

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

May 10, 2010

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**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 quarter ended March 31, 2010
- or**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number 1-14094

Meadowbrook Insurance Group, Inc.

(Exact name of Registrant as specified in its charter)

Michigan
(State of Incorporation)

38-2626206
(IRS Employer Identification No.)

**26255 American Drive,
Southfield, Michigan 48034**
(Address, zip code of principal executive offices)

(248) 358-1100
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a 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 May 4, 2010, was 54,211,542.

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Table of Contents**PART 1 FINANCIAL INFORMATION****ITEM 1 FINANCIAL STATEMENTS****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF INCOME****For the Three Months Ended March 31,**

	2010	2009
	(Unaudited)	
	(In thousands, except share data)	
Revenues		
Premiums earned		
Gross	\$ 179,613	\$ 155,014
Ceded	(28,172)	(25,976)
Net earned premiums	151,441	129,038
Net commissions and fees	9,868	10,237
Net investment income	13,029	12,342
Realized losses:		
Total other-than-temporary impairments on securities	(305)	(2,051)
Portion of loss recognized in other comprehensive income		
Net other-than-temporary impairments on securities recognized in earnings	(305)	(2,051)
Net realized gains excluding other-than-temporary impairments on securities	171	59
Net realized losses	(134)	(1,992)
Total revenues	174,204	149,625
Expenses		
Losses and loss adjustment expenses	99,321	93,806
Reinsurance recoveries	(11,841)	(18,911)
Net losses and loss adjustment expenses	87,480	74,895
Policy acquisition and other underwriting expenses	51,879	38,993
General selling & administrative expenses	5,906	8,166
General corporate expenses	1,977	1,922
Amortization expense	1,401	1,508
Interest expense	2,443	2,782
Total expenses	151,086	128,266

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Income before taxes and equity earnings	23,118	21,359
Federal and state income tax expense	7,658	7,869
Equity earnings of affiliates, net of tax	522	
Equity earnings of unconsolidated subsidiaries, net of tax	452	50
Net income	\$ 16,434	\$ 13,540
Earnings Per Share		
Basic	\$ 0.30	\$ 0.24
Diluted	\$ 0.30	\$ 0.24
Weighted average number of common shares		
Basic	55,272,310	57,392,499
Diluted	55,477,098	57,410,327
Dividends paid per common share	\$ 0.03	\$ 0.02

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

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Three Months Ended March 31,**

	2010	2009
	(Unaudited)	
	(In thousands)	
Net income	\$ 16,434	\$ 13,540
Other comprehensive income, net of tax:		
Unrealized gains on securities	4,798	6,035
Unrealized gains in affiliates and unconsolidated subsidiaries	147	
Depreciation on non-credit other-than-temporary impairments on securities	(607)	
Net deferred derivative gain (losses) hedging activity	(178)	329
Less reclassification adjustment for investment losses included in net income	156	2,014
Other comprehensive gains, net of tax	4,316	8,378
Comprehensive income	\$ 20,750	\$ 21,918

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

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**MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED BALANCE SHEETS**

	March 31, 2010 (Unaudited)	December 31, 2009
	(In thousands, except share data)	
ASSETS		
Investments		
Debt securities available for sale, at fair value (amortized cost of \$1,093,396 and \$1,045,454)	\$ 1,141,412	\$ 1,088,554
Equity securities available for sale, at fair value (amortized cost of \$26,793 and \$26,919)	29,232	28,342
Cash and cash equivalents	72,691	86,319
Accrued investment income	12,477	11,599
Premiums and agent balances receivable, net	178,275	155,327
Reinsurance recoverable on:		
Paid losses	7,727	7,724
Unpaid losses	269,524	266,801
Prepaid reinsurance premiums	35,523	35,298
Deferred policy acquisition costs	76,988	68,787
Deferred federal income taxes	4,060	5,645
Goodwill	118,842	118,842
Other intangible assets	39,912	41,301
Other assets	73,070	75,277
Total assets	\$ 2,059,733	\$ 1,989,816
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities		
Losses and loss adjustment expenses	\$ 978,448	\$ 949,177
Unearned premiums	353,475	325,915
Debt	47,063	49,875
Debtures	80,930	80,930
Accounts payable and accrued expenses	40,320	34,251
Funds held and reinsurance balances payable	29,360	29,161
Payable to insurance companies	3,985	3,314
Other liabilities	14,609	14,312
Total liabilities	1,548,190	1,486,935
Shareholders Equity		
Common stock, \$0.01 stated value; authorized 75,000,000 shares; 54,261,542 and 55,519,970 shares issued and outstanding	543	555
Additional paid-in capital	297,461	304,930

