt	(20,000)		
Payment for restricted stock awards	(10,273)		
Tax benefit (short-fall) on stock-based compensation	(399)	9	376
Net cash used in financing activities	(351,509)	(90,708)	(89,985)
Net increase in cash	30,102	4,365	3,545
Cash at beginning of year	14,843	10,478	6,933
Cash at end of year	$ 44,945	$ 14,843	$ 10,478

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

ZENITH NATIONAL INSURANCE CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

(In thousands)	Year Ended December 31, 2010	2009	2008
Reconciliation of net income to net cash used in operating activities:			
Net income (loss)	$ (104,233)	$ 34,400	$ 95,300
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Depreciation expense	8,426	8,119	8,376
Net amortization (accretion)	5,699	1,734	(6,634)
Net realized losses (gains) on investments	(101,017)	(36,252)	18,507
Change in net unrealized gains on investments (see Note 4)	72,290		
Stock-based compensation expense	10,313	5,613	6,143
Loss on asset impairment	3,023		
Decrease (increase) in:			
Accrued investment income	2,338	3,501	(1,706)
Premiums receivable	2,255	6,477	6,755
Reinsurance recoverables	29,090	30,771	60,795
Deferred policy acquisition costs	1,174	1,813	2,264
Net income taxes	20,705	44,273	(16,034)
Increase (decrease) in:			
Unpaid losses and loss adjustment expenses	(21,266)	(83,482)	(178,784)
Unearned premiums	(2,492)	(11,232)	(16,724)
Policyholders' dividends accrued	(1,222)	(28,620)	(2,247)
Accrued expenses	(2,666)	(2,905)	(2,276)
Other	12,712	3,745	719
Net cash used in operating activities	$ (64,871)	$ (22,045)	$ (25,546)

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

ZENITH NATIONAL INSURANCE CORP. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)

	Year Ended December 31,		
(Dollars in thousands, except per share data)	2010	2009	2008
Preferred stock (see Note 2)	None	None	None
Common stock, $1 par value:			
Beginning of year	$ 37,482	$ 45,019	$ 44,802
Change in par value of common stock (see Note 2)	(37,892)		
Treasury stock retirement (see Note 11)		(7,695)	
Conversion of Convertible Senior Notes payable			69
Restricted stock vested	448	158	148
End of year	38	37,482	45,019
Additional paid-in capital:			
Beginning of year	360,464	472,312	464,932
Change in par value of common stock (see Note 2)	37,892		
Treasury stock retirement (see Note 11)		(116,890)	
Recognition of stock-based compensation expense	9,865	5,455	5,995
Excess tax benefit (short-fall) on stock-based compensation	474	(413)	162
Conversion of Convertible Senior Notes payable			1,223
Payment for restricted stock awards (see Note 3)	(10,273)		
End of year	398,422	360,464	472,312
Retained earnings:			
Beginning of year	624,537	722,996	718,175
Treasury stock retirement (see Note 11)		(42,067)	
Net income (loss)	(104,233)	34,400	95,300
Dividends declared to common stockholders	(301,866)	(90,792)	(90,479)
End of year	218,438	624,537	722,996
Accumulated other comprehensive income (loss):			
Beginning of year	36,448	(50,238)	12,100
Net change in unrealized gains (losses) on available-for-sale investments, net of tax and reclassification adjustment	(28,684)	86,005	(62,338)
Net change in other-than-temporary impairments for which the credit related portion was recognized in net realized gains, net of tax		681	
End of year	7,764	36,448	(50,238)
Treasury stock:			
Beginning of year		(166,652)	(166,652)
Treasury stock retirement (see Note 11)		166,652	
End of year	0	0	(166,652)
Total stockholders' equity	$ 624,662	$ 1,058,931	$ 1,023,437
Comprehensive income (loss):			
Net income (loss)	$ (104,233)	$ 34,400	$ 95,300
Net change in unrealized gains (losses) on available-for-sale investments, net of tax and reclassification adjustment	(28,684)	86,005	(62,338)
Net change in other-than-temporary impairments for which the credit related portion was recognized in net realized gains, net of tax		681	
Comprehensive income (loss)	$ (132,917)	$ 121,086	$ 32,962

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

Note 1. Basis of Presentation and Summary of Operations

Basis of Presentation
The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and include Zenith National Insurance Corp. (“Zenith National”) and its subsidiaries. All intercompany transactions and balances have been eliminated in consolidation.

Organization and Operations
Zenith National is a Delaware holding company, which is an indirect wholly-owned subsidiary of Fairfax Financial Holdings Limited (“Fairfax”) (see Note 2). Fairfax is a Canadian financial services holding company, whose common stock is publicly traded on the Toronto Stock Exchange, and is principally engaged in property and casualty insurance, reinsurance and associated investment management.

Zenith National is engaged, through its wholly-owned subsidiaries (primarily Zenith Insurance Company (“Zenith Insurance”)), in the workers’ compensation insurance business, nationally. Unless otherwise indicated, all references to “Zenith,” “we,” “us,” “our,” the “Company” or similar terms refer to Zenith National together with its subsidiaries.

The accompanying audited Consolidated Financial Statements differ from those published by Fairfax due to the timing of the Merger, purchase accounting adjustments recorded by Fairfax and differences between GAAP and accounting principles generally accepted in Canada.

Use of Estimates
GAAP requires the use of assumptions and estimates in reporting certain assets and liabilities and related disclosures. Actual results could differ from those estimates.

Subsequent events
We evaluated subsequent events through the date and time the Consolidated Financial Statements were issued on February 28, 2011.

Reclassifications
Certain prior year amounts in the accompanying Consolidated Financial Statements have been reclassified to conform to the current year presentation.

Note 2. Merger and Long-Term Debt Consent

On May 20, 2010, Fairfax, through its affiliates, acquired all of the outstanding shares of Zenith National common stock that it did not already own for $38 per share in cash pursuant to a merger transaction (“Merger”) as provided for in an Agreement and Plan of Merger dated as of February 17, 2010.

On May 26, 2010, Zenith National received the requisite consents from the holders of our long-term debt securities to amend certain terms of the Indenture. The amendments were conditioned on the closing of the Merger and allowed Zenith National to provide the Indenture Trustee annual audited consolidated financial statements and quarterly unaudited financial statements prepared in accordance with GAAP in lieu of providing reports required to be filed under the Securities and Exchange Act of 1934 (“Exchange Act”) with the Securities and Exchange Commission.

In connection with the closing of the Merger, Zenith National’s common stock was delisted from the New York Stock Exchange (“NYSE”) and trading of the common stock on the NYSE was suspended. Zenith

National also deregistered all common stock covered under registration statements on Form S-8 and suspended its reporting obligations under Section 12 of the Exchange Act. All shares of Zenith National's common stock were deregistered and delisted and Zenith National is no longer a public company under the securities laws.

In connection with the Merger, the par value of Zenith National's common stock was reduced from $1.00 to $0.001 per share and the number of shares authorized was reduced from 100 million to 40 million. In addition, the one million shares of Zenith National's preferred stock previously authorized were eliminated. In September 2010, the Certificate of Incorporation of Zenith National was amended to reduce the total number of authorized common shares from 40 million to 40,000, increase the par value per share from $0.001 to $1.00 and effect a 1,000 to 1 reverse stock-split of the outstanding shares of common stock. These actions did not have any impact on our consolidated financial position or results of operations.

Note 3. Summary of Accounting Policies

Investments

As of December 31, 2010, investments in fixed maturity and equity securities and short-term investments purchased prior to April 1, 2010 were classified as available-for-sale and reported at fair value with unrealized gains and losses excluded from earnings and reported in a separate component of stockholders' equity, net of tax. We elected the fair value option for recording investments in fixed maturities and equity securities and short-term investments acquired after March 31, 2010. The resulting changes in fair value for these investments are recorded in the change in net unrealized losses on investments in the Statement of Operations. This election was made to closely align Zenith's accounting for investments to Fairfax's accounting for investments under International Financial Reporting Standards beginning January 1, 2011. At December 31, 2009, all of our investments in fixed maturity and equity securities and short-term investments were classified as available-for-sale.

