

MERCHANTS GROUP INC

Form DEFM14A

January 04, 2007

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SCHEDULE 14A INFORMATION
Proxy Statement Pursuant To Section 14(A) of
The Securities Exchange Act of 1934 (Amendment No.)

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

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Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant to 240.14a-11(c) or 240.14a

MERCHANTS GROUP, INC.

(Name of Registrant as Specified In Its Charter)

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MERCHANTS GROUP, INC.
250 Main Street
Buffalo, New York 14202

MERGER PROPOSED YOUR VOTE IS IMPORTANT

Dear Stockholder:

You are cordially invited to attend a special meeting of the stockholders of Merchants Group, Inc., which will be held at the offices of Hodgson Russ LLP, One M&T Plaza, Suite 2000, Buffalo, New York 14203, on February 1, 2007 at 10:00 a.m., local time.

At the special meeting, we will ask you to consider and adopt a merger agreement that we entered into with American European Group, Inc. and American European Financial, Inc. on October 31, 2006 and a proposal to transact other business that may properly be brought before the meeting including procedural matters, such as a motion to adjourn the special meeting, if necessary or appropriate, to solicit additional proxies for the approval of the merger agreement.

If our stockholders adopt the merger agreement, if the other conditions to the proposed merger are satisfied, and if the proposed merger is completed, then Merchants Group will become a direct wholly-owned subsidiary of American European Group, Inc., and you will be entitled to receive \$33.00 in cash, without interest, plus (subject to the conditions described in the Summary section of the enclosed proxy statement) a per diem amount equal to a pro rated portion of Merchant Group's current dividend rate of \$1.00 per share per annum for each day since the last day of the last quarter prior to the closing of the merger for which Merchants Group has declared and paid a quarterly dividend, for each share of our common stock that you own.

After careful consideration, our board of directors has unanimously approved the merger agreement and determined that the proposed merger is advisable and fair to and in the best interests of our corporation and our stockholders. Our board of directors unanimously recommends that you vote FOR the adoption of the merger agreement.

The proxy statement attached to this letter provides a detailed description of the proposed merger, the merger agreement and related matters. We urge you to read the proxy statement and its annexes carefully.

Your vote is very important regardless of the number of shares you own. We cannot complete the proposed merger unless the merger agreement is adopted by the affirmative vote of the holders of a majority of the outstanding shares of our common stock entitled to vote at the special meeting. As a result, a failure to submit a proxy or vote in person will have the same effect as a vote against the adoption of the merger agreement.

Whether or not you plan to attend the special meeting in person, please complete, date and sign the enclosed proxy card and return it in the envelope provided as soon as possible. No postage need be affixed if you mail the proxy card in the enclosed envelope anywhere in the United States. If you receive more than one proxy card because you own shares that are registered differently, please vote all of your shares shown on all of your proxy cards. If your shares are held in an account at a brokerage firm or bank, you must instruct them on how to vote your shares. If you submit a proxy, that will not prevent you from voting your shares in person if you subsequently choose to attend the special meeting.

If you have any questions about the proposed merger, please call Georgeson Inc. at (866) 647-8869.

Thank you for your cooperation and your continued support.

Thomas E. Kahn
Chairman of the Board of Directors

Neither the Securities and Exchange Commission nor any state securities regulatory agency has approved or disapproved the proposed merger, passed upon the merits or fairness of the proposed merger or passed upon the adequacy or accuracy of the disclosure in this document. Any representation to the contrary is a criminal offense.

**THE PROXY STATEMENT IS DATED JANUARY 4, 2007 AND IS FIRST BEING
MAILED TO STOCKHOLDERS ON OR ABOUT JANUARY 8, 2007.**

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**MERCHANTS GROUP, INC.
250 Main Street
Buffalo, New York 14202**

**NOTICE OF SPECIAL MEETING OF STOCKHOLDERS
To Be Held On February 1, 2007**

To the Stockholders of Merchants Group, Inc.:

We will hold a special meeting of the stockholders of Merchants Group, Inc., a Delaware corporation, which will be held at the offices of Hodgson Russ LLP, One M&T Plaza, Suite 2000, Buffalo, New York 14203 on February 1, 2007 at 10:00 a.m., local time:

1. To act on a proposal to approve and adopt the Agreement and Plan of Merger dated as of October 31, 2006, by and among American European Group, Inc. (AEG), its subsidiary American European Financial, Inc., and Merchants Group under which Merchants Group will become a direct wholly-owned subsidiary of AEG and each outstanding share of Merchants Group common stock (other than shares held by Merchants Group or by any of its subsidiaries, which will be canceled, and shares held by holders who properly elect to exercise appraisal rights under Delaware law) will be converted into the right to receive \$33.00 in cash plus (subject the conditions described in the Summary section of the enclosed proxy statement) a per diem amount equal to a pro rated portion of Merchant Group s current dividend rate of \$1.00 per share per annum for each day since the last day of the last quarter prior to the closing of the merger for which Merchants Group has declared and paid a quarterly dividend, and to approve the merger and related transactions contemplated by the merger agreement; and
2. To consider and vote upon a proposal to adjourn or postpone the special meeting, if necessary, in order to solicit additional proxies in favor if there are not sufficient favorable votes at the time of the meeting to adopt the merger agreement and approve the merger and related transactions; and
3. To transact any other business that may properly come before the special meeting or any adjournment or postponement of the special meeting, including to consider any procedural matters incident to the conduct of the special meeting.

Only holders of record of Merchants Group common stock as of the close of business on December 20, 2006 are entitled to notice of, and to vote at, the special meeting and any adjournment or postponement of the special meeting. The affirmative vote of the holders of a majority of the outstanding shares of Merchants Group common stock entitled to vote is required in order to adopt the merger agreement. The affirmative vote of holders of a majority of the shares of Merchants Group common stock present and entitled to vote is required to adjourn or postpone the special meeting.

Your vote is very important regardless of the number of shares you own. A failure to submit a proxy or vote in person will have the same effect as a vote against adoption of the merger agreement.

Whether or not you plan to attend the special meeting in person, please complete, date and sign the enclosed proxy card and return it in the envelope provided as soon as possible. No postage need be affixed if the proxy card is mailed in the United States. If you receive more than one proxy card because you own shares that are registered differently, please vote all of your shares shown on all of your proxy cards. If you return a properly signed proxy card but do not indicate how you want to vote, your shares will be voted FOR adoption of the merger agreement and, within the discretion of the proxies, FOR approval of any adjournment or postponement proposal made in order to obtain the necessary votes for approval of the merger agreement. If your shares are held in an account at a brokerage firm or

bank, you must instruct them on how to vote your shares. Submitting a proxy will not prevent you from voting your shares in person if you subsequently choose to attend the special meeting.

The Merchants Group board of directors unanimously recommends that stockholders vote FOR adoption of the merger agreement.

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PLEASE DO NOT SEND ANY STOCK CERTIFICATES AT THIS TIME. IF THE MERGER IS COMPLETED, YOU WILL BE SENT INSTRUCTIONS REGARDING THE SURRENDER OF YOUR STOCK CERTIFICATES.

Under the General Corporation Law of the State of Delaware, holders of Merchants Group common stock who do not vote in favor of adopting the merger agreement will have the right to seek appraisal of the fair value of their shares as determined by the Delaware Court of Chancery if the proposed merger is completed, but only if they submit a written demand for an appraisal prior to the vote on the adoption of the merger agreement, they do not vote or otherwise submit a proxy in favor of the merger agreement, and they comply with the procedures under the General Corporation Law of the State of Delaware explained in the accompanying proxy statement. See the section captioned Appraisal Rights.

The enclosed proxy statement provides a detailed description of the proposed merger, the merger agreement and related matters. We urge you to read the proxy statement and its annexes carefully. If you have any questions about the proposed merger, please call Georgeson Inc. at (866) 647-8869.

By Order of the Board of Directors,

Thomas E. Khan
Chairman of the Board of Directors

Date: January 4, 2007

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**MERCHANTS GROUP, INC.
250 Main Street
Buffalo, New York 14202**

PROXY STATEMENT

SUMMARY

This summary highlights important information discussed in greater detail elsewhere in this proxy statement. This summary may not contain all of the information that is important to you. Accordingly, we urge you to read carefully this entire proxy statement, its annexes and the documents referred to or incorporated by reference in this proxy statement. We have included page references parenthetically to direct you to a more complete description of the topics in this summary. In this proxy statement, the terms we , us , our , our corporation , and Merchants Group refer to Merchants Group, Inc., the term AEG refers to American European Group, Inc., and the term Merger Sub refers to American European Financial, Inc.

Questions and Answers About the Special Meeting and the Proposed Merger

Q. Why am I receiving this proxy statement and proxy card?

A. You are being asked to consider and vote upon approval and adoption of a merger agreement that we entered into with AEG and its subsidiary Merger Sub on October 31, 2006, pursuant to which, if the merger contemplated by the agreement is completed, Merchants Group will become a direct wholly-owned subsidiary of AEG and each outstanding share of Merchants Group common stock (other than shares held by Merchants Group or any of its subsidiaries that will be canceled and shares held by holders who properly elect to exercise appraisal rights under Delaware law) will be converted into the right to receive \$33.00 in cash, without interest, plus an additional amount per share equal to a pro rated portion of our current regular dividends that have not been paid through the time of the closing of the merger. The additional amount will be computed by multiplying a fraction, which will be equal to the number of days before the closing of the merger since the end of the last quarter in which we have declared and paid a regular quarterly dividend divided by 365, times our current annual dividend rate of \$1.00 per share. The additional amount will only be payable if our subsidiary, Merchants Insurance Company of New Hampshire, Inc., which we refer to as Merchants New Hampshire, either has paid a dividend to Merchants Group prior to the closing that is equal to the aggregate additional amounts to be paid on our shares, or if Merchants New Hampshire has not paid a dividend to Merchants group equal to the aggregate of the additional amounts, then if no regulatory authority has notified us prior to the closing that Merchants New Hampshire will be prohibited from paying a dividend to the surviving company that is equal to the aggregate of the additional amounts to be paid on our shares. In this proxy statement we will refer to this additional amount as the Dividend Adjustment. *The merger agreement is attached as Annex A to this proxy statement. We urge you to read it carefully.* See the section captioned *The Merger Agreement* on page 30.

Q. Who is soliciting my proxy?

A. This proxy is being solicited by the Merchants Group board of directors.

Q. If the proposed merger is completed, what will I be entitled to receive for my shares of Merchants Group common stock?

A. Unless you submit a written demand for an appraisal prior to the vote on the adoption of the merger agreement, do not vote or otherwise submit a proxy in favor of the merger agreement and otherwise comply with the

procedures under the General Corporation Law of the State of Delaware described in this proxy statement, you will be entitled to receive \$33.00 in cash, without interest, plus any required Dividend Adjustment, for each share of our common stock that you own. After the merger closes, the exchange agent for AEG will arrange for a letter of transmittal containing detailed instructions to be sent to each stockholder. The letter of transmittal and instructions will tell you how to surrender your common stock certificates in exchange for the merger consideration. The merger consideration will be paid to a stockholder once that stockholder submits a properly completed letter of transmittal accompanied by that stockholder's stock certificates and any other required documentation. See the section captioned "The Merger Agreement - Merger Consideration" on page 30.

