

MEADOWBROOK INSURANCE GROUP INC  
Form 10-Q  
August 14, 2013

---

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, 2013

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 38-2626206  
(State of Incorporation) (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 12, 2013, was 49,887,200.

---

---

TABLE OF CONTENTS

	<u>Page</u>
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 Statements of Cash Flows (unaudited)</u>	7
<u>Notes to Consolidated Financial Statements (unaudited)</u>	8-33
ITEM 2 – <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	34-52
ITEM 3 – <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	53-55
ITEM 4 – <u>CONTROLS AND PROCEDURES</u>	55
PART II – OTHER INFORMATION	
ITEM 1 – <u>LEGAL PROCEEDINGS</u>	56
ITEM 1A – <u>RISK FACTORS</u>	56
ITEM 2 – <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	68
ITEM 3 – <u>DEFAULTS UPON SENIOR SECURITIES</u>	68
ITEM 4 – <u>MINE SAFETY DISCLOSURES</u>	68
ITEM 5 – <u>OTHER INFORMATION</u>	68
ITEM 6 – <u>EXHIBITS</u>	69
<u>SIGNATURES</u>	70
1	

---

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,

	2013	2012
	(Unaudited)	
	(In thousands, except share data)	
Revenues		
Premiums earned		
Gross	\$264,853	\$248,581
Ceded	(89,072 )	(37,278 )
Net earned premiums	175,781	211,303
Net commissions and fees	8,539	8,552
Net investment income	11,768	13,683
Realized gains:		
Total other-than-temporary impairments on securities	-	-
Portion of loss recognized in other comprehensive income	-	-
Net other-than-temporary impairments on securities recognized in earnings	-	-
Net realized gains excluding other-than-temporary impairments on securities	2,869	1,567
Net realized gains	2,869	1,567
Total revenues	198,957	235,105
Expenses		
Losses and loss adjustment expenses	200,807	196,976
Reinsurance recoveries	(55,436 )	(31,218 )
Net losses and loss adjustment expenses	145,371	165,758
Policy acquisition and other underwriting expenses	58,450	68,993
General, selling and administrative expenses	5,901	6,327
General corporate expenses	760	758
Amortization expense	1,038	1,307
Goodwill impairment expense	115,397	-
Interest expense	3,653	2,033
Total expenses	330,570	245,176
Loss before taxes and equity earnings	(131,613 )	(10,071 )
Federal and state income tax benefit	(17,604 )	(1,782 )
Equity earnings of affiliates, net of tax	945	562
Equity earnings (losses) of unconsolidated subsidiaries, net of tax	6	(5 )
Net loss	\$(113,058 )	\$(7,732 )
Losses Per Share		
Basic	\$(2.27 )	\$(0.15 )
Diluted	\$(2.27 )	\$(0.15 )

Weighted average number of common shares

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

Basic	49,887,200	50,251,591
Diluted	49,887,200	50,251,591
Dividends paid per common share	\$0.02	\$0.05

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

2

---

Table of ContentsMEADOWBROOK INSURANCE GROUP, INC.  
CONSOLIDATED STATEMENTS OF INCOME

For the Six Months Ended June 30,

	2013	2012
	(Unaudited)	
	(In thousands, except share data)	
Revenues		
Premiums earned		
Gross	\$529,195	\$476,027
Ceded	(182,826 )	(71,909 )
Net earned premiums	346,369	404,118
Net commissions and fees	18,173	17,517
Net investment income	22,908	27,415
Realized gains:		
Total other-than-temporary impairments on securities	-	-
Portion of loss recognized in other comprehensive income	-	-
Net other-than-temporary impairments on securities recognized in earnings	-	-
Net realized gains excluding other-than-temporary impairments on securities	3,185	2,299
Net realized gains	3,185	2,299
Total revenues	390,635	451,349
Expenses		
Losses and loss adjustment expenses	392,781	358,495
Reinsurance recoveries	(125,594 )	(59,990 )
Net losses and loss adjustment expenses	267,187	298,505
Policy acquisition and other underwriting expenses	109,055	132,106
General, selling and administrative expenses	11,924	12,666
General corporate expenses	2,276	2,131
Amortization expense	2,109	2,723
Goodwill impairment expense	115,397	-
Interest expense	5,850	4,010
Total expenses	513,798	452,141
Loss before taxes and equity earnings	(123,163 )	(792 )
Federal and state income tax (benefit) expense	(15,768 )	73
Equity earnings of affiliates, net of tax	1,383	1,250
Equity losses of unconsolidated subsidiaries, net of tax	36	(13 )
Net (loss) income	\$(105,976 )	\$372
(Losses) Earnings Per Share		
Basic	\$(2.13 )	\$0.01
Diluted	\$(2.13 )	\$0.01
Weighted average number of common shares		
Basic	49,855,716	50,583,368
Diluted	49,855,716	50,583,368

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

Dividends paid per common share	\$0.04	\$0.10
---------------------------------	--------	--------

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

3

---

Table of ContentsMEADOWBROOK INSURANCE GROUP, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Three Months Ended June 30,

	2013	2012
	(Unaudited)	
	(In thousands)	
Net loss	\$(113,058)	\$(7,732)
Other comprehensive loss, net of tax:		
Unrealized (losses) gains on securities	(32,487 )	7,325
Unrealized gains in affiliates and unconsolidated subsidiaries	50	16
Increase on non-credit other-than-temporary impairments on securities	-	34
Net deferred derivative gains (losses) - hedging activity	2,233	(413 )
Less reclassification adjustment for investment gains included in net income	(1,890 )	(1,070)
Other comprehensive (losses) gains, net of tax	(32,094 )	5,892
Comprehensive loss	\$(145,152)	\$(1,840)

MEADOWBROOK INSURANCE GROUP, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Six Months Ended June 30,

	2013	2012
	(Unaudited)	
	(In thousands)	
Net (loss) income	\$(105,976)	\$372
Other comprehensive (loss) income, net of tax:		
Unrealized (losses) gains on securities	(35,269 )	6,908
Unrealized gains in affiliates and unconsolidated subsidiaries	62	165
Increase on non-credit other-than-temporary impairments on securities	-	292
Net deferred derivative gains (losses) - hedging activity	3,038	(113 )
Less reclassification adjustment for investment gains included in net income	(2,077 )	(1,532)
Other comprehensive (loss) gains, net of tax	(34,246 )	5,720
Comprehensive (loss) income	\$(140,222)	\$6,092

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



Table of ContentsMEADOWBROOK INSURANCE GROUP, INC.  
CONSOLIDATED BALANCE SHEETS

	June 30, 2013 (Unaudited)	December 31, 2012
	(In thousands, except share data)	
<b>ASSETS</b>		
Investments		
Debt securities available for sale, at fair value (amortized cost of \$1,431,965 and \$1,211,794)	\$ 1,445,076	\$ 1,286,807
Equity securities available for sale, at fair value (cost of \$101,625 and \$20,389)	108,723	22,661
Cash and cash equivalents	118,048	342,124
Accrued investment income	13,966	11,167
Premiums and agent balances receivable, net	218,191	208,743
Reinsurance recoverable on:		
Paid losses	22,432	13,612
Unpaid losses	445,100	381,905
Prepaid reinsurance premiums	100,735	143,180
Deferred policy acquisition costs	54,904	45,417
Deferred income taxes, net	42,057	10,929
Goodwill	5,644	121,041
Other intangible assets	26,155	28,264
Other assets	131,865	97,424
Total assets	\$2,732,896	\$2,713,274
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities		
Losses and loss adjustment expenses	\$ 1,531,849	\$ 1,455,980
Unearned premiums	411,974	439,418
Debt	162,975	78,500
Debtures	80,930	80,930
Accounts payable and accrued expenses	28,360	29,190
Funds held and reinsurance balances payable	54,290	49,622
Payable to insurance companies	3,926	5,641
Other liabilities	39,126	15,714
Total liabilities	2,313,430	2,154,995
Shareholders' Equity		
Common stock, \$0.01 par value; authorized 75,000,000 shares; 49,887,200 and 49,776,011 shares issued and outstanding	499	505
Additional paid-in capital	276,024	272,472
Retained earnings	129,223	237,351
Note receivable from officer	(722 )	(737 )
Accumulated other comprehensive income	14,442	48,688
Total shareholders' equity	419,466	558,279
Total liabilities and shareholders' equity	\$2,732,896	\$2,713,274

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

5

---

Table of ContentsMEADOWBROOK INSURANCE GROUP, INC.  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

	Common Stock	Additional Paid-In Capital	Retained Earnings	Note Receivable from Officer	Accumulated Other Comprehensive Income	Total Shareholders' Equity
	(Unaudited, In thousands)					
Balances December 31, 2012	\$505	\$272,472	\$237,351	\$ (737 )	\$ 48,688	\$ 558,279
Net loss	-	-	(105,976)	-	-	(105,976 )
Dividends declared	-	-	(1,995 )	-	-	(1,995 )
Change in unrealized gain or loss on available for sale securities, net of tax	-	-	-	-	(37,192 )	(37,192 )
Change in valuation allowance on deferred tax assets	-	-	-	-	(154 )	(154 )
Net deferred derivative gain - hedging activity	-	-	-	-	3,038	3,038
Stock award	1	190	-	-	-	191
Long term incentive plan; stock award for 2012 and 2013 plan years	-	212	-	-	-	212
Change in investment of affiliates, net of tax	-	-	-	-	33	33
Change in investment of unconsolidated subsidiaries	-	-	-	-	29	29
Stock warrant issuance	-	3,023	-	-	-	3,023
Other reclass	(7 )	127	(157 )	-	-	(37 )
Note receivable from officer	-	-	-	15	-	15
Balances June 30, 2013	\$499	\$276,024	\$129,223	\$ (722 )	\$ 14,442	\$ 419,466

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

Table of ContentsMEADOWBROOK INSURANCE GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Six Months Ended June 30,

	2013	2012
	(Unaudited)	
	(In thousands)	
Cash Flows From Operating Activities		
Net (loss) income	\$(105,976)	\$372
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:		
Amortization of other intangible assets	2,109	2,723
Amortization of deferred debenture issuance costs	63	63
Impairment of goodwill	115,397	-
Depreciation of furniture, equipment, and building	2,384	2,821
Net amortization of discount and premiums on bonds	5,270	2,990
Accretion of issued debt/original issue discount	417	-
Amortization of capitalized convertible note fees	118	-
Gain on sale of investments	(3,195 )	(2,356 )
Gain on sale of fixed assets	(44 )	(44 )
Long-term incentive plan expense	212	106
Stock award	191	194
Equity earnings of affiliates, net of taxes	(1,383 )	(1,250 )
Equity (earnings) losses of unconsolidated subsidiaries, net of tax	(36 )	13
Deferred income tax expense (benefit)	(13,053 )	(2,075 )
Goodwill adjustment	-	(249 )
Write-off of book of business	-	123
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Premiums and agent balances receivable	(9,448 )	(33,325 )
Reinsurance recoverable on paid and unpaid losses	(72,015 )	(36,395 )
Prepaid reinsurance premiums	42,445	(3,924 )
Deferred policy acquisition costs	(9,487 )	(6,087 )
Other assets	(20,530 )	(3,561 )
Increase (decrease) in:		
Losses and loss adjustment expenses	75,869	106,025
Unearned premiums	(27,444 )	38,010
Payable to insurance companies	(1,715 )	1,738
Funds held and reinsurance balances payable	4,668	8,361
Other liabilities	13,684	(1,233 )
Total adjustments	104,477	72,668
Net cash (used in) provided by operating activities	(1,499 )	73,040
Cash Flows From Investing Activities		
Purchase of debt securities available for sale	(334,138)	(169,329)
Proceeds from sales and maturities of debt securities available for sale	109,397	69,247
Purchase of equity securities available for sale	(93,641 )	-
Proceeds from sales of equity securities available for sale	14,240	2,506
Capital expenditures	(764 )	(958 )

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

Other investing activities	228	(4,367 )
Net cash used in investing activities	(304,678)	(102,901)
Cash Flows From Financing Activities		
Proceeds from line of credit	-	10,000
Proceeds from FHLB advance	-	30,000
Payments on term loan	(3,000 )	(7,375 )
Proceeds from convertible senior notes	96,324	-
Payments for convertible senior notes hedge	(12,942 )	-
Proceeds from issuance of warrants	3,023	-
Book overdrafts	676	197
Dividends paid on common stock	(1,995 )	(5,057 )
Share repurchases	-	(11,517 )
Other financing activities	15	15
Net cash provided by financing activities	82,101	16,263
Net decrease in cash and cash equivalents	(224,076)	(13,598 )
Cash and cash equivalents, beginning of period	342,124	101,757
Cash and cash equivalents, end of period	\$118,048	\$88,159
Supplemental Disclosure of Cash Flow Information:		
Interest paid	\$3,590	\$3,695
Net income taxes paid (1)	\$1,165	\$3,476
Supplemental Disclosure of Non-Cash Investing and Financing Activities:		
Stock-based employee compensation	\$191	\$194

(1) Tax return refunds were received in first quarter of 2013 and 2012 for \$3,067 and \$475, respectively.

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 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, 2013 are not necessarily indicative of the results expected for the full year. In addition, certain amounts in the 2012 financial statements have been reclassified to conform to the 2013 presentation as a result of adopting the new Accumulated Other Comprehensive guidance noted below.

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 fiscal year ended December 31, 2012.

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.

8

---

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Assumed premium estimates include business where the company accepts a portion of the risk from a ceding carrier as well as the mandatory assumed pool business from the National Council on Compensation Insurance (“NCCI”), or residual market business. The majority of the assumed premium is from an established book of workers’ compensation business produced by a ceding company in which the Company has an equity stake.

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. Commission adjustments that occur subsequent to the issuance of the policy because of cancellation, typically are recognized when the policy is effectively cancelled. Profit sharing commissions from insurance companies are recognized when determinable, which is when such commissions are received.

Income Taxes

As of June 30, 2013 and December 31, 2012, the Company did not have any unrecognized tax benefits and had no accrued interest or penalties related to uncertain tax positions.

Recent Accounting Pronouncements

Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income

In February 2013, the FASB issued guidance to improve the reporting of reclassifications out of accumulated other comprehensive income. The guidance requires an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. The guidance is to be applied prospectively for reporting periods beginning after December 15, 2012. The Company adopted this new guidance on January 1, 2013 and included the required disclosures in note 10 ~ Accumulated Other Comprehensive Income.