In November 2010, we closed on a mortgage loan to a non-profit corporation which is carried at the unpaid principal balance, secured by a first lien in real estate, and matures in October 2020. All of the unpaid principal is considered to be collectible and there is no provision for uncollectible amounts.

Other investments totaling $92.0 million are comprised of $75.2 million invested in partnerships and limited liability companies managed by professionals and related to commercial real estate, alternative energy, investing and trading securities, privately-held educational investments and entertainment assets, as well as $16.8 million of commercial rental properties. Partnerships and limited liability company investments of $45.4 million are recorded at cost because our ownership is minor and we do not have significant operating or financial influence. The net asset values of such cost-based investments exceeded the carrying value by approximately $11.3 million at December 31, 2010. Gains from cost-based investments are recognized when we receive distributions and impairments are recognized when we determine that an other-than-temporary impairment has occurred. An investment in a partnership valued at $29.8 million at December 31, 2010 is recorded at our share of its net asset value using the equity method of accounting because our ownership share is more than minor. The investments in commercial rental properties of $16.8 million at December 31, 2010 are recorded at cost less accumulated depreciation. At December 31, 2010, we had additional commitments of $46.5 million to investments in partnerships and limited liability companies.

Investments that we currently own could be subject to default by the issuer or could suffer declines in fair value that become other-than-temporary. We continually assess the prospects for individual available-

for-sale securities as part of our ongoing portfolio management, including the identification of other-than-temporary declines in fair values. Our other-than-temporary assessment includes reviewing the extent and duration of declines in fair values of such investments below the amortized cost basis, the seniority and duration of the securities, historical and projected company financial performance, company-specific news and other developments, the outlook for industry sectors, credit ratings and macro-economic changes, including government policy initiatives. For available-for-sale debt securities, the amount of an other-than-temporary impairment related to a credit loss or an impairment on a security that we have the intent, at the balance sheet date, to sell before recovery of our cost is recognized in earnings and reflected as a reduction in the cost basis of the security. The amount of an other-than-temporary impairment on available-for-sale debt securities related to other factors is recorded consistent with changes in the fair value of all other available-for-sale securities as a component of stockholders' equity in other comprehensive income (loss) with no change to the cost basis of the security. For available-for-sale equity securities, an other-than-temporary impairment is recognized in earnings and reflected as a reduction in the cost basis of the security based on the extent and duration that fair value is below cost, in addition to issuer specific events.

In determining whether a credit loss exists on available-for-sale debt securities when there is an other-than-temporary impairment as of each balance sheet date, we estimate the present value of cash flows expected to be collected from the debt securities. Considerable judgment is required in determining estimated cash flows for each individual security and we use market observable data as well as management judgment. The cash flow estimates incorporate our assumptions regarding the probability of default, and the timing and amount of recoveries associated with a default. We develop our estimates using information based on market observable data such as industry analysts' reports and forecasts, analysis of investment yield spreads to comparable peer company securities where there are no indications of credit related impairments, analysis of credit default swap spreads and other data relevant to the collectability of a security.

Investment income is recorded when earned. Realized capital gains and losses are calculated based on the cost of securities sold which was determined by the "identified cost" method prior to the Merger. On May 20, 2010, the Company elected to change its method of calculating realized capital gains and losses to the "average cost" method used by Fairfax. This change in method was not material to prior period financial statements.

Cash

Cash includes demand deposits with financial institutions.

Recognition of Property-Casualty Revenue and Expense

Revenue Recognition

The consideration paid for an insurance policy is generally known as a "premium." Premiums billed to and paid by our policyholders are the revenues attributable to our workers' compensation business. Premiums are billed and collected according to policy terms, predominantly in the form of installments during the policy period. Premiums are earned pro-rata over the terms of the policies. Billed premiums applicable to the unexpired terms of policies in-force are recorded in the accompanying consolidated balance sheets as a liability for unearned premiums. Premiums exclude policyholder surcharges which are primarily attributable to California business and generally consist of state insolvency fund assessments. These insolvency fund assessments are generally paid in advance to the various state

agencies and subsequently collected from policyholders in the form of a surcharge, and do not affect our results of operations.

Workers' Compensation Premiums

Workers' compensation premiums are determined based upon the payroll of the insured, the applicable premium rates and, where applicable, an experience-based modification factor and a debit or credit applied by our underwriters based upon individual risk characteristics. An audit of the policyholders' records is conducted after policy expiration to make a final determination of applicable premiums. Included with premiums earned is an estimate of the impact of final audit premiums. We can estimate this adjustment because we monitor, by policy, how much additional premium is billed or refunded in final audit invoices as a percentage of the original estimated amount that was billed. We use the historical percentage and current trends to estimate the probable amount to be billed or refunded as of the balance sheet date. At times, such as 2010 and 2009 when payrolls declined during the policy periods due to the recession, we billed more premium than was actually owed and we established a liability for the estimated amount to be refunded to our policyholders. Included in other liabilities was $4.2 million at both December 31, 2010 and 2009 for estimated amounts of premiums to be refunded to our policyholders.

Any amounts receivable for billed premiums are charged-off upon initiating the legal collection process. An estimate of amounts that are likely to be charged-off is established as an allowance for doubtful accounts as of the balance sheet date. The estimate is comprised of any specific accounts that are past due and are considered probable to be charged-off and a provision against remaining accounts receivable based on historical charge-off data. Premiums receivable are reported net of an allowance for estimated uncollectible premium amounts which was $650,000 and $620,000 at December 31, 2010 and 2009, respectively.

We have written a relatively small number of workers' compensation policies that are retrospectively rated. Under this type of policy, subsequent to policy expiration, the policyholder may be entitled to a refund or may owe additional premium based on the amount of losses sustained under the policy. These retrospective premium adjustments are limited in the amount by which they increase or decrease the standard amount of premium applicable to the policy. We can estimate these retrospective premium adjustments because we know the underlying loss experience of the policies involved. The estimated net liability for refund of premiums under retrospectively rated workers' compensation policies included in unearned premiums was approximately $41,000 and $1.5 million at December 31, 2010 and 2009, respectively.

Losses and Loss Adjustment Expenses Incurred

Losses and loss adjustment expenses incurred in the accompanying consolidated statements of operations include provisions for the amount we expect to ultimately pay for all reported and unreported claims for the applicable periods. Loss adjustment expenses are the expenses applicable to the process of administering, settling and investigating claims, including related legal expenses.

Estimates of losses from environmental and asbestos related claims are included in overall loss reserves and to date have not been material.

Unpaid Losses and Loss Adjustment Expenses

The liabilities for unpaid losses and loss adjustment expenses ("loss reserves") in the accompanying consolidated balance sheets are estimates of the unpaid amounts that we expect to pay for the ultimate

cost of reported and unreported claims as of the balance sheet date. Loss reserves are estimates and are inherently uncertain; they do not and cannot represent an exact measure of ultimate liability. We perform a comprehensive review of our loss reserves at the end of every quarter. Estimating loss reserves is a complex process that involves a combination of actuarial techniques and methods and management judgment to establish the most reasonable estimate of loss reserves. Any resulting adjustments to loss reserves are reflected in our Consolidated Statements of Operations in the period in which the change is made.

