

MEADOWBROOK INSURANCE GROUP INC  
Form 10-Q  
August 09, 2011

---

---

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

---

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2011

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 1-14094

Meadowbrook Insurance Group, Inc.  
(Exact name of Registrant as specified in its charter)

Michigan  
(State of Incorporation)

38-2626206  
(IRS Employer Identification No.)

26255 American Drive, Southfield, Michigan 48034

(Address, zip code of principal executive offices)

(248) 358-1100

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company

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

The aggregate number of shares of the Registrant's Common Stock, \$.01 par value, outstanding on August 2, 2011, was 52,875,204.

---

---

---

## TABLE OF CONTENTS

|                                | Page   |
|--------------------------------|--|
| PART I – FINANCIAL INFORMATION |  |
| ITEM 1 –                       | FINANCIAL STATEMENTS   |
|                                | <u>Consolidated Statements of Income (unaudited)</u> 2-3   |
|                                | <u>Consolidated Statements of Comprehensive Income (unaudited)</u> 4                               |
|                                | <u>Consolidated Balance Sheets (unaudited)</u> 5   |
|                                | <u>Consolidated Statement of Shareholders' Equity (unaudited)</u> 6                                |
|                                | <u>Consolidated Statement of Cash Flows (unaudited)</u> 7  |
|                                | <u>Notes to Consolidated Financial Statements (unaudited)</u> 8-27                                 |
| ITEM 2 –                       | <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u> 28-44 |
| ITEM 3 –                       | <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u> 44-46                            |
| ITEM 4 –                       | <u>CONTROLS AND PROCEDURES</u> 47  |
| PART II – OTHER INFORMATION    |  |
| ITEM 1 –                       | <u>LEGAL PROCEEDINGS</u> 48  |
| ITEM 1A –                      | <u>RISK FACTORS</u> 48   |
| ITEM 2 –                       | <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u> 48                              |
| ITEM 6 –                       | <u>EXHIBITS</u> 49   |
|                                | <u>SIGNATURES</u> 50   |

TABLE OF CONTENTS

## PART 1 - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF INCOME

For the Three Months Ended June 30,

|   | 2011                              | 2010      |
|---|-----------------------------------|-----------|
|   | (Unaudited)                       |           |
|   | (In thousands, except share data) |           |
| Revenues  |                                   |           |
| Premiums earned   |                                   |           |
| Gross   | \$209,676                         | \$192,789 |
| Ceded   | (28,206 )                         | (30,029 ) |
| Net earned premiums   | 181,470                           | 162,760   |
| Net commissions and fees  | 7,897                             | 7,135     |
| Net investment income   | 13,765                            | 13,454    |
| Realized gains (losses):  |                                   |           |
| Total other-than-temporary impairments on securities                        | -                                 | (106 )    |
| Portion of loss recognized in other comprehensive income                    | -                                 | -         |
| Net other-than-temporary impairments on securities recognized in earnings   | -                                 | (106 )    |
| Net realized gains excluding other-than-temporary impairments on securities | 1,094                             | 398       |
| Net realized gains  | 1,094                             | 292       |
| Total revenues  | 204,226                           | 183,641   |
| Expenses  |                                   |           |
| Losses and loss adjustment expenses   | 141,356                           | 119,576   |
| Reinsurance recoveries  | (19,953 )                         | (20,364 ) |
| Net losses and loss adjustment expenses                                     | 121,403                           | 99,212    |
| Policy acquisition and other underwriting expenses                          | 62,450                            | 57,370    |
| General, selling and administrative expenses                                | 5,631                             | 5,321     |
| General corporate expenses  | (719 )                            | 1,269     |
| Amortization expense  | 1,206                             | 1,121     |
| Interest expense  | 2,082                             | 2,411     |
| Total expenses  | 192,053                           | 166,704   |
| Income before taxes and equity earnings                                     | 12,173                            | 16,937    |
| Federal and state income tax expense  | 2,408                             | 4,738     |
| Equity earnings of affiliates, net of tax                                   | 173                               | 644       |
| Equity earnings of unconsolidated subsidiaries, net of tax                  | 1                                 | 18        |
| Net income  | \$9,939                           | \$12,861  |
| Earnings Per Share  |                                   |           |
| Basic   | \$0.19                            | \$0.24    |
| Diluted   | \$0.19                            | \$0.24    |
| Weighted average number of common shares                                    |                                   |           |

Edgar Filing: MEADOWBROOK INSURANCE GROUP INC - Form 10-Q

|                                 |            |            |
|---------------------------------|------------|------------|
| Basic                           | 53,100,479 | 54,018,868 |
| Diluted                         | 53,248,573 | 54,268,668 |
| Dividends paid per common share | \$0.04     | \$0.03     |

The accompanying notes are an integral part of the Consolidated Financial Statements.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF INCOME

For the Six Months Ended June 30,

|   | 2011                              | 2010       |
|---|-----------------------------------|------------|
|   | (Unaudited)                       |            |
|   | (In thousands, except share data) |            |
| Revenues  |                                   |            |
| Premiums earned   |                                   |            |
| Gross   | \$410,362                         | \$372,402  |
| Ceded   | (58,234 )                         | (58,201 )  |
| Net earned premiums   | 352,128                           | 314,201    |
| Net commissions and fees  | 16,335                            | 17,003     |
| Net investment income   | 27,337                            | 26,483     |
| Realized gains (losses):  |                                   |            |
| Total other-than-temporary impairments on securities                        | (84 )                             | (411 )     |
| Portion of loss recognized in other comprehensive income                    | -                                 | -          |
| Net other-than-temporary impairments on securities recognized in earnings   | (84 )                             | (411 )     |
| Net realized gains excluding other-than-temporary impairments on securities | 1,990                             | 569        |
| Net realized gains  | 1,906                             | 158        |
| Total revenues  | 397,706                           | 357,845    |
| Expenses  |                                   |            |
| Losses and loss adjustment expenses   | 270,079                           | 218,897    |
| Reinsurance recoveries  | (43,414 )                         | (32,205 )  |
| Net losses and loss adjustment expenses                                     | 226,665                           | 186,692    |
| Policy acquisition and other underwriting expenses                          | 119,888                           | 109,249    |
| General, selling and administrative expenses                                | 11,875                            | 11,227     |
| General corporate expenses  | 636                               | 3,246      |
| Amortization expense  | 2,438                             | 2,522      |
| Interest expense  | 4,254                             | 4,854      |
| Total expenses  | 365,756                           | 317,790    |
| Income before taxes and equity earnings                                     | 31,950                            | 40,055     |
| Federal and state income tax expense  | 8,119                             | 12,396     |
| Equity earnings of affiliates, net of tax                                   | 1,246                             | 1,166      |
| Equity earnings of unconsolidated subsidiaries, net of tax                  | (22 )                             | 470        |
| Net income  | \$25,055                          | \$29,295   |
| Earnings Per Share  |                                   |            |
| Basic   | \$0.47                            | \$0.54     |
| Diluted   | \$0.47                            | \$0.53     |
| Weighted average number of common shares                                    |                                   |            |
| Basic   | 53,175,824                        | 54,642,127 |
| Diluted   | 53,323,802                        | 54,887,561 |
| Dividends paid per common share   | \$0.08                            | \$0.06     |

The accompanying notes are an integral part of the Consolidated Financial Statements.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Three Months Ended June 30,

|  | 2011           | 2010     |
|--|----------------|----------|
|  | (Unaudited)    |          |
|  | (In thousands) |          |
| Net income   | \$9,939        | \$12,861 |
| Other comprehensive income, net of tax:  |                |          |
| Unrealized gains on securities   | 13,528         | 13,469   |
| Unrealized gains (losses) in affiliates and unconsolidated subsidiaries          | 50             | (7 )     |
| (Decrease) increase on non-credit other-than-temporary impairments on securities | (231 )         | 1,092    |
| Net deferred derivative losses - hedging activity                                | (381 )         | (447 )   |
| Less reclassification adjustment for investment gains included in net income     | (1,070 )       | (216 )   |
| Other comprehensive gains, net of tax  | 11,896         | 13,891   |
| Comprehensive income   | \$21,835       | \$26,752 |

## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Six Months Ended June 30,

|  | 2011           | 2010     |
|--|----------------|----------|
|  | (Unaudited)    |          |
|  | (In thousands) |          |
| Net income   | \$25,055       | \$29,295 |
| Other comprehensive income, net of tax:                                      |                |          |
| Unrealized gains on securities   | 11,148         | 18,267   |
| Unrealized (losses) gains in affiliates and unconsolidated subsidiaries      | (1 )           | 140      |
| Increase on non-credit other-than-temporary impairments on securities        | 85             | 485      |
| Net deferred derivative gains (losses) - hedging activity                    | 285            | (625 )   |
| Less reclassification adjustment for investment gains included in net income | (1,880 )       | (60 )    |
| Other comprehensive gains, net of tax  | 9,637          | 18,207   |
| Comprehensive income   | \$34,692       | \$47,502 |

The accompanying notes are an integral part of the Consolidated Financial Statements.



TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

|  | June 30,<br>2011<br>(Unaudited)      | December<br>31,<br>2010 |
|--|--------------------------------------|-------------------------|
|  | (In thousands, except<br>share data) |                         |
| <b>ASSETS</b>  |                                      |                         |
| <b>Investments</b>   |                                      |                         |
| Debt securities available for sale, at fair value (amortized cost of \$1,228,767 and \$1,170,795)                        | \$1,297,993                          | \$1,226,360             |
| Equity securities available for sale, at fair value (cost of \$26,135 and \$25,632)                                      | 29,664                               | 28,483                  |
| Cash and cash equivalents  | 77,122                               | 90,414                  |
| Accrued investment income  | 13,882                               | 13,021                  |
| Premiums and agent balances receivable, net  | 195,500                              | 169,866                 |
| Reinsurance recoverable on:  |                                      |                         |
| Paid losses  | 9,854                                | 13,342                  |
| Unpaid losses  | 296,113                              | 280,854                 |
| Prepaid reinsurance premiums   | 28,500                               | 28,208                  |
| Deferred policy acquisition costs  | 84,833                               | 78,755                  |
| Deferred income taxes, net   | 616                                  | 5,569                   |
| Goodwill   | 118,842                              | 118,842                 |
| Other intangible assets  | 34,328                               | 36,637                  |
| Other assets   | 93,759                               | 87,290                  |
| <b>Total assets</b>  | <b>\$2,281,006</b>                   | <b>\$2,177,641</b>      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                                      |                         |
| <b>Liabilities</b>   |                                      |                         |
| Losses and loss adjustment expenses  | \$1,125,216                          | \$1,065,056             |
| Unearned premiums  | 379,842                              | 352,585                 |
| Debt   | 31,250                               | 37,750                  |
| Debentures   | 80,930                               | 80,930                  |
| Accounts payable and accrued expenses  | 39,860                               | 38,645                  |
| Funds held and reinsurance balances payable  | 31,649                               | 28,824                  |
| Payable to insurance companies   | 5,127                                | 2,754                   |
| Other liabilities  | 14,096                               | 23,996                  |
| <b>Total liabilities</b>   | <b>1,707,970</b>                     | <b>1,630,540</b>        |
| <b>Shareholders' Equity</b>  |                                      |                         |
| Common stock, \$0.01 stated value; authorized 75,000,000 shares; 52,875,204 and 53,236,542 shares issued and outstanding | 516                                  | 520                     |
| Additional paid-in capital   | 289,902                              | 292,705                 |
| Retained earnings  | 238,387                              | 219,298                 |
| Note receivable from officer   | (781)                                | (797)                   |
| Accumulated other comprehensive income   | 45,012                               | 35,375                  |

Edgar Filing: MEADOWBROOK INSURANCE GROUP INC - Form 10-Q

|  |             |             |
|--|-------------|-------------|
| Total shareholders' equity                 | 573,036     | 547,101     |
| Total liabilities and shareholders' equity | \$2,281,006 | \$2,177,641 |

The accompanying notes are an integral part of the Consolidated Financial Statements.