Table of Contents

## MEADOWBROOK INSURANCE GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 2 – Investments

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, 2013 and December 31, 2012 were as follows (in thousands):

	June 30, 2013				
	Cost or Amortized Cost	Gross Unrealized		Non-Credit OTTI	Estimated Fair Value
		Gains	Losses		
Debt Securities:					
U.S. Government and agencies	\$24,438	\$670	\$(159 )	\$ -	\$24,949
Obligations of states and political subs	741,419	28,203	(19,807)	-	749,815
Corporate securities	484,266	16,013	(12,257)	-	488,022
Redeemable preferred stocks	854	362	-	-	1,216
Residential mortgage-backed securities	131,759	2,744	(3,441 )	-	131,062
Commercial mortgage-backed securities	33,357	1,007	(944 )	-	33,420
Other asset-backed securities	15,872	745	(25 )	-	16,592
Total debt securities available for sale	1,431,965	49,744	(36,633)	-	1,445,076
Equity Securities:					
Perpetual preferred stock	6,007	1,393	-	-	7,400
Common stock	95,618	6,837	(1,132 )	-	101,323
Total equity securities available for sale	101,625	8,230	(1,132 )	-	108,723
Total securities available for sale	\$1,533,590	\$57,974	\$(37,765)	\$ -	\$1,553,799

	December 31, 2012				
	Cost or Amortized Cost	Gross Unrealized		Non-Credit OTTI	Estimated Fair Value
		Gains	Losses		
Debt Securities:					
U.S. Government and agencies	\$26,788	\$918	\$(22 )	\$ -	\$27,684
Obligations of states and political subs	587,276	43,124	(1,427)	-	628,973
Corporate securities	482,290	25,569	(858 )	-	507,001
Redeemable preferred stocks	1,743	436	-	-	2,179
Residential mortgage-backed securities	73,530	4,393	(41 )	-	77,882
Commercial mortgage-backed securities	33,732	1,800	-	-	35,532
Other asset-backed securities	6,435	1,125	(4 )	-	7,556
Total debt securities available for sale	1,211,794	77,365	(2,352)	-	1,286,807
Equity Securities:					
Perpetual preferred stock	6,930	1,578	-	-	8,508
Common stock	13,459	901	(207 )	-	14,153
Total equity securities available for sale	20,389	2,479	(207 )	-	22,661



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

Total securities available for sale	\$1,232,183	\$79,844	\$(2,559)	\$	-	\$1,309,468
-------------------------------------	-------------	----------	-----------	----	---	-------------

---

10

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, 2013 and December 31, 2012 were as follows (in thousands):

	June 30, 2013	December 31, 2012
Unrealized gains	\$57,974	\$79,844
Unrealized losses	(37,765)	(2,559 )
Non-credit OTTI	-	-
Net unrealized gains	20,209	77,285
Deferred federal income tax expense	(7,073 )	(26,957 )
Net unrealized gains on investments, net of deferred federal income taxes	\$13,136	\$50,328

Net realized gains (losses including OTTI) on securities, for the three months and six months ended June 30, 2013 and 2012 were as follows (in thousands):

	For the Three Months Ended June 30, 2013		For the Six Months Ended June 30, 2012	
Realized gains (losses):				
Debt securities:				
Gross realized gains	\$1,500	\$1,328	\$1,530	\$1,994
Gross realized losses	(162 )	(21 )	(170 )	(33 )
Total debt securities	1,338	1,307	1,360	1,961
Equity securities:				
Gross realized gains	1,570	338	1,845	395
Gross realized losses	(1 )	-	(10 )	-
Total equity securities	1,569	338	1,835	395
Net realized gains	\$2,907	\$1,645	\$3,195	\$2,356
OTTI included in realized losses on securities above	\$-	\$-	\$-	\$-

Proceeds from the sales of debt and equity securities available for sale were \$69.7 million and \$9.6 million for the three months ended June 30, 2013 and 2012, respectively. Proceeds from the sales of debt and equity securities available for sale were \$76.2 million and \$20.4 million for the six months ended June 30, 2013 and 2012, respectively.

Table of Contents

## MEADOWBROOK INSURANCE GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

At June 30, 2013, 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 Cost	Estimated Fair Value
Due in one year or less	\$43,167	\$43,678
Due after one year through five years	371,017	383,473
Due after five years through ten years	627,935	635,550
Due after ten years	208,858	201,301
Mortgage-backed securities, collateralized obligations and asset-backed securities	180,988	181,074
	\$1,431,965	\$1,445,076

Net investment income for the three months and six months ended June 30, 2013 and 2012 was as follows (in thousands):

	For the Three Months		For the Six Months	
	Ended June 30, 2013	2012	Ended June 30, 2013	2012
Net Investment Income Earned From:				
Debt securities	\$11,016	\$13,507	\$21,704	\$26,800
Equity securities	930	370	1,550	876
Cash and cash equivalents	199	143	393	417
Total gross investment income	12,145	14,020	23,647	28,093
Less investment expenses	377	337	739	678
Net investment income	\$11,768	\$13,683	\$22,908	\$27,415

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

Available for sale securities are reviewed for declines in fair value, excluding other-than-temporary declines. For a debt security, if the Company intends to sell a security and it is more likely than not that 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 that 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 that 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, sales 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 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/or
- 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.

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 of the cost of the security 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 of the cost of the security, 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.

Table of Contents

## MEADOWBROOK INSURANCE GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Company reviewed its investment portfolio in relation to its OTTI policy and determined that the Company did not record a credit related OTTI loss or recognize a non-credit related OTTI loss in other comprehensive income for the three months and six months ended June 30, 2013 and 2012.

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, 2013								
	Less than 12 months			Greater than 12 months			Total		
	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Non-Credit OTTI	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Non-Credit OTTI	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Non-Credit OTTI
Debt Securities:									
U.S. Government and agencies Obligations of states and political subs	8	\$ 8,325	\$(159 )	-	\$ -	\$ -	8	\$ 8,325	\$(159 )
Corporate securities	133	324,046	(19,807 )	-	-	-	133	324,046	(19,807 )
Redeemable preferred stocks	-	-	-	-	-	-	-	-	-
Residential mortgage-backed securities	13	85,963	(3,440 )	1	23	(1 )	14	85,986	(3,441 )
Commercial mortgage-backed securities	6	13,093	(944 )	-	-	-	6	13,093	(944 )
Other asset-backed securities	2	4,369	(25 )	-	-	-	2	4,369	(25 )
Total debt securities	273	721,610	(36,632 )	1	23	(1 )	274	721,633	(36,633 )
Equity Securities:									
Perpetual preferred stock	-	-	-	-	-	-	-	-	-
Common stock	33	17,635	(766 )	2	4,514	(366 )	35	22,149	(1,132 )
Total equity securities	33	17,635	(766 )	2	4,514	(366 )	35	22,149	(1,132 )
Total securities	306	\$ 739,245	\$(37,398 )	3	\$ 4,537	\$(367 )	309	\$ 743,782	\$(37,765 )



Table of Contents

## MEADOWBROOK INSURANCE GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

	December 31, 2012			Greater than 12 months			Total		
	Less than 12 months	Fair Value of Investments with Unrealized Losses	Gross Unrealized Non-Credit OTTI	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Non-Credit OTTI	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Non-Credit OTTI
Debt Securities:									
U.S. Government and agencies	5	\$7,063	\$(22 )	-	\$-	\$-	5	\$7,063	\$(22 )
Obligations of states and political subs	23	69,016	(1,427 )	-	-	-	23	69,016	(1,427 )
Corporate securities	50	113,348	(858 )	-	-	-	50	113,348	(858 )
Redeemable preferred stocks	-	-	-	-	-	-	-	-	-
Residential mortgage-backed securities	1	10,219	(40 )	1	24	(1 )	2	10,243	(41 )
Commercial mortgage-backed securities	-	-	-	-	-	-	-	-	-
Other asset-backed securities	2	463	(4 )	-	-	-	2	463	(4 )
Total debt securities	81	200,109	(2,351 )	1	24	(1 )	82	200,133	(2,352 )
Equity Securities:									
Perpetual preferred stock	-	-	-	-	-	-	-	-	-
Common stock	-	-	-	2	4,583	(207 )	2	4,583	(207 )
Total equity securities	0	-	-	2	4,583	(207 )	2	4,583	(207 )
Total securities	81	\$200,109	\$(2,351 )	3	\$4,607	\$(208 )	84	\$204,716	\$(2,559 )

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 December 31, 2012	\$(156)
Additional credit impairments on:	
Previously impaired securities	-

Securities for which an impairment was not previously recognized	-
Reductions	156
Balance as of June 30, 2013	\$-

NOTE 3 – Fair Value Measurements

According to accounting guidance for fair value measurements and disclosures, fair value is the price that would be received in the sale of an asset or would be paid in the transfer of 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”).

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:

15



Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 7.1% 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 92.7% 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 0.2% of the fair value of the total investment portfolio.

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.

16

---

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 17 securities totaling \$3.7 million or 0.2% 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 1 holding. Benchmarking techniques based upon industry sector, rating and other factors are used on 16 holdings.

Also included in Level 3 valuation are the conversion feature within the Notes (as defined below) and the convertible senior notes hedge. The estimated fair values of the both the conversion feature and the convertible senior notes hedge are obtained from the third party financial institution counterparties valued using non-binding broker quotations and significant unobservable inputs.

17

---

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, 2013 (in thousands):

	June 30, 2013 Total	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Debt Securities:</b>				
U.S. Government and agencies	\$24,949	\$-	\$24,949	\$ -
Obligations of states and political subs	749,815	-	749,815	-
Corporate securities	488,022	-	487,063	959
Redeemable preferred stocks	1,216	1,216	-	-
Residential mortgage-backed securities	131,062	-	131,062	-
Commercial mortgage-backed securities	33,420	-	33,241	179
Other asset-backed securities	16,592	-	14,073	2,519
Total debt securities available for sale	1,445,076	1,216	1,440,203	3,657
<b>Equity Securities:</b>				
Perpetual preferred stock	7,400	7,183	217	-
Common stock	101,323	101,323	-	-
Total equity securities available for sale	108,723	108,506	217	-
Total securities available for sale	\$1,553,799	\$109,722	\$1,440,420	\$ 3,657
<b>Derivatives:</b>				
Derivatives - interest rate swaps	\$145	\$-	\$145	\$ -
Cash conversion feature of cash convertible notes	(12,967 )	-	-	(12,967 )
Purchased cash convertible note hedge	12,967	-	-	12,967
Total derivatives	\$145	\$-	\$145	\$ -
Total securities available for sale and derivatives	\$1,553,944	\$109,722	\$1,440,565	\$ 3,657

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 and derivatives measured at fair value on a recurring basis as of June 30, 2013 (in thousands):

	Fair Value Measurement Using Significant Unobservable Inputs - Level 3
Balance as of December 31, 2012	\$ 5,444
Total gains or losses (realized/unrealized):	
Included in earnings	721
Included in other comprehensive income	(476 )
Purchases	-
Issuances	-
Settlements	(2,032 )
Transfers in and out of Level 3	-
Balance as of June 30, 2013	\$ 3,657

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 three months and six months ended June 30, 2013, no transfers into or out of Levels 1, 2 and 3 were required.

NOTE 4 – Debt

## Credit Facilities

On August 29, 2012, the Company executed \$130.0 million in senior credit facilities (the "Credit Facilities"). The Credit Facilities include a \$30.0 million term loan facility and a \$100.0 million revolving credit facility.

The term loan facility has a four year term with a \$30.0 million borrowing limit, which, subject to certain exceptions, can be increased up to an additional \$25.0 million. As of June 30, 2013, the outstanding balance on its term loan facility was \$25.5 million. The Company had \$20.0 million outstanding under its revolving credit facility as of June 30, 2013, and \$0.5 million in letters of credit had been issued as of June 30, 2013. The undrawn portion of the revolving credit facility, which was \$79.5 million as of June 30, 2013, is available to finance working capital and for other general corporate purposes, including but not limited to, surplus contributions to its Insurance Company Subsidiaries to support premium growth or strategic acquisitions. These Credit Facilities replaced the Company's

former term loan and revolving credit agreement, which were terminated upon the closing of the Credit Facilities. At December 31, 2012, the Company had an outstanding balance of \$28.5 million on its term loan and a \$20.0 million outstanding balance on its revolving credit facility. There was \$0.5 million in letters of credit that had been issued as of December 31, 2012.

19

---

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The principal amount outstanding under the Credit Facilities provides for interest at either the Alternative Base Rate (“ABR”) or the London interbank offered rate (“LIBOR”). ABR borrowings under the Agreement will bear interest at the greatest of (a) the Administrative Agent’s prime rate, (b) the federal funds effective rate plus 0.5%, or (c) the adjusted LIBOR for a one-month period plus 1.0%, in each case, plus a margin that is adjusted on the basis of Company’s consolidated leverage ratio. Eurodollar borrowings under the Agreement will bear interest at the adjusted LIBOR for the interest period in effect plus a margin that is adjusted on the basis of Company’s consolidated leverage ratio. In addition, the Credit Facilities provide for an unused facility fee ranging between twenty basis points and thirty basis points, based on the Company’s consolidated leverage ratio as defined by the Credit Facilities. At June 30, 2013, the interest rate on the Company’s term loan was 2.72%, which consisted of a weighted fixed rate of 0.72%, plus an applicable margin of 2.00%, as described in Note 5 ~ Derivative Instruments. At June 30, 2013, the interest rate on the Company’s revolving credit facility was 0.31%, plus a 2.00% margin.

The financial covenants applicable to the Credit Facilities consist of: (1) minimum consolidated net worth starting at eighty percent of December 31, 2011 consolidated shareholders’ equity, with quarterly increases thereafter of fifty percent of net income (2) minimum Risk Based Capital Ratio for Star of 1.50 to 1.00 and all other Insurance Company Subsidiaries of 1.75 to 1.00, (3) maximum permitted consolidated leverage ratio of 0.35 to 1.00, (4) minimum consolidated fixed charge coverage ratio of 1.25 to 1.00, and (5) minimum A.M. Best rating of “B+.” As of June 30, 2013, the Company was not in compliance with the minimum consolidated net worth and the maximum permitted consolidated leverage ratio covenants as a result of the goodwill impairment recorded in the second quarter of 2013, as described in Note 11 ~ Subsequent Events. Pursuant to the credit agreement, the lenders may take either or both of the following actions related to the non-compliance with the covenants: (i) immediate termination of the loan commitments, and (ii) declaration of the \$45.5 million outstanding loans to be due and payable in whole together with accrued interest. As a result of the non-compliance with these covenants, the Company is currently in discussions with the lending group to amend the loan agreements that may include obtaining a waiver and revision of the financial covenants. While the Company remains in discussions with the lending group, the Company has not obtained, and there can be no assurance that the Company will obtain such an amendment.

20

---

Table of Contents

## MEADOWBROOK INSURANCE GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## FHLBI

During 2011, several of the Insurance Company 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. As of June 30, 2013, the Company had borrowed \$30.0 million from the FHLBI after pledging as collateral residential mortgage-backed securities (“RMBS”) having a carrying value of \$45.6 million, and making a FHLBI common stock investment of approximately \$1.6 million. The Company has the ability to increase its borrowing capacity through purchasing additional investments in FHLBI and pledging additional securities. The Company retains all the rights regarding the collateralized RMBS.

## 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, 2013 (1)	Principal Amount
2003	Junior subordinated debentures	2008	2033	Three-month LIBOR, plus 4.05%	4.32 %	\$ 10,310
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.00%	4.28 %	13,000
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.20%	4.47 %	12,000
2005	Junior subordinated debentures	2010	2035	Three-month LIBOR, plus 3.58%	3.85 %	20,620
	Junior subordinated debentures (2)	2007	2032	Three-month LIBOR, plus 4.00%	4.28 %	15,000
	Junior subordinated debentures (2)	2008	2033	Three-month LIBOR, plus 4.10%	4.38 %	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 issuances 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 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.

21

---



Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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.

Cash Convertible Senior Notes

On March 18, 2013, the Company issued \$100.0 million of 5.0% cash convertible senior notes (the "Notes"), which mature on March 15, 2020. Interest on the Notes is payable semi-annually in arrears on March 15 and September 15 of each year, commencing September 15, 2013. Until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert their Notes solely into cash at any time on or after September 15, 2019 or earlier under certain circumstances determined by: (i) the market price of the Company's stock, (ii) the trading price of the Notes, or (iii) the occurrence of specified corporate transactions. The notes are not convertible into Meadowbrook common stock or any other securities under any circumstances. The initial conversion rate is 108.8732 shares of common stock per \$1,000 principal amount of the Notes (equivalent to an initial conversion price of approximately \$9.18 per share), subject to adjustment upon the occurrence of certain events. Additionally, in the event of a fundamental change, the holders may require the Company to repurchase the Notes for a cash price equal to 100% of the principal, plus any accrued and unpaid interest. The proceeds from the issuance of the Notes were bifurcated into a debt component and an embedded conversion option component.

Due to the bifurcation, the debt component reflects an original issue discount ("OID") of \$12.9 million. The OID and deferred issuance costs of \$3.7 million will be amortized into interest expense over the term of the Notes. After considering the contractual interest payments and amortization of the OID, the Notes' effective interest rate is 7.4%. Interest expense, including amortization of deferred issuance costs, recognized on the Notes was \$1.7 million and \$2.0 million for the three and six months ended June 30, 2013, respectively.