When losses are reported to us, we establish individual estimates of the ultimate cost of the claims, known as "case reserves." These case reserves are continually monitored and revised in response to new information and for amounts paid. Our actuaries use this information about reported claims in some of their estimation techniques. In estimating our total loss reserves, we make provision for two types of loss development. At the end of any calendar period, there are a number of claims that have not yet been reported but will arise out of accidents that have already occurred. These are referred to in the insurance industry as incurred but not reported ("IBNR") claims and our loss reserves contain an estimate for IBNR claims. In addition to this provision for late reported claims, we also have to estimate, and make provision for, the extent to which the case reserves on known claims may also develop. These types of reserves are referred to in the insurance industry as "bulk" reserves. Our loss reserves make provision for both IBNR and bulk reserves in total, but not separately.

The principal uncertainty in our workers' compensation loss reserve estimates at this time is the trend of increasing claim costs, particularly medical. In estimating loss reserves, our actuaries consider medical costs by evaluating longer term trends. The additional uncertainties considered in estimating ultimate loss costs include the ultimate number of expensive cases and the length of time required to settle long-term expensive cases. Expensive claims are those involving permanent disability of an injured worker and are paid over many years. The ultimate costs of expensive claims are difficult to estimate because of such factors as the on-going and possibly increasing need for medical care, length of disability, life expectancy and benefits for dependents.

We believe our loss reserve estimates are adequate. However, the ultimate losses will not be known with any certainty for several years. We assume that increasing medical cost trends will continue and will impact our long-term claim costs and loss reserves. We will continue to evaluate our loss reserve estimates every quarter to reflect the most current data and judgments.

Deferred Policy Acquisition Costs

Policy acquisition costs, consisting of agent commissions and premium taxes that vary with, and are primarily related to, the production of new or renewal business are deferred and amortized as the related premiums are earned.

A premium deficiency is recognized if the sum of expected claims costs, claims adjustment expenses, expected dividends to policyholders, unamortized acquisition costs and policy maintenance costs exceeds the remaining premiums. A premium deficiency would first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency were greater than unamortized acquisition costs, a liability would be accrued for the excess deficiency. We do not consider anticipated investment income when determining if a premium deficiency exists. There was no premium deficiency at December 31, 2010 or 2009.

Policyholders' Dividends

Most of our workers' compensation policies are non-participating; however, we issue certain policies in which the policyholder may participate in favorable claims experience through a dividend. An estimated provision for workers' compensation policyholders' dividends is accrued as the related premiums are earned. Such dividends do not become a fixed liability unless and until declared by the respective Board of Directors of our insurance subsidiaries. The dividend to which a policyholder may be entitled is set forth in the policy and is related to the amount of losses incurred under the policy. Dividends are calculated after policy expiration (usually at 6 months and 18 months after expiration). We are able to estimate any liability we may have because we know the underlying loss experience of the policies we have written with dividend provisions and can estimate the future liability from the policy terms.

State Guarantee Fund Assessments

State guarantee funds ("Guarantee Funds") exist to ensure that policyholders (holders of direct insurance policies but not of reinsurance policies) receive payment of their claims if insurance companies become insolvent. The Guarantee Funds are funded primarily by statutorily prescribed assessments they bill to insurance companies doing business in their states. Various mechanisms exist in some of these states for assessed insurance companies to recover these assessments. Upon the insolvency of an insurance company, the Guarantee Funds become primarily liable for the payment of the insolvent company's liabilities to policyholders. The declaration of an insolvency establishes the presumption that assessments by the Guarantee Funds are probable. We write workers' compensation insurance in many states in which unpaid workers' compensation liabilities are the responsibility of the Guarantee Funds and have received, and expect to continue to receive, Guarantee Fund assessments, some of which may be based on a certain amount of the premiums we have already earned as of December 31, 2010.

We recorded an estimate of $5.6 million and $6.4 million for our expected net liability at December 31, 2010 and 2009, respectively, for Guarantee Fund assessments; the ultimate impact of such assessments will depend upon the amount and timing of the assessments and of any recoveries to which we are entitled.

Reinsurance Ceded

In the ordinary course of business and in accordance with general insurance industry practices, we purchase excess of loss reinsurance to protect us against the impact of large, irregularly occurring losses in the workers' compensation business. Such reinsurance reduces the magnitude of such losses on net income and the capital of Zenith Insurance. Reinsurance makes the assuming reinsurer liable to the ceding company to the extent of the reinsurance. It does not, however, discharge the ceding company from its primary liability to its policyholders in the event the reinsurer is unable to meet its obligations under such reinsurance agreement. We monitor the financial condition of our reinsurers and do not believe that we are currently exposed to any material credit risk through our ceded reinsurance arrangements because most of our reinsurance is recoverable from large, well-capitalized reinsurance companies.

Premiums earned and losses and loss adjustment expenses incurred are stated in the accompanying Consolidated Statements of Operations after deduction of amounts ceded to reinsurers. Balances due from reinsurers on unpaid losses, including an estimate of such recoverables related to reserves for IBNR losses, are reported as assets and are included in reinsurance recoverables even though amounts due on unpaid losses and loss adjustment expenses are not recoverable from the reinsurer until such

losses are paid. Receivable from reinsurers on unpaid losses and loss adjustment expenses amounted to $220.7 million and $245.3 million at December 31, 2010 and 2009, respectively.

In 1998, Zenith Insurance acquired substantially all of the assets and certain liabilities of RISCORP, Inc. and certain of its subsidiaries (collectively, “RISCORP”) related to its workers’ compensation business. Also, in 1998, we entered into an aggregate excess of loss reinsurance agreement which provides ceded reinsurance for unpaid losses assumed by Zenith Insurance from RISCORP up to $50.0 million in excess of $182.0 million. Receivable from reinsurers on unpaid losses and loss adjustment expenses at December 31, 2010 and 2009 includes recoverable under such insurance of $9.6 million and $10.6 million, respectively, which is fully secured by an investment grade security held in a trust account. The deferred benefit associated with such reinsurance was $3.7 million and $4.2 million at December 31, 2010 and 2009, respectively.

Properties and Equipment

Properties and equipment used in operations, including certain costs incurred to develop and obtain computer software, are capitalized and carried at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis using the following useful lives: buildings — up to 40 years; and other property and equipment — 3 to 10 years. Expenditures for maintenance and repairs are charged to operations as incurred. Additions and improvements to buildings and other fixed assets are capitalized and depreciated over the useful lives of the properties and equipment. Upon disposition, the asset cost and related depreciation are removed from the accounts and the resulting gain or loss is included in income.

Intangible Assets

At December 31, 2010 and 2009, goodwill from acquisitions was $21.0 million, of which $19.0 million is included in assets of Zenith Insurance with the remaining $2.0 million included in Zenith National’s assets. Goodwill represents amounts from acquisitions prior to the Merger and does not reflect the purchase price adjustments associated with the Merger. Other than goodwill, we had no intangible assets at December 31, 2010 or 2009. We test goodwill for impairment annually as of December 31 and more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. A reporting unit is an operating segment or a unit one level below the operating segment. The impairment tests include a comparison of the carrying amount of goodwill to the present value of future cash flows of both our workers’ compensation business and our Florida workers’ compensation business operation, a reporting unit. The fair value, estimated based on the present value of future cash flows of the reporting unit exceeded its carrying amount as of December 31, 2010, therefore, goodwill of the reporting unit is not considered impaired.

Restricted Stock

Under a restricted stock plan in effect prior to the Merger (“Restricted Stock Plan”), non-employee Directors and key employees were awarded shares of Zenith National’s common stock with restricted ownership rights. Upon the completion of the Merger, all of the 430,000 unvested shares became vested due to change in control provisions of the Restricted Stock Plan and the Merger agreement, resulting in a non-cash charge of the remaining unrecognized compensation expense of $8.0 million before tax. Compensation expense before tax recognized for stock-based awards under the Restricted Stock Plan for the full year ended December 31, 2010 was $9.6 million compared to $5.6 million and $6.1 million for the years ended December 31, 2009 and 2008, respectively.