5

---

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

|   | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Note<br>Receivable<br>from<br>Officer | Accumulated<br>Other<br>Comprehensive<br>Income | Total<br>Shareholders'<br>Equity |
|---|-----------------|----------------------------------|----------------------|---------------------------------------|---|----------------------------------|
| (Unaudited, In thousands)   |                 |                                  |                      |                                       |   |                                  |
| Balances December 31, 2010  | \$520           | \$292,705                        | \$219,298            | \$(797 )                              | \$ 35,375                                       | \$ 547,101                       |
| Net income  | -               | -                                | 25,055               | -                                     | -   | 25,055                           |
| Dividends declared and paid   | -               | -                                | (4,262 )             | -                                     | -   | (4,262 )                         |
| Change in unrealized on<br>available for sale securities,<br>net of tax | -               | -                                | -                    | -                                     | 9,320   | 9,320                            |
| Change in valuation<br>allowance on deferred tax<br>assets              | -               | -                                | -                    | -                                     | 33  | 33                               |
| Net deferred derivative gain -<br>hedging activity                      | -               | -                                | -                    | -                                     | 285   | 285                              |
| Stock award   | -               | 366                              | -                    | -                                     | -   | 366                              |
| Long term incentive plan;<br>stock award for 2009-2011<br>plan years    | -               | (973 )                           | -                    | -                                     | -   | (973 )                           |
| Change in investment of<br>affiliates, net of tax                       | -               | -                                | -                    | -                                     | (1 )  | (1 )                             |
| Repurchase of 400,000 shares<br>of common stock                         | (4 )            | (2,196 )                         | (1,704 )             | -                                     | -   | (3,904 )                         |
| Note receivable from officer  | -               | -                                | -                    | 16                                    | -   | 16                               |
| Balances June 30, 2011  | \$516           | \$289,902                        | \$238,387            | \$(781 )                              | \$ 45,012                                       | \$ 573,036                       |

The accompanying notes are an integral part of the Consolidated Financial Statements.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Six Months Ended June 30,

|   | 2011           | 2010       |
|---|----------------|------------|
|   | (Unaudited)    |            |
|   | (In thousands) |            |
| Cash Flows From Operating Activities  |                |            |
| Net income  | \$25,055       | \$29,295   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                |            |
| Amortization of other intangible assets   | 2,438          | 2,522      |
| Amortization of deferred debenture issuance costs                                 | 63             | 132        |
| Depreciation of furniture, equipment, and building                                | 2,697          | 2,793      |
| Net amortization of discount and premiums on bonds                                | 1,829          | 1,759      |
| Gain on sale of investments, net  | (1,880 )       | (60 )      |
| Gain on sale of fixed assets  | (44 )          | (44 )      |
| Long-term incentive plan expense  | (973 )         | 501        |
| Stock award   | 366            | 385        |
| Equity earnings of affiliates, net of taxes                                       | (1,246 )       | (1,166 )   |
| Equity loss (earnings) of unconsolidated subsidiaries, net of tax                 | 22             | (470 )     |
| Deferred income tax expense   | (185 )         | (37 )      |
| Changes in operating assets and liabilities:                                      |                |            |
| Decrease (increase) in:   |                |            |
| Premiums and agent balances receivable  | (25,634 )      | (25,181 )  |
| Reinsurance recoverable on paid and unpaid losses                                 | (11,771 )      | (11,467 )  |
| Prepaid reinsurance premiums  | (292 )         | 1,258      |
| Deferred policy acquisition costs   | (6,078 )       | (8,539 )   |
| Other assets  | (285 )         | (2,953 )   |
| Increase (decrease) in:   |                |            |
| Losses and loss adjustment expenses   | 60,160         | 63,479     |
| Unearned premiums   | 27,257         | 24,592     |
| Payable to insurance companies  | 2,373          | (438 )     |
| Funds held and reinsurance balances payable                                       | 2,825          | 218        |
| Other liabilities   | (14,826 )      | (3,687 )   |
| Total adjustments   | 36,816         | 43,597     |
| Net cash provided by operating activities   | 61,871         | 72,892     |
| Cash Flows From Investing Activities  |                |            |
| Purchase of debt securities available for sale                                    | (133,777 )     | (116,523 ) |
| Proceeds from sales and maturities of debt securities available for sale          | 78,352         | 49,366     |
| Proceeds from sales of equity securities available for sale                       | 200            | 420        |
| Capital expenditures  | (3,970 )       | (2,379 )   |
| Acquisition of rights renewals  | (129 )         | (148 )     |
| Other investing activities  | 592            | (286 )     |
| Net cash used in investing activities   | (58,732 )      | (69,550 )  |
| Cash Flows From Financing Activities  |                |            |
| Payment of lines of credit  | (6,500 )       | (5,625 )   |
| Book overdrafts   | (1,785 )       | 933        |
| Dividends paid on common stock  | (4,262 )       | (3,272 )   |

|  |           |           |
|--|-----------|-----------|
| Cash payment for payroll taxes associated with long-term incentive plan net stock issuance | -         | (35 )     |
| Share repurchases  | (3,904 )  | (17,130 ) |
| Other financing activities   | 20        | (69 )     |
| Net cash used in financing activities  | (16,431 ) | (25,198 ) |
| Net decrease in cash and cash equivalents  | (13,292 ) | (21,856 ) |
| Cash and cash equivalents, beginning of period   | 90,414    | 86,319    |
| Cash and cash equivalents, end of period   | \$77,122  | \$64,463  |
| Supplemental Disclosure of Cash Flow Information:  |           |           |
| Interest paid  | \$4,070   | \$4,193   |
| Net income taxes paid (1)  | \$14,678  | \$16,601  |
| Supplemental Disclosure of Non-Cash Investing and Financing Activities:                    |           |           |
| Stock-based employee compensation  | \$366     | \$385     |

(1) In first quarter 2011, \$731,795 was received for amended tax return refunds.

The accompanying notes are an integral part of the Consolidated Financial Statements.

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 1 –Summary of Significant Accounting Policies

Basis of Presentation and Management Representation

The consolidated financial statements include accounts, after elimination of intercompany accounts and transactions, of Meadowbrook Insurance Group, Inc. (the “Company” or “Meadowbrook”), its wholly owned subsidiary Star Insurance Company (“Star”), and Star’s wholly owned subsidiaries, Savers Property and Casualty Insurance Company (“Savers”), Williamsburg National Insurance Company (“Williamsburg”), and Ameritrust Insurance Corporation (“Ameritrust”). The consolidated financial statements also include Meadowbrook, Inc., Crest Financial Corporation, and their respective subsidiaries. In addition, the consolidated financial statements also include ProCentury Corporation (“ProCentury”) and its wholly owned subsidiaries. ProCentury’s wholly owned subsidiaries consist of Century Surety Company (“Century”) and its wholly owned subsidiary ProCentury Insurance Company (“PIC”). In addition, ProCentury Risk Partners Insurance Company, Ltd., is a wholly owned subsidiary of ProCentury. Star, Savers, Williamsburg, Ameritrust, Century, and PIC are collectively referred to as the Insurance Company Subsidiaries.

In the opinion of management, the consolidated financial statements reflect all normal recurring adjustments necessary to present a fair statement of the results for the interim period. Preparation of financial statements under generally accepted accounting principles (“GAAP”) requires management to make estimates. Actual results could differ from those estimates. The results of operations for the three months and six months ended June 30, 2011 are not necessarily indicative of the results expected for the full year.

These financial statements and the notes thereto should be read in conjunction with the Company’s audited financial statements and accompanying notes included in its Annual Report on Form 10-K, as filed with the United States Securities and Exchange Commission, for the year ended December 31, 2010.

Revenue Recognition

Premiums written, which include direct, assumed and ceded amounts are recognized as earned on a pro rata basis over the life of the policy term. Unearned premiums represent the portion of premiums written that are applicable to the unexpired terms of policies in force. Provisions for unearned premiums on reinsurance assumed from others are made on the basis of ceding reports when received and actuarial estimates.

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Assumed premium estimates are specifically related to an established book of workers compensation business on which the Company has established an equity ownership relationship and the mandatory assumed pool business from the National Council on Compensation Insurance (“NCCI”), or residual market business. The pool cedes workers’ compensation business to participating companies based upon the individual company’s market share by state. The activity is reported from the NCCI to participating companies on a two quarter lag. To accommodate this lag, the Company estimates premium and loss activity based on historical and market based results. Historically, the Company has not experienced any material difficulties or disputes in collecting balances from NCCI; therefore, no provision for doubtful accounts is recorded related to the assumed premium estimate.

Fee income, which includes risk management consulting, loss control, and claims services, is recognized during the period the services are provided. Depending on the terms of the contract, claims processing fees are recognized as revenue over the estimated life of the claims, or the estimated life of the contract. For those contracts that provide services beyond the expiration or termination of the contract, fees are deferred in an amount equal to management’s estimate of the Company’s obligation to continue to provide services in the future.

Commission income, which includes reinsurance placement, is recorded on the later of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of any sub-producer commission expense. Any commission adjustments that occur subsequent to the earnings process are recognized upon notification from the insurance companies. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

Income Taxes

As of June 30, 2011 and December 31, 2010, the Company did not have any unrecognized tax benefits.

Interest costs and penalties related to income taxes are classified as interest expense and other administrative expenses, respectively. As of June 30, 2011 and December 31, 2010, the Company had no accrued interest or penalties related to uncertain tax positions.

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Recent Accounting Pronouncements

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

In October 2010, the Financial Accounting Standards Board (“FASB”) issued guidance to assist in a consistent application of accounting for costs related to acquiring or renewing insurance contracts among industry practice. The new guidance restricts the capitalization of a contract’s acquisition costs to those that are directly related to the successful acquisition of a new or renewing insurance contract. The new guidance is effective for interim and annual reporting periods beginning after December 15, 2011. The Company is still evaluating the impact of adoption on its financial condition and results of operations.

Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs

In May 2011, the FASB issued guidance to achieve common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and International Financial Reporting Standards (IFRSs). The guidance explains how to measure fair value and does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting. The guidance is to be applied prospectively for interim and annual periods beginning after December 15, 2011. The Company is still evaluating the impact of adoption on its financial condition and results of operations

Presentation of Comprehensive Income

In June 2011, the FASB issued guidance to increase the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders’ equity. The guidance requires that all nonowner changes in stockholders’ equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance is to be applied retrospectively and is effective for interim and annual periods beginning after December 15, 2011, with early adoption permitted. The Company has not yet adopted this guidance and will not have a material impact on its financial condition and results of operations.



TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

## NOTE 2 – Investments

The estimated fair value of investments in securities is determined primarily based upon published market quotations and broker/dealer quotations. The cost or amortized cost, gross unrealized gains, losses, non-credit other-than-temporary impairments (“OTTI”) and estimated fair value of investments in securities classified as available for sale at June 30, 2011 and December 31, 2010 were as follows (in thousands):

|  | Cost or<br>Amortized<br>Cost | Gains    | June 30, 2011<br>Gross Unrealized |                    | Estimated<br>Fair Value |
|--|------------------------------|----------|-----------------------------------|--------------------|-------------------------|
|  |                              |          | Losses                            | Non-Credit<br>OTTI |                         |
| <b>Debt Securities:</b>                    |                              |          |                                   |                    |                         |
| U.S. Government and agencies               | \$23,323                     | \$1,379  | \$(6)                             | \$-                | \$24,696                |
| Obligations of states and political subs   | 541,941                      | 30,152   | (510)                             | -                  | 571,583                 |
| Corporate securities                       | 432,085                      | 24,741   | (749)                             | -                  | 456,077                 |
| Redeemable preferred stocks                | 1,924                        | 492      | -                                 | -                  | 2,416                   |
| Residential mortgage-backed securities     | 173,964                      | 11,922   | (515)                             | (102)              | 185,269                 |
| Commercial mortgage-backed securities      | 39,829                       | 1,461    | (155)                             | -                  | 41,135                  |
| Other asset-backed securities              | 15,701                       | 1,717    | (31)                              | (570)              | 16,817                  |
| Total debt securities available for sale   | 1,228,767                    | 71,864   | (1,966)                           | (672)              | 1,297,993               |
| <b>Equity Securities:</b>                  |                              |          |                                   |                    |                         |
| Perpetual preferred stock                  | 10,824                       | 2,509    | -                                 | -                  | 13,333                  |
| Common stock                               | 15,311                       | 1,373    | (353)                             | -                  | 16,331                  |
| Total equity securities available for sale | 26,135                       | 3,882    | (353)                             | -                  | 29,664                  |
| Total securities available for sale        | \$1,254,902                  | \$75,746 | \$(2,319)                         | \$(672)            | \$1,327,657             |

|  | Cost or<br>Amortized<br>Cost | Gains   | December 31, 2010<br>Gross Unrealized |                    | Estimated<br>Fair Value |
|--|------------------------------|---------|---------------------------------------|--------------------|-------------------------|
|  |                              |         | Losses                                | Non-Credit<br>OTTI |                         |
| <b>Debt Securities:</b>                  |                              |         |                                       |                    |                         |
| U.S. Government and agencies             | \$25,375                     | \$1,363 | \$(24)                                | \$-                | \$26,714                |
| Obligations of states and political subs | 527,080                      | 22,176  | (2,125)                               | -                  | 547,131                 |
| Corporate securities                     | 379,974                      | 21,555  | (1,355)                               | (3)                | 400,171                 |
| Redeemable preferred stocks              | 3,368                        | 1,044   | -                                     | -                  | 4,412                   |
| Residential mortgage-backed securities   | 181,966                      | 12,182  | (694)                                 | (151)              | 193,303                 |
| Commercial mortgage-backed securities    | 34,942                       | 1,236   | (478)                                 | -                  | 35,700                  |
| Other asset-backed securities            | 18,090                       | 1,476   | (33)                                  | (604)              | 18,929                  |
| Total debt securities available for sale | 1,170,795                    | 61,032  | (4,709)                               | (758)              | 1,226,360               |
| <b>Equity Securities:</b>                |                              |         |                                       |                    |                         |
| Perpetual preferred stock                | 10,869                       | 2,006   | (6)                                   | -                  | 12,869                  |
| Common stock                             | 14,763                       | 1,255   | (404)                                 | -                  | 15,614                  |

Edgar Filing: MEADOWBROOK INSURANCE GROUP INC - Form 10-Q

|  |             |          |          |   |        |               |
|--|-------------|----------|----------|---|--------|---------------|
| Total equity securities available for sale | 25,632      | 3,261    | (410     | ) | -      | 28,483        |
| Total securities available for sale        | \$1,196,427 | \$64,293 | \$(5,119 | ) | \$(758 | ) \$1,254,843 |

11

---

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Gross unrealized gains, losses, and non-credit OTTI on available for sale securities as of June 30, 2011 and December 31, 2010 were as follows (in thousands):

|   | June 30,<br>2011 | December<br>31, 2010 |
|---|------------------|----------------------|
| Unrealized gains  | \$ 75,746        | \$ 64,293            |
| Unrealized losses   | (2,319 )         | (5,119 )             |
| Non-credit OTTI   | (672 )           | (758 )               |
| Net unrealized gains  | 72,755           | 58,416               |
| Deferred federal income tax expense                                       | (25,464 )        | (20,445 )            |
| Net unrealized gains on investments, net of deferred federal income taxes | \$ 47,291        | \$ 37,971            |