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The following table shows the amounts recorded for the debt component of the Notes as of June 30, 2013 (in thousands):

Outstanding principal	\$100,000
Unamortized OID	(12,525 )
Total debt component	\$87,475

As the conversion feature is structured under the cash settlement method, the embedded conversion option is reported as a derivative liability.

In connection with the offering of the Notes, the Company also entered into cash convertible senior notes hedge transactions (the "Note Hedges") and warrant transactions (the "Warrants") with respect to its common stock with certain counter-parties. Upon conversion, the Note Hedges are intended to offset potential cash payments in excess of the principal of the Notes. The Note Hedges and Warrants are separate transactions, entered into by the Company with certain counter-parties and are not part of the terms of the Notes.

The Company paid \$12.9 million for the Note Hedges, which are exercisable upon conversion of the Notes. The Note Hedges are structured under the cash settlement method and are accounted for as a derivative asset.

The Company received \$3.0 million for the warrants sold to certain counter-parties. The warrants have a strike price of \$11.69 and will be net share settled; meaning the Company will issue a number of shares per warrant corresponding to the difference between its share price on each warrant exercise date and the exercise price. The warrants meet the definition of derivatives under the guidance in ASC 815; however, because these instruments have been determined to be indexed to the Company's own stock and meet the criteria for equity classification under ASC 815-40, the warrants have been accounted for as an adjustment to the Company's paid-in-capital.

If the market value per share of the Company's common stock exceeds the strike price of the warrants, the warrants will have a dilutive effect on the Company's net income per share and the Company will use the "treasury stock" method in calculating the dilutive effect on earnings per share.

23

---

Table of Contents

## MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)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.

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 Amount at	
				Fixed Rate	June 30, 2013
6/30/2013	6/30/2023	Junior subordinated debentures	Three-month LIBOR, plus 4.05%	6.340%	\$ 10,000
4/29/2013	4/29/2023	Senior debentures	Three-month LIBOR, plus 4.00%	6.250%	13,000
9/28/2012	8/30/2016	Term loan (1)	Three-month LIBOR	0.724%	25,500
8/15/2008	8/15/2013	Junior subordinated debentures (2)(3)	Three-month LIBOR	3.780%	10,000
9/4/2008	9/4/2013	Junior subordinated debentures (2)(3)	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
				Total	\$ 105,500

(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 2.00% in accordance with the Credit Facilities.

(2) During the quarter ended June 30, 2012, the Company entered into forward starting interest rate swaps. The swaps will replace the identified interest rate swap, upon their expiration in 2013. The fixed rates on the forward starting interest rate swaps are approximately 150 basis points less than the fixed rates on the current swaps in place.

Additionally, the forward starting interest rate swaps will expire ten years from the effective date.

(3) 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, 2013 and 2012, was approximately \$0.6 million and \$0.7 million, respectively. The net interest expense incurred for the six months ended June 30, 2013 and 2012, was approximately \$1.3 million and \$1.5 million, respectively.

24

---

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

As of June 30, 2013 and December 31, 2012, the total fair value of the interest rate swaps were unrealized gains (losses) of \$0.1 million and (\$4.5 million), respectively. At June 30, 2013 and December 31, 2012, accumulated other comprehensive income included accumulated gain (loss) on the cash flow hedge, net of taxes, of approximately \$0.1 million and (\$2.9 million), respectively.

In March 2012, the Company replaced its existing \$5.6 million convertible note and \$664,000 demand note receivables with an unaffiliated insurance agency into new debt instruments with a related limited liability company. The new instruments were effective January 1, 2012 and consist of a \$2 million convertible note and a \$4.2 million term loan. The interest rate on the convertible note is 3% and is due on January 1, 2022. This note is convertible at the option of the Company based upon a pre-determined formula. The interest rate on the term loan is 5.5% and is due on April 30, 2016. As security for the note and term loan, the borrower granted the Company a first lien on all of its accounts receivable, cash, general intangibles, and other assets. As additional collateral for the note and term loan, the Company obtained guaranties of payment and performance from certain affiliated companies of the borrower, as well as related individuals, which guaranties are secured by additional collateral.

Cash Convertible Senior Notes and Note Hedges

As discussed in Note 4 ~ Debt, the Company issued the Notes. Holders may convert their cash convertible notes subject to certain conversion provisions. In order to offset the risk associated with the cash conversion feature, the Company entered into convertible note hedges with certain counterparties. Both the cash conversion feature and the purchased convertible note hedges are measured at fair value with gains and losses recorded in the Company's Consolidated Statements of Income.

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"). No restricted stock awards were issued in 2012 or 2013. 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 \$82,000 of restricted stock awards compensation expense for both the three months ended June 30, 2013 and 2012, respectively. The Company recorded approximately \$164,000 and \$128,000 of restricted stock awards compensation expense for the six months ended June 30, 2013 and 2012, respectively.

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

On February 13, 2013, and February 23, 2012 the Company issued 2,400 and 1,500 non-restricted stock awards, respectively, to members of the Board of Directors, which vested immediately. The Company recorded zero non-restricted stock awards compensation expense for the three months ended June 30, 2013 and 2012, respectively. The Company recorded approximately \$137,000 and \$148,500 of non-restricted stock awards compensation expense for the six months ended June 30, 2013 and 2012, respectively.

NOTE 7 – Shareholders’ Equity

At June 30, 2013, shareholders’ equity was \$419.5 million, or a book value of \$8.41 per common share, compared to \$558.3 million, or a book value of \$11.22 per common share, at December 31, 2012. The decrease in shareholders’ equity from year end primarily relates to the goodwill impairment expense that was recorded in the three months ended June 30, 2013, as described in Note 11 ~ Subsequent Events.

On October 28, 2011, 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, 2013, there were no share repurchases. For the three months and six months ended June 30, 2012, the Company purchased and retired approximately 0.7 million and 1.3 million shares of common stock for a total cost of approximately \$6.5 million and \$11.5 million, respectively.

For the six months ended June 30, 2013, the Company paid dividends to its common shareholders of \$2.0 million. For the six months ended June 30, 2012, cash dividends paid to common shareholders totaled \$5.1 million.

On July 26, 2013, the Company’s Board of Directors declared a quarterly dividend of \$0.02 per common share. The dividend is payable on August 26, 2013, to shareholders of record as of August 12, 2013. In addition, so long as the Company is in default under its Credit Facilities, it is prohibited by the terms thereof from paying any dividends without breaching the Credit Facilities. Refer to Note 4 ~ Debt, for additional information specific to the Company’s financial covenants.

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, regulatory constraints related to the Insurance Company Subsidiaries, 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.

Table of ContentsNOTE 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 Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
Net (loss) income	\$ (113,058 )	\$ (7,732 )	\$ (105,976 )	\$ 372
Common shares:				
Basic				
Weighted average shares outstanding	49,887,200	50,251,591	49,855,716	50,583,368
Diluted				
Weighted average shares outstanding	49,887,200	50,251,591	49,855,716	50,583,368
Dilutive effect of:				
Share awards under long term incentive plan	-	-	-	-
Total	49,887,200	50,251,591	49,855,716	50,583,368
Net (loss) income per common share				
Basic				
	\$ (2.27 )	\$ (0.15 )	\$ (2.13 )	\$ 0.01
Diluted				
	\$ (2.27 )	\$ (0.15 )	\$ (2.13 )	\$ 0.01

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 the policy of insurance at issue, errors and omissions insurance, extra-contractual coverage under the reinsurance treaty related to the policy of insurance at issue or other appropriate insurance. In terms of any retentions or deductibles associated with such insurance, the Company has established accruals for such retentions or deductibles, when necessary, based upon current available information. 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 reasonably estimable, then 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 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 a party to will have a material adverse effect on the Company's financial condition.

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Other than with regard to the arbitration described below, the Company does not believe there is a reasonable possibility that any material loss exceeding the amounts already accrued for these matters, if any, has been incurred. However, the ultimate resolutions of these matters are inherently unpredictable. As such, the Company's financial condition and results of operations could be adversely affected in any particular period by the unfavorable resolution of one or more of the above-mentioned matters.

Legal Proceedings

Arbitration

The Company purchased a three year underlying per occurrence excess of loss reinsurance agreement (the "Retention Buy Down Treaty") reinsuring the Company's statutory workers' compensation business for the period of January 1, 1999 through January 1, 2002. Under the Retention Buy Down Treaty, the Company has ceded losses to the reinsurer of approximately \$42.6 million. The Company was also a party to an unrelated excess of loss treaty with another reinsurer for its workers compensation business covering the same periods (the "Excess of Loss Treaty"). Under the Excess of Loss Treaty, the Company's retention was \$250,000 per occurrence. The Company purchased the Retention Buy Down Treaty in order to reduce its \$250,000 existing retention to \$100,000. In approximately 2008, a dispute arose between the parties as to how the Retention Buy Down Treaty applied to certain ceded losses. When the Company and the Reinsurer could not come to a mutual understanding, the Company initiated arbitration proceedings. On July 23, 2013, the Arbitration Panel issued an interim final award finding that the Retention Buy Down Treaty did not include certain ceded losses that the Company believed were subject to the Retention Buy Down Treaty.

28

---



Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

During the arbitration, the reinsurer sought from the Company an award of \$1.6 million. This amount reflected the difference between what the Company claimed was due from the reinsurer (\$2.9 million) and what the reinsurer claimed it was due back from the Company (\$4.5 million). The panel awarded the reinsurer \$1.6 million, and \$2.0 million in interest, plus attorney's fees. Based upon the panel's interpretation of the Retention Buy Down Treaty, the Company was required to reverse certain of its ceded incurred losses due from the reinsurer. The Company recorded this change in ceded incurred losses during the second quarter of 2013. Notwithstanding the Panel's netting of the outstanding balances, the panel requested the Company submit additional documentation listing all programs covered by the Retention Buy Down Treaty and the Company's retained limit for each program. The Company will be submitting additional documentation to the panel. The reinsurer will be allowed to respond, as well as submit its claim for attorney fees. The Company continues to explore all of its legal remedies as allowed by law. Resolution of this matter is inherently unpredictable. Given the inherent uncertainty surrounding the conclusion of this proceeding, an adverse outcome in this matter could have a material impact on our results of operations or cash flows on a particular quarter or annual period. At this time, an estimate of possible loss or range of loss cannot be made. The \$1.6 million and the interest of \$2.0 million were expensed by the Company during the second quarter and an estimate for the attorney fee portion of the award was also reserved for by the Company in the second quarter of 2013 in an amount that would fully pay the attorney fee request of the reinsurer.

29

---

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)NOTE 10 – Accumulated Other Comprehensive Income

The Company's comprehensive income includes net earnings plus unrealized gain or loss on available-for-sale investment securities, net of tax. In reporting comprehensive earnings on a net basis in the income statement, we used a 35 percent tax rate. The following table illustrates the amounts reclassified from accumulated other comprehensive income:

Reclassifications out of accumulated other comprehensive income: Three Months Ended June 30, 2013 (in thousands)

Details about accumulated other comprehensive income components	Amount reclassified from accumulated other comprehensive income	Affected line item in the statement where net income is presented
Unrealized gain or loss on available for sale securities	\$ 2,907	Net realized gains
	(1,017)	)Tax expense
	\$ 1,890	Net of tax

Reclassifications out of accumulated other comprehensive income: Three Months Ended June 30, 2012 (in thousands)

Details about accumulated other comprehensive income components	Amount reclassified from accumulated other comprehensive income	Affected line item in the statement where net income is presented
Unrealized gain or loss on available for sale securities	\$ 1,645	Net realized gains
	(575)	)Tax expense
	\$ 1,070	Net of tax

Reclassifications out of accumulated other comprehensive income: Six Months Ended June 30, 2013 (in thousands)

Details about accumulated other comprehensive income components	Amount reclassified from	Affected line item in the statement where net income is presented
---	--------------------------	---

accumulated  
other  
comprehensive  
income

Unrealized gain or loss on available for sale securities

\$ 3,195	Net realized gains
(1,118)	)Tax expense
\$ 2,077	Net of tax

Reclassifications out of accumulated other comprehensive income: Six Months Ended June 30, 2012 (in thousands)

Amount  
reclassified  
from  
accumulated  
other

Details about accumulated other comprehensive income components

comprehensive income Affected line item in the statement where net income is presented

Unrealized gain or loss on available for sale securities

\$ 2,356	Net realized gains
(824)	)Tax expense
\$ 1,532	Net of tax

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

NOTE 11 – Subsequent Events

Adverse Reinsurance Arbitration Award

On July 23, 2013, the Company was notified of an adverse interim final award in a reinsurance arbitration against it on ceded losses that relate to a reinsurance treaty in place for the 1999 to 2001 policy periods, a provision for these ceded losses was recorded as a \$5.2 million allowance for ceded recoverables. With an accrual for other items of approximately \$2.9 million, the total pre-tax impact was \$8.2 million and the after-tax impact was \$5.3 million, or \$0.11 per diluted share. This subsequent event was recorded in the second quarter 2013 financial statements. Refer to Note 9 ~ Commitments and Contingencies, for additional information specific to the arbitration award.

A.M. Best Downgrades the Company's Financial Strength Rating

On August 2, 2013, A.M. Best Company ("A.M. Best"), insurance industry rating agency, lowered Meadowbrook's issuer credit rating, as well its financial strength ratings and downgraded the Company's Insurance Company Subsidiaries' financial strength rating from "A-" (Excellent) with a "negative" outlook to "B++" (Good) with a "stable" outlook. The Company cannot make an estimate of the financial effect to the Company as a result of the A.M. Best downgrades.

Agreement to Provide "A" Rated Policy Insurance Solution

On August 4, 2013, the Company's Insurance Company Subsidiaries entered into agreements with State National Insurance Company and its affiliates, which will provide the Company's Insurance Company Subsidiaries the use of an "A" rated policy insurance company for a portion of its business where an "A" rated policy issuer is required. The Company cannot make an estimate of the financial effect to the Company as a result of the agreements.

Goodwill Impairment

The Company evaluates existing goodwill for impairment on an annual basis, or more frequently if events or changes in circumstances indicate that the asset might be impaired. Goodwill impairment is performed at the reporting unit level.

On August 2, 2013, A.M. Best lowered Meadowbrook's issuer credit rating, as well its financial strength ratings and the issuer credit ratings of its Insurance Company Subsidiaries, following the Company's reported weaker-than-anticipated second-quarter results. These events represented triggering events for potential goodwill impairment. The Company has performed an interim goodwill impairment evaluation as of June 30, 2013, as required under ASC 350, Goodwill and Other Intangible Assets. Pursuant to ASC 350, goodwill and intangible assets with indefinite lives must be tested for impairment at least once a year or more frequently if management believes indicators of impairment exist. Carrying values are compared with fair values, and if the carrying value exceeds the fair value, the carrying value of the impaired asset or goodwill is reduced to its fair value. The performance of the test requires a two-step process.

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Step 1 of the impairment test involves comparing the estimated fair values of the applicable reporting units with their aggregate carrying values, including goodwill. If the carrying amount of a reporting unit exceeds the reporting unit's estimated fair value, the Company performs Step 2 of the goodwill impairment test to determine the amount of impairment, if any. Step 2 of the goodwill impairment test requires comparing the implied fair value of the affected reporting unit's goodwill against the carrying value of that goodwill.

In accordance with accounting guidance, the Company concluded its reporting units to be Specialty Insurance Operations and Agency Operations. The nature of the business and economic characteristics of all agency operations and all Specialty Insurance Operations are similarly based upon, but not limited to, the following: (1) management alignment within each reporting unit, (2) the Company's Insurance Company Subsidiaries operating under a reinsurance pooling arrangement, and (3) the ability of the Company to leverage its expertise and fixed costs within each reporting unit.