In September 2010, Fairfax adopted a Restricted Stock Plan for Zenith Officers ("Plan"). Under the Plan, Fairfax can grant up to 200,000 shares of its subordinate voting shares, no par value ("Restricted Stock") to Zenith officers. The Restricted Stock vests no earlier than 50% on the 3rd anniversary of the date of grant and the remaining 50% on the 5th anniversary of the date of grant. The Restricted Stock vests in full upon the death or disability of the Plan participant. Restricted Stock is generally forfeited by employees who terminate employment prior to vesting. During the vesting period, the Plan participants are also entitled to voting rights and ordinary cash dividends paid by Fairfax from the date of grant. In June 2010, Zenith paid $10.3 million for the open market purchase of 26,458 Fairfax subordinate voting shares. In September 2010, these shares were awarded to certain Zenith officers as Restricted Stock under the Plan, resulting in a $10.3 million charge to equity. Restricted Stock awards under the Plan are accounted for as equity awards and compensation expense is recognized over the vesting period based on the grant date fair value of $10.5 million with an offsetting entry to the initial charge to equity. Compensation expense before tax under this new plan was $0.7 million for the year ended December 31, 2010.

Recent Accounting Guidance

In December 2010, the Financial Accounting Standards Board ("FASB") issued a new standard which modifies step 1 of the goodwill impairment test for entities with a zero or negative carrying value to require entities to assess, considering qualitative factors, whether it is more likely than not that a goodwill impairment exists. If an entity concludes that it is more likely than not that a goodwill impairment exists, the entity must perform step 2 of the goodwill impairment test. The new standard allows an entity to use either the equity or the enterprise valuation premise to determine the carrying amount of a reporting unit. The new standard will be effective for impairment tests performed during fiscal years and interim periods within those years that begin after December 15, 2010. The adoption of the new standard will not have a material impact on the Company's consolidated financial statements.

In October 2010, the FASB issued guidance which amends the accounting for costs incurred that can be capitalized in the acquisition of new or renewal insurance contracts. The new guidance limits capitalization of certain acquisition costs to those incurred in the successful acquisition of new and renewal contracts, and is effective for interim and annual reporting periods beginning on January 1, 2012, with early adoption permitted. The adoption of this guidance will not have a material impact on our consolidated financial condition or results of operations.

In July 2010, the FASB issued guidance on "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses," which requires additional information to assist financial statement users in assessing an entity's credit risk exposures and evaluating the adequacy of its allowance for credit losses. The additional disclosure would apply to reinsurance recoverables but not to premiums receivable as these can be categorized as trade accounts receivable with contractual maturities of one year or less that arise from the sale of goods or services. The expanded disclosures will include information regarding the credit quality of recoverables as well as their aging as of the end of a reporting period. This guidance is effective for financial statements issued for fiscal years ending on or after December 15, 2011. The adoption of this guidance will not have an impact on our consolidated financial condition or results of operations.

In January 2010, the FASB issued guidance on "Improving Disclosures about Fair Value Measurements" that requires additional disclosures in regards to fair value measurements. This guidance requires entities to disclose separately the amount of significant transfers in and out of Level 1 and Level 2 fair value measurements, and describe the reasons for the transfers. For Level 3 fair value measurements, information about purchases, sales, issuances and settlements are required to be presented on a gross

rather than net basis. This guidance was effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures regarding Level 3 fair value measurements which are effective for fiscal years beginning after December 15, 2010. The additional disclosures required by this guidance are provided in Note 5.

In June 2009, the FASB issued guidance which 1) replaces the quantitative-based risks and rewards calculation for determining whether an enterprise is the primary beneficiary in a variable interest entity with an approach that is primarily qualitative, 2) requires ongoing assessments of whether an enterprise is the primary beneficiary of a variable interest entity and 3) requires additional disclosures about an enterprise's involvement in variable interest entities. This guidance was effective for financial statements issued for fiscal years beginning after November 15, 2009. The adoption of this guidance did not have an impact on our consolidated financial condition or results of operations.

Note 4. Investments

The decline in the value of investment portfolio as of December 31, 2010 compared to December 31, 2009 is primarily attributable to the $282.9 million dividend paid to Fairfax affiliates and the decrease in the fair value of long-term U.S. Government bonds and municipal bonds during the fourth quarter 2010 as a result of an increase in treasury rates.

At December 31, 2010, $1.1 billion of our fixed maturity securities, including short-term investments, and equity securities were recorded using the fair value option with unrealized losses of $72.3 million included in our results of operations for the year ended December 31, 2010. At December 31, 2010 and 2009, $289.4 million and $1.9 billion, respectively, of our fixed maturity securities, including short-term investments, and equity securities were classified as available-for-sale and recorded at fair value with unrealized gains before tax of $11.9 million and $56.1 million, respectively, recorded as a component of equity.

ZENITH NATIONAL INSURANCE CORP. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The cost or amortized cost, fair value and carrying value of investments at December 31, 2010 and 2009 were as follows:

(In thousands)	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value	Carrying Value
December 31, 2010					
Fair value option investments:					
Fixed maturity securities:					
U.S. Government debt	$ 665,962	$ 24	$ (50,419)	$ 615,567	$ 615,567
State and local government debt	397,669	319	(24,431)	373,557	373,557
Corporate debt	29,678	1,593	(652)	30,619	30,619
Total fixed maturity securities	1,093,309	1,936	(75,502)	1,019,743	1,019,743
Short-term investments	48,455			48,455	48,455
Equity securities	45,303	5,639	(4,363)	46,579	46,579
Total fair value option investments	$ 1,187,067	$ 7,575	$ (79,865)	$ 1,114,777	$ 1,114,777
Available-for-sale investments:					
Fixed maturity securities:					
U.S. Government debt	$ 1,320	$ 6		$ 1,326	$ 1,326
State and local government debt	124,517	4,726	$ (1)	129,242	129,242
Corporate debt	87,588	4,834	(160)	92,262	92,262
Redeemable preferred stocks	26,764	1,411	(91)	28,084	28,084
Commercial mortgage-backed securities	2,014	60		2,074	2,074
Foreign government debt	2,624	114		2,738	2,738
Total fixed maturity securities	244,827	11,151	(252)	255,726	255,726
Short-term investments	100			100	100
Equity securities	32,575	1,055	(9)	33,621	33,621
Total available-for-sale investments	$ 277,502	$ 12,206	$ (261)	$ 289,447	$ 289,447
Mortgage loan					31,595
Other investments					92,043
Total investments					$ 1,527,862
December 31, 2009					
Available-for-sale investments:					
Fixed maturity securities:					
U.S. Government debt	$ 3,341	$ 4	$ (1)	$ 3,344	$ 3,344
State and local government debt	161,379	6,309	(175)	167,513	167,513
Corporate debt	1,218,304	47,809	(3,211)	1,262,902	1,262,902
Redeemable preferred stocks	26,853	477	(477)	26,853	26,853
Commercial mortgage-backed securities	11,821		(54)	11,767	11,767
Foreign government debt	2,661	27		2,688	2,688
Total fixed maturity securities	1,424,359	54,626	(3,918)	1,475,067	1,475,067
Short-term investments	416,097	269	(3)	416,363	416,363
Equity securities	50,875	5,219	(119)	55,975	55,975
Total available-for-sale investments	$ 1,891,331	$ 60,114	$ (4,040)	$ 1,947,405	$ 1,947,405
Other investments					55,425
Total investments					$ 2,002,830

Fixed maturity securities, including short-term investments, by contractual maturity at December 31, 2010 were as follows:

(In thousands)	Amortized Cost	Fair Value
Fair value option investments:		
Due in 1 year or less	$ 48,456	$ 48,456
Due after 1 year through 5 years	13,694	13,988
Due after 10 years	1,079,614	1,005,754
Total fair value option investments	$1,141,764	$ 1,068,198
Available-for-sale investments:		
Due in 1 year or less	$ 10,626	$ 10,669
Due after 1 year through 5 years	222,089	232,439
Due after 5 years through 10 years	7,707	8,304
Due after 10 years	4,505	4,414
Total available-for sale investments	$ 244,927	$ 255,826
Total fixed maturity and short-term investments	$1,386,691	$ 1,324,024