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Q. What effects will the proposed merger have on Merchants Group?

A. As a result of the proposed merger, Merchants Group will cease to be a publicly traded corporation and will instead become a direct wholly-owned subsidiary of AEG. Following completion of the proposed merger, the registration of our common stock and our reporting obligations under the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act, will be terminated upon application to the Securities and Exchange Commission, which we refer to as the SEC. In addition, upon completion of the proposed merger, our common stock will no longer be listed on any exchange or quotation system where our common stock may at such time be listed or quoted, including the American Stock Exchange. See the section captioned *Effects of the Proposed Merger on Merchants Group* on page 27.

Q. When do you expect the proposed merger to be completed?

A. We expect that the proposed merger will be completed by the end of the first quarter of 2007, after all conditions to the proposed merger have been satisfied or waived. In addition to adoption of the merger agreement by the Merchants Group stockholders and the other conditions described under the caption *The Merger Agreement Conditions to the Proposed Merger* on page 31, the proposed merger is conditioned upon receipt of applicable regulatory approvals including approval of the State of New Hampshire Insurance Department, which we sometimes refer to as the New Hampshire Insurance Department, and expiration or termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended. We cannot specify when, or assure you that, all conditions to the proposed merger will be satisfied or waived. We intend to complete the proposed merger as promptly as practicable.

Q. Will the merger be a taxable transaction to me?

A. Yes. The receipt of cash for shares of our common stock pursuant to the proposed merger will be a taxable transaction for U.S. federal income tax purposes and may also be taxable under applicable state, local, foreign, and other tax laws. In general, you will recognize gain or loss for U.S. federal income tax purposes equal to the difference between the amount of cash you receive and the adjusted tax basis of your shares of our common stock. For a more detailed explanation of the U.S. federal income tax consequences of the proposed merger, see the section captioned *Material U.S. Federal Income Tax Consequences* on page 29 of this proxy statement. You should consult your tax advisor regarding the specific tax consequences of the proposed merger to you.

Q. What if I oppose the proposed merger?

A. If you are a stockholder who objects to the proposed merger, you may vote against adoption of the merger agreement. In addition, if you submit a written demand for an appraisal prior to the vote on the adoption of the merger agreement, do not vote or otherwise submit a proxy in favor of adopting the merger agreement, and otherwise comply with the procedures under the General Corporation Law of the State of Delaware described in this proxy statement, you may elect to pursue your statutory appraisal rights to receive the judicially determined fair value of your shares, which could be more than, the same, or less than the amount a stockholder would be entitled to receive under the terms of the merger agreement.

See the section captioned *Appraisal Rights* on page 40.

Q. What happens if the proposed merger is abandoned?

A. If the proposed merger is abandoned, Merchants Group will remain a publicly traded company listed on the American Stock Exchange. See the section captioned *The Proposed Merger Effects on Merchants Group if the*

Proposed Merger is not Completed on page 28. Under specified circumstances, Merchants Group may be required to pay AEG a termination fee, as described under the caption The Merger Agreement Termination Fees on page 38.

Q. What should I do now?

- A.** We urge you to read carefully this entire proxy statement, its annexes and the other documents referred to or incorporated by reference in this proxy statement, consider how the proposed merger would affect you as a stockholder and then vote. After you read this proxy statement, whether or not you plan to attend the special meeting in person, please complete, date and sign the enclosed proxy card and return it in the envelope

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provided as soon as possible. See the section captioned The Special Meeting of Stockholders Procedures for Voting on page 12.

Q. If my shares are held in street name by my broker, will my broker vote my shares for me?

A. Your broker will only be permitted to vote your shares if you instruct your broker how to vote. You should follow the procedures provided by your broker regarding the voting of your shares. See the section captioned The Special Meeting of Stockholders Procedures for Voting on page 12.

Q. When should I send in my proxy card?

A. You should send in your proxy card as soon as possible so that your shares will be voted at the special meeting.

Q. May I change my vote after I have mailed my signed proxy card?

A. Yes. You may change your vote at any time before your proxy card is voted at the special meeting. See the section captioned The Special Meeting of Stockholders Revocability of Proxies on page 12.

Q. What does it mean if I get more than one proxy card?

A. If you have shares of our common stock that are registered differently, you will receive more than one proxy card. Please follow the directions for voting on each of the proxy cards you receive to ensure that all of your shares are voted. See the section captioned The Special Meeting of Stockholders Procedures for Voting on page 12.

Q. May I vote in person?

A. Yes. You may attend the special meeting of stockholders and vote your shares of common stock in person. If you hold shares in street name, you must provide a proxy executed by your bank or broker in order to vote your shares in person. Submitting a proxy will not prevent you from voting your shares in person if you subsequently choose to attend the special meeting. See the section captioned The Special Meeting of Stockholders Procedures for Voting and Revocability of Proxies on page 12.

Q. What happens if I do not send in my proxy, if I do not instruct my broker to vote my shares, or if I abstain from voting?

A. If you fail to send in your proxy, or do not instruct your broker or other nominee to vote your shares or abstain from voting, it will have the same effect as a vote against the adoption of the merger agreement. Failure to vote will have no effect on the proposal to adjourn or postpone the special meeting, if necessary, to solicit additional proxies in favor of adoption of the merger agreement if there are insufficient votes at the time of the meeting to adopt the merger agreement. See the section captioned The Special Meeting of Stockholders Voting of Proxies and Failure to Vote on page 12.

Q. What happens if I return a properly signed proxy card but do not indicate how I want to vote?

A. If you return a properly signed proxy card but do not indicate how you want to vote, your proxy will be counted as a vote FOR adoption of the merger agreement and FOR approval of any adjournment or postponement proposal. See the section captioned The Special Meeting of Stockholders Voting of Proxies and Failure to Vote on page 12.

Q. Should I send in my stock certificates now?

- A.** No. You should not return any stock certificates you hold with the enclosed proxy card. Following completion of the proposed merger, the exchange agent designated by AEG will arrange for a letter of transmittal containing detailed instructions to be sent to each stockholder. The letter of transmittal and instructions will tell you how to surrender your common stock certificates in exchange for the merger consideration, and you should not forward your stock certificates to Merchants Group or AEG without a letter of transmittal.

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Q. What should I do if I have questions or would like additional copies of documents or have company specific questions?

- A.** If you have more questions about the special meeting, the proposed merger or this proxy statement, would like additional copies of this proxy statement or the proxy card or have questions about or require assistance in completing and submitting proxy cards, please contact our proxy soliciting agent, Georgeson Inc. at (866) 647-8869.

If you have questions about Merchants Group, please refer to the periodic reports and other information that Merchants Group files with and furnishes to the SEC. You may read and copy this information at the SEC's public reference facilities. Please call the SEC at 1-800-SEC-0330 for information about these facilities. This information is also available on the website maintained by the SEC at <http://www.sec.gov>. See the section captioned "Where You Can Find More Information" on page 45.

Parties to the Proposed Merger

Merchants Group, Inc.

250 Main Street
Buffalo, NY 14202

Merchants Group, Inc. is a Delaware holding company that offers property and casualty insurance generally to preferred risk individuals and small to medium sized businesses in the northeastern United States through its wholly owned subsidiary, Merchants Insurance Company of New Hampshire, Inc., whom we refer to as Merchants New Hampshire. Merchants Group and Merchants New Hampshire operate and manage their business in conjunction with Merchants Mutual Insurance Company, whom we refer to as Mutual, under a services agreement. Merchants Group and Merchants New Hampshire do not have any operating assets or employees. Under the services agreement, Mutual provides Merchants Group and Merchants New Hampshire with the facilities, management and personnel required to operate their day-to-day businesses. Merchants Group common stock is traded on the American Stock Exchange under the symbol "MGP".

American European Group, Inc.

444 Madison Avenue
New York, New York 10022-2585

American European Group, Inc., a Delaware corporation, is a private holding company for property and casualty insurance operating subsidiaries.

American European Financial, Inc.

c/o American European Group, Inc.
444 Madison Avenue
New York, 10022-2585

American European Financial, Inc., a Delaware corporation, is a direct, wholly-owned subsidiary of AEG, newly formed for the purpose of consummating the proposed merger and the related financing transactions. In this proxy statement, the term "Merger Sub" refers to American European Financial, Inc.

The Special Meeting of Stockholders (page 10)

Date, Time, and Place. The special meeting will be held on February 1, 2007, at 10:00 a.m., local time, at the offices of Hodgson Russ LLP, One M&T Plaza, Suite 2000, Buffalo, New York 14203.

Proposals to be Considered. At the special meeting, you will be asked to consider a proposal to adopt the merger agreement and approve the merger and related transactions. You will also be asked to consider a proposal to adjourn or postpone the special meeting, if necessary, in order to solicit additional proxies in favor if there are not sufficient favorable votes at the time of the meeting to adopt the merger agreement and approve the merger and related transactions.

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Record Date; Shares Entitled to Vote; Quorum. Only holders of record of our common stock as of the close of business on December 20, 2006, the record date for the special meeting, are entitled to vote at the special meeting. Each outstanding share of our common stock on the record date entitles the holder to notice of and to one vote on each matter submitted to stockholders for approval at the special meeting. As of the record date, there were 2,145,652 shares of our common stock outstanding and entitled to be voted on the proposals to be considered at the special meeting. The presence, in person or by proxy, of holders of a majority of the outstanding Merchants Group common stock entitled to vote at the special meeting constitutes a quorum for the transaction of business at the special meeting.

Vote Required. Under Delaware law, and pursuant to the merger agreement, we cannot complete the proposed merger unless the merger agreement is adopted by the affirmative vote of the holders of a majority of the outstanding shares of our common stock entitled to vote at the special meeting. Under Delaware law, the affirmative vote of a majority of the shares present and entitled to vote is required to adjourn or postpone the special meeting, if necessary, to solicit additional proxies in favor of adoption of the merger agreement if there are insufficient votes at the time of the meeting to adopt the merger agreement.

Our directors and executive officers as a group beneficially own 258,310 shares, or 12.0% of our common stock. See the section captioned *The Proposed Merger Interests of Our Directors and Executive Officers in the Proposed Merger* on page 28. Neither Merchants Group nor AEG has entered into any agreements with these directors or officers with respect to the voting of their shares in connection with the merger; however, we expect these directors and officers to vote their shares in favor of the proposed merger.

Procedures for Voting. Holders of record of our common stock may vote their shares by attending the special meeting and voting their shares of our common stock in person, or by completing the enclosed proxy card, dating and signing it and mailing it in the enclosed postage-prepaid envelope.

Stockholders who hold their shares of our common stock in *street name*, meaning in the name of a bank, broker or other person who is the record holder, must either direct the record holder of their shares of our common stock how to vote their shares or obtain a proxy from the record holder to vote their shares at the special meeting.