Estimating the fair value of reporting units is a subjective process involving the use of estimates and judgments, particularly related to future cash flows, discount rates (including market risk premiums) and market multiples. The fair values of the reporting units were determined using a blend of two commonly used valuation techniques, the market approach and the income approach. The Company gives consideration to both valuation techniques, as either technique can be an indicator of value. For the market approach, the valuations of the reporting units were based on an analysis of price multiples of net income, net book value and net tangible book value. The peer group price multiples used in the analysis were selected based on management's judgment. For the income approach, the Company estimated value using a discounted cash flow method ("DCF method"). A DCF method was selected to be comparable to what would be used by market participants to estimate fair value. The DCF method incorporated expected future growth rates, terminal value amounts, and the applicable weighted-average cost of capital to discount estimated cash flows. The projections used in the estimate of fair value are consistent with the Company's forecast and long-range plans.

The Company completed Step 1 of the impairment test and concluded that a potential impairment existed in its Specialty Insurance Operations reporting unit. The Company is in the process of conducting a Step 2 analysis; however, that analysis remains incomplete as of the date of this report due to the complexity of the required calculations. Step 2 involves determining the potential impairment of goodwill as the difference between the carried goodwill and the hypothetical fair value of enterprise less the fair value of the tangible net assets and less the estimation of identifiable intangible assets, such as agent relationships, licenses, trademarks and other intangibles that may not be carried on the books at fair value. Our preliminary analysis indicates that the estimation of the other identifiable intangible assets is greater than the carrying amount of other intangible assets. To the extent this estimation is greater than the carried amount of other intangibles, we are not permitted to write up the other intangibles to fair value. The Company expects to complete the Step 2 analysis during the third quarter of 2013.

32

---

Table of Contents

MEADOWBROOK INSURANCE GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Management has reviewed the results of the Step 1 analysis and concluded that an impairment of goodwill exists at June 30, 2013 and has estimated an impairment amount of \$115.4 million. This provisional impairment adjustment will be revised, if necessary, during the third quarter of 2013. Management believes any adjustment to this preliminary charge will not be material; however, until such time as the evaluation is complete any potential changes are uncertain.

The non-cash impairment of goodwill of \$115.4 million was recorded in the three months ended June 30, 2013.

The following summarizes the carrying amount of goodwill as of June 30, 2013 (in thousands):

	Agency Operations	Specialty Insurance Operations	Total
Balance at April 1, 2013	\$ 5,644	\$ 115,397	\$ 121,041
Goodwill Impairment	-	(115,397 )	(115,397)
Balance at June 30, 2013	\$ 5,644	\$ -	\$ 5,644

33

Table of Contents

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

For the Periods ended June 30, 2013 and 2012

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: actual loss and loss adjustment expenses exceeding our reserve estimates; competitive pressures in our business; the failure of any of the loss limitation methods we employ; our ability to secure a waiver from our lenders under our credit agreement in connection with the financial covenant non-compliance described under Note 4 - Debt; a failure of additional capital to be available or only available on unfavorable terms; our geographic concentration and the business, economic, natural perils, man made perils, and regulatory conditions within our most concentrated region; our ability to appropriately price the risks we underwrite; goodwill impairment risk employed as part of our growth strategy and the anticipated impact of the goodwill impairment charge recognized in the second quarter of 2013; efforts with regard to the review of strategic alternatives; actions taken by regulators, rating agencies or lenders, including the impact of the downgrade by A.M. Best of the Company's Insurance Company Subsidiaries' financial strength rating; increased risks or reduction in the level of our underwriting commitments due to market conditions; a failure of our reinsurers to pay losses in a timely fashion, or at all; interest rate changes; continued difficult conditions in the global capital markets and the economy generally; market and credit risks affecting our investment portfolio; liquidity requirements forcing us to sell our investments; a failure to introduce new products or services to keep pace with advances in technology; the new federal financial regulatory reform; our holding company structure and regulatory constraints restricting dividends or other distributions by our Insurance Company Subsidiaries; minimum capital and surplus requirements imposed on our Insurance Company Subsidiaries; acquisitions and integration of acquired businesses resulting in operating difficulties, which may prevent us from achieving the expected benefits; our reliance upon producers, which subjects us to their credit risk; loss of one of our core selected producers; our dependence on the continued services and performance of our senior management and other key personnel; our reliance on our information technology and telecommunications systems; managing technology initiatives and obtaining the efficiencies anticipated with technology implementation; a failure in our internal controls; the cyclical nature of the property and casualty insurance industry; severe weather conditions and other catastrophes; the effects of litigation; state regulation; and assessments imposed upon our Insurance Company Subsidiaries to provide funds for failing insurance companies.

34

---

## Table of Contents

For additional information with respect to certain of these and other factors, refer to the Item 1A of Part II Report on Form 10-Q for the first quarter ended June 30, 2013 and subsequent filings made with the United States Securities and Exchange Commission. We are not under any obligation to (and expressly disclaim any 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 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 2.2% of our total consolidated revenues. Our agencies are located in Michigan, California, Massachusetts, and Florida and produce commercial, personal lines, life and accident and health insurance that is placed primarily with unaffiliated insurance carriers. These agencies are a minimal source of business for our Insurance Company Subsidiaries.

We recognize revenue related to the services and coverages within the following categories: net earned premiums, management administrative fees, claims fees, commission revenue, net investment income, 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 insurance brokers. 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 periodically 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 8, 2013, are those that we consider to be our critical accounting estimates. For the three months and six months ended June 30, 2013, there have been no material changes in regard to any of our critical accounting estimates.



Table of Contents

## Non-GAAP Financial Measures

## Statutory Surplus

Statutory surplus is a non-GAAP measure with the most directly comparable financial GAAP measure being shareholders' equity. The following is a reconciliation of statutory surplus to shareholders' equity:

Meadowbrook Insurance Group, Inc.

## Consolidated Statutory Surplus to GAAP Shareholders' Equity

For Six Months Ended June 30, 2013

(In thousands)

Statutory Consolidated Surplus		\$498,393
Statutory to GAAP differences:		
Deferred policy acquisition costs	54,904	
Unrealized gain (loss) on securities available for sale	(114 )	
Non-admitted assets and other	13,226	
Total Statutory to GAAP differences	68,016	
Total Non-Regulated Entities	(146,943)	
GAAP Consolidated Shareholders' Equity		\$419,466

## Net Operating (Loss) Income and Net Operating (Loss) Income Per Share

Net operating (loss) income and net operating (loss) income per share are non-GAAP measures that represent net (loss) income excluding net realized gains or loss, net of tax. The most directly comparable financial GAAP measures to net operating (loss) income and net operating (loss) income per share are net (loss) income and net (loss) income per share, respectively. Net operating (loss) income and net operating (loss) income per share are intended as supplemental information and are not meant to replace net (loss) income or net (loss) income per share. Net operating (loss) income and net operating (loss) income per share should be read in conjunction with the GAAP financial results. The following is a reconciliation of net operating (loss) income to net (loss) income, as well as net operating (loss) income per share to net (loss) income per share:

36

---

Table of Contents

	For the Three Months		For the Six Months Ended	
	Ended June 30, 2013	2012	June 30, 2013	2012
	(In thousands, except share and per share data)		(In thousands, except share and per share data)	
Net operating (loss) income	\$(115,090 )	\$(8,752 )	\$(108,213 )	\$(1,225 )
Net realized gains, net of tax	2,032	1,020	2,237	1,597
Net (loss) income	\$(113,058 )	\$(7,732 )	\$(105,976 )	\$372
Diluted earnings per common share:				
Net operating (loss) income	\$(2.31 )	\$(0.17 )	\$(2.17 )	\$(0.02 )
Net (loss) income	\$(2.27 )	\$(0.15 )	\$(2.13 )	\$0.01
Diluted weighted average common shares outstanding	49,887,200	50,251,591	49,855,716	50,583,368

We use net operating (loss) income and net operating (loss) 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 (loss) 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 loss or profitability of our business. We believe that it is useful for investors to evaluate net operating (loss) income and net operating (loss) income per share, along with net (loss) income and net (loss) income per share, when reviewing and evaluating our performance.

**Combined Ratio**

The combined loss and expense ratio (or combined ratio), expressed as a percentage, is the key measure of underwriting profitability traditionally used in the property and casualty insurance business. The combined ratio is a statutory (non-GAAP) accounting measurement, which represents the sum of (i) the ratio of losses and loss expenses to premiums earned (loss ratio), plus (ii) the ratio of underwriting expenses to premiums written (expense ratio). The combined ratios above have been modified to reflect GAAP accounting, as we evaluate the performance of our underwriting operations using the GAAP combined ratio. Specifically, the GAAP combined ratio is the sum of the loss ratio, plus the ratio of GAAP underwriting expenses (which include the change in deferred policy acquisition costs) to premiums earned (expense ratio). When the combined ratio is under 100%, underwriting results are generally considered profitable; when the combined ratio is over 100%, underwriting results are generally considered unprofitable.

Table of Contents

The accident year combined ratio is a non-GAAP measure that excludes changes in net ultimate loss estimates from prior accident year loss reserves. The accident year combined ratio provides us with an assessment of the specific policy year's profitability (which matches policy pricing with related losses) and assists us in our evaluation of product pricing levels and quality of business written. We use accident year combined ratio as one component to assess the Company's current year performance and as a measure to evaluate, and if necessary, adjust current year pricing and underwriting. The following is a reconciliation of the accident year combined ratio to the GAAP combined ratio:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
Accident year combined ratio	100.9%	97.8 %	99.9 %	97.1 %
Increase in net ultimate loss estimates on prior year loss reserves	15.1 %	13.3 %	8.7 %	9.5 %
GAAP Combined ratio	116.0%	111.1%	108.6%	106.6%

We believe the accident year combined ratio 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 combined ratio and GAAP combined ratio separately when reviewing and evaluating our performance.

## Recent Developments

## Adverse Reinsurance Arbitration Award

On July 23, 2013, we were notified of an adverse interim final award in a reinsurance arbitration against us on ceded losses that date back to a reinsurance treaty in place for the 1999 to 2001 policy periods, a provision for these ceded losses was recorded as a \$5.2 million allowance for ceded recoverables. With an accrual for other items of approximately \$2.9 million, the total pre-tax impact was \$8.2 million and the after-tax impact was \$5.3 million, or \$0.11 per diluted share. This subsequent event was recorded in the second quarter 2013 financial statements. Refer to Note 9 ~ Commitments and Contingencies, for additional information specific to the arbitration award.

## A.M. Best Downgrades the Company's Financial Strength Rating

On August 2, 2013, A.M. Best Company ("A.M. Best") lowered Meadowbrook's issuer credit rating, as well its financial strength ratings and downgraded the Company's Insurance Company Subsidiaries' financial strength rating from "A-" (Excellent) with a "negative" outlook to "B++" (Good) with a "stable" outlook. As a result of this recent development we could experience a negative impact to our operations as described in our updated risk factors section below.

## Table of Contents

### Agreement to Provide “A” Rated Policy Insurance Solution

On August 4, 2013, our Insurance Company Subsidiaries entered into agreements with State National Insurance Company and its affiliates, which will provide our Insurance Company Subsidiaries the use of an “A” rated policy insurance company for a portion of its business where an “A” rated policy issuer is required.

### Goodwill Impairment

The company recorded a non-cash impairment of goodwill of \$115.4 million in the three months ended June 30, 2013, as described in Note 11 ~ Subsequent Events.

### Financial Covenants

As of June 30, 2013, we were not in compliance with some of our financial covenants applicable to the Credit Facilities as a result of the goodwill impairment recorded in the second quarter of 2013. While we remain in discussions with the lending group to amend the loan agreements that may include obtaining a waiver and revision of the financial covenants. We have not obtained, and there can be no assurance that we will obtain such an amendment. Refer to Note 4 ~ Debt, for additional information specific to our financial covenants.

## RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED JUNE 30, 2013 AND 2012

### Executive Overview

Our results for the second quarter of 2013 were impacted by a \$115.4 million, or \$2.31 per diluted share, goodwill impairment charge that we recorded as described under “Recent Developments”. In addition our results for the second quarter of 2013 were impacted by an evaluation of the impact of an adverse interim final reinsurance arbitration award, which added 3.8 percentage points to the GAAP combined ratio, above average storm losses, which added 2.7 percentage points to the GAAP combined ratio, and the increase in net ultimate loss estimates for 2012 and prior accident years, which added 15.1 percentage points to the GAAP combined ratio. The second quarter of 2013 results also reflect a 4.5 combined ratio percentage points impact from the quota share reinsurance treaty that was entered into during the fourth quarter of 2012. Our GAAP combined ratio was 116.0% for the second quarter of 2013, compared to a GAAP combined ratio of 111.1% for the comparable quarter in 2012. Our accident year combined ratio was 100.9% for the second quarter of 2013, compared to 97.8% in 2012.

Net operating loss, a non-GAAP measure, was (\$115.1 million), or (\$2.31) per diluted share for the second quarter ended June 30, 2013. Excluding the impact of the goodwill impairment charge, net operating loss was (\$13.6 million), or (\$0.27) per diluted share for the second quarter ended June 30, 2013, compared to net operating loss of (\$8.8 million), or (\$0.17) per diluted share for the second quarter ended June 30, 2012. The second quarter 2013 results include an after-tax increase in net ultimate loss estimates for 2012 and prior accident years of \$17.2 million, or \$0.35 per diluted share. By contrast, the second quarter of 2012 results include an after-tax increase in net ultimate loss estimates for 2011 and prior accident years of \$18.3 million, or \$0.37 per diluted share. The second quarter 2013 after-tax results were impacted by \$5.3 million, or \$0.11 per diluted share, as a result of the adverse reinsurance arbitration award and \$3.8 million, or \$0.08 per diluted share, as a result of above average storm losses. In addition, the second quarter 2013 after-tax results were impacted by \$2.0 million, or \$0.04 per diluted share as a result of the quota share reinsurance treaty.

Table of Contents

Gross written premium decreased to \$234.1 million in the second quarter ended June 30, 2013, compared to \$256.1 million in the comparable period of 2012. This anticipated decrease primarily reflects the impact of business that was discontinued in 2012. This decrease was largely offset by the accelerating pace of rate increases that have been achieved in combination with the maturation of existing programs.

## Results of Operations

Net loss for the three months ended June 30, 2013, was (\$113.1 million), or (\$2.27) per dilutive share. Excluding the impact of the goodwill impairment charge, net loss for the three months ended June 30, 2013, was (\$11.5 million), or (\$0.23) per dilutive share, compared to net loss of (\$7.7 million), or (\$0.15) per dilutive share, for the comparable period of 2012. Net operating loss, a non-GAAP measure, for the three months ended June 30, 2013 was (\$115.1 million) or (\$2.31) per dilutive share. Excluding the impact of the goodwill impairment charge, net operation loss for the three months ended June 30, 2013 was (\$13.6 million), or (\$0.27) per dilutive share, compared to net operating loss of (\$8.8 million), or (\$0.17) per dilutive share for the comparable period in 2012. Total diluted weighted average shares outstanding for the three months ended June 30, 2013 was 49,887,200 compared to 50,251,591 for the comparable period in 2012. This decrease reflects the impact of our Share Repurchase Plan.

## Revenues

Revenues for the three months ended June 30, 2013 decreased \$36.1 million, or 15.4%, to \$199.0 million, from \$235.1 million for the comparable period in 2012. This decrease primarily reflects the reduction within our net earned premiums.

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

	For the Three Months Ended June 30, 2013      2012	
Revenue:		
Net earned premiums	\$175,781	\$211,303
Management administrative fees	2,791	2,823
Claims fees	1,674	1,599
Commission revenue	4,074	4,130
Net investment income	11,768	13,683
Net realized gains	2,869	1,567
Total revenue	\$198,957	\$235,105

Net earned premiums decreased \$35.5 million, or 16.8%, to \$175.8 million for the three months ended June 30, 2013, from \$211.3 million in the comparable period in 2012. This decrease was primarily the result of the quota share reinsurance treaty as well as termination of, or reductions in, certain programs where pricing and underwriting did not meet our targets.