Commercial mortgage-backed securities are shown as being due at their average expected maturity dates. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Net realized gains (losses) on investments included the following:

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Sales of fixed maturity securities, including short-term investments	$ 94,957	$ 49,792	$ (390)
Partnerships and limited liability companies	6,059	3,882	672
Sales of equity securities	(350)	1,151	5,035
Other	351	507	6
Other-than-temporary impairment losses on:			
Fixed maturity securities		(10,662)	(13,224)
Equity securities		(8,418)	(10,606)
Net realized gains (losses) on investments	$ 101,017	$ 36,252	$ (18,507)

The gross realized gains and the gross realized losses on sales of fixed maturity and equity securities were as follows:

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Available-for-sale investments:			
Gross realized gains	$ 57,743	$ 56,416	$ 26,195
Gross realized losses	(6,290)	(5,473)	(21,550)
Fair value option investments:			
Gross realized gains	43,399	N/A	N/A
Gross realized losses	(245)	N/A	N/A

N/A = Not Applicable

The changes in unrealized gains (losses) on available-for-sale investments recognized as a separate component of stockholders' equity were as follows:

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Fixed maturity securities, including short-term investments	$ (40,075)	$ 123,115	$ (73,312)
Equity securities	(4,054)	10,246	(22,589)
Total before tax	(44,129)	133,361	(95,901)
After tax	(28,684)	86,686	(62,338)

The following table presents the fair value of securities classified as available-for-sale with unrealized losses, aggregated by investment category and length of time the securities have been in a continuous unrealized loss position at December 31, 2010 and 2009:

(Dollars in thousands)	Fair Value	Unrealized Losses	Number of Issues
December 31, 2010			
Less than 12 months:			
Corporate debt	$ 8,374	$ (160)	2
Redeemable preferred stocks	4,414	(91)	2
State and local government debt	999	(1)	1
Total less than 12 months	$ 13,787	$ (252)	5
Greater than 12 months:			
Equity securities	$ 23	$ (9)	1
Total greater than 12 months	$ 23	$ (9)	1
Total available-for-sale:			
Corporate debt	$ 8,374	$ (160)	2
Redeemable preferred stocks	4,414	(91)	2
Equity securities	23	(9)	1
State and local government debt	999	(1)	1
Total available-for-sale	$ 13,810	$ (261)	6
December 31, 2009			
Less than 12 months:			
Corporate debt	$ 114,825	$ (720)	20
Commercial mortgage-backed securities	11,767	(54)	2
U.S. Government debt	1,120	(1)	1
Short-term investments	77,653	(3)	2
Equity securities	763	(27)	6
State and local government debt	17,705	(175)	4
Total less than 12 months	$ 223,833	$ (980)	35
Greater than 12 months:			
Corporate debt	$ 82,848	$ (2,491)	10
Redeemable preferred stocks	4,028	(477)	2
Equity securities	254	(92)	1
Total greater than 12 months	$ 87,130	$ (3,060)	13
Total available-for-sale:			
Corporate debt	$ 197,673	$ (3,211)	30
Redeemable preferred stocks	4,028	(477)	2
Commercial mortgage-backed securities	11,767	(54)	2
U.S. Government debt	1,120	(1)	1
Short-term investments	77,653	(3)	2
Equity securities	1,017	(119)	7
State and local government debt	17,705	(175)	4
Total available-for-sale	$ 310,963	$ (4,040)	48

Available-for-sale investments that we currently own could be subject to default by the issuer or could suffer declines in fair value that become other-than-temporary. As described in Note 3, we continually assess the prospects for individual securities as part of our ongoing portfolio management, including the identification of other-than-temporary declines in fair values.

There were no other-than-temporary impairments recorded during the year ended December 31, 2010. During 2009, net realized gains before tax were reduced by $19.1 million for other-than-temporary impairments, including $9.7 million of credit related impairments. All of the impaired securities were subsequently sold during 2009 and the first three months of 2010. During 2008, net realized losses included $23.8 million of impairment losses on certain securities, with a fair value of $16.5 million at the date of impairment. These securities had unrealized losses continually for six months or had issuer-specific credit and equity events prior to the impairment. All of these impaired securities were sold during 2008 and we realized additional losses of $8.4 million at the time of sale.

The following table presents the change in other-than-temporary credit related impairments before tax recognized in earnings:

(In thousands)		
Beginning balance for securities owned as of December 31, 2008	$	0
Not previously recognized		9,700
Reduction for securities sold subsequent to impairment		(7,840)
Ending balance for securities owned as of December 31, 2009		1,860
Reduction for securities sold subsequent to impairment		(1,860)
Ending balance for securities owned as of December 31, 2010	$	0

Net investment income before tax was as follows:

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Fixed maturity securities	$ 65,507	$ 87,329	$ 85,824
Equity securities	1,617	1,061	2,928
Short-term investments	903	2,247	8,870
Other	157	2,029	3,189
Subtotal	68,184	92,666	100,811
Investment expenses	(6,981)	(7,152)	(6,784)
Net investment income	$ 61,203	$ 85,514	$ 94,027

Investments with a fair value of $780.0 million at December 31, 2010 and $1.0 billion at December 31, 2009 were on deposit with regulatory authorities in compliance with insurance company regulations. At December 31, 2010, we had an additional $409.5 million in qualifying securities available for deposit.

Note 5. Fair Value Measurements

Our fixed maturity securities, including short-term investments, and equity securities are recorded at fair value in the accompanying Consolidated Balance Sheets. Fair value is the price that would be received to sell an asset or would be paid to transfer a liability (i.e., the “exit price”) in an orderly transaction between market participants at the measurement date. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets (“market approach”). We also consider the impact of a significant decrease in volume and level of

activity for an asset or liability when compared with normal activity to identify transactions that are not orderly.

Fair value measurements are determined under a three-level hierarchy that prioritizes the inputs to valuation techniques used to measure fair value, distinguishing between market participant assumptions developed based on market data obtained from sources independent of the reporting entity ("observable inputs") and the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances ("unobservable inputs"). The hierarchy level assigned to each security carried at fair value is based on our assessment of the transparency and reliability of the inputs used in the valuation of each instrument at the measurement date. The highest priority is given to unadjusted quoted prices in active markets for identical assets (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Securities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. We recognize transfers between levels at the end of each reporting period. The three hierarchy levels are defined as follows:

- **Level 1**—Valuations based on unadjusted quoted market prices in active markets for identical securities. The fair values of investments included in the Level 1 category were based on quoted prices that were readily and regularly available in an active market. The Level 1 category includes publicly traded equity securities, highly liquid cash management funds, short-term certificates of deposit and short-term U.S. Government securities.

- **Level 2**—Valuations based on observable inputs (other than Level 1 prices), such as quoted prices for similar assets at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, such as benchmark yields; broker-dealer quotes; issuer spreads and bids. At December 31, 2010, the fair values of securities included in the Level 2 category were based on publicly traded over-the-counter prices, broker-dealer quotes or based on industry accepted valuation models, which are sensitive to certain market observable assumptions, including share price volatility and credit spreads of the issuer. At December 31, 2009, the fair values of fixed maturity securities and short-term investments included in the Level 2 category were based on market values obtained from independent pricing services that were evaluated using pricing models that vary by asset class and incorporate available trade, bid and other market information and price quotes from well-established independent broker-dealers. The independent pricing services monitor market indicators, industry and economic events, and for broker-quoted only securities, obtain quotes from market makers or broker-dealers that they recognize to be market participants. Our Level 2 category includes corporate bonds, U.S. Government securities, foreign government bonds, municipal bonds, commercial mortgage-backed securities, redeemable preferred stocks, convertible non-redeemable preferred stocks and privately held equity securities.