Net realized gains (losses including OTTI) on securities, for the three months and six months ended June 30, 2011 and 2010 were as follows (in thousands):

|  | For the Three Months<br>Ended June 30, |        | For the Six Months<br>Ended June 30, |        |
|--|--|--------|--------------------------------------|--------|
|  | 2011                                   | 2010   | 2011                                 | 2010   |
| Realized gains (losses):                             |  |        |                                      |        |
| Debt securities:                                     |  |        |                                      |        |
| Gross realized gains                                 | \$ 942                                 | \$ 225 | \$ 1,866                             | \$ 373 |
| Gross realized losses                                | (27 )                                  | (54 )  | (141 )                               | (368 ) |
| Total debt securities                                | 915                                    | 171    | 1,725                                | 5      |
| Equity securities:                                   |  |        |                                      |        |
| Gross realized gains                                 | 154                                    | 106    | 154                                  | 116    |
| Gross realized losses                                | -                                      | (61 )  | -                                    | (61 )  |
| Total equity securities                              | 154                                    | 45     | 154                                  | 55     |
| Net realized gains                                   | \$ 1,069                               | \$ 216 | \$ 1,879                             | \$ 60  |
| OTTI included in realized losses on securities above | \$ -                                   | \$ 106 | \$ (84 )                             | \$ 411 |

Proceeds from the sales of fixed maturity securities available for sale were \$11.1 million and \$0.7 million for the three months ended June 30, 2011 and 2010, respectively. Proceeds from the sales of fixed maturity securities available for sale were \$27.4 million and \$1.1 million for the six months ended June 30, 2011 and 2010, respectively.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

At June 30, 2011, the amortized cost and estimated fair value of available for sale debt securities by contractual maturity are shown below. Expected maturities may differ from contractual maturities, because certain borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands):

|  | Available for Sale |                         |
|--|--------------------|-------------------------|
|  | Amortized<br>Cost  | Estimated Fair<br>Value |
| Due in one year or less  | \$ 33,863          | \$ 34,393               |
| Due after one year through five years  | 257,075            | 268,758                 |
| Due after five years through ten years   | 584,531            | 623,341                 |
| Due after ten years  | 123,804            | 128,280                 |
| Mortgage-backed securities, collateralized obligations and asset-backed securities | 229,494            | 243,221                 |
|  | \$ 1,228,767       | \$ 1,297,993            |

Net investment income for the three months and six months ended June 30, 2011 and 2010 was as follows (in thousands):

|                               | For the Three Months<br>Ended June 30, |           | For the Six Months<br>Ended June 30, |           |
|-------------------------------|--|-----------|--------------------------------------|-----------|
|                               | 2011                                   | 2010      | 2011                                 | 2010      |
| Net Investment Income Earned  |  |           |                                      |           |
| From:                         |  |           |                                      |           |
| Debt securities               | \$ 13,436                              | \$ 12,970 | \$ 26,628                            | \$ 25,550 |
| Equity Securities             | 473                                    | 525       | 979                                  | 1,061     |
| Cash and cash equivalents     | 174                                    | 226       | 390                                  | 409       |
| Total gross investment income | 14,083                                 | 13,721    | 27,997                               | 27,020    |
| Less investment expenses      | 318                                    | 267       | 660                                  | 537       |
| Net investment income         | \$ 13,765                              | \$ 13,454 | \$ 27,337                            | \$ 26,483 |

## Other-Than-Temporary Impairments of Securities and Unrealized Losses on Investments

Available for sale securities are reviewed for declines in fair value that are determined to be other-than-temporary. For a debt security, if the Company intends to sell a security and it is more likely than not the Company will be required to sell a debt security before recovery of its amortized cost basis and the fair value of the debt security is below amortized cost, the Company concludes that an OTTI has occurred and the amortized cost is written down to current fair value, with a corresponding charge to realized loss in the Consolidated Statements of Income. If the Company does not intend to sell a debt security and it is not more likely than not the Company will be required to sell a debt security before recovery of its amortized cost basis but the present value of the cash flows expected to be collected is less than the amortized cost of the debt security (referred to as the credit loss), the Company concludes that an OTTI has occurred. In this instance, accounting guidance requires the bifurcation of the total OTTI into the amount related to the credit loss, which is recognized in earnings and the non-credit OTTI, which is recorded in Other Comprehensive Income as an unrealized non-credit OTTI in the Consolidated Statements of Comprehensive Income.



TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

When assessing the Company's intent to sell a debt security, if it is more likely than not the Company will be required to sell a debt security before recovery of its cost basis, facts and circumstances such as, but not limited to, decisions to reposition the security portfolio, sale of securities to meet cash flow needs and sales of securities to capitalize on favorable pricing, are evaluated. In order to determine the amount of the credit loss for a debt security, the Company calculates the recovery value by performing a discounted cash flow analysis based on the current cash flows and future cash flows expected to be recovered. The discount rate is the effective interest rate implicit in the underlying debt security upon issuance. The effective interest rate is the original yield or the coupon if the debt security was previously impaired. If an OTTI exists and there is not sufficient cash flows or other information to determine a recovery value of the security, the Company concludes that the entire OTTI is credit-related and the amortized cost for the security is written down to current fair value with a corresponding charge to realized loss in the Consolidated Statements of Income.

To determine the recovery period of a debt security, the Company considers the facts and circumstances surrounding the underlying issuer including, but not limited to the following:

- Historical and implied volatility of the security;
- Length of time and extent to which the fair value has been less than amortized cost;
- Conditions specifically related to the security such as default rates, loss severities, loan to value ratios, current levels of subordination, third party guarantees, and vintage;
- Specific conditions in an industry or geographic area;
- Any changes to the rating of the security by a rating agency;
- Failure, if any, of the issuer of the security to make scheduled payments; and
- Recoveries or additional declines in fair value subsequent to the balance sheet date.

In periods subsequent to the recognition of an OTTI, the security is accounted for as if it had been purchased on the measurement date of the OTTI. Therefore, for a fixed maturity security, the discount or reduced premium is reflected in net investment income over the contractual term of the investment in a manner that produces a constant effective yield.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

For an equity security, if the Company does not have the ability and intent to hold the security for a sufficient period of time to allow for a recovery in value, the Company concludes that an OTTI has occurred, and the cost of the equity security is written down to the current fair value, with a corresponding charge to realized loss within the Consolidated Statements of Income. When assessing the Company's ability and intent to hold the equity security to recovery, the Company considers, among other things, the severity and duration of the decline in fair value of the equity security, as well as the cause of decline, a fundamental analysis of the liquidity, business prospects and overall financial condition of the issuer.

After reviewing the Company's investment portfolio in relation to this policy, the Company did not record any credit OTTI for the three months ended June 30, 2011. The Company recorded \$84,000 of credit OTTI for the six months ended June 30, 2011. No non-credit related OTTI were recognized for the three months and six months ended June 30, 2011 in other comprehensive income. For the three months and six months ended June 30, 2010, the Company recorded an OTTI loss of \$106,000 and \$411,000, respectively, of which no non-credit related OTTI losses were recognized in other comprehensive income.

The fair value and amount of unrealized losses segregated by the time period the investment has been in an unrealized loss position were as follows (in thousands):

|   | June 30, 2011  |   |   |   |  |   |
|---|--|---|---|---|--|---|
|   | Less than 12 months<br>Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses<br>(69<br>Securities) |   | Greater than 12 months<br>Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses<br>(15<br>Securities) |   | Total<br>Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses<br>(84<br>Securities) |   |
|   | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI  | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI   | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI  | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI |
| <b>Debt Securities:</b>                     |  |   |   |   |  |   |
| U.S. Government and agencies                | \$ 169   | \$(6 )  | \$-   | \$-   | \$ 169   | \$(6 )  |
| Obligations of states and<br>political subs | 31,820   | (509 )  | 185   | (1 )  | 32,005   | (510 )  |
| Corporate securities                        | 55,411   | (749 )  | -   | -   | 55,411   | (749 )  |
| Redeemable preferred stocks                 | -  | -   | -   | -   | -  | -   |
| Residential mortgage-backed<br>securities   | 18,880   | (515 )  | 3,673   | (102 )  | 22,553   | (617 )  |
| Commercial mortgage-backed<br>securities    | 8,734  | (77 )   | 535   | (78 )   | 9,269  | (155 )  |
| Other asset-backed securities               | 1,113  | (20 )   | 2,379   | (581 )  | 3,492  | (601 )  |
| Total debt securities                       | 116,127  | (1,876 )  | 6,772   | (762 )  | 122,899  | (2,638 )  |
| <b>Equity Securities:</b>                   |  |   |   |   |  |   |
| Perpetual preferred stock                   | -  | -   | -   | -   | -  | -   |
| Common stock                                | 48   | -   | 5,098   | (353 )  | 5,146  | (353 )  |
| Total equity securities                     | 48   | -   | 5,098   | (353 )  | 5,146  | (353 )  |

|                  |           |          |   |          |          |   |           |          |   |
|------------------|-----------|----------|---|----------|----------|---|-----------|----------|---|
| Total securities | \$116,175 | \$(1,876 | ) | \$11,870 | \$(1,115 | ) | \$128,045 | \$(2,991 | ) |
|------------------|-----------|----------|---|----------|----------|---|-----------|----------|---|



TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

|   | Less than 12 months   |   | December 31, 2010   |   | Total   |   |
|---|---|---|---|---|---|---|
|   | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses<br>(89<br>Securities) | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses<br>(19<br>Securities) | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses (108<br>Securities) | Gross<br>Unrealized<br>Losses and<br>Non-Credit<br>OTTI |
| Debt Securities:                            |   |   |   |   |   |   |
| U.S. Government and agencies                | \$3,381   | \$(24 )   | \$-   | \$-   | \$3,381   | \$(24 )   |
| Obligations of states and<br>political subs | 71,422  | (2,119 )  | 679   | (6 )  | 72,101  | (2,125 )  |
| Corporate securities                        | 70,411  | (1,358 )  | -   | -   | 70,411  | (1,358 )  |
| Redeemable preferred stocks                 | -   | -   | -   | -   | -   | -   |
| Residential mortgage-backed<br>securities   | 22,161  | (694 )  | 3,631   | (151 )  | 25,792  | (845 )  |
| Commercial mortgage-backed<br>securities    | 7,052   | (183 )  | 311   | (295 )  | 7,363   | (478 )  |
| Other asset-backed securities               | 1,569   | (16 )   | 2,617   | (621 )  | 4,186   | (637 )  |
| Total debt securities                       | 175,996   | (4,394 )  | 7,238   | (1,073 )  | 183,234   | (5,467 )  |
| Equity Securities:                          |   |   |   |   |   |   |
| Perpetual preferred stock                   | 995   | (6 )  | -   | -   | 995   | (6 )  |
| Common stock                                | -   | -   | 5,063   | (404 )  | 5,063   | (404 )  |
| Total equity securities                     | 995   | (6 )  | 5,063   | (404 )  | 6,058   | (410 )  |
| Total securities                            | \$176,991   | \$(4,400 )  | \$12,301  | \$(1,477 )  | \$189,292   | \$(5,877 )  |

Changes in the amount of credit loss on fixed maturities for which a portion of an OTTI related to other factors was recognized in other comprehensive income were as follows (in thousands):

|   |           |
|---|-----------|
| Balance as of January 1, 2010                                       | \$ (547 ) |
| Additional credit impairments on:                                   |           |
| Previously impaired securities                                      | (264 )    |
| Securities for which an impairment was not<br>previously recognized | -         |
| Reductions  | 89        |
| Balance as of December 31, 2010                                     | (722 )    |
| Additional credit impairments on:                                   |           |
| Previously impaired securities                                      | (67 )     |
| Securities for which an impairment was not<br>previously recognized | -         |
| Reductions  | -         |
| Balance as of June 30, 2011   | \$ (789 ) |

NOTE 3 – Fair Value Measurements

According to accounting guidance for fair value measurements and disclosures, fair value is the price that would be received to sell an asset or would be paid to transfer a liability (i.e., the “exit price”) in an orderly transaction between market participants at the measurement date. The guidance establishes a three-level hierarchy for fair value measurements that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (“observable inputs”) and the reporting entity’s own assumptions about market participant assumptions developed based on the best information available in the circumstances (“unobservable inputs”).

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The estimated fair values of the Company's fixed investment portfolio are based on prices provided by a third party pricing service and a third party investment manager. The prices provided by these services are based on quoted market prices, when available, non-binding broker quotes, or matrix pricing. The third party pricing service and the third party investment manager provide a single price or quote per security and the Company has not historically adjusted security prices. The Company obtains an understanding of the methods, models and inputs used by the third party pricing service and the third party investment manager, and has controls in place to validate that amounts provided represent fair values. The Company's control process includes, but is not limited to, initial and ongoing evaluation of the methodologies used, a review of specific securities and an assessment for proper classification within the fair value hierarchy. The hierarchy level assigned to each security in the Company's available for sale portfolio is based upon its assessment of the transparency and reliability of the inputs used in the valuation as of the measurement date. The three hierarchy levels are defined as follows:

Level 1 – Valuations that are based on unadjusted quoted prices in active markets for identical securities. The fair value of exchange-traded preferred and common equities, and mutual funds included in the Level 1 category were based on quoted prices that are readily and regularly available in an active market. The fair value measurements that were based on Level 1 inputs comprise 2.3% of the fair value of the total investment portfolio.