Stockholders who have questions or requests for assistance in completing and submitting proxy cards should contact Georgeson Inc., our proxy solicitor, at (866) 647-8869. See the section captioned *The Special Meeting of Stockholders Procedures for Voting* on page 12.

Voting of Proxies. All shares of our common stock represented by properly executed proxies received in time for the special meeting will be voted at the special meeting in the manner specified by the holder. If a stockholder returns a properly signed proxy card but does not indicate how the stockholder wants to vote, the stockholder's proxy will be counted as a vote *FOR* adoption of the merger agreement and *FOR* approval of the adjournment or postponement proposal. Brokers or other nominees who hold shares of our common stock in *street name* for customers who are the beneficial owners of the shares may not give a proxy to vote those customers' shares in the absence of specific instructions from the customers. These non-voted shares of our common stock will not be counted as votes cast or shares voting and will have the same effect as votes *AGAINST* adoption of the merger agreement. See the section captioned *The Special Meeting of Stockholders Voting of Proxies and Failure to Vote* on page 12.

Revocability of Proxies. Holders of our common stock may change their vote at any time before their proxy card is voted at the special meeting. A stockholder can do this in one of three ways. First, the stockholder can send a written, dated notice to the Secretary of Merchants Group at 250 Main Street, Buffalo, NY 14202, who must receive it before the proxy has been voted at the special meeting, stating that the stockholder would like to revoke the proxy. Second,

before the proxy has been voted at the special meeting, a stockholder can complete, date and submit a new proxy card. Third, a stockholder can attend the meeting and vote in person. Attendance, by itself, will not revoke a proxy. It will only be revoked if the stockholder actually votes at the special meeting. If a stockholder has instructed a broker to vote the stockholder shares, the stockholder must follow directions received from the broker to change those instructions. See the section captioned "The Special Meeting of Stockholders - Revocability of Proxies" on page 12.

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Failure to Vote. If you fail to vote by proxy or in person, it will have the same effect as a vote against the adoption of the merger agreement.

Recommendation of the Merchants Group Board of Directors

On October 31, 2006, after careful consideration at a meeting of the board described below under the caption "The Proposed Merger - Background of the Proposed Merger", our board of directors by a unanimous vote:

determined that the merger agreement was advisable and that the proposed merger and the other transactions contemplated by the merger agreement were fair to and in the best interests of Merchants Group and its stockholders;

approved and adopted the merger agreement; and

recommended that Merchants Group's stockholders vote "FOR" the adoption of the merger agreement.

For a discussion of the principal factors considered by our board of directors in reaching its conclusions, See the section captioned "The Proposed Merger - Reasons for the Proposed Merger and Recommendation of the Board of Directors".

Opinions of Financial Advisors to Our Board of Directors (page 20)

In connection with the proposed merger, SFRi, LLC our financial advisor, which we refer to as SFRi, delivered its opinion to our board of directors, as of the date of the merger agreement and subject to the various assumptions, qualifications and limitations contained in its opinion, that the consideration to be received in the proposed merger by the holders of our common stock was fair, from a financial point of view, to them. The full text of the written opinion of SFRi dated October 31, 2006, which sets forth, among other things, the assumptions made, the procedures followed, matters considered and limitations on the scope of review undertaken, is attached to this proxy statement as Annex B. We urge you to read the opinion carefully in its entirety.

Interests of Our Directors and Executive Officers in the Proposed Merger (page 28)

In considering the recommendation of the Merchants Group board of directors that you vote "FOR" adoption of the merger agreement, you should be aware that the members of the Merchants Group board of directors have personal interests in the proposed merger that are or may be different from, or in addition to, the interests of other Merchants Group stockholders. These interests include:

Robert M. Zak, who acts as our chief executive officer, and who is the President and Chief Executive Officer of Merchants New Hampshire, is the President and Chief Executive Officer of Mutual. From 1994 until June 7, 2006, Mr. Zak served as a director of Merchants Group. Merchants Group and Merchants New Hampshire do not have any operating assets or employees. Under the terms of a services agreement, Mutual provides Merchants Group and Merchants New Hampshire with the facilities, management and personnel required to operate their day-to-day businesses. Mutual is the beneficial owner of 255,000 shares, or 11.9% of our common stock.

The merger agreement provides continued indemnification to current or former directors or officers of Merchants Group and its subsidiaries in respect of liabilities for acts or omissions occurring at or prior to the completion of the proposed merger. In addition, the merger agreement requires that the surviving company maintain continued directors and officers insurance coverage, for six years following completion of the

proposed merger, that is at least as protective to the persons covered as our existing policies in this respect.

Appraisal Rights (page 40)

Under the General Corporation Law of the State of Delaware, holders of Merchants Group common stock who do not vote in favor of adopting the merger agreement will have the right to seek appraisal of the fair value of their shares as determined by the Delaware Court of Chancery if the proposed merger is completed, but only if they submit a written demand for an appraisal prior to the vote on the adoption of the merger agreement, do not vote or otherwise submit a proxy in respect of the merger agreement and comply with the procedures under the General

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Corporation Law of the State of Delaware described in this proxy statement. After the proposed merger, these shares will not represent any interest in the surviving corporation other than the right to receive this cash payment.

Merely voting against the merger agreement will not preserve your right to appraisal under Delaware law. Also, because a signed proxy that is submitted and that is not marked **AGAINST** or **ABSTAIN** will be voted **FOR** the proposal to adopt the merger agreement and approve the merger, the submission of a signed proxy not marked **AGAINST** or **ABSTAIN** will result in the waiver of appraisal rights. If you hold shares in the name of a broker, bank or other nominee, and if you wish to assert your appraisal rights, you must instruct your broker, bank or other nominee to take the steps necessary to enable you to demand appraisal for your shares.

If you validly demand appraisal of your shares in accordance with Delaware law and do not withdraw your demand or otherwise forfeit your appraisal rights, you will not receive the merger consideration. Instead, after completion of the proposed merger, a court will determine the fair value of your shares exclusive of any value arising from the completion or the expectation of the proposed merger. This appraisal amount could be more than, the same as or less than the amount you would be entitled to receive under the terms of the merger agreement.

Appraisal rights will not apply if the proposed merger is not completed for any reason.

Financing

AEG and its subsidiaries will fund the proposed merger through available cash. AEG has represented that it has commitments for sufficient resources to make the cash payments required under the merger agreement, and will continue to have such resources available until the closing of the merger.

The Merger Agreement

Conditions to the Proposed Merger (page 31) The obligations of AEG and Merger Sub to complete the proposed merger are conditioned upon the satisfaction or waiver of the following conditions, among others:

As required by Delaware law, the merger agreement must be adopted by the affirmative vote of holders of a majority of the outstanding shares of our common stock entitled to vote at the special meeting.

Consents expressly required for a change in control from Merchants Group's and Merchants New Hampshire's regulators, including the consent of the New Hampshire Insurance Department must be received and in effect.

There shall not have occurred any material adverse effect, as defined in the merger agreement and described below under the caption **The Merger Agreement - Conditions to the Proposed Merger**.

The waiting period (and any extension thereof) applicable to the proposed merger under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, shall have been terminated or expired.

No law, injunction or order preventing the completion of the proposed merger may be in effect.

There does not exist any misrepresentation or breach of any of the representations and warranties of Merchants Group in the merger agreement, which, individually or in the aggregate, constitutes, or could reasonably be expected to constitute a material adverse effect, disregarding exceptions to the definition of **material adverse effect** concerning negative changes to the rating of Merchants Group or the surviving company or the imposition of restrictions on the ability of Merchants Group or Merchants New Hampshire to pay dividends.

Merchants Group must have complied in all material respects with its obligations under the merger agreement.

Alternative Takeover Proposals; Recommendation of the Merchants Group Board of Directors (page 20)

The merger agreement restricts our ability to, among other things, solicit or enter into discussions or negotiations with a third party regarding alternative merger, business combination or acquisition transactions involving Merchants Group and the ability of our board of directors to change or withdraw its recommendation of the merger agreement. Notwithstanding these restrictions our board of directors may respond to a proposal for an

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alternative acquisition that our board of directors determines in good faith, after consulting with outside counsel, (i) does not result from a violation of our non-solicitation obligations under the merger agreement and (ii) could reasonably be expected to result in a superior proposal (as described under the caption "The Merger Agreement - Right to Accept a Superior Proposal" on page 33) by furnishing information with respect to Merchants Group or by participating in discussions or negotiations with the party or parties making the competing proposal, so long as we comply with certain requirements of the merger agreement to provide notice to AEG. In addition, prior to the time Merchants Group stockholders adopt the merger agreement, our board of directors may cause us to terminate the merger agreement in order for us to enter into an acquisition agreement with respect to a superior proposal, so long as we comply with the terms of the merger agreement. Our board of directors may also withdraw its recommendation of the merger agreement if it concludes that the failure to do so would result in a breach of its fiduciary obligations to Merchants Group's stockholders. In the event that Merchants Group terminates the merger agreement to enter into an acquisition agreement with respect to a superior proposal, Merchants Group is required to pay to AEG a termination fee of \$2,478,228 plus the actual costs and expenses of AEG prior to the termination.

Termination of the Merger Agreement (page 37)

The merger agreement may be terminated at any time prior to the completion of the proposed merger:

by mutual written consent of AEG and Merchants Group;

by either AEG or Merchants Group:

if our stockholders have voted on the merger agreement and the merger and the votes shall not have been sufficient to approve the merger agreement and the merger under our articles of incorporation, bylaws and applicable law;

if an unappealable law, order or injunction issued by a governmental entity prohibits the proposed merger (unless a party has not fulfilled its obligations under the merger agreement to oppose any such order or injunction);

if the proposed merger is not completed on or before March 31, 2007 (which will be extended to June 30, 2007 if the sole unfulfilled condition is the receipt of a required regulatory approval that the parties have received reasonable indications will be received by that date), unless a breach by the party seeking to terminate the merger agreement is the principal cause of the failure to complete the proposed merger;

by Merchants Group:

in connection with entering into a definitive agreement to effect a superior proposal as described above under "Alternative Takeover Proposals; Recommendation of the Board;" subject to our compliance with provisions of the merger agreement concerning responding to superior proposals;

if AEG or Merger Sub breaches any of their respective representations, warranties, covenants or other agreements in the merger agreement, in a manner which constitutes the failure of a condition to our obligation to complete the proposed merger and the breach has not been cured within 30 days after the giving of written notice to AEG; except where (A) such breach cannot reasonably be cured within the 30 day period but can be reasonably cured prior to March 31, 2007, and AEG or Merger Sub is diligently proceeding to cure such breach or (B) Merchants Group's breach of the merger agreement was the principal cause of the failure;

If the parties receive reasonable indications from any governmental authority that the governmental authority has denied or will not grant any necessary regulatory approval on or prior to June 30, 2007;

by AEG:

if Merchants Group breaches any of its representations, warranties or covenants in a manner that constitutes the breach of a condition to AEG's and Merger Sub's obligations to complete the proposed merger and such breach has not been cured within 30 days after the giving of written notice to Merchants Group; except where (A) such breach is incapable of being cured within the 30 day period but can be reasonably cured prior to March 31, 2007 and Merchants Group is diligently proceeding to cure the breach or (B) unless AEG's breach of the merger agreement was the principal cause of the failure; or

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if we enter into an agreement pursuant to a superior proposal or our board of directors withdraws or adversely modifies its recommendation of the merger agreement, or proposes publicly to do so; or

if we violate covenants in the merger agreement restricting our ability to solicit or enter into discussions or negotiations with a third party regarding alternative merger, business combination or acquisition transactions.