- **Level 3**—Valuations based on inputs that are unobservable and significant to the overall fair value measurement and involve management judgment. The fair values of certain privately held or thinly traded securities are determined using internal analytical methods based on the best information available. The Level 3 category consists primarily of an equity security of a company based in the United Kingdom with a fair value approximating its net asset value because a significant portion of its net asset value, excluding cash balances, is comprised of real estate holdings supported by appraisals. The estimated fair value for this investment also includes foreign currency fluctuations and considers the value of an unrecognized tax loss carry forward.

The following table presents our investments measured at fair value on a recurring basis as of December 31, 2010 and 2009 classified by the valuation hierarchy discussed previously:

		Fair Value Measurements Using		
(In thousands)	Total	Level 1	Level 2	Level 3
December 31, 2010				
Fair value option investments:				
Fixed maturity securities:				
U.S. Government debt	$ 615,567		$ 615,567	
State and local government debt	373,557		373,557	
Corporate debt	30,619		30,619	
Total fixed maturity securities	1,019,743		1,019,743	
Short-term investments	48,455	$ 48,455		
Equity securities	46,579	15,005	31,574	
Total fair value option investments	$ 1,114,777	$ 63,460	$ 1,051,317	
Available-for-sale investments:				
Fixed maturity securities:				
U.S. Government debt	$ 1,326		$ 1,326	
State and local government	129,242		129,242	
Corporate debt	92,262		91,262	$ 1,000
Redeemable preferred stocks	28,084		28,084	
Commercial mortgage-backed securities	2,074		2,074	
Foreign government debt	2,738		2,738	
Total fixed maturity securities	255,726		254,726	1,000
Short-term investments	100	$ 100		
Equity securities	33,621	6,302	24	27,295
Total available-for-sale investments	289,447	6,402	254,750	28,295
Total	$1,404,224	$ 69,862	$1,306,067	$ 28,295
December 31, 2009				
Available-for-sale investments:				
Fixed maturity securities:				
U.S. Government debt	$ 3,344	$ 3,344		
State and local government debt	167,513		$ 167,513	
Corporate debt	1,262,902		1,252,379	$ 10,523
Redeemable preferred stocks	26,853		26,853	
Commercial mortgage-backed securities	11,767		11,767	
Foreign government debt	2,688		2,688	
Total fixed maturity securities	1,475,067	3,344	1,461,200	10,523
Short-term investments	416,363	375,598	40,765	
Equity securities	55,975	24,709		31,266
Total	$ 1,947,405	$ 403,651	$ 1,501,965	$ 41,789

The following table presents changes in our Level 3 fixed maturity and equity securities measured at fair value on a recurring basis:

(In thousands)	Corporate Debt	Equity Securities
Balance at December 31, 2008	$ 9,431	$ 28,348
Reclassification from held-to-maturity	5,000	
Maturities	(5,000)	
Purchases	1,000	
Realized and unrealized gains included in:		
Other comprehensive income (a)		2,918
Net income	92	
Balance at December 31, 2009	$ 10,523	$ 31,266
Realized and unrealized gains included in:		
Other comprehensive loss (a)	(76)	(3,947)
Net income	6	810
Purchases		10,000
Transfer out of Level 3 to Level 2 (b) (c)	(9,453)	(10,834)
Balance at December 31, 2010	$ 1,000	$ 27,295

(a) Changes in unrealized gains for equity securities include change in fair value and foreign currency fluctuation.
(b) One convertible non-redeemable preferred equity security was transferred from Level 3 to Level 2 during 2010 because we determined its fair value using observable market inputs.
(c) One corporate debt security was transferred from Level 3 to Level 2 during 2010 because we determined its fair value based on a non-binding quote obtained from a well-established independent broker-dealer.

Note 6. Properties and Equipment

Properties and equipment, included in other assets, consist of the following:

	December 31,	
(In thousands)	2010	2009
Land	$ 9,650	$ 9,650
Buildings	36,062	36,179
Other property and equipment	81,533	87,543
Subtotal	127,245	133,372
Accumulated depreciation	(79,951)	(79,018)
Total	$ 47,294	$ 54,354

In 2010, the Company performed independent appraisals on its land, buildings and aircraft in preparation for the Merger, and determined the fair value of its aircraft (included in other property and equipment) to be $8.9 million, resulting in an impairment charge of $3.0 million.

Depreciation expense for the years ended December 31, 2010, 2009 and 2008 was $8.4 million, $8.1 million and $8.4 million, respectively.

Note 7. Income Tax

The Company will file a consolidated federal income tax return for the period from January 1, 2010 through May 20, 2010. For the period from May 21, 2010, through December 31, 2010 and thereafter, the Company will be included in the consolidated federal income tax return of Fairfax, Inc. and its eligible subsidiaries ("Fairfax Group") and in various state combined or consolidated income tax returns. The Company and Fairfax, Inc. have agreed in principle on a tax sharing agreement which will be finalized during 2011, and will provide for the payment and reimbursement of taxes on a subsidiary group basis. The agreement will have the effect of determining the Company's payments to or refunds from Fairfax, Inc. as if the Company continued to file a consolidated return separate from the Fairfax Group. The insurance subsidiaries pay premium taxes on gross premiums written in lieu of most state income or franchise taxes.

The difference between the statutory income tax rate of 35% and our effective tax rate on income, as reflected in the Consolidated Statements of Operations, was as follows:

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Statutory income tax expense (benefit)	$ (28,045)	$ 18,247	$ 51,519
Increase (reduction) in tax:			
Dividend received deduction and tax-exempt interest	(4,488)	(2,142)	(2,470)
Non-deductible expenses and other	1,571	1,630	2,847
Income tax expense (benefit) before valuation allowance	(30,962)	17,735	51,896
Valuation allowance	55,067		
Income tax expense	$ 24,105	$ 17,735	$ 51,896

Deferred tax is provided based upon temporary differences between the tax and book basis of assets and liabilities. The components of the deferred tax assets and liabilities were as follows:

	December 31,			
	2010		2009	
	Deferred Tax		Deferred Tax	
(In thousands)	Assets	Liabilities	Assets	Liabilities
Unpaid losses and loss adjustment expenses discount	$ 36,573		$ 36,644	
Investments	12,059			$ 28,989
Properties and equipment		$ 4,641		5,680
Deferred policy acquisition costs		1,501		1,911
Limitation on deduction for unearned premiums	5,144		4,904	
Policyholders' dividends accrued	1,815		2,498	
Other	5,618		8,146	1,187
	61,209	$ 6,142	52,192	$ 37,767
Valuation allowance	(55,067)			
Net deferred tax asset	$ 0		$ 14,425	

GAAP requires the Company to evaluate the recoverability of its deferred tax assets and establish a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be realized (a likelihood of more than 50 percent). In making this evaluation, the Company is required to consider all available evidence, both positive and negative, including objectively verifiable evidence of taxable income in the immediate ensuing years. The Company has concluded that it cannot meet this test at this time, and therefore, the Company recorded a $55.1 million non-cash charge to establish a valuation allowance for its net deferred tax asset which fully reserved all future net tax benefits as of December 31, 2010.

The valuation allowance does not adversely affect the Company's ability to use these tax deductions to reduce taxable income in the future. The current tax benefit related to the 2010 net operating loss will be fully recovered through available carry backs to prior years. The net deferred tax asset at December 31, 2010 consists primarily of the discounting of loss reserves for tax purposes and unrealized losses on long term fixed income investments. The deferred tax asset related to discounting of loss reserves of $36.6 million is expected to be fully recoverable in that these assets reverse over 10 to 20 years, and the Company expects to produce sufficient income during this period. The deferred tax asset related to unrealized losses on long-term fixed income investments of $12.1 million, are expected to be recovered because we have the ability to manage when and if we realized any investment losses and the Company expects to produce sufficient income during the carry forward period. The valuation allowance is expected to be reversed in full when the company can provide objectively verifiable evidence of a return to profitability.