Level 2 – Valuations that are based on observable inputs (other than Level 1 prices) such as quoted prices for similar assets at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, either directly or indirectly. The fair value of securities included in the Level 2 category were based on the market values obtained from a third party pricing service that were evaluated using pricing models that vary by asset class and incorporate available trade, bid and other observable market information. The third party pricing service monitors market indicators, as well as industry and economic events. The Level 2 category includes corporate bonds, government and agency bonds, asset-backed, residential mortgage-backed and commercial mortgage-backed securities and municipal bonds. The fair value measurements that were based on Level 2 inputs comprise 97.3% of the fair value of the total investment portfolio.

Level 3 – Valuations that are derived from techniques in which one or more of the significant inputs are unobservable and/or involve management judgment and/or are based on non-binding broker quotes. The fair value measurements that were based on Level 3 inputs comprise 0.4% of the fair value of the total investment portfolio.

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

For corporate, government and municipal bonds, the third party pricing service utilizes a pricing model with standard inputs that include benchmark yields, reported trades, issuer spreads, two-sided markets, benchmark securities, market bids/offers, and other reference data observable in the marketplace. The model uses the option adjusted spread methodology and is a multi-dimensional relational model. All bonds valued under these techniques are classified as Level 2.

For asset-backed, residential mortgage-backed and commercial mortgage-backed securities, the third party pricing service valuation methodology includes consideration of interest rate movements, new issue data, monthly remittance reports and other pertinent data that is observable in the marketplace. This information is used to determine the cash flows for each tranche and identifies the inputs to be used such as benchmark yields, prepayment assumptions and collateral performance. All asset-backed, residential mortgage-backed and commercial mortgage-backed securities valued under these methods are classified as Level 2.

Also included in Level 2 valuation are interest rate swap agreements the Company utilizes to hedge the floating interest rate on its debt, thereby changing the variable rate exposure to a fixed rate exposure for interest on these obligations. The estimated fair value of the interest rate swaps is obtained from the third party financial institution counterparties and measured using discounted cash flow analysis that incorporates significant observable inputs, including the LIBOR forward curve, derivative counterparty spreads, and measurements of volatility.

The Level 3 securities consist of 13 securities totaling \$4.6 million or 0.4% of the total investment portfolio. These primarily represent asset-backed securities and corporate debt securities that have a principal protection feature supported by a U.S. Treasury strip. To fair value these securities, the third party investment manager uses a combination of methods. Non-binding broker/dealer quotes are used on 4 holdings. Benchmarking techniques based upon industry sector, rating and other factors are used on 8 holdings. The Company holds 1 restricted equity security that is not readily marketable; and therefore, is subject to nonrecurring fair value adjustments.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis, classified by the valuation hierarchy as of June 30, 2011 (in thousands):

|  | June 30, 2011<br>Total | Fair Value Measurements Using  |  |  |
|--|------------------------|--|--|--|
|  |                        | Quoted<br>Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>Debt Securities:</b>                    |                        |  |  |  |
| U.S. Government and agencies               | \$ 24,696              | \$ -   | \$ 24,696  | \$ -   |
| Obligations of states and political subs   | 571,583                | -  | 571,583  | -  |
| Corporate securities                       | 456,077                | -  | 455,261  | 816  |
| Redeemable preferred stocks                | 2,416                  | 2,416  | -  | -  |
| Residential mortgage-backed securities     | 185,269                | -  | 185,269  | -  |
| Commercial mortgage-backed securities      | 41,135                 | -  | 41,135   | -  |
| Other asset-backed securities              | 16,817                 | -  | 13,546   | 3,271  |
| Total debt securities available for sale   | 1,297,993              | 2,416  | 1,291,490  | 4,087  |
| <b>Equity Securities:</b>                  |                        |  |  |  |
| Perpetual preferred stock                  | 13,333                 | 12,593   | 740  | -  |
| Common stock                               | 16,331                 | 15,783   | -  | 548  |
| Total equity securities available for sale | 29,664                 | 28,376   | 740  | 548  |
| Total securities available for sale        | \$ 1,327,657           | \$ 30,792  | \$ 1,292,230   | \$ 4,635   |
| Derivatives - interest rate swaps          | \$ (5,494 )            | \$ -   | \$ (5,494 )  | \$ -   |

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The following table presents changes in Level 3 available for sale investments measured at fair value on a recurring basis as of June 30, 2011 (in thousands):

|  | Fair Value<br>Measurement<br>Using<br>Significant<br>Unobservable<br>Inputs - Level<br>3 |
|--|--|
| Balance as of January 1, 2010                | \$ 4,161   |
| Total gains or losses (realized/unrealized): |  |
| Included in earnings                         | (3 )   |
| Included in other comprehensive income       | 463  |
| Purchases                                    | -  |
| Issuances                                    | -  |
| Settlements                                  | (97 )  |
| Transfers in and out of Level 3              | (442 )   |
| Balance as of December 31, 2010              | 4,082  |
| Total gains or losses (realized/unrealized): |  |
| Included in earnings                         | 10   |
| Included in other comprehensive income       | 37   |
| Purchases                                    | -  |
| Issuances                                    | -  |
| Settlements                                  | (10 )  |
| Transfers in and out of Level 3              | 516  |
| Balance as of June 30, 2011                  | \$ 4,635   |

There were no credit losses for the period included in earnings attributable to the change in unrealized losses on Level 3 assets still held at the reporting date.

The Company's policy on recognizing transfers between hierarchy levels is applied at the end of a reporting period. During the quarter ended June 30, 2011, there was one asset-backed security transferred into Level 2 from Level 3 as the third party pricing source calculated the fair value using observable market data inputs.

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 4 – Debt

Credit Facilities

On July 31, 2008, the Company executed \$100 million in senior credit facilities (the “Credit Facilities”). The Credit Facilities included a \$65.0 million term loan facility, which was fully funded upon the closing of its Merger with ProCentury and a \$35.0 million revolving credit facility, which was partially funded upon closing of the Merger. The revolving credit facility includes a letter of credit facility with a sublimit. The total amount of credit available under the revolving credit facility is \$35.0 million, which may include up to \$15 million in letters of credit. As of June 30, 2011, the outstanding balance on its term loan facility was \$31.3 million. The Company had a zero outstanding balance on its revolving credit facility as of June 30, 2011, and \$0.5 million in letters of credit had been issued as of June 30, 2011. The undrawn portion of the revolving credit facility is available to finance working capital and for general corporate purposes, including but not limited to, surplus contributions to its Insurance Company Subsidiaries to support premium growth or strategic acquisitions. At December 31, 2010, the Company had an outstanding balance of \$37.8 million on its term loan and had a zero outstanding balance on its revolving credit facility.

The principal amount outstanding under the Credit Facilities provides for interest at LIBOR, plus the applicable margin, or at the Company’s option, the base rate. The base rate is defined as the higher of the lending bank’s prime rate or the Federal Funds rate, plus 0.50%, plus the applicable margin. The applicable margin is determined by the consolidated indebtedness to consolidated total capital ratio. In addition, the Credit Facilities provide for an unused facility fee ranging between twenty basis points and forty basis points, based on our consolidated leverage ratio as defined by the Credit Facilities. At June 30, 2011, the interest rate on the Company’s term loan was 5.70%, which consisted of a fixed rate of 3.95%, as described in Note 5 ~ Derivative Instruments, plus an applicable margin of 1.75%.

The debt financial covenants applicable to the Credit Facilities consist of: (1) minimum consolidated net worth starting at eighty percent of pro forma consolidated net worth after giving effect to the acquisition of ProCentury, with quarterly increases thereafter, (2) minimum Risk Based Capital Ratio for Star and Century Surety of 1.75 to 1.00, (3) maximum permitted consolidated leverage ratio of 0.35 to 1.00, (4) minimum consolidated debt service coverage ratio of 1.25 to 1.00, and (5) minimum A.M. Best Company rating of “B++.” As of June 30, 2011, the Company was in compliance with these debt covenants.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

During the second quarter of 2011, several of the Company's insurance subsidiaries (Star, Williamsburg, and Ameritrust) became members of the Federal Home Loan Bank of Indianapolis ("FHLBI"). As a member of the FHLBI, these subsidiaries have the ability to borrow on a collateralized basis, providing a source of liquidity. The aggregate investment of approximately \$0.5 million by these subsidiaries provides the ability to borrow up to 20 times the total amount of the FHLBI common stock purchased. As of June 30, 2011, based on the subsidiaries' common stock investment, the Company had the borrowing capacity of up to approximately \$10 million from FHLBI. As of June 30, 2011, the Company did not have any borrowings outstanding from FHLBI.

## Debentures

The following table summarizes the principal amounts and variables associated with the Company's debentures (in thousands):

| Year of Issuance | Description                        | Year Callable | Year Due | Interest Rate Terms           | Interest Rate at June 30, 2011 (1) | Principal Amount |
|------------------|------------------------------------|---------------|----------|-------------------------------|------------------------------------|------------------|
| 2003             | Junior subordinated debentures     | 2008          | 2033     | Three-month LIBOR, plus 4.05% | 4.30 %                             | \$10,310         |
| 2004             | Senior debentures                  | 2009          | 2034     | Three-month LIBOR, plus 4.00% | 4.26 %                             | 13,000           |
| 2004             | Senior debentures                  | 2009          | 2034     | Three-month LIBOR, plus 4.20% | 4.46 %                             | 12,000           |
| 2005             | Junior subordinated debentures     | 2010          | 2035     | Three-month LIBOR, plus 3.58% | 3.83 %                             | 20,620           |
|                  | Junior subordinated debentures (2) | 2007          | 2032     | Three-month LIBOR, plus 4.00% | 4.25 %                             | 15,000           |
|                  | Junior subordinated debentures (2) | 2008          | 2033     | Three-month LIBOR, plus 4.10% | 4.36 %                             | 10,000           |
|                  |                                    |               |          | Total                         |                                    | \$80,930         |

(1) The underlying three-month LIBOR rate varies as a result of the interest rate reset dates used in determining the three-month LIBOR rate, which varies for each long-term debt item each quarter.

(2) Represents the junior subordinated debentures acquired in conjunction with the ProCentury Merger on July 31, 2008.

Excluding the junior subordinated debentures acquired in conjunction with the ProCentury Merger, the Company received a total of \$53.3 million in net proceeds from the issuance of the above long-term debt, of which \$26.2 million was contributed to the surplus of its Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes. Associated with the issuance of the above long-term debt, the Company incurred approximately \$1.7 million in issuance costs for commissions paid to the placement agents in the transactions.



The issuance costs associated with these debentures have been capitalized and are included in other assets on the balance sheet. As of June 30, 2007, these issuance costs were being amortized over a seven year period as a component of interest expense. The seven year amortization period represented management's best estimate of the estimated useful life of the bonds related to both the senior debentures and junior subordinated debentures. Beginning July 1, 2007, the Company re-evaluated its best estimate and determined a five year amortization period to be a more accurate representation of the estimated useful life. Therefore, this change in amortization period from seven years to five years has been applied prospectively beginning July 1, 2007.

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The junior subordinated debentures issued in 2003 and 2005 were issued in conjunction with the issuance of \$10.0 million and \$20.0 million in mandatory redeemable trust preferred securities to a trust formed by an institutional investor from the Company's unconsolidated subsidiary trusts, Meadowbrook Capital Trust I and Meadowbrook Capital Trust II, respectively.

The junior subordinated debentures acquired in the ProCentury Merger were issued in conjunction with the issuance of \$15.0 million and \$10.0 million in floating rate trust preferred securities to a trust formed from the Company's unconsolidated trust, ProFinance Statutory Trust I and ProFinance Statutory Trust II. The Company also acquired the remaining unamortized portion of the capitalized issuance costs associated with these debentures. The remaining unamortized portion of the issuance costs acquired was \$625,000. These issuance costs are included in other assets on the balance sheet. The remaining balance is being amortized over a five year period beginning August 1, 2008, as a component of interest expense.

The junior subordinated debentures are unsecured obligations of the Company and are junior to the right of payment to all senior indebtedness of the Company. The Company has guaranteed that the payments made to the four trusts mentioned above will be distributed to the holders of the respective trust preferred securities.

The Company estimates that the fair value of the above mentioned junior subordinated debentures and senior debentures issued approximate the gross proceeds of cash received at the time of issuance.

NOTE 5 – Derivative Instruments

The Company has entered into interest rate swap transactions to mitigate its interest rate risk on its existing debt obligations. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges. These interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and recognized as an adjustment to interest expense.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

The following table summarizes the rates and amounts associated with the Company's interest rate swaps (in thousands):

| Effective Date | Expiration Date | Debt Instrument                    | Counterparty Interest Rate Terms | Fixed Rate | Fixed Amount at June 30, 2011 |
|----------------|-----------------|------------------------------------|----------------------------------|------------|-------------------------------|
| 4/23/2008      | 6/30/2013       | Junior subordinated debentures     | Three-month LIBOR, plus 4.05%    | 8.020      | % \$10,000                    |
| 4/29/2008      | 4/29/2013       | Senior debentures                  | Three-month LIBOR, plus 4.00%    | 7.940      | % 13,000                      |
| 7/31/2008      | 7/31/2013       | Term loan (1)                      | Three-month LIBOR                | 3.950      | % 31,250                      |
| 8/15/2008      | 8/15/2013       | Junior subordinated debentures (2) | Three-month LIBOR                | 3.780      | % 10,000                      |
| 9/4/2008       | 9/4/2013        | Junior subordinated debentures (2) | Three-month LIBOR                | 3.790      | % 15,000                      |
| 9/8/2010       | 5/24/2016       | Senior debentures                  | Three-month LIBOR, plus 4.20%    | 6.248      | % 5,000                       |
| 9/16/2010      | 9/15/2015       | Junior subordinated debentures     | Three-month LIBOR, plus 3.58%    | 6.160      | % 10,000                      |
| 9/16/2010      | 9/15/2015       | Junior subordinated debentures     | Three-month LIBOR, plus 3.58%    | 6.190      | % 10,000                      |
| 5/24/2011      | 5/24/2016       | Senior debentures                  | Three-month LIBOR, plus 4.20%    | 6.472      | % 7,000                       |

(1) The Company is required to make fixed rate interest payments on the current balance of the term loan, amortizing in accordance with the term loan amortization schedule. The Company fixed only the variable interest portion of the loan. The actual interest payments associated with the term loan also include an additional rate of 1.75% in accordance with the credit agreement.