Table of Contents

Net investment income decreased by \$1.9 million, or 14.0%, to \$11.8 million for the three months ended June 30, 2013, from \$13.7 million in the comparable period in 2012. The decrease reflects the impact from the fourth quarter 2012 sale of a portion of our bond portfolio in order to generate realized gains. We reinvested the proceeds during the first quarter of 2013, with the replacement of those bonds at lower interest rates.

Net realized gains increased by \$1.3 million, or 83.1%, to \$2.9 million for the three months ended June 30, 2013, from \$1.6 million in the comparable period in 2012. The increase in realized gains during 2013 relates to higher volume of sales primarily from repositioning our common equity portfolio.

## Expenses

Expenses increased \$85.4 million from \$245.2 million for the three months ended June 30, 2012 to \$330.6 million for the three months ended June 30, 2013. This increase primarily reflects the \$115.4 million goodwill impairment as discussed under “Recent Developments”.

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

	For the Three Months Ended June 30,	
	2013	2012
Expense:		
Net losses and loss adjustment expenses	\$ 145,371	\$ 165,758
Policy acquisition and other underwriting expenses	58,450	68,993
General selling & administrative expenses	5,901	6,327
General corporate expenses	760	758
Amortization expense	1,038	1,307
Goodwill impairment expense	115,397	-
Interest expense	3,653	2,033
Total expenses	\$330,570	\$245,176

Net loss and loss adjustment expenses (“LAE”) decreased \$20.4 million, to \$145.4 million for the three months ended June 30, 2013, from \$165.8 million for the same period in 2012. Our calendar year loss and LAE ratio was 82.7% for the three months ended June 30, 2013 and 78.4% for the three months ended June 30, 2012. The loss and LAE ratio for the second quarter of 2013 includes a 15.1 percentage point increase from net ultimate loss estimates for accident years 2012 and prior, whereas the 2012 results included a 13.4 percentage point increase from net ultimate loss estimates for accident years 2011 and prior. The accident year loss and LAE ratio was 67.6% for the three months ended June 30, 2013 and 65.1% for the three months ended June 30, 2012. Additional discussion of our reserve activity is described below within the Other Items ~ Reserves section.

Table of Contents

Policy acquisition and other underwriting expenses decreased \$10.5 million, to \$58.5 million for the three months ended June 30, 2013 from \$69.0 million for the same period in 2012. Our expense ratio increased 0.6 percentage points to 33.3% for the three months ended June 30, 2013, from 32.7% for the same period in 2012. The increase in the expense ratio reflects the adverse reinsurance arbitration result which was partly offset by our ability to leverage fixed costs and growth in business where we receive a ceding commission for providing insurance services to a workers' compensation placement facility.

Interest expense for the three months ended June 30, 2013 increased \$1.6 million, to \$3.6 million, from \$2.0 million for the comparable period in 2012. The increase in interest expense is primarily attributed to the Notes we issued in the first quarter of 2013.

The GAAP effective tax rate for the three months ended June 30, 2013 and 2012 was 13.5% and 18.2% respectively. These rates include adjustments to an annual operating effective tax rate. The annual operating effective tax rate for 2013 is expected to be approximately 4.8%. Income tax expense (benefit) on capital gains and the change in our valuation allowance on deferred tax assets was \$0.8 million and \$0.5 million for the three months ended June 30, 2013 and 2012, respectively. Excluding the impact of the goodwill impairment, the GAAP effective tax rate for the three months ended June 30, 2013 would have been 23.7%. The higher GAAP effective tax rate reflects a larger adjustment to the annual operating effective tax rate in 2013 compared to 2012.

RESULTS OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2013 AND 2012

Executive Overview

Our results for the six months ended June 30, 2013 were impacted by a \$115.4 million, or \$2.31 per diluted share, goodwill impairment charge that we recorded as described under "Recent Developments". In addition our results for the six months ended June 30, 2013 were impacted by an evaluation of the impact of an adverse interim final reinsurance arbitration award, which added 1.9 percentage points to the GAAP combined ratio and the increase in net ultimate loss estimates for 2012 and prior accident years, which added 8.7 percentage points to the GAAP combined ratio. The six months ended June 30, 2013 results also reflect a 3.2 combined ratio percentage points impact from the quota share reinsurance treaty that was entered into during the fourth quarter of 2012. Our GAAP combined ratio was 108.6% for the six months ended June 30, 2013, compared to a GAAP combined ratio of 106.6% in 2012. Our accident year combined ratio was 99.9% for the six months ended June 30, 2013, compared to 97.1% in 2012.

Net operating loss, a non-GAAP measure, was (\$108.2 million), or (\$2.17) per diluted share for the six months ended June 30, 2013. Excluding the impact of the goodwill impairment charge, net operating loss was (\$6.7 million), or (\$0.13) per diluted share for the six months ended June 30, 2013, compared to net operating loss of (\$1.2 million), or (\$0.02) per diluted share for the six months ended June 30, 2012. The six months ended June 30, 2013 results include an after-tax increase in net ultimate loss estimates for 2012 and prior accident years of \$19.6 million, or \$0.39 per diluted share. By contrast, the six months ended June 30, 2012 results include an after-tax increase in net ultimate loss estimates for 2011 and prior accident years of \$25.0 million, or \$0.49 per diluted share. The six months ended June 30, 2013 after-tax results were impacted by \$5.3 million, or \$0.11 per diluted share, as a result of the adverse reinsurance arbitration award. In addition, the six months ended June 30, 2013 after-tax results were impacted by \$4.1 million, or \$0.08 per diluted share as a result of the quota share reinsurance treaty.

Table of Contents

Gross written premium decreased to \$501.8 million in the six months ended June 30, 2013, compared to \$514.0 million in the comparable period of 2012. This anticipated decrease primarily reflects the impact of business that was discontinued in 2012. This decrease was largely offset by the accelerating pace of rate increases that have been achieved in combination with the maturation of existing programs.

Results of Operations

Net loss for the six months ended June 30, 2013, was (106.0 million), or (\$2.13) per dilutive share. Excluding the impact of the goodwill impairment charge, net loss for the six months ended June 30, 2013, was (\$4.4 million), or (\$0.09) per dilutive share, compared to net income of \$0.4 million, or \$0.01 per dilutive share, for the comparable period of 2012. Net operating loss, a non-GAAP measure, for the six months ended June 30, 2013 was (\$108.2 million) or (\$2.17) per dilutive share. Excluding the impact of the goodwill impairment charge, net operation loss for the six months ended June 30, 2013, was (\$6.7 million), or (\$0.13) per dilutive share, compared to net operating loss of (\$1.2 million), or (\$0.02) per dilutive share for the comparable period in 2012. Total diluted weighted average shares outstanding for the six months ended June 30, 2013 was 49,855,716 compared to 50,583,368 for the comparable period in 2012. This decrease reflects the impact of our Share Repurchase Plan.

Revenues

Revenues for the six months ended June 30, 2013 decreased \$60.7 million, or 13.5%, to \$390.6 million, from \$451.3 million for the comparable period in 2012. This decrease primarily reflects the reduction within our net earned premiums.



Table of Contents

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

	For the Six Months Ended June 30,	
	2013	2012
Revenue:		
Net earned premiums	\$346,369	\$404,118
Management administrative fees	6,158	5,751
Claims fees	3,416	3,261
Commission revenue	8,599	8,505
Net investment income	22,908	27,415
Net realized gains	3,185	2,299
Total revenue	\$390,635	\$451,349

Net earned premiums decreased \$57.7 million, or 14.3%, to \$346.4 million for the six months ended June 30, 2013, from \$404.1 million in the comparable period in 2012. This decrease was primarily the result of the quota share reinsurance treaty as well as termination of, or reductions in, certain programs where pricing and underwriting did not meet our targets.

Net investment income decreased by \$4.5 million, or 16.4%, to \$22.9 million for the six months ended June 30, 2013, from \$27.4 million in the comparable period in 2012. The decrease reflects the impact from the fourth quarter 2012 sale of a portion of our bond portfolio in order to generate realized gains. We reinvested the proceeds during the first quarter of 2013, with the replacement of those bonds at lower interest rates.

Net realized gains increased by \$0.9 million, or 38.5%, to \$3.2 million for the six months ended June 30, 2013, from \$2.3 million in the comparable period in 2012. The increase in realized gains during 2013 relates to higher volume of sales primarily from repositioning our common equity portfolio.

#### Expenses

Expenses increased \$61.7 million from \$452.1 million for the six months ended June 30, 2012 to \$513.8 million for the six months ended June 30, 2013. This increase primarily reflects the \$115.4 million goodwill impairment as discussed under "Recent Developments".

Table of Contents

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

	For the Six Months Ended June 30,	
	2013	2012
Expense:		
Net losses and loss adjustment expenses	\$267,187	\$298,505
Policy acquisition and other underwriting expenses	109,055	132,106
General selling & administrative expenses	11,924	12,666
General corporate expenses	2,276	2,131
Amortization expense	2,109	2,723
Goodwill impairment expense	115,397	-
Interest expense	5,850	4,010
Total expenses	\$513,798	\$452,141

Net loss and LAE decreased \$31.3 million, to \$267.2 million for the six months ended June 30, 2013, from \$298.5 million for the same period in 2012. Our calendar year loss and LAE ratio was 77.1% for the six months ended June 30, 2013 and 73.9% for the six months ended June 30, 2012. The loss and LAE ratio for the six months ended June 30, 2013 includes a 8.7 percentage point increase from net ultimate loss estimates for accident years 2012 and prior, whereas the 2012 results included a 9.5 percentage point increase from net ultimate loss estimates for accident years 2011 and prior. The accident year loss and LAE ratio was 68.4% for the six months ended June 30, 2013 and 64.4% for the six months ended June 30, 2012. Additional discussion of our reserve activity is described below within the Other Items ~ Reserves section.

Policy acquisition and other underwriting expenses decreased \$23.0 million, to \$109.1 million for the six months ended June 30, 2013 from \$132.1 million for the same period in 2012. Our expense ratio decreased 1.2 percentage points to 31.5% for the six months ended June 30, 2013, from 32.7% for the same period in 2012. The decrease reflects our ability to leverage fixed costs and growth in business for which we receive a ceding commission for providing insurance services to a workers' compensation placement facility. Partly offsetting the decrease was the impact of the recent adverse interim final reinsurance arbitration award discussed under "Recent Developments".

Interest expense for the six months ended June 30, 2013, increased \$1.8 million, to \$5.8 million, from \$4.0 million for the comparable period in 2012. The increase in interest expense is primarily attributed to the Notes we issued in the first quarter of 2013.

The GAAP effective tax rate for the six months ended June 30, 2013 was approximately 13.0%, compared to 15.1%, for the same period in 2012. These rates include adjustments to an annual operating effective tax rate. The annual operating effective tax rate for 2013 is expected to be approximately 4.8%. Income tax expense (benefit) on capital gains and the change in our valuation allowance on deferred tax assets was \$0.9 million and \$0.7 million for the six months ended June 30, 2013 and 2012, respectively. Excluding the impact of the goodwill impairment, the GAAP effective tax rate for the six months ended June 30, 2013 would have been 26.9%. The higher GAAP effective tax rate reflects a larger adjustment to the annual operating effective tax rate in 2013 compared to 2012.

Table of Contents

## 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 Holdings, LLC (“MFH”), for \$14.8 million in cash. We are not required to consolidate this investment because 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 recognizes 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 \$1.0 million, or \$0.02 per dilutive share, for the six months ended June 30, 2013, compared to \$1.3 million, or \$0.02 per dilutive share, for the comparable period of 2012. We received dividends from MFH in the six months ended June 30, 2013 and 2012, for \$1.4 million and \$1.8 million, respectively.

In November 2012, our subsidiary, Century Surety Company, committed to a \$10 million strategic equity investment in Aquiline Financial Services Fund II L.P. As of June 30, 2013, approximately \$4.9 million of the commitment had been satisfied with \$5.1 million of unfunded commitment remaining. Our ownership interest is approximately 1.34% of the fund, which we are accounting for under the equity method of accounting. Century Surety Company will recognize 1.34% of the Fund’s profits and losses as a result of this equity interest ownership. We recognized equity earnings, net of tax, from the Aquiline Financial Services Fund II L.P. of \$0.6 million, or \$0.01 per dilutive share, for the six months ended June 30, 2013.

## Reserves

At June 30, 2013, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was \$1.1 billion. We established a reasonable range of reserves of approximately \$967.6 million to \$1.2 billion. 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	\$417,998	\$495,857	\$468,957
Residual Markets	19,917	22,059	21,418
Commercial Multiple Peril / General Liability	390,813	509,347	444,514
Commercial Automobile	108,685	129,388	119,480
Other	30,193	34,923	32,380
Total Net Reserves	\$967,606	\$1,191,574	\$1,086,749

Table of Contents

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, 2013, and the year ended December 31, 2012.

For the six months ended June 30, 2013, we reported an increase in net ultimate loss estimates for accident years 2012 and prior of \$30.1 million, or 2.8% of \$1.1 billion of beginning net loss and LAE reserves at December 31, 2012. The change in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2013 that differed from the projected activity. The major components of this change in ultimates are as follows (in thousands):

Line of Business	Reserves at December 31, 2012	Incurred Losses			Paid Losses			Reserves at June 30, 2013
		Current Year	Prior Years	Total Incurred	Current Year	Prior Years	Total Paid	
Workers' Compensation	\$448,591	\$106,109	\$18,378	\$124,487	\$9,902	\$94,219	\$104,121	\$468,957
Residual Markets	18,451	6,077	(85 )	5,992	1,274	1,751	3,025	21,418
Commercial Multiple								
Peril / General Liability	427,296	74,791	12,587	87,378	3,311	66,849	70,160	444,514
Commercial Automobile	138,705	24,027	941	24,968	6,201	37,992	44,193	119,480
Other	41,032	26,055	(1,693 )	24,362	11,888	21,126	33,014	32,380
Net Reserves	1,074,075	\$237,059	\$30,128	\$267,187	\$32,576	\$221,937	\$254,513	1,086,749
Reinsurance								
Recoverable	381,905							445,100
Consolidated	\$1,455,980							\$1,531,849

47

Table of Contents

The following table shows the re-estimated December 31, 2012 held reserves by line as of June 30, 2013 (in thousands):

Line of Business	Reserves at December 31, 2012	Re-estimated Reserves for December 31, 2012 at June 30, 2013	Development as a Percentage of Prior Year Reserves	
Workers' Compensation	\$ 448,591	\$ 466,969	4.1	%
Commercial Multiple Peril / General Liability	427,296	439,883	2.9	%
Commercial Automobile	138,705	139,646	0.7	%
Other	41,032	39,339	-4.1	%
Sub-total	1,055,624	1,085,837	2.9	%
Residual Markets	18,451	18,366	-0.5	%
Total Net Reserves	\$ 1,074,075	\$ 1,104,203	2.8	%

## Workers' Compensation Excluding Residual Markets

The net ultimate loss estimates for accident years 2012 and prior in the workers' compensation line of business increased \$18.4 million, or 4.1%. This was driven primarily by increases of \$9.5 million and \$5.9 million in 2011 and 2010, respectively. These increases are related to two California programs. This increase was partially offset by a decrease of \$1.2 million in 2012 related to a countrywide program and a California program. Additional increases of \$1.9 million, \$2.0 million, and \$1.3 million in accident years 2001, 2000, and 1999, respectively, were all related to an evaluation of the impact of an adverse interim final arbitration reinsurance award. The change in ultimate loss estimates for all other accident years was insignificant.