At December 31, 2010 and 2009, there were no material unrecognized tax benefits. We recognize any interest and penalties related to uncertain tax positions in income tax expense; however, there were none for the years ended December 31, 2010, 2009 and 2008.

Tax years 2005 through 2008 have been audited with tax years 2004 and prior no longer statutorily subject to examination by the Internal Revenue Service. Tax years 2005 through 2009 remain subject to examination by state taxing authorities.

Note 8. Unpaid Losses and Loss Adjustment Expenses

The following table represents a reconciliation of changes in the liability for unpaid losses and loss adjustment expenses:

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Beginning of year, net of reinsurance	$ 953,492	$ 1,005,590	$ 1,126,808
Incurred claims:			
Current accident year	337,821	329,079	358,016
Prior accident years	20,409	(9,078)	(78,108)
Total incurred claims	358,230	320,001	279,908
Payments:			
Current accident year	(92,623)	(94,667)	(102,283)
Prior accident years	(263,506)	(277,432)	(298,843)
Total payments	(356,129)	(372,099)	(401,126)
End of year, net of reinsurance	955,593	953,492	1,005,590
Receivable from reinsurers for unpaid losses	214,245	237,612	268,996
End of year, gross of reinsurance	$ 1,169,838	$ 1,191,104	$ 1,274,586

The net unfavorable development on prior accident years of $20.4 million in 2010 consists of workers' compensation net unfavorable development of $25.0 million principally for the 2007, 2008 and 2009 accident years due to modestly higher severity in claim costs trends offset by net favorable development of $4.6 million in the reinsurance operations.

The net favorable development on prior accident years of $9.1 million in 2009 is principally for the 2005 and 2006 accident years due to the reduction in the workers' compensation paid and incurred trends.

The net favorable development on prior accident years of $78.1 million in 2008 is principally related to a reduction in estimated workers' compensation losses for the 1999 through 2005 accident years, partially offset by increases for the 2006 and 2007 accident years.

Note 9. Long-Term Debt

At December 31, 2010 and 2009, the outstanding principal amount of our Subordinated Deferrable Interest Debentures ("long-term debt") was $38.5 million and $58.5 million, respectively, and the fair value was $38.5 million and $49.4 million, respectively. The long-term debt is due in 2028 and bears interest at the rate of 8.55% per annum. In June and September 2010, Zenith National repurchased $13.0 million and $7.0 million, respectively, principal amount of the outstanding long-term debt at par value plus accrued interest. There were no repurchases in 2009 or 2008.

The semi-annual interest payments on the long-term debt may be deferred by Zenith National for up to ten consecutive semi-annual periods. This debt is redeemable by Zenith National at 100% of the principal amount plus a "make-whole premium," if any, together with accrued and unpaid interest. The make-whole premium is the excess of the then present value of the remaining scheduled payments of principal and interest over 100% of the principal amount.

The original issue costs and discount on the long-term debt of $1.7 million are being amortized over the term of the long-term debt. For the year ended December 31, 2010, $4.2 million of interest, issue costs and discount were expensed compared to $5.0 million during each of the years ended December 31, 2009 and 2008.

Note 10. Reinsurance Ceded

We maintain excess of loss and catastrophe reinsurance which provides protection up to $75 million for workers' compensation losses including catastrophe losses arising out of California earthquakes. We retain the first $5 million of each loss. In the layer of $5 million in excess of $5 million, we retain any losses that exceed our annual aggregate limit of $15 million. In the layer of $10 million excess of $10 million we retain 50%.

We maintain excess of loss and catastrophe reinsurance which provides protection up to $20 million for acts of terrorism including nuclear, biological and chemical attacks. We retain the first $5 million of each loss. We retain any losses in the $5 million excess $5 million layer which exceed our annual aggregate of $5 million. We also retain 50% of any loss other than nuclear, biological or chemical in the $10 million excess $10 million layer. We retain none of the loss in the $10 million excess $10 million layer in events of nuclear, biological or chemical attacks.

Reinsurance transactions reflected in the accompanying Consolidated Statements of Operations were as follows:

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Direct premiums earned	$ 439,525	$ 475,997	$ 621,763
Assumed premiums earned	1,563	1,809	4,198
Ceded premiums earned	(12,922)	(14,725)	(18,634)
Net premiums earned	$ 428,166	$ 463,081	$ 607,327
Ceded losses and loss adjustment expenses incurred	$ 17,644	$ 14,112	$ (32,023)

Note 11. Stockholders' Equity and Statutory Financial Information

Treasury Stock

On September 30, 2009, we cancelled and retired 7,695,000 shares of treasury stock which had been repurchased by Zenith National over the years for an aggregate repurchase price of $166.7 million. Upon cancellation and retirement, these shares were returned to the status of authorized and unissued. The excess of the repurchase price of the treasury stock over the par value was allocated between additional paid-in capital and retained earnings. There was no impact on our consolidated stockholders' equity as a result of the cancellation and retirement.

Dividend Restrictions

The California Department of Insurance ("DOI") approved an extraordinary dividend of $282.9 million, which was paid on June 30, 2010, by Zenith Insurance to Zenith National. On the same day, Zenith National paid a dividend of $282.9 million to its stockholders (all Fairfax affiliates).

The California Insurance Holding Company System Regulatory Act limits the ability of Zenith Insurance to pay dividends to Zenith National and for Zenith Insurance to receive dividends from its insurance

subsidiary, by providing that the appropriate insurance regulatory authorities in the state of California must approve any dividend that, together with all other such dividends paid during the preceding twelve months, exceeds the greater of: (a) 10% of the paying company's statutory surplus as regards policyholders at the preceding December 31; or (b) 100% of the net income for the preceding year. In addition, any such dividend must be paid from policyholders' surplus attributable to accumulated earnings. Such restrictions on dividends are not cumulative. Zenith Insurance paid dividends to Zenith National of $297.9 million in 2010 (including $282.9 million extraordinary dividend, described previously), $110.0 million in 2009 and $95.0 million in 2008. Zenith Insurance has the ability to pay up to $69.0 million of dividends to Zenith National between July 1, 2011 and December 31, 2011 without prior approval of the California DOI. Dividend payments from Zenith Insurance to Zenith National must also be in compliance with the California Corporations Code that permit dividends to be paid only out of retained earnings and only if specified ratios between assets and liabilities and between current assets and current liabilities exist after payment.

Statutory Financial Data

The capital stock and surplus and net income of our insurance subsidiaries, prepared in accordance with the statutory accounting practices of the National Association of Insurance Commissioners, were as follows:

	Year Ended December 31,		
(In thousands)	2010	2009	2008
Capital stock and surplus	$ 690,154	$ 979,164	$ 1,015,330
Net income	20,053	45,692	113,665

The insurance business is subject to state-by-state regulation and legislation focused on solvency, pricing, market conduct, claims practices, underwriting, accounting, investment criteria, and other areas. Such regulation and legislation changes frequently. Compliance is essential and is an inherent risk and cost of the business. We believe we are in compliance with all material regulations.