(2) The Company fixed only the variable interest portion of the debt. The actual interest payments associated with the debentures also include an additional rate of 4.10% and 4.00% on the \$10.0 million and \$15.0 million debentures, respectively.

In relation to the above interest rate swaps, the net interest expense incurred for the three months ended June 30, 2011 and 2010, was approximately \$0.9 million and \$1.2 million, respectively. The net interest expense incurred for the six months ended June 30, 2011 and 2010, was approximately \$1.9 million and \$2.3 million, respectively.

As of June 30, 2011 and December 31, 2010, the total fair value of the interest rate swaps was approximately (\$5.5 million) and (\$5.9 million), respectively. Accumulated other comprehensive income at June 30, 2011 and December 31, 2010, included accumulated loss on the cash flow hedge, net of taxes, of approximately \$3.6 million and \$3.9 million, respectively.

In May 2010, the Company amended its existing \$6.0 million convertible note receivable with an unaffiliated insurance agency. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due June 30, 2014. The insurance agency has been a producer for the Company for several years. As security for the loan, the borrower granted the Company a security interest in its accounts, cash, general intangibles, and other intangible property. Also, pledged as collateral are 100% of the common shares of the holding company and its subsidiary insurance agencies, the common shares owned by the shareholder in another agency, and the shareholder also executed a personal guaranty. This note is convertible at the option of the Company based upon a pre-determined formula.

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 6 – Restricted and Non-Restricted Stock Awards

On February 23, 2011 and 2010, the Company issued 28,500 and 202,500 restricted stock awards, respectively, to executives of the Company, out of its 2002 Amended and Restated Stock Option Plan (the “Plan”). The restricted stock awards vest over a four year period, with the first twenty percent vesting immediately on the date issued (i.e., February 23) and the remaining eighty percent vesting annually on a straight line basis over the requisite four year service period. The unvested restricted stock awards are subject to forfeiture in the event the employee is terminated for “Good Cause” or voluntarily resigns their employment without “Good Reason” as provided for in the employee’s respective employment agreements. The Company recorded approximately \$86,000 and \$71,000 of restricted stock awards compensation expense for the three months ended June 30, 2011 and 2010, respectively. The Company recorded approximately \$218,000 and \$381,000 of restricted stock awards compensation expense for the six months ended June 30, 2011 and 2010, respectively.

On February 23, 2011, the Company issued 1,500 non-restricted stock awards to each outside member of the Board of Directors, which vested immediately. The Company recorded zero and \$150,000 of non-restricted stock awards compensation expense for the three months and six months ended June 30, 2011, respectively. No non-restricted stock awards were issued to the directors in 2010.

NOTE 7 – Shareholders’ Equity

At June 30, 2011, shareholders’ equity was \$573.0 million, or a book value of \$10.84 per common share, compared to \$547.1 million, or a book value of \$10.28 per common share, at December 31, 2010.

On February 12, 2010, the Company’s Board of Directors approved a Share Repurchase Plan authorizing management to purchase up to 5.0 million shares of the Company’s common stock in market transactions for a period not to exceed twenty-four months. For the three months and six months ended June 30, 2011, the Company purchased and retired 0.4 million shares of common stock for a total cost of approximately \$3.9 million. For the year ended December 31, 2010, the Company purchased and retired approximately 2.5 million shares of common stock for a total cost of approximately \$19.6 million. As of June 30, 2011, the Company has available approximately 2.1 million shares remaining to be purchased.

For the period ended June 30, 2011, the Company paid dividends to its common shareholders of \$4.3 million. For the year ended December 31, 2010, the Company paid dividends to its common shareholders of \$7.0 million. On July 28, 2011, the Company’s Board of Directors declared a quarterly dividend of \$0.04 per common share. The dividend is payable on August 29, 2011, to shareholders of record as of August 12, 2011.

TABLE OF CONTENTS

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

When evaluating the declaration of a dividend, the Company's Board of Directors considers a variety of factors, including but not limited to, cash flow, liquidity needs, results of operations, industry conditions, and our overall financial condition. As a holding company, the ability to pay cash dividends is partially dependent on dividends and other permitted payments from its Insurance Company Subsidiaries.

## NOTE 8– Earnings Per Share

Basic earnings per share are based on the weighted average number of common shares outstanding during the year, while diluted earnings per share includes the weighted average number of common shares and potential dilution from shares issuable pursuant to stock awards using the treasury stock method.

The following table is a reconciliation of the income and share data used in the basic and diluted earnings per share computations for the three months and six months ended June 30 (in thousands, except per share amounts):

|   | For the Three Months<br>Ended June 30, |            | For the Six Months<br>Ended June 30, |            |
|---|--|------------|--------------------------------------|------------|
|   | 2011                                   | 2010       | 2011                                 | 2010       |
| Net income, as reported                     | \$9,939                                | \$12,861   | \$25,055                             | \$29,295   |
| Common shares:                              |  |            |                                      |            |
| Basic                                       |  |            |                                      |            |
| Weighted average shares outstanding         | 53,100,479                             | 54,018,868 | 53,175,824                           | 54,642,127 |
| Diluted                                     |  |            |                                      |            |
| Weighted average shares outstanding         | 53,100,479                             | 54,018,868 | 53,175,824                           | 54,642,127 |
| Dilutive effect of:                         |  |            |                                      |            |
| Share awards under long term incentive plan | 148,094                                | 249,800    | 147,978                              | 245,434    |
| Total                                       | 53,248,573                             | 54,268,668 | 53,323,802                           | 54,887,561 |
| Net income per common share                 |  |            |                                      |            |
| Basic                                       | \$0.19                                 | \$0.24     | \$0.47                               | \$0.54     |
| Diluted                                     | \$0.19                                 | \$0.24     | \$0.47                               | \$0.53     |

TABLE OF CONTENTS

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 9 – Commitments and Contingencies

The Company, and its subsidiaries, are subject at times to various claims, lawsuits and proceedings relating principally to alleged errors or omissions in the placement of insurance, claims administration, consulting services and other business transactions arising in the ordinary course of business. Where appropriate, the Company vigorously defends such claims, lawsuits and proceedings. Some of these claims, lawsuits and proceedings seek damages, including consequential, exemplary or punitive damages, in amounts that could, if awarded, be significant. Most of the claims, lawsuits and proceedings arising in the ordinary course of business are covered by errors and omissions insurance or other appropriate insurance. In terms of deductibles associated with such insurance, the Company has established provisions against these items, which are believed to be adequate in light of current information and legal advice. In accordance with accounting guidance, if it is probable that an asset has been impaired or a liability has been incurred as of the date of the financial statements and the amount of loss is estimable; an accrual for the costs to resolve these claims is recorded by the Company in the accompanying consolidated balance sheets. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. Management, with the assistance of outside counsel, adjusts such provisions according to new developments or changes in the strategy in dealing with such matters. On the basis of current information, the Company does not expect the outcome of the claims, lawsuits and proceedings to which the Company is subject to, either individually, or in the aggregate, will have a material adverse effect on the Company's financial condition. However, it is possible that future results of operations or cash flows for any particular quarter or annual period could be materially affected by an unfavorable resolution of any such matters

TABLE OF CONTENTS

ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF  
2. OPERATIONS

For the Periods ended June 30, 2011 and 2010

Forward-Looking Statements

This quarterly report may provide information including certain statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These include statements regarding the intent, belief, or current expectations of management, including, but not limited to, those statements that use the words "believes," "expects," "anticipates," "estimates," or similar expressions. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties, and results could differ materially from those indicated by such forward-looking statements. Among the important factors that could cause actual results to differ materially from those indicated by such forward-looking statements are: the frequency and severity of claims; uncertainties inherent in reserve estimates; catastrophic events; a change in the demand for, pricing of, availability or collectability of reinsurance; increased rate pressure on premiums; ability to obtain rate increases in current market conditions; investment rate of return; changes in and adherence to insurance regulation; actions taken by regulators, rating agencies or lenders; attainment of certain processing efficiencies; changing rates of inflation; general economic conditions and other risks identified in our reports and registration statements filed with the Securities and Exchange Commission. We are not under any obligation to (and expressly disclaim any such obligation to) update or alter our forward-looking statements whether as a result of new information, future events or otherwise.

Business Overview

We are a publicly traded specialty niche focused commercial insurance underwriter and insurance administration services company. We market and underwrite specialty property and casualty insurance programs and products on both an admitted and non-admitted basis through a broad and diverse network of independent retail agents, wholesalers, program administrators and general agents, who value service, specialized knowledge, and focused expertise. Program business refers to an aggregation of individually underwritten risks that have some unique characteristic and are distributed through a select group of agents. We seek to combine profitable underwriting, income from our net commissions and fees, investment returns and efficient capital management to deliver consistent long-term growth in shareholder value.

Through our retail property and casualty agencies, we also generate commission revenue, which represents 1.7% of our total consolidated revenues. Our agencies are located in Michigan, California, and Florida and produce commercial, personal lines, life and accident and health insurance that is placed with more than fifty unaffiliated insurance carriers. These agencies produce a minimal amount of business for our affiliated Insurance Company Subsidiaries.



## TABLE OF CONTENTS

We recognize revenue related to the services and coverages within the following categories: net earned premiums, management fees, claims fees, loss control fees, reinsurance placement, investment income, commission revenue, and net realized gains (losses).

We compete in the specialty insurance market. Our wide range of specialty niche insurance expertise allows us to accommodate a diverse distribution network ranging from specialized program agents to retail agents. In the specialty market, competition tends to place considerable focus on availability, service and other tailored coverages in addition to price. Moreover, our broad geographical footprint enables us to function with a local presence on both a regional and national basis. We also have the capacity to write specialty insurance in both the admitted and non-admitted markets. These unique aspects of our business model enable us to compete on factors other than price.

### Critical Accounting Policies

In certain circumstances, we are required to make estimates and assumptions that affect amounts reported in our consolidated financial statements and related footnotes. We evaluate these estimates and assumptions on an on-going basis based on a variety of factors. There can be no assurance, however, that actual results will not be materially different than our estimates and assumptions, and that reported results of operation will not be affected by accounting adjustments needed to reflect changes in these estimates and assumptions. The accounting estimates and related risks described in our Annual Report on Form 10-K as filed with the United States Securities and Exchange Commission on March 16, 2011, are those that we consider to be our critical accounting estimates. For the three months and six months ended June 30, 2011, there have been no material changes in regard to any of our critical accounting estimates.

### Non-GAAP Financial Measures

#### Net Operating Income and Net Operating Income Per Share

Net operating income and net operating income per share are non-GAAP measures that represent net income excluding net realized gains or loss, net of tax. The most directly comparable financial GAAP measures to net operating income and net operating income per share are net income and net income per share. Net operating income and net operating income per share are intended as supplemental information and are not meant to replace net income nor net income per share. Net operating income and net operating income per share should be read in conjunction with the GAAP financial results. The following is a reconciliation of net operating income to net income, as well as net operating income per share to net income per share:

TABLE OF CONTENTS

|  | For the Three Months<br>Ended June 30,             |            | For the Six Months<br>Ended June 30,               |            |
|--|--|------------|--|------------|
|  | 2011   | 2010       | 2011   | 2010       |
|  | (In thousands, except share<br>and per share data) |            | (In thousands, except share<br>and per share data) |            |
| Operating income, net of tax                       | \$8,540  | \$12,622   | \$23,024   | \$29,443   |
| Net realized gains (losses), net of tax            | 1,399  | 239        | 2,031  | (148)      |
| Net income   | \$9,939  | \$12,861   | \$25,055   | \$29,295   |
| <b>Diluted earnings per common share:</b>          |  |            |  |            |
| Net operating income                               | \$0.16   | \$0.23     | \$0.43   | \$0.54     |
| Net income   | \$0.19   | \$0.24     | \$0.47   | \$0.53     |
| Diluted weighted average common shares outstanding | 53,248,573   | 54,268,668 | 53,323,802   | 54,887,561 |

We use net operating income and net operating income per share as components to assess our performance and as measures to evaluate the results of our business. We believe these measures provide investors with valuable information relating to our ongoing performance that may be obscured by the net effect of realized gains and losses as a result of our market risk sensitive instruments, which primarily relate to fixed income securities that are available for sale and not held for trading purposes. Realized gains and losses may vary significantly between periods and are generally driven by external economic developments, such as capital market conditions. Accordingly, net operating income excludes the effect of items that tend to be highly variable from period to period and highlights the results from our ongoing business operations and the underlying profitability of our business. Therefore, we believe that it is useful for investors to evaluate net operating income and net operating income per share, along with net income and net income per share when reviewing and evaluating our performance.