## Commercial Multiple Peril / General Liability

The net ultimate loss estimates for accident years 2012 and prior in the commercial multi-peril/general liability line of business increased \$12.6 million, or 2.9%. This was driven primarily by increases of \$2.7 million, \$2.4 million, \$2.3 million, \$870,000, \$1.8 million, \$770,000 and \$765,000 in accident years 2012, 2009, 2008, 2007, 2006, 2005, and 2004, respectively. This increase was primarily due to an excess liability program. This increase was partially offset by a decrease of \$731,000 in accident year 1999. This decrease was related to a movement in an excess liability program. The change in ultimate loss estimates for all other accident years was insignificant.

## Commercial Automobile

A \$0.9 million increase, or 0.7%, in net ultimate loss estimates, for the commercial automobile line of business was primarily from increases of \$2.4 million and \$632,000 in accident years 2012 and 2010, respectively. This increase was from two California programs and a transportation program. The increase in net ultimate loss estimates was partially offset by decreases of \$701,000, \$852,000, and \$649,000 in accident years 2011, 2009, and 2007, respectively. These decreases were related to smaller movements in several programs. The change in ultimate loss estimates for all other accident years was insignificant.

## Table of Contents

### Other

The \$1.7 million decrease, or 4.1%, in net ultimate loss estimates in other lines of business is primarily from a decrease of \$1.2 million in accident year 2012. This decrease was related to a general agency program. The change in ultimate loss estimates for all other accident years was insignificant.

### Residual Markets

The workers' compensation residual market line of business had a decrease in net ultimate loss estimate of \$85,000, or 0.5% of net reserves. This decrease reflects reductions in the net ultimate loss estimates for various accident years. 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.

## 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.

As an insurance holding company, the Company's ability to continue to pay shareholder dividends is dependent upon the availability of liquid assets, which is dependent in large part on the dividend paying ability of its Insurance Company Subsidiaries. The timing and amount of dividends paid by the Insurance Company Subsidiaries to the Company may vary from year to year. Our Insurance Company Subsidiaries are subject to laws and regulations in the jurisdictions where they operate that restrict the amount and timing of dividends they may pay within twelve consecutive months without the prior approval of regulatory authorities. The restrictions are generally based on net income and on certain levels of policyholders' surplus as determined in accordance with statutory accounting practices. Dividends in excess of such thresholds are considered "extraordinary" and require prior regulatory approval.

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 ordinary dividend available that can be paid from the Insurance Company Subsidiaries during 2013 is \$42.6 million without prior regulatory approval. Of this \$42.6 million, no ordinary dividends have been declared and paid as of June 30, 2013. In addition to ordinary dividends, the Insurance Company Subsidiaries have the capacity to pay \$123.5 million of extraordinary dividends in 2013, subject to prior regulatory approval. The ability to pay ordinary and extraordinary dividends must be reviewed in relation to the impact on key financial measurement ratios, including Risk Based Capital (RBC) ratios and A.M. Best's Capital Adequacy Ratio. 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 \$12.5 million for the six months ended June 30, 2013 and 2012, respectively. As of June 30, 2013, on a trailing twelve month statutory consolidated basis, the gross and net premium leverage ratios were 2.1 to 1.0 and 1.4 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, impairment charges, depreciation, and amortization from non-regulated subsidiaries were approximately \$6.3 million for the six months ended June 30, 2013.

We have a revolving credit facility of \$100.0 million. As of June 30, 2013, we had \$20.0 million outstanding balance under our revolving credit facility and \$0.5 million in letters of credit issued. The undrawn portion of the revolving credit facility, which was \$79.5 million as of June 30, 2013, is available to finance working capital and for other general corporate purposes, including but not limited to, surplus contributions to our Insurance Company Subsidiaries to support premium growth or strategic acquisitions. As of June 30, 2013, we were not in compliance with some of our financial covenants applicable to the Credit Facilities, as described in Note 4 - Debt.

Because of our Insurance Company Subsidiaries' membership in the FHLBI, we have the ability to borrow on a collateralized basis at relatively low borrowing rates, providing a source of liquidity. As of June 30, 2013, we had borrowed \$30.0 million from the FHLBI. The proceeds were used to fund purchases of high quality bonds with maturities that match the maturity of the FHLBI credit facility. Due to the low cost of the FHLBI funding, we expect to generate returns in excess of its cost of borrowing under this strategy. We have the ability to increase our borrowing capacity through additional investments in FHLBI and pledging additional securities. As of December 31, 2012, we had \$30.0 million of borrowings outstanding from the FHLBI.

50

---



## Table of Contents

Cash flows used in operations was \$1.5 million for the six months ended June 30, 2013, compared to cash flows provided by operations of \$73.0 million for the six months ended June 30, 2012. The decrease in operating cash flows reflects a net cash outflow from the quota share treaty that was entered into during the fourth quarter of 2012 as well as a reduction in cash from underwriting activities. 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.

Refer to Note 5 ~ Derivative Instruments of the Notes to the Consolidated Financial Statements, for additional information specific to our interest rate swaps.

#### Credit Facilities, Debentures, and Cash Convertible Senior Notes

Refer to Note 4 ~ Debt of the Notes to the Consolidated Financial Statements, for additional information specific to our credit facilities, debentures, and the Notes.

#### Investment Portfolio

As of June 30, 2013 and December 31, 2012, the recorded values of our investment portfolio, including cash and cash equivalents, were both \$1.7 billion.

In general, we believe our overall investment portfolio is conservatively invested. The effective duration of the investment portfolio at June 30, 2013, is 5.2 years, compared to 4.9 years at June 30, 2012. Our pre-tax book yield, excluding cash and cash equivalents was 3.3% at June 30, 2013, compared to 3.4% at December 31, 2012. The tax equivalent yield, excluding cash and cash equivalents was 3.8% at June 30, 2013, compared to 4.1% at December 31, 2012. Approximately 99.9% 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.

Table of Contents

Contractual Obligations and Commitments

On March 18, 2013, the Company issued \$100.0 million of 5.0% cash convertible senior notes, which mature on March 15, 2020. As a result of the issuance of the cash convertible notes, as of June 30, 2013, the total debt (including debentures) of the Company and its non-regulated subsidiaries was \$243.9 million, and the payments due in more than five years increased to \$180.9 million. For additional information regarding the cash convertible notes, refer to Note 4 ~ Debt of the Notes to the Consolidated Financial Statements. For the six months ended June 30, 2013, there were no other 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.  
52

---

Table of Contents

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, 2013. Our market risk sensitive instruments are primarily related to fixed income securities, which are available for sale and not held for trading purposes.

Interest Rate Risk

Interest rate risk is managed within the context of an asset and liability management strategy for which 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 effective duration of between three and a half and five and a half years. At June 30, 2013, our fixed income portfolio had an effective duration of 5.2 years, compared to 5.1 years at December 31, 2012.

At June 30, 2013, the fair value of our investment portfolio, excluding cash and cash equivalents, was \$1.6 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 common stocks, preferred stocks and mutual funds with an emphasis on dividend income. These investments comprise 7.0% 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 increase our holdings of 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, 2012. 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.

Table of Contents

	Rates Down 100bps	Rates Unchanged	Rates Up 100bps
Fair Value	\$1,518,024	\$1,445,076	\$1,370,700
Yield to Maturity or Call	1.7%	2.6%	3.5%
Effective Duration	5.1	5.2	5.3

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.

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, 2013 and December 31, 2012, we had outstanding 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, 2013, we had an outstanding balance on our term loan of \$25.5 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$255,000. At December 31, 2012 we had an outstanding balance on our term loan of \$28.5 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$285,000.

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 \$100.0 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, 2013 and December 31, 2012, we had a \$20.0 million outstanding balance on our line of credit. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$200,000. In addition, at June 30, 2013 and December 31, 2012, \$0.5 million in letters of credit had been issued.

Table of Contents

Equity Risk

Equity risk is the risk that we may incur economic losses due to adverse changes in equity prices. Our equity securities are classified as available for sale in accordance with GAAP and carried on the balance sheet at fair value. Our outside investment managers are constantly reviewing the financial health of these issuers. In addition, we perform periodic reviews of these issuers.

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, 2013, 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, 2013, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

55

---

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, 2013, which is hereby incorporated by reference.

ITEM 1A. RISK FACTORS

Except as set forth below, 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, 2012 and our other filings with the Securities and Exchange Commission.

In addition to the other information set forth in this report, including the information regarding forward-looking statements set forth in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations", you should carefully consider the following risk factors, categorized by "Risks Related to Our Business", "Risks Related to Our Industry" and "Risks Related to Our Common Stock", which could materially affect our business, financial condition or results of operations in future periods.

Risks Related to Our Business

Actual loss and loss adjustment expenses may exceed our reserve estimates, which would negatively impact our profitability and financial position.

In many cases, several years may elapse between the occurrence of an insured loss, the reporting of the loss to us and our payment of the loss. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities representing estimates of amounts needed to pay reported and unreported losses and the related loss adjustment expenses. Loss reserves are an estimate of what we anticipate the ultimate costs to be and therefore do not represent an exact calculation of liabilities. Estimating loss reserves is a difficult and complex process involving many variables and subjective judgments. As part of the reserving process, we review historical data and consider the impact of various factors such as:

- actuarial and statistical projections of the cost of settlement and administration of claims reflecting facts and circumstances then known;
- historical claims information and loss emergence patterns;
- assessments of currently available data;
- estimates of future trends in claims severity and frequency;
- economic factors such as inflation;
- judicial theories of liability;
- estimates and assumptions regarding social, judicial and legislative trends, and actions such as class action lawsuits and judicial interpretation of coverages or policy exclusions; and
- the level of insurance fraud.

This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future results. It also assumes that adequate historical or other data exists upon which to make these judgments. There is no precise method, however, for evaluating the impact of any specific factor on the adequacy of reserves and actual results are likely to differ from original estimates.

If the actual amount of insured losses is greater than our reserve estimates, our profitability, capital and financial position could suffer. In addition, if our loss reserves are inadequate to cover the actual amount of insured losses, our financial strength rating or the financial strength ratings of our Insurance Company Subsidiaries could be downgraded. An increase in reserves may also require us to write off a portion of our deferred acquisition costs asset, which would also negatively impact our operating results and financial position.

In 2012, we experienced material reserve strengthening because of significant adverse loss development primarily in commercial multiple peril, workers' compensation and commercial auto lines and in the second and third quarters of 2012, we took charges of \$28.2 million and \$42.9 million, respectively. For the six months ended June 30, 2013, we reported an increase in net ultimate loss estimates for accident years 2012 and prior of \$30.1 million, or 2.8% of \$1.1 billion of beginning net loss and LAE reserves at December 31, 2012. The change in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2013 that differed from the projected activity. Additional information relating to our reserves is included within the Losses and Loss Adjustment Expenses and Reinsurance Recoverables section of Note 1 ~ Summary of Significant Accounting Policies, as well as to the Critical Accounting Policies section and the Reserves section of Item 2, Management's Discussion and Analysis. There can be no assurance that we will not in the future experience further significant adverse loss development that could result in further reserve strengthening and additional material charges to earnings.

56

---

## Table of Contents

The decrease in our A.M. Best rating could negatively affect our business.

Financial ratings are an important factor influencing the competitive position of insurance companies. Insurance companies are subject to financial strength ratings produced by external rating agencies. Higher ratings generally indicate greater financial stability and a stronger ability to pay claims. Ratings are assigned by rating agencies to insurers based upon factors they believe are important to policyholders. Ratings evaluations are not directed to potential purchasers of our common stock and are not recommendations to buy, hold, or sell our securities. Financial strength ratings by rating agencies are not ratings of securities or recommendations to buy, hold or sell any security and should not be relied upon as such.

Our ability to write business is most influenced by our rating from A.M. Best (“A.M. Best”). A.M. Best ratings are designed to assess an insurer’s financial strength and ability to meet continuing obligations to policyholders. On August 2, 2013, A.M. Best Company, insurance industry rating agency, lowered Meadowbrook’s issuer credit rating, as well its financial strength ratings and downgraded the Company’s Insurance Company Subsidiaries’ financial strength rating from “A-” (Excellent) with a “negative” outlook to “B++” (Good) with a “stable” outlook. As a result of the foregoing downgrade, our results of operations could be materially and adversely impacted, including as a result of current and future independent agents and insureds who may choose to transact their business with more highly rated competitors. In addition, we may face a significant reduction in the number of insurance contracts we write and the loss of substantial business to our competitors that maintain higher ratings, which would cause premiums and earnings to decrease. The downgrade could negatively impact our ability to raise capital and have a negative impact on our overall liquidity. Because lenders and reinsurers will use our A.M. Best ratings as a factor in deciding whether to transact business with us, the current ratings of our Insurance Company Subsidiaries or their failure to maintain the current ratings may dissuade a financial institution or reinsurance company from conducting any business with us or may increase our interest or reinsurance costs. There can be no assurance that the Company will not be further downgraded.

In response to the downgrade by A.M. Best, on August 4, 2013, the Insurance Company Subsidiaries entered into agreements with State National Insurance Company and its affiliates, which will provide the Insurance Company Subsidiaries the use of an “A” rated policy insurance company for a portion of its business where an “A” rated policy issuer is required. The costs associated with these agreements could negatively impact our results of operations, and there can be no assurance that the Company will not need to enter into additional similar agreements as a result of the downgrade.

We may require additional capital in the future, which may not be available or may only be available on unfavorable terms.

Our future capital requirements depend on many factors, including our ability to write new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. To the extent that our present capital is insufficient to meet future operating requirements and/or cover losses, we may need to raise additional funds through financings. If we had to raise additional capital, equity or debt financing may not be available or may be on terms that are not favorable to us. In the case of equity financings, dilution to our shareholders could result, and in any case such securities may have rights, preferences and privileges that are senior to those of the shares currently outstanding. If we cannot obtain adequate capital on favorable terms or at all, our business, operating results and financial condition could be adversely affected.

As of June 30, 2013, the Company was not in compliance with the minimum consolidated net worth and the maximum permitted consolidated leverage ratio covenants as a result of the goodwill impairment recorded in the second quarter of 2013, as described in Note 11 ~ Subsequent Events. Pursuant to the credit agreement, the lenders may take either or both of the following actions related to the non-compliance with the covenants: (i) immediate termination of the loan commitments, and (ii) declaration of the outstanding loans to be due and payable in whole



together with accrued interest. The acceleration of the outstanding loans may result in cross-defaults under the Notes and other debt obligations of the Company, which would materially and adversely affect our results of operations.

57

---

Table of Contents

In connection with the foregoing covenant non-compliance, the Company is currently in discussions with the lending group to potentially amend the loan agreements, which may include obtaining a waiver and revising the financial covenants. While the Company remains in discussions with the lending group, the Company has not obtained, and there can be no assurance that the Company will obtain, such an amendment.

As a result of the foregoing, we may not be able to successfully obtain additional financing on favorable terms, or at all.

We face competitive pressures in our business that could cause our revenues to decline and adversely affect our profitability.

We compete with a large number of other companies in our selected lines of business. Many of our competitors are substantially larger and may enjoy better name recognition, substantially greater financial resources, higher ratings by rating agencies, broader and more diversified product lines and more widespread agency relationships than us. Insurers in our markets generally compete on the basis of price, consumer recognition, coverages offered, claims handling, financial stability, customer service and geographic coverage. Although pricing is influenced to some degree by that of our competitors, it is not in our best interests to compete solely on price, and we may from time-to-time experience a loss of market share during period of intense price competition. A number of new, proposed or potential legislative or industry developments could further increase competition in our industry including, but not limited to:

- the formation of new insurers and an influx of new capital in the marketplace as existing companies attempt to expand their business as a result of better pricing and/or terms or the offering of similar or better products at or below our prices;
- programs in which state-sponsored entities provide property insurance in catastrophe-prone areas, other alternative market types of coverage, or other non-property insurance; and
- changing practices created by the Internet, which has increased competition within the insurance business.