Termination Fees (page 38)

; Termination Fee Payable by Merchants Group. Under the merger agreement, Merchants Group must pay to AEG a termination fee of \$2,478,228 plus costs and expenses incurred by AEG if:

the merger agreement is terminated by Merchants Group or AEG following the failure of the merger agreement to be approved by our stockholders in a vote on such matter and (A) at the time of such termination, there was outstanding a plan or proposal, which we refer to as an acquisition proposal, for an alternative merger or other business combination or other sale of over 20% of the stock, assets or business of Merchants Group (other than with AEG or any of its affiliates), which we refer to as an alternative transaction, (B) within 18 months after such termination, Merchants Group or any of its subsidiaries enters into an agreement providing for, or completes, an alternative transaction and (C) the aggregate purchase price for Merchants Group (or its assets) pursuant to such alternative transaction equals or exceeds the merger consideration payable under the merger agreement;

the merger agreement is terminated by AEG due to a breach of the merger agreement by Merchants Group which constitutes a failure of a condition to close the merger, which failure is not cured within 30 days and (A) at the time of the termination, there was outstanding an acquisition proposal, (B) Merchants Group or any of its subsidiaries enters into an agreement providing for, or completes, an alternative transaction within 18 months after the termination of the merger agreement, and (C) the aggregate purchase price for Merchants Group (or its assets) pursuant to the alternative transaction equals or exceeds the merger consideration payable under the merger agreement;

Merchants Group or AEG terminates the merger agreement following the failure of the merger agreement to receive the necessary number of votes for approval from our stockholders, if prior to the vote our board of directors withdraws or adversely modifies its recommendation of the merger agreement, or proposes publicly to do so;

Merchants Group terminates the merger agreement because our board of directors exercises its rights to cause Merchants Group to enter into an acquisition agreement with respect to a superior proposal as described above under Alternative Takeover Proposals; Recommendation of the Board ;

AEG terminates the merger agreement because our board of directors exercises its rights to cause Merchants Group to enter into an acquisition agreement with respect to a superior proposal or our board of directors withdraws or adversely modifies its recommendation of the merger agreement, or proposes publicly to do so; or

AEG terminates the merger agreement because Merchants Group violates restrictions in the merger agreement concerning solicitation of or entry into discussions or negotiations with a third party regarding alternative merger, business combination or acquisition transactions involving Merchants Group and the ability of our board of directors to change or withdraw its recommendation of the merger agreement;

One purpose of this termination fee is to compensate AEG, in the event that the proposed merger is abandoned by Merchants Group to pursue a competing proposal, for the financial and other resources which AEG has expended in connection with entering into the merger agreement and seeking to complete the proposed merger. One effect of the termination fee provision is to make it more expensive for any other potential acquiror of Merchants Group to acquire control of Merchants Group.

For additional information regarding the termination fee provisions and the circumstances under which these fees are payable, see the section captioned *The Merger Agreement Termination Fees* on page 39.

Regulatory Matters (page 28)

As described above under *Conditions to the Proposed Merger*, the obligations of AEG and Merger Sub to effect the proposed merger are subject to the satisfaction or waiver of,

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among other conditions, the termination or expiration of any waiting period (and any extension thereof) applicable to the proposed merger under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended. The Hart-Scott-Rodino Antitrust Improvements Act of 1976 and related rules provide that transactions such as the proposed merger may not be completed until specified information has been submitted to the Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice and specified waiting period requirements have been satisfied. Merchants Group and AEG filed Notification and Report Forms with the Antitrust Division of the Federal Trade Commission on December 29, 2006.

The merger requires the approval of the New Hampshire Insurance Department because Merchants of New Hampshire is a New Hampshire domiciled insurance company. An application for approval, known as a Form A, was filed with the New Hampshire Insurance Department on January 4, 2007. A copy of the Form A filing is available on a web site maintained by Merchants Group at http://geocities.com/aeg_merchantsforma/MainPage.html or can be obtained by contacting Merchants Group (see *Where You Can Find Additional Information* on page 46). Also, Merchants New Hampshire is the sole owner of a New York domiciled premium finance company, M.F.C. of New York, Inc. Under applicable New York laws, the merger requires approval of the New York Superintendent of Banking. However, because M.F.C. of New York has not conducted business in over ten years, we intend to surrender M.F.C.'s license to conduct business as a premium finance company and negate the need for the approval.

Subsequent Event

Following the execution of the Merger Agreement, discussions commenced among Mutual, AEG and Merchants Group concerning a possible sale by Merchants New Hampshire to Mutual of rights to renew insurance policies directly written by MNH. As a result of those discussions, on December 22, 2006, Mutual, AEG and Merchants Group entered into an agreement, which we refer to as the renewal rights agreement, which provides that upon the closing of the transactions contemplated by the merger agreement, Merchants New Hampshire will transfer its rights to renew its existing directly written insurance policies to a subsidiary of Mutual in consideration of the payment of license fees for use of data in connection with such policies, of between \$3,375,000 and \$3,456,000. The renewal rights agreement also provides that upon completion of the closing of the transactions contemplated by the merger agreement, (i) the existing Reinsurance Pooling Agreement will continue through December 31, 2009, (ii) Merchants Group and each of its affiliates will transfer all of their rights to the name Merchants to Mutual in exchange for \$100,000, and (iii) AEG and Mutual, on behalf of themselves and their respective affiliates, have reciprocally agreed to not solicit certain insurance business for a term of two years. In addition, the renewal rights agreement provides that the Administrative Services Annex to the Services Agreement will terminate shortly after the consummation of the merger transaction with AEG or on the close of business on June 30, 2007, whichever ever occurs earlier.

A complete copy of the renewal rights agreement was filed as an exhibit to the Form 8-K filed by Merchants Group on December 27, 2006.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This proxy statement contains forward-looking statements about our plans, objectives, expectations and intentions. You can identify these statements by words such as *expect*, *anticipate*, *intend*, *plan*, *believe*, *seek*, *estimate* and *continue* or similar words. You should read statements that contain these words carefully. They discuss our future expectations or state other forward-looking information, and may involve known and unknown risks over which we have no control, including, without limitation:

The satisfaction of the conditions to complete the proposed merger, including the receipt of the required stockholder and regulatory approvals;

The occurrence of any event, change, or other circumstances that could give rise to the termination of the merger agreement;

The failure of the proposed merger to close for any other reason;

General economic and market conditions;

The effect of war, terrorism or catastrophic events;

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The effect of the announcement of the proposed merger on our customer relationships, operating results and business generally; and

Other risks detailed in our current filings with the SEC, including our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

You should not place undue reliance on forward-looking statements. We cannot guarantee when, or whether, the conditions to the proposed merger will be satisfied or waived and therefore when, or whether, the proposed merger will be completed. In addition, we cannot guarantee any future results, levels of activity, performance or achievements. The statements made in this proxy statement represent our views as of the date of this proxy statement, and it should not be assumed that the statements made herein remain accurate as of any future date. Moreover, we assume no obligation to update forward-looking statements or update the reasons actual results could differ materially from those anticipated in forward-looking statements, except as required by law.

THE SPECIAL MEETING OF STOCKHOLDERS

We are furnishing this proxy statement to you, as a holder of our common stock, as part of the solicitation of proxies by Merchants Group's board of directors for use at the special meeting of stockholders described below.

Date, Time and Place of the Special Meeting

The special meeting will be held at the offices of Hodgson Russ LLP, One M&T Plaza, Buffalo, New York 14203 on February 1, 2007 at 10:00 a.m., local time.

Proposals to be Considered at the Special Meeting

At the special meeting you will be asked:

1. To act on a proposal to adopt the Agreement and Plan of Merger dated as of October 31, 2006, by and among AEG, its subsidiary Merger Sub, and Merchants Group, and to approve the merger and related transactions contemplated by the merger agreement. A copy of the merger agreement is attached as Annex A to this proxy statement.
2. To consider and vote upon a proposal to adjourn or postpone the special meeting, if necessary, to solicit additional proxies in favor if there are not sufficient favorable votes at the time of the meeting to adopt the merger agreement and approve the merger and related transactions.

If the proposed merger is completed, each share of stock will be converted into the right to receive \$33.00 in cash, without interest, plus any required Dividend Adjustment. After the merger, these shares will not represent any interest in the surviving corporation other than the right to receive this cash payment. Merchants Group stockholders who perfect their appraisal rights in accordance with Delaware law will not receive the merger consideration. See the section captioned *Appraisal Rights* on page 40.

Our Board's Recommendation

After careful consideration, our board of directors, by a unanimous vote at the meeting held on October 31, 2006:

determined that the merger agreement was advisable and that the proposed merger and the other transactions contemplated by the merger agreement were fair to and in the best interests of Merchants Group and its

stockholders;

approved and adopted the merger agreement; and

recommends that Merchants Group's stockholders vote FOR the adoption of the merger agreement.

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Record Date; Stock Entitled to Vote

Only holders of record of Merchants Group common stock as of the close of business on December 20, 2006 are entitled to notice of, and to vote at, the special meeting and any adjournment or postponement of the special meeting. Each outstanding share of our common stock on the record date entitles the holder to notice of and to one vote on each matter submitted to stockholders for approval at the special meeting. As of the record date, there were 2,145,652 shares of our common stock outstanding and entitled to be voted on the proposals to be considered at the special meeting.

Quorum

A quorum of our stockholders is necessary to have a valid stockholders' meeting. The required quorum for the transaction of business at the special meeting is the presence, in person or represented by proxy, of holders of a majority of the outstanding Merchants Group common stock entitled to vote at the special meeting. Both abstentions and broker non-votes will be counted as present for purposes of determining the existence of a quorum. In the event that a quorum is not present at the special meeting, we currently expect that we will adjourn or postpone the special meeting to solicit additional proxies in favor of adoption of the merger agreement.

Vote Required

Under Delaware law, and pursuant to the merger agreement, we cannot complete the proposed merger unless the merger agreement is adopted by the affirmative vote of the holders of a majority of the outstanding shares of our common stock entitled to vote at the special meeting. Under Delaware law, the affirmative vote of a majority of the shares present and entitled to vote is required to adjourn or postpone the special meeting, if necessary, to solicit additional proxies in favor of adoption of the merger agreement if there are insufficient votes at the time of the meeting to adopt the merger agreement.