**Accident Year Loss Ratio**

The accident year loss ratio is a non-GAAP measure and represents our net loss and LAE ratio adjusted for any adverse or favorable development on prior year reserves. The most directly comparable financial GAAP measure to the accident year loss ratio is the net loss and LAE ratio. The accident year loss ratio is intended as supplemental information and is not meant to replace the net loss and LAE ratio. The accident year loss ratio should be read in conjunction with the GAAP financial results. The following is a reconciliation of the accident year loss ratio to the net loss and LAE ratio, which is the most directly comparable GAAP measure:

|  | For the Three Months<br>Ended June 30, |        | For the Six Months<br>Ended June 30, |        |
|--|--|--------|--------------------------------------|--------|
|  | 2011                                   | 2010   | 2011                                 | 2010   |
| Accident year loss ratio                       | 66.4                                   | % 65.1 | % 65.0                               | % 64.7 |
| Adverse (favorable) development on prior years | 0.5                                    | % -4.1 | % -0.6                               | % -5.3 |
| Net loss & LAE ratio                           | 66.9                                   | % 61.0 | % 64.4                               | % 59.4 |

TABLE OF CONTENTS

We use the accident year loss ratio as one component to assess our current year performance and as a measure to evaluate, and if necessary, adjust our pricing and underwriting. Our net loss and LAE ratio is based on calendar year information. Adjusting this ratio to an accident year loss ratio allows us to evaluate information based on the current year activity. We believe this measure provides investors with valuable information for comparison to historical trends and current industry estimates. We also believe that it is useful for investors to evaluate the accident year loss ratio and net loss and LAE ratio separately when reviewing and evaluating our performance.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED JUNE 30, 2011 AND 2010

Executive Overview

Our results for the three months ended June 30, 2011 include the positive impact from continued selective growth, coupled with our adherence to strict corporate underwriting guidelines, as well as a focus on current accident year price adequacy and the benefits derived from leveraging of fixed costs. Our generally accepted accounting principles (“GAAP”) combined ratio was 101.3% for the three months ended June 30, 2011, compared to 96.2% for the comparable three months ended June 30, 2010. Our accident quarter combined ratio was 100.8% for the three months ended June 30, 2011, compared to 100.3% for the comparable three months ended June 30, 2010. The second quarter 2011 results were impacted by higher than normal storm losses, which added 3.5 percentage points to both the GAAP and accident quarter combined ratios. Comparably, the second quarter 2010 results were impacted by higher than normal storm losses, which added 1.2 percentage points to both the GAAP and accident quarter combined ratios.

Net operating income decreased \$4.1 million from \$12.6 million for the three months ended June 30, 2010 to \$8.5 million for the three months ended June 30, 2011. The second quarter 2011 results include \$4.1 million of higher than normal after-tax storm losses. Comparably, the second quarter 2010 results include \$1.3 million of higher than normal after-tax storm losses. Development on prior year reserves reduced net operating income by \$0.6 million in 2011, compared to an increase in net operating income by \$4.4 million in 2010. Excluding higher than normal storm loss activity, second quarter 2011 net operating income on an accident year basis increased to \$13.2 million, compared to \$9.5 million for the second quarter 2010.

Gross written premium increased \$22.9 million, or 12.0%, to \$212.7 million in 2011, compared to \$189.8 million in 2010 for the three months ended June 30. The increase during the quarter relates to the maturation of programs initiated in recent years and rate increases that were achieved during the quarter.

TABLE OF CONTENTS

## Results of Operations

Net income for the three months ended June 30, 2011, was \$9.9 million, or \$0.19 per diluted share, compared to net income of \$12.9 million, or \$0.24 per diluted share, for the comparable period of 2010. Net operating income, a non-GAAP measure, decreased \$4.1 million, or 32.3%, to \$8.5 million, or \$0.16 per diluted share, compared to net operating income of \$12.6 million, or \$0.23 per diluted share for the comparable period in 2010. Total diluted weighted average shares outstanding for the three months ended June 30, 2011 were 53,248,573, compared to 54,268,668 for the comparable period in 2010. This decrease reflects the impact of our Share Repurchase Plan (the "Plan") in which we repurchased 0.4 million shares during the second quarter of 2011. We currently have approximately 2.1 million more shares available for repurchase under the Plan.

## Revenues

Revenues for the three months ended June 30, 2011, increased \$20.6 million, or 11.2%, to \$204.2 million, from \$183.6 million for the comparable period in 2010. This increase primarily reflects overall growth within our existing programs and new business that was implemented in recent years.

The following table sets forth the components of revenues (in thousands):

|                                | For the Three Months<br>Ended June 30, |           |
|--------------------------------|--|-----------|
|                                | 2011                                   | 2010      |
| Revenue:                       |  |           |
| Net earned premiums            | \$181,470                              | \$162,760 |
| Management administrative fees | 3,041                                  | 2,829     |
| Claims fees                    | 1,606                                  | 1,752     |
| Commission revenue             | 3,250                                  | 2,554     |
| Net investment income          | 13,765                                 | 13,454    |
| Net realized gains             | 1,094                                  | 292       |
| Total revenue                  | \$204,226                              | \$183,641 |

Net earned premiums increased \$18.7 million, or 11.5%, to \$181.5 million for the three months ended June 30, 2011, from \$162.8 million in the comparable period in 2010. This increase was primarily the result of growth within our existing programs and the new business we began writing in recent years.

Commission revenue increased \$0.7 million, or 26.9%, to \$3.3 million for the three months ended June 30, 2011, from \$2.6 million for the comparable period in 2010. This increase primarily reflects Michigan agency business that was added in the current year.

Net investment income increased \$0.3 million, or 2.3%, to \$13.8 million for the three months ended June 30, 2011, from \$13.5 million for the comparable period in 2010. This increase primarily reflects the increase in average invested assets from \$1.3 billion in 2010 to \$1.4 billion in 2011. This increase in our average investment balance is due primarily to positive cash flows generated from operations. The average investment yield for June 30, 2011 was 4.0% compared to 4.3% in 2010. The current pre-tax book yield was 4.2% compared to 4.5% in 2010. The current after-tax book yield was 3.1% compared to 3.4% in 2010. The effective duration of the investment portfolio is 5.0 years at June 30, 2011, compared to 4.8 years at June 30, 2010.



TABLE OF CONTENTS

Net realized gains improved by \$0.8 million, to \$1.1 million gain for the three months ended June 30, 2011, from a \$0.3 million gain for the comparable period in 2010. The increase in realized gains relates to the sale of securities sold in 2011.

## Expenses

Expenses increased \$25.4 million from \$166.7 million for the three months ended June 30, 2010 to \$192.1 million for the three months ended June 30, 2011.

The following table sets forth the components of expenses (in thousands):

|  | For the Three Months<br>Ended June 30, |           |
|--|--|-----------|
|  | 2011                                   | 2010      |
| Expense:   |  |           |
| Net losses and loss adjustment expenses            | \$121,403                              | \$99,212  |
| Policy acquisition and other underwriting expenses | 62,450                                 | 57,370    |
| General selling & administrative expenses          | 5,631                                  | 5,321     |
| General corporate expenses                         | (719 )                                 | 1,269     |
| Amortization expense                               | 1,206                                  | 1,121     |
| Interest expense                                   | 2,082                                  | 2,411     |
| Total expenses                                     | \$192,053                              | \$166,704 |

Net loss and loss adjustment expenses (“LAE”) increased \$22.2 million, to \$121.4 million for the three months ended June 30, 2011 from \$99.2 million for the same period in 2010. Our loss and LAE ratio was 66.9% for the three months ended June 30, 2011 and 61.0% for the three months ended June 30, 2010. The accident year loss and LAE ratio was 66.4% for the three months ended June 30, 2011 up from 65.1% in the comparable period in 2010. The 2011 accident quarter loss and LAE ratio includes 3.5 percentage points of higher than normal storm losses noted above. Comparably, the 2010 accident quarter loss and LAE ratio includes 1.2 percentage points of higher than normal storm losses noted above. Excluding the higher than normal storm losses, the 2011 accident quarter loss and LAE ratio improved to 62.9%, compared to 63.9% in the prior year quarter. Additional discussion of our reserve activity is described below within the Other Items ~ Reserves section.

Policy acquisition and other underwriting expenses increased \$5.1 million, to \$62.5 million for the three months ended June 30, 2011, from \$57.4 million for the same period in 2010. Our expense ratio decreased 0.8% percentage points to 34.4% for the three months ended June 30, 2011, from 35.2% for the same period in 2010. The 2011 expense ratio improvement reflects the reduction in variable compensation.

General corporate expenses decreased \$2.0 million to a benefit of \$0.7 million for the three months ended June 30, 2011 from \$1.3 million for the same period in 2010. The current quarter amount reflects a reduction in the accrual for variable compensation, as compared to accruing a provision for variable compensation in 2010.

TABLE OF CONTENTS

Interest expense for the three months ended June 30, 2011, decreased \$0.3 million, to \$2.1 million, from \$2.4 million for the comparable period in 2010. Interest expense is primarily attributable to our debentures, which are described within the Liquidity and Capital Resources section of Management's Discussion and Analysis, as well as our term loan. The overall decrease reflects the decline in the average outstanding balance on our term loan to \$34.5 million for the period ended June 30, 2011 from \$47.0 million for same period in 2010.

Federal income tax expense for the three months ended June 30, 2011 was \$2.2 million, or 18.3% of income before taxes, compared to \$4.6 million, or 27.3% of income before taxes, for the same period in 2010. Income tax expense on capital gains and the change in our valuation allowance for other than temporary impairments, was a benefit of \$305,000 and an expense of \$54,000 for the three months ended June 30, 2011 and 2010, respectively. Excluding the impact of this deferred tax valuation, the effective income tax rate would have been 22.9% and 27.4% for the three months ended June 30, 2011 and 2010, respectively. The lower rate is due to a higher portion of income being tax exempt interest income.

Other Items

Equity earnings of affiliated, net of tax;

In July 2009, our subsidiary, Star, purchased a 28.5% ownership interest in an affiliate, Midwest Financial Holding, LLC ("MFH"), for \$14.8 million in cash. We are not required to consolidate this investment as we are not the primary beneficiary of the business nor do we control the entity's operations. Our ownership interest is significant, but is less than a majority ownership and, therefore, we are accounting for this investment under the equity method of accounting. Star will recognize 28.5% of the profits and losses as a result of this equity interest ownership. We recognized equity earnings, net of tax, from MFH of \$0.2 million, which had no per diluted share impact, for the three months ended June 30, 2011, compared to \$0.6 million, or \$0.01 per diluted share, for the comparable period of 2010. We received dividends from MFH in the three months ended June 30, 2011 and 2010, of \$1.2 million and \$0.7 million, respectively.

Reserves

For the three months ended June 30, 2011, we reported an increase in net ultimate loss estimates for accident years 2010 and prior of \$0.9 million, or 0.1% of \$784.2 million of net loss and LAE reserves at December 31, 2010. There were no significant changes in the key assumptions utilized in the analysis and calculations of our reserves during 2010 and 2011.

TABLE OF CONTENTS

Other-Than-Temporary Impairments (OTTI)

Refer to Note 2 ~ Investments of the Notes to the Consolidated Financial Statements, for additional information specific to OTTI and their fair value and amount of unrealized losses segregated by the time period the investment has been in an unrealized loss position.

RESULTS OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2011 AND 2010

Executive Overview

Our results for the six months ended June 30, 2011, include the positive impact from continued selective growth, coupled with our adherence to strict corporate underwriting guidelines, as well as a focus on current accident year price adequacy and the benefits derived from leveraging of fixed costs. Our generally accepted accounting principles (“GAAP”) combined ratio was 98.4% for the six months ended June 30, 2011, compared to 94.2% for the comparable six months ended June 30, 2010. Our accident year combined ratio was 99.0% for the six months ended June 30, 2011, compared to 99.5% for the comparable six months ended June 30, 2010. The year-to-date 2011 results were impacted by higher than normal storm losses, which added 1.6 percentage points to both the GAAP and accident year combined ratios. Comparably, the year-to-date 2010 results were impacted by higher than normal storm losses, which added 0.6 percentage points to both the GAAP and accident year combined ratios.

Net operating income decreased \$6.4 million from \$29.4 million for the six months ended June 30, 2010 to \$23.0 million for the six months ended June 30, 2011. The second quarter 2011 results include \$3.6 million of higher than normal after-tax storm losses. Comparably, the second quarter 2010 results include \$1.3 million of higher than normal after-tax storm losses. Development on prior year reserves increased net operating income by \$1.5 million in 2011, compared to an increase in net operating income by \$10.7 million in 2010. Excluding higher than normal storm loss activity, year-to-date 2011 net operating income on an accident year basis increased to \$25.1 million, compared to \$20.0 million for the second year-to-date 2010.

Gross written premium increased \$40.6 million, or 10.2%, to \$437.6 million in 2011, compared to \$397.0 million in 2010 for the six months ended June 30. The increase relates to the maturation of programs initiated in recent years, rate increases that were achieved during the year, and the conversion of an existing fee-based program into an insured program where we now assume the risk.



TABLE OF CONTENTS

## Results of Operations

Net income for the six months ended June 30, 2011, was \$25.1 million, or \$0.47 per diluted share, compared to net income of \$29.3 million, or \$0.53 per diluted share, for the comparable period of 2010. Net operating income, a non-GAAP measure, decreased \$6.4 million, or 21.8%, to \$23.0 million, or \$0.43 per diluted share, compared to net operating income of \$29.4 million, or \$0.54 per diluted share for the comparable period in 2010. Total diluted weighted average shares outstanding for the six months ended June 30, 2011 were 53,323,802, compared to 54,887,561 for the comparable period in 2010. This decrease reflects the impact of our Plan in which we repurchased 0.4 million shares during the six months ended June 30, 2011. We currently have approximately 2.1 million more shares available for repurchase under the Plan.