New competition resulting from these and other developments could make the property and casualty insurance marketplace more competitive by increasing the supply of insurance capacity. In that event, the current market may soften further, and it may negatively influence our ability to maintain or increase rates. Consequently, our profitability could be adversely impacted by increased competition.

The failure of any of the loss limitation methods we employ could have a material adverse effect on our results of operations and financial condition.

Various provisions of our policies, such as limitations or exclusions from coverage or choice of forum, have been negotiated to limit our exposure to certain types of risks and expanding theories of legal liability. In addition, many of our policies limit the period during which a policyholder may bring a claim under the policy, which period in many cases is shorter than the statutory period under which these claims can be brought by our policyholders. While these exclusions and limitations help us assess and control our loss exposure, it is possible that a court or regulatory authority could nullify or void an exclusion, or legislation could be enacted that modifies or voids the use of such endorsements and limitations in a way that could have a materially adverse impact on our financial condition and operating results. Such actions could result in higher than anticipated losses and LAE by extending coverage beyond our underwriting intent or increasing the number or size of claims, which could have a material adverse effect on our operating results. In some instances, these changes may not become apparent until some time after we have issued the insurance policies that are affected by the changes and litigation relating to the insurance policy interpretation has been resolved. As a result, the full extent of liability under our insurance contracts may not be known for many years after a policy is issued.

Our geographic concentration ties our performance to the business, economic, natural perils, man made perils, and regulatory conditions within our most concentrated region.

Our revenues and profitability are subject to the prevailing regulatory, legal, economic, political, demographic, competitive, weather and other conditions in the principal states in which we do business. Changes in any of these conditions could make it less attractive for us to do business in such states and would have a more pronounced effect on us compared to companies that are more geographically diversified. In addition, our exposure to severe losses from localized perils, such as earthquakes, hurricanes, tropical storms, tornadoes, wind, ice storms, hail, fires, terrorism, riots and explosions, is increased in those areas where we have written significant numbers of insurance policies.

58

---

Table of Contents

One of our predominate lines of business is workers' compensation (41.9% of net earned premiums in 2012), which has a high concentration in California. Accordingly, unfavorable business, economic or regulatory conditions in this state could negatively impact our business. California is also exposed to climate and environmental changes, natural perils such as earthquakes, water supplies, and the possibility of pandemics or terrorist acts. Because our business is concentrated in this manner, we may be exposed to economic and regulatory risks or risk from natural perils that are greater than the risks associated with greater geographic diversification. Refer to Note [5] ~ Reinsurance for further information regarding our reinsurance structure related to workers' compensation business.

Our success depends on our ability to appropriately price the risks we underwrite.

Our financial results depend on our ability to underwrite and collect adequate premium rates for a wide variety of risks. Rate adequacy is necessary to generate sufficient premiums to pay losses, loss expenses, and underwriting expenses and to earn a profit. To price our products accurately, we must collect and properly analyze a substantial amount of data, develop, test and apply appropriate rating formulas, monitor and react to changes in trends and project both severity and frequency of losses with reasonable accuracy. These activities are subject to a number of risks and uncertainties that are outside our control, including:

- availability of sufficient reliable data and our ability to properly analyze available data;
- uncertainties that inherently characterize estimates and assumptions;
- selection and application of appropriate rating and pricing techniques;
- changes in legal standards, claim settlement practices, medical care expenses and restoration costs;
- changes in mandated rates or benefits set by the state regulators; and
- legislative actions.

Consequently, we could underprice risks, which would negatively affect our profit margins, or we could overprice risks, which could reduce our sales volume and competitiveness. In either event, our profitability could be materially and adversely affected.

We are exposed to goodwill impairment risk as part of our growth strategy.

Goodwill represents the excess of the amounts we paid to acquire subsidiaries and other businesses over the fair value of their net assets at the date of acquisition. We are required to perform a goodwill impairment analysis at least annually and whenever events or circumstances indicate that the carrying value of a reporting unit may not be recoverable from estimated future cash flows. Upon a determination that goodwill has been impaired, we are required to write down goodwill by the amount of the impairment, with a corresponding charge to net income.

On August 2, 2013, A.M. Best lowered Meadowbrook's issuer credit rating, as well its financial strength ratings and the issuer credit ratings of its Insurance Company Subsidiaries, following the Company's reported weaker-than-anticipated second-quarter results. These events represented triggering events for potential goodwill impairment. The Company has performed an interim goodwill impairment evaluation as of June 30, 2013, as required under ASC 350, Goodwill and Other Intangible Assets. Management has concluded that an impairment of goodwill exists at June 30, 2013 and has estimated an impairment amount of \$115.4 million. This provisional impairment adjustment will be revised, if necessary, during the third quarter of 2013. Management believes any adjustment to this preliminary charge will not be material; however, until such time as the evaluation is complete any potential changes are uncertain. The non-cash impairment of goodwill of \$115.4 million was recorded in the three months ended June 30, 2013. Such impairments could have a material adverse effect on our results of operations, capital and financial position.

## Table of Contents

If market conditions cause our reinsurance to be more costly or unavailable, we may be required to bear increased risks or reduce the level of our underwriting commitments.

As part of our overall risk and capacity management strategy, we purchase reinsurance for significant amounts of risk underwritten by our Insurance Company Subsidiaries, especially for the excess-of-loss and severity risks. We purchase reinsurance by transferring part of the risk we have written (known as ceding) to a reinsurance company in exchange for part of the premium we receive in connection with the risk under pro-rata and excess-of-loss contracts. These reinsurance arrangements are intended to diversify our business and reduce our exposure to large losses or from hazards of an unusual nature.

Market conditions beyond our control determine the availability and cost of the reinsurance we purchase, which may affect the level of our business and profitability. Our reinsurance facilities are generally subject to annual renewal. We may be unable to maintain our current reinsurance facilities or to obtain other reinsurance in adequate amounts and at favorable rates. Increases in the cost of reinsurance would adversely affect our profitability. In addition, if we are unable to renew our expiring facilities or to obtain new reinsurance on favorable terms, either our net exposure to risk would increase or, if we are unwilling to bear an increase in net risk exposures, we would have to reduce the amount of risk we underwrite.

Our reinsurers may not pay on losses in a timely fashion, or at all, which may cause a substantial loss and increase our costs.

Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred, the ceding of insurance does not discharge us of our primary liability to our policyholder. As a result, ceded reinsurance arrangements do not limit our ultimate obligations to policyholders to pay claims. Therefore, we are subject to credit risk with respect to the obligations of our reinsurers. We are also subject to the risk that their reinsurers may dispute their obligations to pay our claims. In addition, our reinsurance agreements are subject to specified limits and we would not have reinsurance coverage to the extent that it exceeds those limits. Should an unlikely event occur that exceeds our reinsurance coverage, then the amounts in excess of our reinsurance coverage could adversely impact our financial condition or results of operations. In order to minimize our exposure to significant losses from reinsurer insolvencies, we evaluate the financial condition of our reinsurers and monitor the economic characteristics of the reinsurers on an ongoing basis and, if appropriate, we may require trust agreements to collateralize reinsurers' financial obligation to us. Nevertheless, if our reinsurers fail to pay us or fail to pay on a timely basis, our financial results and financial condition could be adversely affected.

We may be adversely affected by interest rate changes.

Our investment portfolio is predominantly comprised of fixed income securities. These securities are sensitive to changes in interest rates. An increase in interest rates typically reduces the fair market value of fixed income securities. In addition, if interest rates decline, investment income earned from future investments in fixed income securities will be lower. We generally hold our fixed income securities to maturity, so our interest rate exposure does not usually result in realized losses. However, as noted above, rising interest rates could result in a significant reduction of our book value. A low investment yield environment could adversely impact our net earnings, as a result of fixed income securities maturing and being replaced with lower yielding securities which impact investing results.

Interest rates are highly sensitive to many factors beyond our control including general economic conditions, governmental monetary policy, and political conditions. As discussed above, fluctuations in interest rates may adversely impact our business. See "Item 3 Qualitative and Quantitative Disclosures About Market Risk" for further discussion on interest rate risk.

Continued difficult conditions in the global capital markets and the economy generally may materially and adversely affect our business and results of operations.

Our results of operations are materially affected by conditions in the global capital markets and the economy generally, both in the U.S. and elsewhere around the world. Recently, concerns over the slow economic recovery, level of U.S. national debt, the U.S. mortgage market, inflation levels, energy costs and geopolitical issues have contributed to increased volatility and diminished expectations for the economy and global capital markets going forward. These factors, combined with volatile oil prices, reduced business and consumer confidence and continued high unemployment, have negatively impacted the U.S. economy. Although liquidity has improved, the market for fixed income instruments continues to experience some price volatility, credit downgrade events and elevated probabilities of default.

60

---

Table of Contents

Factors such as consumer spending, business investment, government spending, the volatility and strength of the capital markets, investor and consumer confidence and inflation levels all affect the business and economic environment and, ultimately, the amount and profitability of our business. In an economic downturn characterized by higher unemployment, lower family income, lower corporate earnings, lower business investment, negative investor sentiment and lower consumer spending, the demand for our insurance products could be adversely affected. Our policyholders may choose to defer paying insurance premiums or stop paying insurance premiums altogether. In addition, we may experience an elevated incidence of claims and lapses or surrenders of policies. Adverse changes in the economy could negatively affect our net income and could have a material adverse effect on our business, results of operations and financial condition.

In addition, continuing market turmoil has resulted in, and may continue to raise the possibility of, legislative, regulatory and governmental actions. We cannot predict whether or when such actions may occur, or what impact, if any, such actions could have on our business, results of operations and financial condition.

Even in the absence of a market downturn, our insurance products, as well as our investment returns and our access to and cost of financing, are sensitive to equity, fixed income, real estate and other market fluctuations and general economic and political conditions. These fluctuations and conditions could materially and adversely affect our results of operations, financial condition and liquidity.

Our investment portfolio is subject to market and credit risks, which could affect our financial results and ability to conduct business.

Our investment portfolio is subject to overall market risk and credit risk of the individual issuers of securities. The value of investments in marketable securities is subject to impairment as a result of deterioration in the creditworthiness of the issuer. Although we try to manage this risk by diversifying our portfolio and emphasizing credit quality, our investments are subject to losses as a result of a general downturn in the economy. A severe economic downturn could have a material adverse impact on our results from operations and our financial condition.

We could be forced to sell investments to meet our liquidity requirements.

We invest the premiums we receive from customers until they are needed to pay policyholder claims or until they are recognized as profits. Consequently, we seek to match the duration of our investment portfolio with the duration of our loss and loss adjustment expense reserves to ensure strong liquidity and avoid having to liquidate securities to fund claims. As an example, we ladder the maturities of our investment portfolio to ensure we have adequate liquidity to fund anticipated liabilities that are coming due. Risks such as inadequate loss and loss adjustment reserves or unfavorable trends in litigation could potentially result in the need to sell investments to fund these liabilities. Such sales could result in significant realized losses depending on the conditions of the general market, interest rates and credit issues with individual securities.

If we are unable to successfully introduce new products or services or fail to keep pace with advances in technology, our business, financial condition and results of operations will be adversely affected.

The successful implementation of our business model depends on our ability to adapt to evolving technologies and industry standards and introduce new products and services. We cannot assure you that we will be able to introduce new products, or that any new products will achieve market acceptance. Moreover, competitors may develop competitive products that could adversely affect our results of operations. A failure by us to introduce planned products or other new products could have an adverse effect on our business, financial condition and results of operations.

If we cannot adapt to changing technologies, our products and services may become obsolete, and our business could suffer. Our success will depend, in part, on our ability to continue to enhance our existing products and services, develop new technology that addresses the increasingly sophisticated and varied needs of our prospective customers and respond to technological advances on a timely and cost-effective basis. We may not be successful in using new technologies effectively or adapting our proprietary technology to evolving customer requirements, and, as a result, our business could suffer.

61

---



Table of Contents

We are unable to predict the impact on us of the federal financial regulatory reform.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) enacted in July, 2010, expands the federal presence in insurance oversight. The Dodd-Frank Act's requirements include streamlining the state-based regulation of reinsurance and nonadmitted insurance (property or casualty insurance placed from insurers that are eligible to accept insurance, but are not licensed to write insurance in a particular state). The Dodd-Frank Act also establishes a new Federal Insurance Office within the U.S. Department of the Treasury with regulatory authority over all lines of insurance except health insurance, certain long-term care insurance and crop insurance. The Federal Insurance Office has the power to, among other things, monitor aspects of the insurance industry, identify issues in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the overall financial system, coordinate federal policy on international insurance matters and preempt state insurance measures under certain circumstances.

The Dodd-Frank Act provides a framework for further regulation and governance initiatives. These regulations and initiatives cover many aspects of public company governance including, but not limited to, new and enhanced executive compensation disclosures, nonbinding stockholder votes on executive compensation, new independence standards for compensation committee membership, and incentive compensation clawback policies. Because the SEC has not yet completed its required rulemaking under the Dodd-Frank Act, we are unable to predict with certainty the overall impact these new regulations and initiatives will have on us. However, the cost of compliance with new regulations and initiatives could be significant, and adversely impact our results of operations, equity, business, and insurer financial strength and debt ratings.

Our ability to meet ongoing cash requirements and pay dividends may be limited by our holding company structure and regulatory constraints restricting dividends or other distributions by our Insurance Company Subsidiaries.

We are a holding company that transacts the majority of our business through our Insurance Company Subsidiaries. Our ability to meet our obligations on our outstanding debt, and to pay our expenses and shareholder dividends, depends upon the dividend paying capacity of our Insurance Company Subsidiaries. We will be limited by the earnings of our Insurance Company Subsidiaries, and the distribution or other payment of such earnings to it in the form of dividends, loans, advances or the reimbursement of expenses. Payments of dividends to us by our Insurance Company Subsidiaries are subject to various business considerations and restricted by state insurance laws, including laws establishing minimum solvency and liquidity thresholds, and could be subject to revised restrictions in the future. As of June 30, 2013, the ordinary dividend available that can be paid from the Insurance Company Subsidiaries during 2013 without prior regulatory approval is \$42.6 million. The ability to pay ordinary and extraordinary dividends must be reviewed in relation to the impact on key financial measurement ratios, including Risk Based Capital (RBC) ratios and A.M. Best’s Capital Adequacy Ratio (“BCAR”), which in turn could affect our A.M. Best rating. As a result, at times, we may not be able to receive dividends from our Insurance Company Subsidiaries in amounts necessary to meet our debt obligations, to pay shareholder dividends on our capital stock or to pay corporate expenses. Therefore, the inability of our Insurance Company Subsidiaries to pay dividends or make other distributions could have a material adverse effect on our business and financial condition.

Our Insurance Company Subsidiaries are subject to minimum capital and surplus requirements. Failure to meet these requirements could subject us to regulatory action.

Our Insurance Company Subsidiaries are subject to minimum capital and surplus requirements imposed under the laws of their respective states of domicile and each state in which they issue policies. Any failure by one of our Insurance Company Subsidiaries to meet minimum capital and surplus requirements imposed by applicable state law will subject it to corrective action, which may include requiring adoption of a comprehensive financial plan, revocation of its license to sell insurance products or placing the subsidiary under state regulatory control. A decline in

the risk based capital ratios of our Insurance Company Subsidiaries could limit their ability to pay dividends to us. Any new minimum capital and surplus requirements adopted in the future may require us to increase the capital and surplus of our Insurance Company Subsidiaries, which we may not be able to do.

62

---

Table of Contents

Acquisitions and integration of acquired businesses and other strategic transactions may result in operating difficulties, which may prevent us from achieving the expected benefits.