Note 12. Related Party Transactions

We have fixed maturity investments in Fairfax subsidiaries that were purchased in the ordinary course of business prior to the Merger. Investment income from these fixed maturity investments was $3.7 million for the year ended December 31, 2010. Interest income subsequent to the Merger (May 21, 2010 through December 31, 2010) was $2.2 million. The fair value of these fixed maturity investments at December 31, 2010 and 2009 were as follows:

	December 31,	
(In thousands)	2010	2009
Fairfax	$ 40,447	$ 39,696
Odyssey Re Holdings Corp. ("Odyssey")	6,868	6,695
	$ 47,315	$ 46,391

We continue to be parties to various reinsurance treaties with affiliates of Fairfax that were entered into in the ordinary course of business prior to the Merger, primarily consisting of a quota share reinsurance agreement with Odyssey in which we ceded 10% of our workers' compensation premiums written from January 1, 2002 through December 31, 2004. This quota share reinsurance agreement ended on December 31, 2004. At December 31, 2010 and 2009, we recorded reinsurance recoverables of

$10.4 million and $12.6 million, respectively, related to this quota share and other reinsurance agreements.

In connection with the Merger, the management of all of our investments became centralized at Fairfax through investment management agreements entered into as of May 20, 2010, the parties to which agreements are Zenith National's insurance subsidiaries and Fairfax and Hamblin Watsa Investment Counsel, Ltd., a Fairfax affiliate. Investment management expenses incurred under these agreements in the year ended December 31, 2010 were $1.2 million.

In July 2010, $389 million of long-term U.S. Government bonds were used by Zenith Insurance to complete the purchase of municipal bonds from various Fairfax subsidiaries (California DOI approval for this transaction was received in June 2010). The exchange of the U.S. Government bonds resulted in a realized gain of $13.3 million before tax.

Note 13. Other Comprehensive Income (Loss)

Other comprehensive income (loss) is comprised of changes in unrealized gains on investments classified as available-for-sale. The following table summarized the components of our comprehensive income (loss), other than net income (loss):

(In thousands)	Pre-Tax	Income Tax Effect	After-Tax
Year ended December 31, 2010			
Net unrealized gains arising during the year	$ 7,841	$ 2,744	$ 5,097
Less: reclassification adjustment for net realized gains included in net loss	(51,970)	(18,189)	(33,781)
Total other comprehensive (loss)	$ (44,129)	$ (15,445)	$ (28,684)
Year ended December 31, 2009			
Net unrealized gains arising during the year	$ 146,169	$ 51,158	$ 95,011
Less: reclassification adjustment for net realized gains included in net income	(12,808)	(4,483)	(8,325)
Total other comprehensive income	$ 133,361	$ 46,675	$ 86,686
Year ended December 31, 2008			
Net unrealized losses arising during the year	$ (115,517)	$ (40,431)	$ (75,086)
Less: reclassification adjustment for net realized losses included in net income	19,616	6,868	12,748
Total other comprehensive loss	$ (95,901)	$ (33,563)	$ (62,338)

The following table summarized the components of accumulated other comprehensive income:

	December 31,	
(In thousands)	2010	2009
Net unrealized gains on investments, before tax	$ 11,945	$ 56,074
Deferred tax expense	4,181	19,626
Total accumulated other comprehensive income	$ 7,764	$ 36,448

Note 14. Employee Benefit and Retirement Plans

We offer a tax deferred savings plan created under Section 401(k) of the Internal Revenue Code for all eligible employees. We match 50% of employee contributions that are 6% or less of salary on a current basis and we are not liable for any future payments under the plan. Prior to the Merger, Zenith National common stock was an investment option to plan participants. Shortly after the Merger, Fairfax subordinate voting shares were added as an investment option to plan participants. We contributed $2.4 million for each of the years ended December 31, 2010, 2009 and $2.5 million for 2008.

Prior to the Merger, we provided a stock purchase plan in which we matched 25% of employee's contributions to purchase shares of Zenith National common stock at market value. A new stock purchase plan was approved by Zenith National's board of directors in June 2010 providing for the purchase of up to 100,000 Fairfax subordinate voting shares. The plan limits employee contributions to 10% of base salary or wage before tax for each payroll period. Under this new stock purchase plan, we match 30% of employee's contribution and purchase Fairfax subordinate voting shares at market value. For the year ended December 31, 2010, we contributed $0.5 million in total for both plans and $0.7 million during each of the years ended December 31, 2009 and 2008.

Note 15. Commitments and Contingencies

Leases

We have office space, equipment and automobile leases expiring through 2016. The minimum lease payments on these non-cancelable operating leases at December 31, 2010 were as follows:

(In thousands)	Equipment and Auto Fleet	Offices	Total
2011	$ 1,009	$ 6,420	$ 7,429
2012	801	5,459	6,260
2013	120	4,704	4,824
2014	13	2,248	2,261
2015		1,744	1,744
Thereafter		637	637
Total	$ 1,943	$ 21,212	$ 23,155

Rent expense for the years ended December 31, 2010, 2009 and 2008 was $10.3 million, $11.2 million and $10.8 million, respectively.

We have investments in five commercial rental properties under non-cancelable lease terms with minimum future rental income totaling $1.3 million for each of the next five years.

Litigation

We are involved in various litigation proceedings that arise in the ordinary course of our business. Disputes adjudicated in the workers' compensation administrative systems may be appealed to review boards or civil courts, depending on the issues and local jurisdictions involved. From time to time, plaintiffs also sue us on theories falling outside of the exclusive jurisdiction and remedies of the workers' compensation claims adjudication systems. Certain of these legal proceedings seek injunctive relief or substantial monetary damages, including claims for punitive damages, which may not be covered by our

reinsurance agreements. Historically, the Company has not experienced any material exposure or damages from any of these legal proceedings. In addition, in the opinion of management, after consultation with legal counsel, all of our currently outstanding litigation is either without merit or the ultimate liability, if any, is not expected to have a material adverse effect on our consolidated financial condition, results of operations or cash flows.

Note 16. Condensed Financial Information of Zenith National

The assets, liabilities and stockholders' equity of Zenith National as of December 31, 2010 and 2009 were as follows:

	December 31,	
(In thousands)	2010	2009
Assets:		
Short-term investments, at fair value (cost $12,073 in 2010 and $91,066 in 2009)	$ 12,073	$ 91,110
Cash	10,046	3,542
Investment in subsidiaries (a)	641,489	1,049,924
Other assets	2,856	16,635
Total assets	$ 666,464	$1,161,211
Liabilities:		
Long-term debt (b)	$ 38,415	$ 77,145
Dividends payable to stockholders		18,973
Other liabilities	3,387	6,162
Total liabilities	41,802	102,280
Stockholders' equity:		
Preferred stock, (see Note 2)		
Common stock, $1 par value, authorized shares of 40 in 2010 and 100,000 in 2009; issued and outstanding of 38 in 2010 and 37,482 in 2009 (see Note 2)	38	37,482
Additional paid-in capital	398,422	360,464
Retained earnings (a)	218,438	624,537
Accumulated other comprehensive income	7,764	36,448
Total stockholders' equity	624,662	1,058,931
Total liabilities and stockholders' equity	$ 666,464	$1,161,211

(a) Reflects, among other items, the $282.9 million dividend paid to Fairfax affiliates on June 30, 2010 and $55.1 million valuation allowance on deferred tax assets as of December 31, 2010, see Note 7.

(b) Prior to December 2010, Zenith National had $77.3 million aggregate principal amount of the 8.55% Subordinated Deferrable Interest Debentures due 2028 ("Subordinated Debentures") outstanding. All of the Subordinated Debentures were held by the Zenith National Insurance Capital Trust I, a Delaware statutory trust ("Capital Trust"), which previously issued 8.55% Redeemable Capital Securities (Liquidation Amount $1,000 per Capital Security) ("Capital Securities").

In December 2010, the Capital Trust was dissolved and $75.0 million of the Subordinated Debentures were distributed to holders of the Capital Securities. Zenith National was distributed $38.8 million of the Subordinated Debentures in exchange for Capital Securities held by it.

Subsequent to the dissolution of the Capital Trust, the $38.8 million aggregate principal amount of Subordinated Debentures held by Zenith National was cancelled. After the cancellation, $38.5 million principal amount of the Subordinated Debentures were outstanding at December 31, 2010.