Our directors and executive officers as a group beneficially own 258,310 shares, or approximately 12.0%, of our common stock. See the section captioned "The Proposed Merger - Interests of our Directors and Executive Officers in the Proposed Merger" on page 28. Neither we nor AEG or its subsidiaries have entered into any agreements with these directors or officers with respect to the voting of their shares in connection with the merger; however, we expect these directors and officers to vote their shares in favor of the proposed merger.

Procedures for Voting

Holders of record of our common stock may vote their shares by attending the special meeting and voting their shares of our common stock in person, or by completing the enclosed proxy card, dating and signing it and mailing it in the enclosed postage-prepaid envelope.

Stockholders who hold their shares of our common stock in "street name", meaning in the name of a bank, broker or other person who is the record holder, must either direct the record holder of their shares of our common stock how to vote their shares or obtain a proxy from the record holder to vote their shares at the special meeting.

Stockholders who have questions or requests for assistance in completing and submitting proxy cards should contact Georgeson Inc., our proxy solicitor, at (866) 647-8869.

Voting of Proxies and Failure to Vote

All shares of our common stock represented by properly executed proxies received in time for the special meeting will be voted at the special meeting in the manner specified by the holder. If a stockholder returns a properly signed proxy card but does not indicate how the stockholder wants to vote, the stockholder's proxy will be counted as a vote FOR adoption of the merger agreement and FOR approval of the adjournment or postponement proposal.

If a stockholder fails to vote by proxy or in person, it will have the same effect as a vote AGAINST the adoption of the merger agreement. Failure to vote your proxy or to vote in person will have no effect on the approval of the adjournment or postponement proposal.

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Brokers or other nominees who hold shares of our common stock in street name for customers who are the beneficial owners of such shares may not give a proxy to vote those customers' shares in the absence of specific instructions from those customers. These non-voted shares of our common stock (i) will not be counted as votes cast or shares voting and will have the same effect as votes AGAINST adoption of the merger agreement and (ii) will have no effect on the approval of the adjournment or postponement proposal.

Revocability of Proxies

Holders of our common stock may change their vote at any time before their proxy card is voted at the special meeting. A stockholder can do this in one of three ways. First, the stockholder can send a written, dated notice to the Secretary of Merchants Group at 250 Main Street, Buffalo, NY 14202, who must receive it before the proxy has been voted at the special meeting, stating that the stockholder would like to revoke the proxy. Second, before the proxy has been voted at the special meeting, a stockholder can complete, date and submit a new proxy card. Third, a stockholder can attend the meeting and vote in person. Attendance, by itself, will not revoke a proxy. It will only be revoked if the stockholder actually votes at the special meeting. If a stockholder has instructed a broker to vote the stockholder shares, the stockholder must follow directions received from the broker to change those instructions.

Solicitation of Proxies

In addition to solicitation by mail, our directors, officers and employees may solicit proxies by telephone, other electronic means or in person. Our directors, officers and employees will not receive any additional compensation for their services, but we will reimburse them for their out-of-pocket expenses. We will reimburse banks, brokers, nominees, custodians and fiduciaries for their reasonable expenses in forwarding copies of this proxy statement to the beneficial owners of shares of our common stock and in obtaining voting instructions from those owners. We will pay all expenses of filing, printing and mailing this proxy statement.

We have retained Georgeson Inc. to assist in the solicitation of proxies by mail, telephone or other electronic means, or in person, for a fee of approximately \$7,500 (subject to increase if additional services are requested), plus reasonable expenses relating to the solicitation.

Other Business

We are not currently aware of any business to be acted upon at the special meeting other than the matters discussed in this proxy statement. Under our bylaws, business transacted at the special meeting is limited to matters relating to the purposes stated in the notice of special meeting, which is provided at the beginning of this proxy statement. If other matters do properly come before the special meeting, or at any adjournment or postponement of the special meeting, we intend that shares of our common stock represented by properly submitted proxies will be voted by and at the discretion of the persons named as proxies on the proxy card. In addition, the grant of a proxy will confer discretionary authority on the persons named as proxies on the proxy card to vote in accordance with their best judgment on procedural matters incidental to the conduct of the special meeting.

THE PROPOSED MERGER

Background of the Proposed Merger

On February 2, 2005, we retained Philo Smith Capital Corporation (Philo Smith), to help us explore strategic alternatives for our long term development. In particular, Philo Smith was to assist us in exploring possible strategic alternatives which would put to use the excess capital of our insurance subsidiary, Merchants New Hampshire. Among the alternatives to be considered were possible acquisitions of books of business, the acquisition of

underwriting or general insurance agencies, a merger with another insurance company, or the sale of Merchants Group or Merchants New Hampshire.

During the remainder of the 2005 calendar year, Philo Smith explored a number of strategic alternatives, none of which were found by our board to be a strategic transaction that would be beneficial to our shareholders. During

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2005, Philo Smith contacted approximately 85 firms with respect to a possible strategic transaction with Merchants Group, 33 of which signed confidentiality agreements and received information concerning Merchants Group.

On January 5, 2006, at the suggestion of Joseph Lehrer, an attorney with Greensfelder, Hemker & Gale, P.C. and acting as special counsel to our board of directors, representatives of Merchants Group including Thomas Kahn, Chairman of our board of directors, Mr. Lehrer, David Stark of our general counsel Hodgson Russ LLP, and Donald Pfundstein of Gallagher, Callahan & Gartrell, P.A., our special New Hampshire regulatory counsel, met with representatives of Mutual including Bryant Prentice, Chairman of the Board of Directors of Mutual, Robert Zak, President of Mutual (and Chief Operating Officer of Merchants Group), James Tanous of Jaeckle Fleischmann & Mugel general counsel to Mutual, and Steve Lauwers (participating by telephone), special New Hampshire regulatory counsel to Mutual. The purpose of the meeting was to begin exploring the possibility of the acquisition of Merchants Group or Merchants New Hampshire by Mutual. As a result of that meeting, Mutual and Merchants Group determined to further explore the possibility of a transaction between Mutual and Merchants Group.

On February 1, 2006, at the suggestion of Mutual, representatives of Mutual including Robert Zak, James Tanous, and representatives of Mutual's financial advisors, held a second meeting with representatives of Merchants Group including Thomas Kahn, Joseph Lehrer, David Stark, Donald Pfundstein, and James Inglis (participating by telephone) of Philo Smith. The financial advisor to Mutual gave a presentation at the meeting, and they advised the meeting of their conclusion that the fair value of the stock of Merchants Group was approximately \$27 per share, which was below the then recent trading price for Merchants Group's stock.

Bryant Prentice sent a letter dated March 20, 2006 to Thomas Kahn, Chairman of the Board of Merchants Group, which conveyed a non-binding proposal by Mutual to purchase all of our issued and outstanding stock for a cash price of \$29.00 per share. In the letter, Mr. Prentice stated that the \$29.00 per share price was, in his opinion, fair, in light of our inability of Merchants Group to identify a strategic alternative for our long term development, and in light of the possibility that the Reinsurance Pooling Agreement and the Services Agreement, under which Mutual manages and operates the business of Merchants Group and Merchants of New Hampshire, could be cancelled as of December 31, 2007. Mr. Prentice further justified the price as being fair to our shareholders on the basis of the absence of a significant public market for Merchants Group shares and of the risks, timing issues, and costs that would be involved in liquidating or maintaining shares in Merchants Group. Mutual made the letter public through an amendment to its report of beneficial ownership on Schedule 13D that it filed with the SEC on March 20, 2006. The letter and the amended Schedule 13D stated Mutual's offer to negotiate an all cash acquisition of Merchants Group at \$29.00 per share would remain open through April 4, 2006.

Mr. Tanous and Mr. Lehrer held continuing discussions of a possible acquisition transaction between Mutual and Merchants Group. Concurrently with those discussions, independent members of our board of directors held discussions with SFRi regarding the engagement of SFRi to act as their financial advisor with respect to negotiations with Mutual and other possible strategic alternatives. On April 4, 2006, Mutual filed a further amendment to its Schedule 13D, which stated that its proposal to negotiate an all cash acquisition of Merchants Group would remain open until the close of business on April 21, 2006, rather than April 4, 2006, as originally contemplated.

On April 3, 2006, the Executive Committee of our board of directors formed a special committee (the Special Committee) for the purpose of discussing a possible strategic transaction with Mutual and other interested parties. The Special Committee included all of the members of our board of directors other than Mr. Zak. At a meeting of the Special Committee immediately following the meeting of the Executive Committee of our board, the Special Committee resolved to retain SFRi as its financial advisor and the Greensfelder firm as its legal counsel, which was subsequently documented by an engagement letter with SFRi dated May 1, 2006. The Special Committee also discussed the agenda of a contemplated meeting to be held between representatives of Merchants Group and representatives of Mutual.

On April 4, 2006, Merchants Group issued a press release and filed a related Current Report on Form 8-K with the SEC announcing that our board of directors had formed the Special Committee, consisting of all of the directors other than Mr. Zak, to conduct discussions with Mutual and to consider other potential strategic transactions.

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Separately, Merchants Group also retained David R. Bradley as a consultant to assist the Special Committee regarding operational and transitional matters in its discussions with parties interested in a potential transaction with Mutual.

At the invitation of Mutual, on April 6, 2006 representatives of Merchants Group met with representatives of Mutual in Chicago, Illinois for the purpose of discussing a possible strategic transaction between Mutual and Merchants Group. In attendance at the meeting on behalf of Mutual were Mr. Prentice, Mr. Tanous, Mr. Zak, Steven Lauwers, New Hampshire counsel to Mutual, and representatives of Mutual's financial advisors; in attendance on behalf of Merchants Group were Mr. Kahn, Mr. Lehrer, Mr. Pfundstein (by telephone), and representatives of SFRi. During the meeting, the parties discussed the feasibility of the acquisition of Merchants Group by Mutual. At the meeting, the representatives of Merchants Group told the representatives of Mutual that they would advise our board to consider an offer from Mutual for the acquisition of Merchants Group at a price of \$33.00 to \$34.00 per share. As a result of the meeting, representatives of Mutual and SFRi stated that discussions between the parties should continue. At the meeting, Mr. Kahn informed Mutual that, with the assistance of SFRi, the Special Committee would conduct a sale process and attempt to solicit other competing bids for the purchase of Merchants Group.

On April 12, 2006, at a meeting of the Special Committee, Mr. Kahn, Mr. Lehrer, and representatives of SFRi reported to the Special Committee concerning the April 6 meeting with Mutual and described the process by which negotiations would continue with Mutual and by which indications of interest would be solicited from other potential acquirors of Merchants Group.

On April 21, 2006, Mutual filed another amendment to its Schedule 13D stating that although the date through which Mutual agreed to extend its offer to negotiate with Merchants Group (i.e. April 21, 2006) had passed, discussions between representatives of Mutual and Merchants Group would continue.