At times, we may investigate and pursue acquisition opportunities if we believe such opportunities are consistent with our long-term objectives and that the expected benefits exceed the risks. Achieving such benefits is subject to a number of uncertainties, including whether the combined businesses are integrated in an efficient and effective manner; assumption of unknown material liabilities, including deficient provisions for unpaid claims; diversion of management's attention from other business concerns; failure to achieve financial or operating objectives; potential loss of policyholders or key employees of acquired companies; and general competitive factors in the marketplace. We believe we have a robust due diligence process; however, integrating an acquired company or business can be a complex and costly endeavor. Integration may result in the loss of key employees, disruption to the existing business or the business of the acquired company, or otherwise harm our ability to retain customers and employees or achieve the anticipated benefits of the acquisition. Also, the negative effect of any financial commitments required by regulatory authorities or rating agencies in acquisitions or business combinations may be greater than expected. We may be unable to integrate or profitably operate any business, operations, personnel, services or products that we may acquire in the future, which could materially impact our projected benefits from the transaction, business, financial condition, results of operations, and cash flows.

On August 2, 2013, the Company announced that its board of directors is undertaking a review of strategic alternatives. The pursuit of strategic alternatives raises some of the same risks associated with pursuing acquisitions, including diversion of management's attention from other business concerns; failure to achieve financial or operating objectives; potential loss of policyholders or key employees of acquired companies; and volatility in the Company's stock price.

Our reliance upon producers subjects us to their credit risk.

With respect to agency-billed premiums and premiums generated by brokers, producers collect premiums from the policyholders and forward them to us. We rely, and will continue to rely, heavily on these producers to attract new business. Independent producers generally have the ability to bind insurance policies and collect premiums on our behalf, actions over which we have a limited ability to exercise preventative control. In the event that an independent agent exceeds its authority by binding us to a risk that does not comply with our underwriting guidelines, we may be at risk for that policy until we effect a cancellation. Any improper use of such authority may result in losses that could have a material adverse effect on our business, results of operations and financial condition.

In certain jurisdictions, when the insured pays premium for these policies to producers for payment, the premium might be considered to have been paid under applicable insurance laws and the insured will no longer be liable to us for those amounts, whether or not we have actually received the premium from the producer. Consequently, we assume a degree of credit risk associated with producers. Although producers' failures to remit premiums to us have not caused a material adverse impact on us to date, there may be instances where producers collect premium but do not remit it to us and we may be required under applicable law to provide the coverage set forth in the policy despite the actual lack of collection of the premium by us. Because the possibility of these events is dependent in large part upon the financial condition, cash flows, and internal operations of our producers, we may not be able to quantify any potential exposure presented by the risk. If we are unable to collect premium from our producers in the future, our financial condition and results of operations could be materially and adversely affected.

One of our core selected producers accounts for a large portion of our premium volume, loss of business provided by this entity could adversely affect us.

Our largest producer in 2012 was Midwest General Insurance Agency, LLC (“Midwest General”), which in combination with its affiliates, accounted for 13.1% of our gross written premium. No other producer was responsible for more than 10% of our gross written premium. We do not have an exclusive relationship with Midwest General, and there can be no assurance that this relationship will continue in the future. If Midwest General reduces its marketing of our products or moves some or all of its business to another carrier, then our business, investment financial condition and results of operations may be adversely affected.

63

---

## Table of Contents

Our performance is dependent on the continued services and performance of our senior management and other key personnel.

The success of our business is dependent on our ability to retain and motivate our senior management and key management personnel and their efforts. The loss of the services of any of our executive officers or other key employees could have a material adverse effect on our business, financial condition, results of operations, and cash flows. We have existing employment or severance agreements with Robert S. Cubbin, Christopher J. Timm, Karen M. Spaun, Michael G. Costello, and other senior executives. We maintain a “key person” life insurance policy on Robert S. Cubbin, our President and CEO. The loss of any of these officers or other key personnel could cause our ability to implement our business strategies to be delayed or hindered.

Our future success also will depend on our ability to attract, train, motivate and retain other highly skilled technical, managerial, marketing, and customer service personnel. Competition for these employees is strong and we may not be able to successfully attract, integrate or retain sufficiently qualified personnel. In addition, our future success depends on our ability to attract, retain and motivate our agents and other producers. Our failure to attract and retain the necessary personnel and producers could have a material adverse effect on our business, financial condition, results of operations, and cash flows.

We rely on our information technology and telecommunications systems to conduct our business.

Our business is dependent upon the uninterrupted functioning of our information technology and telecommunication systems. We rely upon our systems, as well as the systems of our vendors, to underwrite and process our business; make claim payments; provide customer service; provide policy administration services, such as endorsements, cancellations and premium collections; comply with insurance regulatory requirements; and perform actuarial and other analytical functions necessary for pricing and product development. Our operations are dependent upon our ability to timely and efficiently process our business and protect our information and telecommunications systems from physical loss, telecommunications failure or other similar catastrophic events, as well as from security breaches. While we have implemented business contingency plans and other reasonable and appropriate internal controls to protect our systems from interruption, loss or security breaches, a sustained business interruption or system failure could adversely impact our ability to process our business, provide customer service, pay claims in a timely manner or perform other necessary business functions. Likewise, a security breach of our computer systems could also interrupt or damage our operations or harm our reputation in the event confidential customer information is disclosed to third-parties. We could also be subject to fines and penalties from a security breach. The cost to remedy a severe security breach could also be substantial. These circumstances could have a material adverse effect upon our financial condition, results of operations, cash flows, and reputation.

Managing technology initiatives and obtaining the efficiencies anticipated with technology implementation may present significant challenges.

While technological enhancements and initiatives can streamline several business processes and ultimately reduce the costs of operations, these initiatives can present short-term costs and implementation risks. Projections of associated costs, implementation timelines, and the benefits of those results may be inaccurate and such inaccuracies could increase over time. In addition, there are risks associated with not achieving the anticipated efficiencies from technology implementation that could impact our financial condition, results of operations, and cash flows.

Our internal controls are not fail-safe.

We continually enhance our operating procedures and internal controls to effectively support our business and comply with our regulatory and financial reporting requirements. As a result of the inherent limitations in all control systems,

no system of controls can provide absolute assurance that all control objectives have been or will be met, and that every instance of error or fraud has been or will be detected. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by individual acts or by collusion of two or more persons. The design of any system of controls is based in part upon assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Internal controls may also become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Further, the design of a control system must reflect resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our internal controls and procedures are designed to provide reasonable, not absolute, assurance that the control objectives are met.

64

---

Table of Contents

Risks Related to Our Industry and Our Regulatory and Litigation Environment

The property and casualty insurance industry is cyclical in nature, which may affect our overall financial performance.

Historically, the financial performance of the property and casualty insurance industry has tended to fluctuate in cyclical periods of price competition, excess capacity and lower levels of profitability (known as a soft market) followed by periods of high premium rates, shortages of underwriting capacity, and higher levels of profitability (known as a hard market). Although an individual insurance company's financial performance is dependent on its own specific business characteristics, the profitability of most property and casualty insurance companies tends to follow this cyclical market pattern. Specific factors that can drive the industry's profitability include:

- rising levels of actual costs that are not known by companies at the time they price their products;
- volatile and unpredictable developments, including man-made, weather-related and other natural catastrophes or terrorist attacks;
- changes in loss reserves resulting from the general claims and legal environments as different types of claims arise and judicial interpretations relating to the scope of insurer's liability develop;
- fluctuations in interest rates, inflationary pressures and other changes in the investment environment, which affect returns on invested assets and may impact the ultimate payout of losses; and
- increases in medical costs beyond historic or expected annual inflationary levels.

Because the cyclical nature of our industry is due in large part to the actions of competitors and general economic conditions, we cannot predict with certainty the timing or duration of changes in the market cycle. We have been in a prolonged soft market and cannot necessarily predict how long it will take to harden.

Severe weather conditions and other catastrophes are inherently unpredictable and could cause us to suffer material financial losses.

The majority of our property business is exposed to the risk of severe weather conditions and other catastrophes. Catastrophes can be caused by various events, including natural events, such as hurricanes, winter weather, tornadoes, windstorms, earthquakes, hailstorms, severe thunderstorms and fires, and other events, such as explosions, terrorist attacks and riots. The incidence and severity of catastrophes and severe weather conditions are inherently unpredictable. Generally these losses result in an increase in the number of claims incurred as well as the amount of compensation sought by claimants.

One or more catastrophic or other events could result in claims that substantially exceed our expectations, which could have an adverse effect on our results of operations or financial condition. Along with other insurers in the industry, we use models in assessing our exposure to catastrophe losses that assume various conditions and probability scenarios. However, these models do not necessarily accurately predict future losses or accurately measure losses currently incurred. Catastrophe models use historical information about various catastrophes and detailed information about our in-force business. While we use this information in connection with our pricing and risk management activities, there are limitations with respect to their usefulness in predicting losses in any reporting period. Such limitations lead to questionable predictive capability and post-event measurements that have not been well understood or proven to be sufficiently reliable. In addition, the models are not necessarily reflective of our or state-specific policy language, demand surge for labor and materials or loss settlement expenses, all of which are subject to wide variation by catastrophe.

Table of Contents

Litigation may have an adverse effect on our business

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 the policy of insurance at issue, errors and omissions insurance, extra-contractual coverage under the reinsurance treaty related to the policy of insurance at issue or other appropriate insurance. In terms of any retentions or deductibles associated with such insurance, the Company has established accruals for such retentions or deductibles, when necessary, based upon current available information. Period expenses related to the defense of such claims are included 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 a party to 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.

Because we are heavily regulated by the states in which we operate, we may be limited in the way we operate.

We are subject to extensive supervision and regulation in the states in which we operate. The supervision and regulation relate to numerous aspects of our business and financial condition. The primary purpose of the supervision and regulation is to maintain compliance with insurance regulations and to protect policyholders. The extent of regulation varies, but generally is governed by state statutes. These statutes delegate regulatory, supervisory and administrative authority to state insurance departments. This system of regulation covers, among other things:

- standards of solvency, including risk-based capital measurements;
- restrictions on the nature, quality and concentration of investments;
- restrictions on the types of terms that we can include in the insurance policies we offer;
- restrictions on our ability to withdraw from unprofitable lines of insurance or unprofitable market areas;
- required methods of accounting;
- required reserves for unearned premiums, losses and other purposes;
- permissible underwriting and claims settlement practices;
- assessments for the provision of funds necessary for the settlement of covered claims under certain insurance policies provided by impaired, insolvent or failed insurance companies;
- approval of policy forms and rates; and
- restrictions on transactions between our Insurance Company Subsidiaries and their affiliates.

The regulations of the state insurance departments may affect the cost or demand for our products and may impede us from obtaining rate increases or taking other actions we might wish to take to increase our profitability. Furthermore, we may be unable to maintain all required licenses and approvals and our business may not fully comply with the wide variety of applicable laws and regulations or the relevant authority's interpretation of the laws and regulations. Also, regulatory authorities have relatively broad discretion to grant, renew or revoke licenses and approvals. If we do not have the requisite licenses and approvals, or do not comply with applicable regulatory requirements, the insurance regulatory authorities could stop or temporarily suspend us from conducting some or all of our activities or monetarily penalize us. In addition, state regulators and the NAIC regularly examine existing laws and regulations applicable to insurance companies. Changes in these laws and regulations or the interpretations thereof could adversely impact our business.





## Table of Contents

Although the United States federal government does not directly regulate the insurance business, changes in federal legislation, regulation, and/or administrative policies in several areas, including changes in financial services regulation and federal taxation, can significantly harm the insurance industry.

Most states assess our Insurance Company Subsidiaries to provide funds for failing insurance companies and those assessments could be material.

Our Insurance Company Subsidiaries are subject to assessments in most states where we are licensed for the provision of funds necessary for the settlement of covered claims under certain policies provided by impaired, insolvent or failed insurance companies. These assessments, which are levied by guaranty associations within the state, up to prescribed limits, are imposed on all member insurers in the applicable state on the basis of the proportionate share of the premiums written by member insurers in the lines of business in which the impaired, insolvent or failed insurer was engaged. Accordingly, the assessments levied on us by the states in which we are licensed to write insurance may increase as we increase our premiums written. Maximum contributions required by law in any one year vary by state, and have historically been less than one percent of annual premiums written. In addition, as a condition to the ability to conduct business in certain states, insurance companies are required to participate in mandatory reinsurance funds. We cannot predict with certainty the amount of future assessments or level of participation in mandatory reinsurance funds. Significant assessments and the effect of mandatory reinsurance arrangements, or changes therein, could have a material adverse effect on our financial condition and results of operations.

## Risks Related to Our Common Stock

The price of our common stock may be volatile.

The trading price of our common stock may fluctuate substantially due to a variety of factors, some of which are beyond our control and may not be related to our operating performance. These fluctuations could be significant and could cause a loss in the amount invested in our shares of common stock. Factors that could cause fluctuations include, but are not limited to, the following:

Variations in our actual or anticipated operating results or changes in the expectations of financial market analysts with respect to our results;

Investor perceptions of the insurance industry in general and the Company in particular;

Market conditions in the insurance industry and any significant volatility in the market;

Major catastrophic events; and

Departure of key personnel.

Provisions of the Michigan Business Corporation Act, our articles of incorporation and other corporate governing documents and the insurance laws may discourage takeover attempts.

The Michigan Business Corporation Act contains “anti-takeover” provisions. Chapter 7A (the “Fair Price Act”) of the Business Corporation Act applies to us and may have an anti-takeover effect and may delay, defer or prevent a tender offer or takeover attempt that a shareholder might consider in their best interest, including those attempts that might result in shareholders receiving a premium over market price for their shares.

In general, subject to certain exceptions, the Fair Price Act prohibits a Michigan corporation from engaging in a “business combination” with an “interested shareholder” for a period of five years following the date that such shareholder became an interested shareholder, unless (i) prior to such date, the board of directors approved the business combination or (ii) on or subsequent to such date, the business combination is approved by at least 90% of the votes of

each class of the corporation's stock entitled to vote and by at least two-thirds of such voting stock not held by the interested shareholder or such shareholder's affiliates. The Fair Price Act defines a "business combination" to include certain mergers, consolidations, dispositions of assets or shares and recapitalizations. An "interested shareholder" is defined by the Fair Price Act to include a beneficial owner, directly or indirectly, of 10% or more of the voting power of the outstanding voting shares of the corporation.

Our articles of incorporation allow our Board of Directors to issue one or more classes or series of preferred stock with voting rights, preferences and other privileges as the Board of Directors may determine. The possible issuance of preferred shares could adversely affect the holders of our common stock and could prevent, delay, or defer a change of control.

67

---

Table of Contents

We are also subject to the laws of Michigan, Ohio, Texas, California, Washington D.C., Missouri, and other states, which govern insurance holding companies. Under these laws, a person generally must obtain the applicable Insurance Department's approval to acquire, directly or indirectly, five to ten percent or more of the outstanding voting securities of our Insurance Company Subsidiaries. An Insurance Department's determination of whether to approve an acquisition would be based on a variety of factors, including an evaluation of the acquirer's financial stability, the competence of its management, and whether competition in that state would be reduced. These laws may prevent, delay or defer a change of control of us or our Insurance Company Subsidiaries.

Although we have paid cash dividends in the past, we may not pay cash dividends in the future.

The declaration and payment of dividends is subject to the discretion of our Board of Directors and will depend on our financial condition, results of operations, cash flows, cash requirements, future prospects, regulatory and contractual restrictions on the payment of dividends by our Insurance Company Subsidiaries and other factors deemed relevant by our Board of Directors. There is no requirement that we must, and we cannot assure you that we will, declare and pay any dividends in the future. Our Board of Directors may determine to retain such capital for general corporate or other purposes. In addition, so long as the Company is in default under its Credit Facilities it is prohibited by the terms thereof from paying any dividends, without breaching the Credit Facilities.

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

Not Applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable

ITEM 5. OTHER INFORMATION

Not Applicable

68

---

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

69

---

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 14, 2013

70

---

Table of Contents

EXHIBITS INDEX

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

71

---