## Revenues

Revenues for the six months ended June 30, 2011, increased \$39.9 million, or 11.2%, to \$397.7 million, from \$357.8 million for the comparable period in 2010. This increase primarily reflects overall growth within our existing programs and new business that was implemented in recent years.

The following table sets forth the components of revenues (in thousands):

|                                | For the Six Months<br>Ended June 30, |           |
|--------------------------------|--------------------------------------|-----------|
|                                | 2011                                 | 2010      |
| Revenue:                       |                                      |           |
| Net earned premiums            | \$352,128                            | \$314,201 |
| Management administrative fees | 6,399                                | 7,784     |
| Claims fees                    | 3,213                                | 3,499     |
| Commission revenue             | 6,723                                | 5,720     |
| Net investment income          | 27,337                               | 26,483    |
| Net realized gains             | 1,906                                | 158       |
| Total revenue                  | \$397,706                            | \$357,845 |

Net earned premiums increased \$37.9 million, or 12.1%, to \$352.1 million for the six months ended June 30, 2011, from \$314.2 million in the comparable period in 2010. This increase was primarily the result of growth within our existing programs and the new business we began writing in recent years.

Management fees decreased \$1.4 million, or 17.9%, to \$6.4 million for the six months ended June 30, 2011, from \$7.8 million for the comparable period in 2010. This decrease primarily reflects the impact of a program that we converted from a fee based business to an underwritten program in the current year.

Commission revenue increased \$1.0 million, or 17.5%, to \$6.7 million for the six months ended June 30, 2011, from \$5.7 million for the comparable period in 2010. This increase primarily reflects Michigan agency business that was added in the current year.

TABLE OF CONTENTS

Net investment income increased \$0.8 million, or 3.2%, to \$27.3 million for the six months ended June 30, 2011, from \$26.5 million for the comparable period in 2010. This increase primarily reflects the increase in average invested assets from \$1.2 billion in 2010 to \$1.3 billion in 2011. This increase in our average investment balance is due primarily to positive cash flows generated from operations that were primarily due to favorable underwriting results. The average investment yield for June 30, 2011 was 4.0% compared to 4.3% in 2010. The current pre-tax book yield was 4.2% compared to 4.5% in 2010. The current after-tax book yield was 3.1% compared to 3.4% in 2010. The effective duration of the investment portfolio is 5.0 years at June 30, 2011, compared to 4.8 years at June 30, 2010.

Net realized gains improved by \$1.7 million, to a \$1.9 million gain for the six months ended June 30, 2011, from a \$0.2 million gain for the comparable period in 2010. The increase in realized gains relates to the sale of securities sold in 2011.

## Expenses

Expenses increased \$48.0 million from \$317.8 million for the six months ended June 30, 2010 to \$365.8 million for the six months ended June 30, 2011.

The following table sets forth the components of expenses (in thousands):

|  | For the Six Months<br>Ended June 30, |           |
|--|--------------------------------------|-----------|
|  | 2011                                 | 2010      |
| Expense:   |                                      |           |
| Net losses and loss adjustment expenses            | \$226,665                            | \$186,692 |
| Policy acquisition and other underwriting expenses | 119,888                              | 109,249   |
| General selling & administrative expenses          | 11,875                               | 11,227    |
| General corporate expenses                         | 636                                  | 3,246     |
| Amortization expense                               | 2,438                                | 2,522     |
| Interest expense                                   | 4,254                                | 4,854     |
| Total expenses                                     | \$365,756                            | \$317,790 |

Net loss and loss adjustment expenses (“LAE”) increased \$40.0 million, to \$226.7 million for the six months ended June 30, 2011 from \$186.7 million for the same period in 2010. Our loss and LAE ratio was 64.4% for the six months ended June 30, 2011 and 59.4% for the six months ended June 30, 2010. The accident year loss and LAE ratio was 65.0% for the six months ended June 30, 2011 up from 64.7% in the comparable period in 2010. The 2011 accident year loss and LAE ratio includes 1.6 percentage points of higher than normal storm losses noted above. Comparably, the 2010 accident year loss and LAE ratio includes 0.6 percentage points of higher than normal storm losses noted above. Excluding the higher than normal storm losses, the 2011 accident year loss and LAE ratio improved to 63.4%, compared to 64.1% in the prior year. Additional discussion of our reserve activity is described below within the Other Items ~ Reserves section.

Policy acquisition and other underwriting expenses increased \$10.7 million, to \$119.9 million for the six months ended June 30, 2011, from \$109.2 million for the same period in 2010. Our expense ratio decreased 0.8 percentage points to 34.0% for the six months ended June 30, 2011, from 34.8% for the same period in 2010. The 2011 expense ratio improvement reflects the reduction in variable compensation.

TABLE OF CONTENTS

General corporate expenses decreased \$2.6 million to \$0.6 million for the six months ended June 30, 2011 from \$3.2 million for the same period in 2010. The current quarter amount reflects a reduction in the accrual for variable compensation, as compared to accruing a provision for variable compensation in 2010.

Interest expense for the six months ended June 30, 2011, decreased \$0.6 million, to \$4.3 million, from \$4.9 million for the comparable period in 2010. Interest expense is primarily attributable to our debentures, which are described within the Liquidity and Capital Resources section of Management's Discussion and Analysis, as well as our term loan. The overall decrease reflects the decline in the average outstanding balance on our term loan to \$34.5 million for the period ended June 30, 2011 from \$47.0 million for same period in 2010.

Federal income tax expense for the six months ended June 30, 2011 was \$7.6 million, or 24.1% of income before taxes, compared to \$12.0 million, or 30.3% of income before taxes, for the same period in 2010. Income tax expense on capital gains and the change in our valuation allowance for other than temporary impairments, was a benefit of \$125,000 and an expense of \$306,000 for the six months ended June 30, 2011 and 2010, respectively. Excluding the impact of this deferred tax valuation, the effective income tax rate would have been 26.1% and 29.7% for the six months ended June 30, 2011 and 2010, respectively. The lower rate is due to a higher portion on income being tax exempt interest income.

Other Items

Equity earnings of affiliated, net of tax;

In July 2009, our subsidiary, Star, purchased a 28.5% ownership interest in an affiliate, Midwest Financial Holding, LLC ("MFH"), for \$14.8 million in cash. We are not required to consolidate this investment as we are not the primary beneficiary of the business nor do we control the entity's operations. Our ownership interest is significant, but is less than a majority ownership and, therefore, we are accounting for this investment under the equity method of accounting. Star will recognize 28.5% of the profits and losses as a result of this equity interest ownership. We recognized equity earnings, net of tax, from MFH of \$1.2 million, or \$0.02 per diluted share, for the six months ended June 30, 2011, compared to \$1.2 million, or \$0.02 per diluted share, for the comparable period of 2010. We received dividends from MFH in the six months ended June 30, 2011 and 2010, of \$1.7 million and \$1.0 million, respectively.

TABLE OF CONTENTS

## Reserves

At June 30, 2011, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was \$829.1 million. We established a reasonable range of reserves of approximately \$735.6 million to \$905.8 million. This range was established primarily by considering the various indications derived from standard actuarial techniques and other appropriate reserve considerations. The following table sets forth this range by line of business (in thousands):

| Line of Business                              | Minimum Reserve Range | Maximum Reserve Range | Selected Reserves |
|---|-----------------------|-----------------------|-------------------|
| Workers' Compensation                         | \$ 293,743            | \$ 335,208            | \$ 315,969        |
| Residual Markets                              | 16,493                | 18,267                | 17,736            |
| Commercial Multiple Peril / General Liability | 282,574               | 392,310               | 343,060           |
| Commercial Automobile                         | 109,686               | 122,697               | 116,911           |
| Other   | 33,075                | 37,275                | 35,427            |
| Total Net Reserves                            | \$ 735,571            | \$ 905,757            | \$ 829,103        |

Reserves are reviewed and established by our internal actuaries for adequacy and peer reviewed by our third-party actuaries. When reviewing reserves, we analyze historical data and estimate the impact of numerous factors such as (1) per claim information; (2) industry and our historical loss experience; (3) legislative enactments, judicial decisions, legal developments in the imposition of damages, and changes in political attitudes; and (4) trends in general economic conditions, including the effects of inflation. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of reserves, because the eventual deficiency or redundancy is affected by multiple factors.

The key assumptions used in our selection of ultimate reserves included the underlying actuarial methodologies, a review of current pricing and underwriting initiatives, an evaluation of reinsurance costs and retention levels, and a detailed claims analysis with an emphasis on how aggressive claims handling may be impacting the paid and incurred loss data trends embedded in the traditional actuarial methods. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the six months ended June 30, 2011, and the year ended December 31, 2010.

TABLE OF CONTENTS

For the six months ended June 30, 2011, we reported a decrease in net ultimate loss estimates for accident years 2010 and prior of \$2.4 million, or 0.3% of \$784.2 million of beginning net loss and LAE reserves at December 31, 2010. The change in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2011 that differed from the projected activity. There were no significant changes in the key assumptions utilized in the analysis and calculations of our reserves during 2010 and for the six months ended June 30, 2011. The major components of this change in ultimates are as follows (in thousands):

| Line of Business                              | Reserves at December 31, 2010 | Incurred Losses |             |                | Paid Losses  |             |            | Reserves at June 30, 2011 |
|---|-------------------------------|-----------------|-------------|----------------|--------------|-------------|------------|---------------------------|
|   |                               | Current Year    | Prior Years | Total Incurred | Current Year | Prior Years | Total Paid |                           |
| Workers' Compensation                         | \$ 285,069                    | \$ 96,486       | \$ 3,634    | \$ 100,120     | \$ 9,871     | \$ 59,349   | \$ 69,220  | \$ 315,969                |
| Residual Markets                              | 18,963                        | 1,490           | (1,259)     | 231            | 507          | 951         | 1,458      | 17,736                    |
| Commercial Multiple Peril / General Liability | 330,850                       | 55,780          | (3,971)     | 51,809         | 2,787        | 36,812      | 39,599     | 343,060                   |
| Commercial Automobile                         | 112,388                       | 41,944          | 2,298       | 44,242         | 10,834       | 28,885      | 39,719     | 116,911                   |
| Other   | 36,932                        | 33,332          | (3,069)     | 30,263         | 12,674       | 19,094      | 31,768     | 35,427                    |
| Net Reserves                                  | 784,202                       | \$ 229,032      | \$ (2,367)  | \$ 226,665     | \$ 36,673    | \$ 145,091  | \$ 181,764 | 829,103                   |
| Reinsurance Recoverable                       | 280,854                       |                 |             |                |              |             |            | 296,113                   |
| Consolidated                                  | \$ 1,065,056                  |                 |             |                |              |             |            | \$ 1,125,216              |

| Line of Business                              | Reserves at December 31, 2010 | Total   |      | Development as a Percentage of Prior Year Reserves |
|---|-------------------------------|---|------|--|
|   |                               | Re-estimated Reserves at June 30, 2011 on Prior Years |      |  |
| Workers' Compensation                         | \$ 285,069                    | \$ 288,703  | 1.3  | %  |
| Commercial Multiple Peril / General Liability | 330,850                       | 326,879   | -1.2 | %  |
| Commercial Automobile                         | 112,388                       | 114,686   | 2.0  | %  |
| Other   | 36,932                        | 33,863  | -8.3 | %  |
| Sub-total                                     | 765,239                       | 764,131   | -0.1 | %  |
| Residual Markets                              | 18,963                        | 17,704  | -6.6 | %  |
| Total Net Reserves                            | \$ 784,202                    | \$ 781,835  | -0.3 | %  |

## Workers' Compensation Excluding Residual Markets

The projected net ultimate loss estimate for the workers' compensation line of business excluding residual markets increased \$3.6 million, or 1.3% of net workers' compensation reserves. This net overall increase reflects increases of \$3.7 million, \$1.1 million, and \$850,000 for accident years 2010, 2009, and 2003, respectively. This increase in the

net ultimate loss estimate for these accident years was due to greater than expected claim emergence. The 2009 and 2010 accident years' emergence was from a countrywide program, a New England program, and two Florida programs. Collectively, California based programs had insignificant development. Accident year 2003 emergence came from a single claim reserve increase. These increases were partially offset by decreases of \$783,000, \$875,000, and \$592,000 for accident years 2008, 2007, and 2006, respectively. The decrease in the net ultimate loss estimates for these accident years was due to less than expected claim emergence in a Florida program and several countrywide programs. The change in ultimate loss estimates for all other accident years was insignificant.

TABLE OF CONTENTS

Commercial Multiple Peril / General Liability

The commercial multiple peril line and general liability line of business had a decrease in net ultimate loss estimates of \$4.0 million, or 1.2% of net commercial multiple peril and general liability reserves. The net decrease reflects decreases of \$2.8 million, \$2.7 million, \$1.4 million, and \$714,000 in the ultimate loss estimates for accident years 2010, 2009, 2008, and 2006, respectively. The decreases in the net ultimate loss estimates for these accident years were due to better than expected claim emergence in several general liability programs and two excess liability programs. The decreases were offset by increases of \$2.3 million and \$1.7 million for accident years 2005 and 2004, respectively. These increases in the net ultimate loss estimates for these accident years was due to greater than expected claim emergence in an excess liability program. The change in ultimate loss estimates for all other accident years was insignificant.