Beginning on or about April 25, 2006, SFRi sent sale process letters and a summary of business and financial information concerning Merchants Group to 30 targeted potential strategic buyers identified by SFRi and Philo Smith. As a result of those letters and other contacts, a total of eight firms signed confidentiality agreements and requested more information concerning Merchants Group in connection with a potential strategic transaction. AEG and the Second Bidder (described below) were among the firms executing a confidentiality agreement. At a meeting on May 4, 2006, representatives of SFRi informed members of the Special Committee of progress with respect to the sale process and preliminary expressions of interest from various firms.

In response to the sale process letters and additional discussions, primarily between interested third parties and representatives of SFRi, Merchants Group received responses from nine potential strategic buyers who expressed varying degrees of interest in engaging in a strategic transaction with Merchants Group. Some indications of interest were from start-up newly formed firms that would need to raise the necessary capital from outside financing sources; some were from privately-held companies who wanted to engage in a merger with Merchants Group; and, two (not including Mutual) were from companies engaged in the property and casualty insurance business, that were interested in a purchase of the stock of Merchants Group for cash.

On June 5, 2006, Mutual submitted a letter expressing an interest to acquire all of the stock of Merchants Group at a price of \$29.50 per share, and Mutual disclosed its letter in an amendment to its report of beneficial ownership on Schedule 13D that it filed on the same date. The proposal letter from Mutual stated that unless Merchants Group indicated to Mutual that it was interested in negotiating a definitive agreement consistent with the terms of Mutual's letter on or before June 16, 2006, the expression of interest by Mutual would be void.

Mr. Zak did not stand for re-election at our annual meeting of shareholders held on June 7, 2006; on and after that date the membership of the Special Committee was identical with membership of our entire board of directors.

Among the proposals received by the Special Committee was a proposal, dated May 24, 2006, from AEG to acquire all of the stock of Merchants Group at a price of \$35 per share, subject to the completion of AEG's due diligence investigation of the Company and other conditions. At a meeting of the Special Committee held on June 7, 2006 at which all members were present, after considering the advice of SFRi concerning the financial terms of the proposals received prior to that date, our board of directors found that the proposal from AEG was the superior proposal for the acquisition of Merchants Group, and the board authorized Mr. Kahn to execute a letter of intent to

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engage in a sale transaction with AEG, subject to the negotiation of a mutually satisfactory definitive agreement, satisfactory completion of AEG's due diligence investigation, and other conditions.

On June 8, 2006, representatives of Merchants Group including Thomas Kahn, Andrew Alberti (one of our directors), David Bradley, and a representative of SFRi, met with representatives of AEG including Nachum Stein, President and CEO of AEG, and Robert Kohl and Evan Greebel of Katten Muchin Rosenman LLP, counsel to AEG. At the meeting, AEG provided background information concerning its business, organization, and history, and described its plans for acquiring Merchants Group.

On June 12, 2006, we disclosed in a press release and in a Current Report on Form 8-K filed with the SEC that the Special Committee of our board of directors had received proposals for a possible sale or merger of Merchants Group, that the Special Committee has reviewed these proposals, and that it had entered into discussions with selected interested parties.

Merchants Group and AEG executed a letter of intent concerning a sale transaction on June 18, 2006. The letter specifically allowed Merchants Group to engage in discussions with other parties interested in engaging in a strategic transaction with Merchants Group, subject to the reimbursement of legal and due diligence expenses of AEG not to exceed \$300,000 in the event that the AEG proposal was rejected in favor of a proposal determined by Merchants Group to be a superior proposal.

Between June 18, 2006 and August 4, 2006, AEG continued its due diligence investigation with respect to the acquisition of Merchants Group, including meetings with the New Hampshire Department of Insurance and insurance company rating agencies. During this period, attorneys for Merchants Group and attorneys for AEG exchanged drafts of a definitive agreement for the acquisition of Merchants Group at \$35 per share. On or about August 4, 2006, Nachum Stein, President of AEG, informed Mr. Kahn and SFRi that, based upon the results of AEG's due diligence investigation and, in particular, on the response of insurance company rating agencies to the proposed transaction, AEG was reconsidering its proposal for the acquisition of Merchants Group. Negotiations concerning a definitive agreement for the acquisition of Merchants Group by AEG were then temporarily suspended until AEG had completed its reassessment of the transaction.

After considering advice from SFRi, on August 8, 2006 our board of directors determined to reopen negotiations with other parties who had earlier expressed interest in engaging in a strategic transaction with Merchants Group. One of the other parties (the Second Bidder) had earlier indicated its expression of interest in purchasing all of the stock of Merchants Group at approximately \$30 - \$32 per share. On September 14, 2006, our board executed a letter of intent with the Second Bidder, which provided for a proposed purchase of Merchants Group for a cash price of \$33 per share, subject to a number of conditions including the successful completion of a due diligence investigation of the transaction and Merchants Group by the Second Bidder. In order to accommodate the Second Bidder's completion of its due diligence investigation, the letter of intent also provided that we would not engage in another transaction for the acquisition of Merchants Group before October 12, 2006.

On September 22, 2006, Mr. Stein, President of AEG, indicated to SFRi that AEG was prepared to move forward with a revised proposal for the acquisition of Merchants Group at a price of \$32.50 per share. To that end, AEG sent a revised definitive merger agreement for consideration and negotiation between the attorneys representing AEG and Merchants Group.

On September 29, 2006, Mr. Kahn and a representative of SFRi met briefly with Nachum Stein at his office where they discussed AEG's revised offer.

On October 12, 2006, the Second Bidder indicated that it had not completed its due diligence investigation of Merchants Group. At the request of Merchants Group, SFRi told the Second Bidder that it could continue its due diligence investigation of Merchants Group and that our board of directors intended to make a decision regarding the purchaser of Merchants Group at a special meeting of the board scheduled for October 31, 2006. The letter of intent with such Second Bidder was not extended and, therefore, Merchants Group was permitted to enter into an alternative transaction with AEG or any other purchaser after October 12, 2006.

Prior to the date of the meeting of our board on October 31, 2006, we negotiated the terms of separate, definitive merger agreements with each of AEG and the Second Bidder. Prior to the meeting, Mr. Lehrer presented

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an analysis of the legal terms of the representations and warranties, covenants, and conditions for closing the transaction of the two definitive agreements and advised our board that he believed that the terms were substantially similar from the point of view of Merchants Group.

On October 26, 2006, on the instructions of Mr. Kahn for the Special Committee, SFRi sent to each of AEG and the Second Bidder a letter in which the recipient of the letter was requested to submit a signed copy of the definitive merger agreement, as negotiated between the respective parties, which would contain its best and final per share offer for the purchase of Merchants Group.

On October 30, 2006, SFRi received an indication from Mr. Stein that AEG was increasing its offer for the purchase of Merchants Group to \$33.00 in cash per share, plus a per diem amount equal to a pro rated portion of Merchants Group's current dividend of \$1.00 per annum for each day since the last day of the last quarter prior to the closing of the merger for which Merchants Group had declared and paid a quarterly dividend for each outstanding share. Mr. Stein indicated that this price was AEG's best and final offer for Merchants Group.

On October 30, 2006, Mr. Lehrer received a telephone call from the attorney representing the Second Bidder. In that call, the attorney stated that his client was considering lowering its offer for the purchase of Merchants Group to a price that was below \$33.00 per share on the basis of the results of its due diligence investigation of Merchants Group. The attorney further stated in that telephone conversation that under no circumstances would his client be willing to increase its price beyond \$33.00 per share. On the morning of October 31, 2006, the attorney for the Second Bidder called Mr. Lehrer, and the financial advisor for the Second Bidder called SFRi, and each indicated that the best and final price being offered by the Second Bidder for the purchase of Merchants Group was \$33.00 per share, plus a per diem amount equal to a pro rated portion of Merchants Group's current dividend of \$1.00 per annum for each day since the last day of the last quarter prior to the closing of the merger for which Merchants Group had declared and paid a quarterly dividend for each outstanding share, provided that the Dividend Adjustment could not exceed our actual earnings per share during the applicable period.

On the evening of October 30, 2006, all of the members of our board attended an informal dinner meeting with representatives of SFRi, of the Greensfelder law firm, and of the Hodgson Russ law firm, at which they discussed the two offers for the acquisition of Merchants with their financial and legal advisors. No decision was made by the Board with respect to a choice between the two offers at that meeting.

Our board of directors held a special meeting to consider the two offers, beginning at approximately 8:20 AM on October 31, 2006 at the offices of Hodgson Russ in Buffalo, New York. All of the directors were physically present at the meeting. Also in attendance were John Hendrickson, Steven Webersen and Jung Lee of SFRi, Joseph Lehrer of the Greensfelder law firm, Ward Hinkle of the Hodgson Russ law firm, David Bradley, and Donald Pfundstein, regulatory counsel to Merchants Group (attending by phone). Mr. Lehrer made a presentation regarding the fiduciary duties of the board with respect to a determination to engage in a change of control transaction involving a merger of Merchants Group in exchange for cash consideration, and he presented an analysis of the respective merger agreements submitted by AEG and the Second Bidder. The representatives of SFRi discussed the manner in which the sale process had been carried out, and they presented a detailed explanation of the methodology and conclusions of the financial analysis that SFRi had performed in connection with the preparation of SFRi's fairness opinion. Mr. Pfundstein reviewed the requisite regulatory process and the approval of the New Hampshire Department of Insurance (DOI) that would be necessary to complete the transaction. Mr. Hinkle summarized securities and corporate law issues in connection with obtaining shareholder approval of a merger.

At the meeting, the members of our board held lengthy and detailed discussions among themselves and their advisors concerning which of the two offers was preferable. Mr. Kahn discussed with the board the reasons why, based upon his experience as the primary negotiating contact with the bidders on behalf of the board, that he believed that the

AEG proposal was more favorable than that of the Second Bidder. Among the reasons for favoring the AEG proposal that Mr. Kahn discussed with board (in addition to the items contained in the Reasons for the Merger) were:

AEG appeared to be more committed than the Second Bidder to completing the transaction at the proposed merger consideration. The board members discussed the Second Bidder's recent statement that it was

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considering a reduction in the purchase price and concerns expressed by the Second Bidder with respect to possible competitive actions that might be taken by Mutual.

Because the Second Bidder had expressed its intention to compete to obtain the insurance business that had been written by Merchants Group and Mutual while AEG had stated that it was willing to discuss an arrangement with Mutual for a sale of renewal rights with respect to policies which had been written by Merchants New Hampshire, it appeared more likely that Mutual would be able to reach an accommodation with AEG than with the Second Bidder concerning the manner in which the business of Merchants Group would be continued after the merger. Such an accommodation could be helpful in obtaining regulatory approvals and meeting other conditions for the closing of the merger.

Both AEG and the Second Bidder were representing in their definitive merger agreements that sufficient financing would be available to complete the merger transaction, and both AEG and the Second Bidder submitted evidence of the availability of equity or debt necessary to complete the transaction. However, the Second Bidder had indicated to the New Hampshire DOI that it wished to make a dividend distribution from Merchants New Hampshire of between \$15 million and \$30 million, which would be used towards the merger consideration, and AEG had not made a similar request; AEG was planning to use an equity financing for a substantial portion of the purchase price, whereas the Second Bidder was planning to finance the merger consideration through a large debt financing.