Commercial Automobile

The projected net ultimate loss estimate for the commercial automobile line of business increased \$2.3 million, or 2.0% of net commercial automobile reserves. This net overall increase reflects increases in the net ultimate loss estimate of \$1.7 million, \$1.1 million, and \$563,000 for accident years 2010, 2009, and 2007, respectively. This increase in the net ultimate loss estimates for these accident years was due to greater than expected claim emergence in a garage program and a countrywide transportation program. This increase was partially offset by a decrease of \$576,000 for accident year 2008. The decrease in the net ultimate loss estimates for this accident year was due to less than expected claim emergence in a California based programs and several countrywide programs. The change in ultimate loss estimates for all other accident years was insignificant.

Other

The projected net ultimate loss estimate for the other lines of business decreased \$3.1 million, or 8.3% of net reserves. This net decrease reflects decreases of \$1.7 million and \$648,000 in accident years 2010 and 2009, respectively. This decrease is primarily due to better than expected case reserve development during the calendar year in three professional liability programs, an inland marine program, and an ocean marine program. The change in ultimate loss estimates for all other accident years was insignificant.

## TABLE OF CONTENTS

### Residual Markets

The workers' compensation residual market line of business had a decrease in net ultimate loss estimate of \$1.3 million, or 6.6% of net reserves. This decrease reflects a reduction of \$1.0 million in accident year 2009. We record loss reserves as reported by the National Council on Compensation Insurance ("NCCI"), plus a provision for the reserves incurred but not yet analyzed and reported to us due to a two quarter lag in reporting. These changes reflect a difference between our estimate of the lag incurred but not reported and the amounts reported by the NCCI in the year. The change in ultimate loss estimates for all other accident years was insignificant.

### Other-Than-Temporary Impairments (OTTI)

Refer to Note 2 ~ Investments of the Notes to the Consolidated Financial Statements, for additional information specific to OTTI and their fair value and amount of unrealized losses segregated by the time period the investment has been in an unrealized loss position

## LIQUIDITY AND CAPITAL RESOURCES

Our principal sources of funds are insurance premiums, investment income, proceeds from the maturity and sale of invested assets from our Insurance Company Subsidiaries, and risk management fees and agency commissions from our non-regulated subsidiaries. Funds are primarily used for the payment of claims, commissions, salaries and employee benefits, other operating expenses, shareholder dividends, share repurchases, capital expenditures, and debt service.

A significant portion of our consolidated assets represents assets of our Insurance Company Subsidiaries that may not be transferable to the holding company in the form of dividends, loans or advances in accordance with state insurance laws. These laws generally specify that dividends can be paid only from unassigned surplus and only to the extent that all dividends in the current twelve months do not exceed the greater of 10% of total statutory surplus as of the end of the prior fiscal year or 100% of the statutory net income for the prior year, less any dividends paid in the prior twelve months. Using these criteria, the available ordinary dividend available to be paid from the Insurance Company Subsidiaries during 2011 is \$43.8 million without prior regulatory approval. Of this \$43.8 million, an ordinary dividend of \$20 million was declared in June 2011 and subsequently paid in July 2011. In addition to ordinary dividends, the Insurance Company Subsidiaries have the capacity to pay \$78.1 million of extraordinary dividends as of June 30, 2011, subject to prior regulatory approval. The Insurance Company Subsidiaries' ability to pay future dividends without advance regulatory approval is dependent upon maintaining a positive level of unassigned surplus, which in turn, is dependent upon the Insurance Company Subsidiaries generating net income. Total ordinary dividends paid from our Insurance Company Subsidiaries to our holding company were zero and \$20.9 million for the six months ended June 30, 2011 and 2010, respectively. We remain well within our targets as they relate to our premium leverage ratios, even taking into consideration the dividends paid by our Insurance Company Subsidiaries. Our targeted maximum leverage ratios for gross and net written premium to statutory surplus are 2.75 to 1.0 and 2.25 to 1.0, respectively. As of June 30, 2011, on a trailing twelve month statutory consolidated basis, the gross and net premium leverage ratios were 2.3 to 1.0 and 2.0 to 1.0, respectively.



TABLE OF CONTENTS

We also generate operating cash flow from non-regulated subsidiaries in the form of commission revenue, outside management fees, and intercompany management fees. These sources of income are used to meet debt service, shareholders' dividends, and other operating expenses of the holding company and non-regulated subsidiaries. Earnings before interest, taxes, depreciation, and amortization from non-regulated subsidiaries were approximately \$6.3 million for the six months ended June 30, 2011.

We have a total revolving credit facility of \$35.0 million, which may include up to \$15.0 million in letters of credit. As of June 30, 2011, we had a zero outstanding loan balance on our revolving credit facility and \$0.5 million in letters of credit issued. The undrawn portion of the revolving credit facility is available to finance working capital and for general corporate purposes, including but not limited to, surplus contributions to our Insurance Company Subsidiaries to support premium growth or strategic acquisitions.

During the second quarter of 2011, several of our insurance subsidiaries (Star, Williamsburg, and Ameritrust) became members of the Federal Home Loan Bank of Indianapolis ("FHLBI"). As a member of the FHLBI, these subsidiaries have the ability to borrow on a collateralized basis at relatively low borrowing rates, providing a source of liquidity. The aggregate investment of approximately \$0.5 million by these subsidiaries provides the ability to borrow up to 20 times the total amount of the FHLBI common stock purchased. As of June 30, 2011, based on the subsidiaries' common stock investment, we had the borrowing capacity of up to approximately \$10 million from FHLBI. As of June 30, 2011, we did not have any borrowings outstanding from FHLBI.

Cash flow provided by operations was \$61.9 million and \$72.9 million for the six months ended June 30, 2011 and 2010, respectively. The decrease in operating cash flows is driven primarily by higher paid losses. We maintain a strong balance sheet with diversified geographic risks, high quality reinsurance, and a high quality investment portfolio.

Other Items – Liquidity and Capital Resources

Interest Rate Swaps

We have entered into interest rate swap transactions to mitigate our interest rate risk on our existing debt obligations. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges. These interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and recognized as an adjustment to interest expense.

TABLE OF CONTENTS

Refer to Note 5 ~ Derivative Instruments, for additional information specific to our interest rate swaps.

Credit Facilities

Refer to Note 4 ~ Debt for additional information specific to our credit facilities and debentures.

Investment Portfolio

As of June 30, 2011 and December 31, 2010, the recorded values of our investment portfolio, including cash and cash equivalents, were \$1.4 billion and \$1.3 billion, respectively.

In general, we believe our overall investment portfolio is conservatively invested. The effective duration of the investment portfolio at June 30, 2011, is 5.0 years, compared to 4.8 years at June 30, 2010. Our pre-tax book yield is 4.2%, compared to 4.5% in 2010. The current after-tax yield is 3.1%, compared to 3.4% in 2010. Approximately 98.9% of our fixed income investment portfolio is investment grade.

Shareholders' Equity

Refer to Note 7 ~ Shareholders' Equity of the Notes to the Consolidated Financial Statements.

Contractual Obligations and Commitments

For the six months ended June 30, 2011, there were no material changes in relation to our contractual obligations and commitments, outside of the ordinary course of our business.

Recent Accounting Pronouncements

Refer to Note 1 ~ Summary of Significant Accounting Policies of the Notes to the Consolidated Financial Statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates as well as other relevant market rate or price changes. The volatility and liquidity in the markets in which the underlying assets are traded directly influence market risk. The following is a discussion of our primary risk exposures and how those exposures are currently managed as of June 30, 2011. Our market risk sensitive instruments are primarily related to fixed income securities, which are available for sale and not held for trading purposes.

TABLE OF CONTENTS

Interest rate risk is managed within the context of an asset and liability management strategy where the target duration for the fixed income portfolio is based on the estimate of the liability duration and takes into consideration our surplus. The investment policy guidelines provide for a fixed income portfolio duration of between three and a half and five and a half years. At June 30, 2011 and December 31, 2010, our fixed income portfolio had an effective duration of 5.0.

At June 30, 2011, the fair value of our investment portfolio, excluding cash and cash equivalents, was \$1.3 billion. Our market risk to the investment portfolio is primarily interest rate risk associated with debt securities. Our exposure to equity price risk is related to our investments in relatively small positions of preferred stocks and mutual funds with an emphasis on dividend income. These investments comprise 2.2% of our investment portfolio.

Our investment philosophy is one of maximizing after-tax earnings and has historically included significant investments in tax-exempt bonds. We continue to purchase tax-exempt securities based on our desire to maximize after-tax investment income. For our investment portfolio, there were no significant changes in our primary market risk exposures or in how those exposures are managed compared to the year ended December 31, 2010. We do not anticipate significant changes in our primary market risk exposures or in how those exposures are managed in future reporting periods based upon what is known or expected to be in effect.

A sensitivity analysis is defined as the measurement of potential loss in future earnings, fair values, or cash flows of market sensitive instruments resulting from one or more selected hypothetical changes in interest rates and other market rates or prices over a selected period. In our sensitivity analysis model, a hypothetical change in market rates is selected that is expected to reflect reasonable possible near-term changes in those rates. "Near term" means a period of up to one year from the date of the consolidated financial statements. In our sensitivity model, we use a hypothetical change to measure our potential loss in fair value of debt securities assuming an upward and downward parallel shift in interest rates. The table below presents our model's estimate of changes in fair values given a change in interest rates. Dollar values are in thousands.

|                           | Rates Down 100bps | Rates Unchanged | Rates Up 100bps |
|---------------------------|-------------------|-----------------|-----------------|
| Fair Value                | \$1,359,394       | \$1,297,993     | \$1,232,697     |
| Yield to Maturity or Call | 2.27%             | 3.24%           | 4.24%           |
| Effective Duration        | 4.5               | 5.0             | 5.2             |

The other financial instruments, which include cash and cash equivalents, equity securities, premium receivables, reinsurance recoverables, line of credit and other assets and liabilities, when included in the sensitivity model, do not produce a material change in fair values.

TABLE OF CONTENTS

Our debentures are subject to variable interest rates. Thus, our interest expense on these debentures is directly correlated to market interest rates. At June 30, 2011 and December 31, 2010, we had debentures of \$80.9 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$809,000.

Our term loan is subject to variable interest rates. Thus, our interest expense on our term loan is directly correlated to market interest rates. At June 30, 2011, we had an outstanding balance on our term loan of \$31.3 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$313,000. At December 31, 2010, we had an outstanding balance on our term loan of \$37.8 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$378,000.

We have entered into interest rate swap transactions to mitigate our interest rate risk on our existing debt obligations. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges. These interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and recognized as an adjustment to interest expense. Refer to Note 5 ~ Derivative Instruments for further detail relating to our interest rate swap transactions.

In addition, our revolving line of credit under which we can borrow up to \$35.0 million is subject to variable interest rates. Thus, our interest expense on the revolving line of credit is directly correlated to market interest rates. At June 30, 2011 and December 31, 2010, we had a zero outstanding balance on our revolving line of credit and \$0.5 million in letters of credit had been issued.

TABLE OF CONTENTS

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, the “Exchange Act”), which we refer to as disclosure controls, are controls and procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Exchange Act, such as this Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any control system. A control system, no matter how well conceived and operated, can provide only reasonable assurance that its objectives are met. No evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

As of June 30, 2011, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of disclosure controls. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls were effective in recording, processing, summarizing, and reporting, on a timely basis, material information required to be disclosed in the reports we file under the Exchange Act and is accumulated and communicated, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no significant changes in our internal control over financial reporting during the three month period ended June 30, 2011, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

TABLE OF CONTENTS

## PART II – OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

The information required by this item is included under Note 9 - Commitments and Contingencies of the Notes to the Consolidated Financial Statements of the Company's Form 10-Q for the six months ended June 30, 2011, which is hereby incorporated by reference.

## ITEM 1A. RISK FACTORS

There have been no material changes to the Risk Factors previously disclosed in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2010 and our other filings with the Securities and Exchange Commission.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On February 12, 2010, the Company's Board of Directors authorized management to purchase up to 5,000,000 shares of the Company's common stock in market transactions for a period not to exceed twenty-four months.

The following table represents information with respect to repurchases of the Company's common stock for the quarterly period ended June 30, 2011:

| Period                   | Total<br>Number of<br>Shares | Average<br>Price Paid<br>Per Share | Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that may<br>still be<br>Repurchased<br>Under the Plans<br>or Programs |
|--------------------------|------------------------------|------------------------------------|--|--|
| April 1 - April 30, 2011 | -                            | \$ -                               | -  | 2,519,000  |
| May 1 - May 31, 2011     | 400,000                      | 9.76                               | -  | 2,119,000  |
| June 1 - June 30, 2011   | -                            | -                                  | -  | 2,119,000  |
| Total                    | 400,000                      | \$ 9.76                            | -  |  |

TABLE OF CONTENTS

## ITEM 6. EXHIBITS

The following documents are filed as part of this Report:

## Exhibit

| No.  | Description   |
|------|---|
| 31.1 | Certification of Robert S. Cubbin, Chief Executive Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).  |
| 31.2 | Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).  |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Robert S. Cubbin, Chief Executive Officer of the Corporation.                         |
| 32.2 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation. |
| 101  | Interactive Data File   |

TABLE OF CONTENTS

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Meadowbrook Insurance Group, Inc.

By: /s/

Karen M. Spaun  
Senior Vice President and  
Chief Financial Officer

Dated: August 9, 2011



TABLE OF CONTENTS

## EXHIBITS INDEX

| Exhibit No. | Description   |
|-------------|---|
| <u>31.1</u> | Certification of Robert S. Cubbin, Chief Executive Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).  |
| <u>31.2</u> | Certification of Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation, pursuant to Securities Exchange Act Rule 13a-14(a).  |
| <u>32.1</u> | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Robert S. Cubbin, Chief Executive Officer of the Corporation.                         |
| <u>32.2</u> | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer of the Corporation. |
| 101         | Interactive Data File   |

51

---