After the board's discussion of their preference for the relative merits of the AEG proposal, SFRi submitted its executed fairness opinion to the Board of Merchants Group to the effect that, as of that date and based on and subject to the assumptions, qualifications, and limitations described in its opinion, the merger consideration to be received in the proposed merger by the holders of Merchants Group common stock was fair, from a financial point of view, to them.

Thereafter, upon motion duly made and seconded, the Board of Directors of Merchants Group unanimously approved the AEG proposal as contained in the submitted merger agreement and authorized Thomas Kahn to execute the merger agreement on behalf of Merchants Group. Mr. Kahn executed the merger agreement with AEG on behalf of Merchants Group immediately after the board meeting.

Reasons for the Proposed Merger

After careful consideration, our board of directors, by a unanimous vote at the October 31, 2006 meeting described above, approved and adopted the merger agreement, determining that the merger agreement was advisable and that the proposed merger and the other transactions contemplated by the merger agreement were fair to and in the best interests of Merchants Group and its stockholders. In the course of reaching its decision to approve and adopt the merger agreement and the proposed merger, our board of directors consulted with its financial and legal advisors and considered a number of factors that it believed supported its decision, including the following:

The \$33.00 per share price to be paid in cash in respect of each share of Merchants Group common stock, which represents an 8.5% premium over the closing price of \$30.40 per share of our common stock on October 30, 2006, the last trading day before Merchants Group publicly announced that we had entered into the merger agreement, a 10% premium over the average closing price of our common stock during the thirty trading days prior to such announcement, and a 10.9% premium over the closing price of \$29.75 per share of our common stock on June 2, 2006, the last trading day before the last acquisition proposal from Mutual was announced on June 5, 2006;

The services agreement between Merchants Group and Mutual, under which Mutual manages all of the operations of Merchants Group and Merchants New Hampshire (the Services Agreement), may be terminated by Mutual effective as of January 1, 2008. Administrative services under the Administrative Services Annex to the Services Agreement may be terminated as of March 31, 2007. Merchants Group and Merchants New Hampshire have no employees, and the termination of the Services Agreement would necessitate either the hiring of a staff of executive officers and other employees to manage and operate the business of Merchants Group and Merchants New Hampshire, or alternatively, Merchants Group could

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retain third party independent contractors to manage the business and operations of Merchants Group and Merchants New Hampshire. Under either alternative, the board realized that there is substantial management risk and risk of a substantially higher cost structure for Merchants Group if the Services Agreement is terminated by Mutual.

Mutual and Merchants New Hampshire pool, or share, underwriting results on their traditional insurance business by means of a reinsurance pooling agreement (the Pooling Agreement). The Pooling Agreement provides for Merchants New Hampshire to cede, or transfer, to Mutual all premiums and risks on its traditional insurance business during the term of the agreement, and for it to assume from Mutual a percentage of all of Mutual's and Merchant New Hampshire's combined traditional business. Accordingly, Mutual retains a share of the risk in Merchant New Hampshire's traditional business under Mutual's control pursuant to a profit and loss sharing arrangement in the Pooling Agreement based on the loss and loss adjustment expense experience of the pooled business. Our board believes the Pooling Agreement and profit (or loss) sharing feature included therein aligns the interests of Merchants New Hampshire and Mutual. Nevertheless, the Pooling Agreement may be terminated by Mutual at the beginning of any calendar year, beginning January 1, 2008.

As a consequence of the Pooling Agreement and the Services Agreement, virtually all contact with insurance agents who solicit insurance business on behalf of Merchants New Hampshire is with employees of Mutual. Upon termination of the Services Agreement and Pooling Agreement, Merchants New Hampshire will have a competitive disadvantage in soliciting and retaining insurance policies through insurance agents used by Mutual.

Our regulatory counsel informed our board that if Merchants Group attempted to liquidate Merchants of New Hampshire by not writing any further insurance policies, the substantial portion of the assets held by Merchants New Hampshire will not be available for distribution to Merchants Group and its stockholders for an extended period of time, and any distributions from Merchants New Hampshire to Merchants Group could only be made with the consent of the New Hampshire Insurance Department. Further, Merchants New Hampshire would be required to offer renewals of certain insurance policies under applicable state law. Further, during the period of liquidation, Merchants New Hampshire would continue to be exposed to risks with respect to claims under previously written insurance policies and will incur ongoing expenses to manage and operate the company, without the benefit of premiums from new insurance business, thereby creating risk of a diminution of the book value of Merchants Group.

The financial analysis and presentations of SFRi presented to our board of directors at its meeting on October 31, 2006 and the opinion dated October 31, 2006, of SFRi to our board of directors to the effect that, as of that date and based on and subject to the various assumptions, qualifications and limitations set forth in their respective presentations, the consideration to be received by the holders of our common stock in the proposed merger was fair, from a financial point of view, to those holders. The full text of the SFRi opinion, which sets forth the assumptions made, matters considered, and limitations on the scope of review undertaken by SFRi in rendering its opinion, is attached to this proxy statement as Annex B.

In the course of its deliberations, our board of directors also considered a variety of risks and other countervailing factors related to entering into the merger agreement and the proposed merger, including:

the risk that the proposed merger might not be completed in a timely manner or at all, including the risk that the proposed merger will not occur if the required regulatory approvals are not received in a timely manner;

the restrictions on the conduct of Merchants Group's business prior to the completion of the proposed merger, requiring Merchants Group to conduct its business in the usual, regular and ordinary course in substantially the

same manner as previously conducted, subject to specific limitations, which may delay or prevent Merchants Group from undertaking business opportunities that may arise pending completion of the proposed merger;

the risks and costs to Merchants Group if the proposed merger does not close, including the need to retain management and other employees previously provided by Mutual under the Services Agreement, and the

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incurrence of additional operating costs and the potential disruptive effect on business and customer relationships;

the possibility that, although the proposed merger provides our stockholders with the opportunity to realize a premium over the price at which our common stock has traded, the price of our common stock might have increased in the future to a price greater than \$33.00 per share, and the merger would prevent our current stockholders from capturing this future upside growth;

the restrictions that the merger agreement imposes on soliciting competing proposals;

the possibility that the termination fee of \$2,478,228 plus actual costs and expenses of AEG potentially payable by Merchants Group may discourage other bidders and impact our ability to engage in another transaction for up to 18 months should we fail to complete the proposed merger; and

the fact that an all cash transaction would be a taxable transaction to Merchants Group's stockholders for U.S. Federal income tax purposes.

The foregoing discussion of the factors considered by our board of directors is not intended to be exhaustive, but does set forth the principal factors considered by our board of directors. Our independent board of directors collectively reached the conclusion to approve the merger agreement and the proposed merger in light of the various factors described above and other factors that the members of our board of directors believed were appropriate. In view of the wide variety of factors considered by our board of directors in connection with its evaluation of the proposed merger and the complexity of these matters, our board of directors did not consider it practical, and did not attempt, to quantify, rank or otherwise assign relative weights to the specific factors it considered in reaching its decision and did not undertake to make any specific determination as to whether any particular factor, or any aspect of any particular factor, was favorable or unfavorable to the ultimate determination of our board of directors. Rather, our board of directors made its recommendation based on the totality of information presented to and the investigation conducted by it. In considering the factors discussed above, individual directors may have given different weights to different factors.

Recommendation of the Merchants Group Board of Directors

After careful consideration, our board of directors, by a unanimous vote at the October 31, 2006 meeting described above:

determined that the merger agreement was advisable and that the proposed merger and the other transactions contemplated by the merger agreement were fair to and in the best interests of Merchants Group and its stockholders;

approved and adopted the merger agreement; and

recommended that Merchants Group's stockholders vote FOR the adoption of the merger agreement.

Opinion of Financial Advisor to Our Board of Directors

The Special Committee retained SFRi to act as its financial advisor in connection with its review of acquisition proposals and Merchants Group's strategic options and, if requested, to render a fairness opinion in connection with a proposed merger. The Special Committee selected SFRi to act as a financial advisor based on SFRi's qualifications, expertise, reputation and knowledge with respect to the valuation of insurance and insurance-related businesses which

are similar to Merchants Group.

Under its engagement letter with us dated May 1, 2006, SFRi rendered its written opinion to our board of directors on October 31, 2006, to the effect that, as of the date of the opinion and based upon and subject to the assumptions, qualifications, and limitations set forth in the opinion, the consideration to be received in the proposed merger by the holders of Merchants Group's common stock was fair, from a financial point of view, to them.

The full text of the written opinion of SFRi, dated as of October 31, 2006, which sets forth, among other things, the assumptions made, procedures followed, matters considered and limitations on the scope of the review

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undertaken, is attached as Annex B to this proxy statement and is incorporated herein by reference. You are urged to read the opinion carefully and in its entirety.

SFRi's written opinion has been delivered to Merchants Group's board of directors in connection with and for the purposes of its evaluation of the merger, and addresses only the fairness from a financial point of view of the consideration to be received in the proposed merger by the holders of Merchants Group's common stock as of the date of such opinion and does not address any other aspect of the merger or any other securities of Merchant Group. SFRi's opinion is not intended to be and does not constitute a recommendation to the our board or any of our stockholders as to how our board or stockholders, respectively, should vote, or take any other action, with respect to the merger and should not be relied upon by stockholders of Merchants Group as such. The summary of SFRi's opinion set forth in this proxy statement is qualified in its entirety by reference to the full text of such opinion attached as Annex B hereto, which should be read carefully and in its entirety.

In arriving at its opinion, SFRi, among other things:

reviewed (a) Merchants Group's financial statements included in its annual reports to stockholders on Form 10-K for the fiscal years ended 2003, 2004 and 2005 and Merchants Group's quarterly reports on Form 10-Q for the quarters ended March 31, June 30 and September 30, 2005, and March 31 and June 30, 2006 and (b) internal interim financial statements prepared by Merchants Group for the periods ended July 31, August 31 and September 30, 2006, which Merchants Group's management has identified as being the most current internal financial statements available;

reviewed Merchants Group's statutory annual financial statements for the years ended December 31, 2004 and 2005 and quarterly statutory financial statements for the quarters ended March 31 and June 30, 2006;

reviewed copies of the Services Agreement and Reinsurance Pooling Agreement each between Merchants New Hampshire and Mutual and each dated January 1, 2003;

reviewed the actuarial loss reserve analysis for Merchants Group prepared by Milliman Inc. as of December 31, 2005, various Merchants Group board of director materials prepared during 2006 and rating agency presentation materials;

met with certain members of the senior management of Merchants Group to discuss the operations, financial condition, future prospects and projected operations and performance of Merchants Group, and met and/or spoken telephonically with representatives of Merchants Group's independent accounting firm, investment bankers and counsel to discuss certain matters;

participated in discussions and negotiations among the representatives of Merchants Group and AEG and their financial and legal advisors;

reviewed certain forecasts and projections prepared by Merchants Group's management with respect to Merchants Group for the years ended December 31, 2006 and 2007;

reviewed the historical market prices and trading volume for Merchants Group's publicly traded securities;

reviewed certain other publicly available financial data for certain companies that we deem comparable to Merchants Group, and publicly available prices and premiums paid in other transactions that we considered similar to the merger;

reviewed drafts of certain documents to be delivered at the closing of the merger; and

conducted such other studies, analyses and inquiries as SFRi deemed appropriate.

In SFRi's review and analysis, and in arriving at its opinion, SFRi assumed and relied upon the accuracy and completeness of all of the financial and other information provided to it (including information furnished to SFRi orally or otherwise discussed with SFRi by the management of Merchants Group) or publicly available and neither attempted to verify independently, nor assumed responsibility or liability for verifying, any of such information. SFRi relied upon the assurances of the management of Merchants Group that they are not aware of any facts that would or could be reasonably expected to make such information inaccurate or misleading. Furthermore, SFRi did not obtain, conduct and was not provided with, or assume any responsibility for obtaining or conducting, any

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independent valuation or appraisal of the properties, assets or liabilities (contingent or otherwise) of Merchants Group, nor did SFRi evaluate the solvency of Merchants Group under any state or federal laws relating to bankruptcy, insolvency or similar matters. SFRi is not expert in the evaluation of loss reserves, and did not make any independent evaluation of the adequacy of the loss reserves of Merchants Group and, as a result, assumed that the loss reserves of Merchants Group were adequate.

In relying on the financial forecasts, analyses and projections (and the assumptions and bases therefor) for Merchants Group that were provided to SFRi, SFRi assumed, with Merchants Group's consent, that such forecasts and projections had been reasonably prepared in good faith on the basis of reasonable assumptions and reflected the best currently available estimates and judgments of their respective managements as to the future financial condition and performance of Merchants Group and SFRi further assumed, with Merchants Group's consent, that such projections and forecasts will be realized in the amounts and in the time periods currently estimated. Merchants Group does not publicly disclose internal management projections of the type provided to SFRi in connection with its analysis of the merger, and such projections were not prepared with a view toward public disclosure. These projections were based on numerous variables and assumptions that are inherently uncertain and may be beyond the control of the management of Merchants Group, including, without limitation, factors relating to general economic and competitive conditions and prevailing interest rates. Accordingly, actual results could vary significantly from those set forth in such projections.

SFRi also assumed that the merger will be consummated upon the terms set forth in the Merger Agreement without material alteration or waiver thereof. SFRi assumed in the course of obtaining the necessary regulatory or other consents and approvals (contractual or otherwise) for the merger, no restrictions, including any amendments or modifications, will be imposed that will have a material adverse effect on the contemplated benefits of the merger. In addition, SFRi assumed that the historical financial statements of Merchants Group reviewed by it had been prepared and fairly presented in accordance with U.S. generally accepted accounting principles and statutory accounting principals, as applicable, consistently applied. SFRi further assumed that as of October 31, 2006 there had been no material adverse change in Merchants Group's assets, financial condition, results of operations, business or prospects since the date of the last audited financial statements made available to SFRi.

SFRi's opinion is necessarily based upon market, economic and other conditions as they exist and can be evaluated on, and on the information made available to it as of, October 31, 2006. It should be understood that subsequent developments may affect the conclusion expressed in SFRi's opinion and that SFRi disclaims any undertaking or obligation to update, revise or reaffirm its opinion or otherwise comment upon events occurring after October 31, 2006. SFRi's opinion is limited to the fairness, from a financial point of view and as of the date of its opinion, of the consideration to be paid in the proposed merger to the holders of Merchants Group common stock. SFRi did not express any opinion as to any tax or other consequences that might result from the merger. SFRi was not retained to advise Merchants Group with respect to, nor does its opinion address, the relative merits of the merger compared with any other business strategy that Merchants Group's board of directors has considered or may be considering, nor does it address the underlying business decision of Merchants Group to engage in the merger. SFRi's opinion does not address whether any alternative transaction might produce consideration for Merchants Group's stockholders in excess of the amounts contemplated in the merger. Furthermore, SFRi's opinion does not address any legal or accounting matter, as to which it understands that Merchants Group obtained such advice as it deemed necessary from qualified professionals. SFRi's opinion does not address the accuracy of Merchants Group's forecasts, projections or estimates or the reasonableness of the underlying assumptions on which such forecasts, projections or estimates have been based.

In accordance with customary investment banking practice, SFRi employed generally accepted valuation methods in reaching its opinion. The following is a summary of the material analyses performed by SFRi in connection with rendering SFRi's opinion described above. The following summary, however, does not purport to be a complete description of the financial analyses performed by SFRi, nor does the order of the analyses described represent relative

importance or weight given to those analyses by SFRi. Some of the summaries of the financial analyses include information presented in tabular format. The tables must be read together with the full text of each summary and are not alone a complete description of SFRi's financial analyses. Except as otherwise noted, the following quantitative information, to the extent that it is based on market data, is based on market data as it existed on or before October 31, 2006 and is not necessarily indicative of current market conditions. It is a condition to the

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closing of the merger that the board of directors of Merchants Group receive an opinion dated the closing date that the consideration received in the merger is fair from a financial point of view to the holders of its common stock. The Board anticipates that it will receive a substantially similar opinion from SFRi, dated on the date of the closing of the merger, to the one described above.

Summary of Proposal. SFRi reviewed the financial terms of the proposed transaction. Under the terms of the merger agreement, each share of Merchants Group common stock will be converted into the right to receive \$33 per share, plus any required Dividend Adjustment (collectively, the Merger Consideration) in cash. AEG has no financing contingency in the Merger Agreement and has provided SFRi and the board of directors of Merchants Group with letters describing the sources of its financing for the acquisition.

Historical Trading Value Analysis. As part of its analysis, SFRi reviewed the historical trading statistics of Merchants Group. In its analysis, SFRi noted the following:

Merchants Group stock price has traded within a range of \$27.60 to \$31.95 per share over the latest twelve months ended October 27, 2006, and had an average price over this period of \$29.83 per share;

Over the past five years, the Company's stock price has averaged \$24.86 per share;

The trading volume of Merchants Group has totaled 512,300 shares, and had an average daily volume of 2,025 shares, or 0.10% of the shares outstanding, over the latest twelve months;

Over the past five years, Merchants Group's average daily trading volume was 1,400 shares which represented 0.07% of the outstanding shares;

Merchants Group's historical multiple of price to book value has averaged 0.83 times (with a high of 0.88 times) over the twelve months prior to October 31, 2006 and 0.76 times over the five years prior to October 31, 2006;

The Merger Consideration per share represents a price to book value multiple of 0.92 times (using the latest publicly available book value for Merchants Group), which is a 10.8% premium to the average multiple for the twelve months prior to October 31, 2006, a 21.1% premium over average multiple for the five year period prior to October 31, 2006, and a 4.6% premium to the all-time high book value multiple over the five years prior to October 31, 2006.

Comparable Public Company Analysis. As part of its analysis, SFRi reviewed certain financial information and calculated commonly used valuation measurements for Merchants Group, as applicable, to corresponding information and measurements for groups of selected publicly traded companies.

The companies below were chosen in part due to certain similar characteristics they share with Merchants Group, including operating structure, lines of business, geographical presence, type of distribution and overall size. There are, however, certain characteristics of Merchants Group which are unique to Merchants Group and which SFRi took into account in performing its analysis and issuing its fairness opinion.

These characteristics include the fact that Merchants Group is managed and operated by Mutual under various agreements that are scheduled to expire effective December 31, 2007. Merchants Group has no management or operating infrastructure of its own and is reliant upon Mutual for all aspects of management, facilities and operations. Merchants Group's current financial strength rating from A.M. Best acknowledges the dependent relationship Merchants Group has with Mutual, and in the absence of such an arrangement A.M. Best might have given Merchants

Group a lower rating. As of October 31, 2006, Merchants Group did not have a business plan or strategy in place pursuant to which it could operate independently subsequent to 2007 in the absence of an agreement with Mutual. Accordingly, no estimate of earnings for Merchants Group exists beyond 2007, and since the Services Agreement does not clearly indicate the terms and conditions for any separation from Mutual will take place, the ability to assess Merchants Group's costs associated with any separation and its earnings potential is limited.

Merchants Group has experienced declining revenues due to its reduced share of the Pooled Business resulting from the terms of the Pooling Agreement with Mutual and the absence of any other source of revenues outside of the arrangement with Mutual. The diminished revenues and business profile has adversely impacted the expense ratio at which Merchants Group operates, since certain of the expenses it shares with Mutual under the Services Agreement

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do not vary with relative premium income between the two companies. Further, the earnings of Merchants Group in recent periods have benefited from the release of prior period loss reserves, and in the absence of such loss reserve releases, current year earnings and returns would have been materially less than those reported.

The selected public companies used in the comparable public company analysis can be divided into three groups with each group having particular characteristics that are comparable to Merchants Group. The first group is identified as Mutual Affiliates and was chosen based on similarity of ownership and operating structure (partial ownership by, and operating in conjunction with, respective affiliated mutual insurers) and to a lesser extent based on the type of insurance business written. This group included the following companies:

ALFA Corporation

Donegal Group Inc.

EMC Insurance Group Inc.

Harleysville Group Inc.

The second group of public companies chosen, which is referred to as Small Cap Companies, and which generally included property-casualty companies with market capitalizations less than \$200 million. Smaller market capitalization companies were relevant to SFRi's analysis because these companies have limited liquidity caused by limited publicly traded shares, and limited or no coverage by research analysts, factors which can adversely affect these companies' public market valuations as compared to companies with larger market valuations which typically have greater liquidity in the market for their shares and broader research analyst coverage. These companies include:

North Pointe Holdings Corporation

Mercer Insurance Group, Inc.

National Atlantic Holdings Corporation

Specialty Underwriters Alliance, Inc.

The third group included one company which was chosen due to similarities it had to Merchants Group for a period in its history. This situation is referred to as the Arch Capital Group Case Study. From January 2000 until October 2001, Arch Capital Group, following the sale of its operating assets, operated as an insurance holding company with no ongoing operations.

Collectively, Mutual Affiliates, the Small Cap Companies, and the Arch Capital Group Case Study are referred to in this proxy as the comparable public companies. While noting that none of the comparable public companies listed above are identical to Merchants Group, SFRi selected these companies because they are publicly traded companies with similar characteristics that, for purposes of this analysis, are considered comparable to those of Merchants Group.

When comparing Merchants Group to the comparable public companies, SFRi noted certain financial performance and other measures between Merchants Group and the comparable public companies which were relevant to its analysis. These financial performance and other measures included:

Merchants Group's ownership percentage by Mutual of Merchants Group is 12% as compared to a range of 47% to 57% for the group of Mutual Affiliates;