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Retained earnings	184,261	172,441
Note receivable from officer	(818)	(825)
Accumulated other comprehensive income	30,096	25,780
Total shareholders' equity	511,543	502,881
Total liabilities and shareholders' equity	\$ 2,059,733	\$ 1,989,816

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

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**MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**

	Common Stock	Additional Paid-In Capital	Retained Earnings	Note Receivable from Officer (In thousands)	Accumulated Other Comprehensive (Loss) Income	Total Shareholders Equity
Balances December 31, 2009	\$ 555	\$ 304,930	\$ 172,441	\$ (825)	\$ 25,780	\$ 502,881
Net income			16,434			16,434
Dividends declared and paid			(1,647)			(1,647)
Net unrealized appreciation on available for sale securities					4,347	4,347
Net deferred derivative gain hedging activity					(178)	(178)
Stock award	2	273				275
Long term incentive plan; stock award for 2009-2011 plan years		251				251
Repurchase of 1,456,000 shares of common stock	(14)	(7,993)	(2,967)			(10,974)
Change in investment of affiliates, net of tax					90	90
Change in investment of unconsolidated subsidiaries					57	57
Note receivable from officer				7		7
Balances March 31, 2010	\$ 543	\$ 297,461	\$ 184,261	\$ (818)	\$ 30,096	\$ 511,543

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

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MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Three Months Ended March 31,

	2010	2009
	(Unaudited)	
	(In thousands)	
Cash Flows From Operating Activities		
Net income	\$ 16,434	\$ 13,540
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of other intangible assets	1,401	1,508
Amortization of deferred debenture issuance costs	66	121
Depreciation of furniture, equipment, and building	1,309	1,221
Net amortization of discount and premiums on bonds	981	815
Loss on sale of investments, net	156	2,014
Gain on sale of fixed assets	(22)	(22)
Long-term incentive plan expense	251	203
Stock award	310	
Equity earnings of affiliates, net of taxes	(522)	
Equity earnings of unconsolidated subsidiaries, net of tax	(452)	
Deferred income tax expense	47	1,710
Changes in operating assets and liabilities:		
Decrease (increase) in:		
Premiums and agent balances receivable	(22,948)	(9,336)
Reinsurance recoverable on paid and unpaid losses	(2,726)	(2,140)
Prepaid reinsurance premiums	(225)	(500)
Deferred policy acquisition costs	(8,201)	(811)
Other assets	(2,220)	(216)
Increase (decrease) in:		
Losses and loss adjustment expenses	29,271	11,993
Unearned premiums	27,560	4,978
Payable to insurance companies	671	(2,947)
Funds held and reinsurance balances payable	199	525
Other liabilities	3,336	685
Total adjustments	28,242	9,801
Net cash provided by operating activities	44,676	23,341
Cash Flows From Investing Activities		
Purchase of debt securities available for sale	(73,468)	(59,740)
Proceeds from sales and maturities of debt securities available for sale	28,166	35,685
Purchase of equity securities available for sale		(198)
Proceeds from sales of equity securities available for sale	137	
Capital expenditures	(1,040)	(360)
Acquisition of rights renewals	(12)	
Other investing activities	159	1,065

Net cash used in investing activities	(46,058)	(23,548)
Cash Flows From Financing Activities		
Payment of lines of credit	(2,813)	(2,375)
Book overdrafts	1,519	712
Dividends paid on common stock(1)		(1,149)
Cash payment for payroll taxes associated with long-term incentive plan net stock issuance	(35)	(330)
Share repurchases	(10,883)	
Other financing activities	(34)	(31)
Net cash used in financing activities	(12,246)	(3,173)
Net decrease in cash and cash equivalents	(13,628)	(3,380)
Cash and cash equivalents, beginning of period	86,319	76,588
Cash and cash equivalents, end of period	\$ 72,691	\$ 73,208

Supplemental Disclosure of Non-Cash Investing and Financing Activities:

(1) Dividend of \$1,647,046 was paid on April 5, 2010

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

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MEADOWBROOK INSURANCE GROUP, INC.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

NOTE 1 Summary of Significant Accounting Policies

Basis of Presentation and Management Representation

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

In the opinion of management, the consolidated financial statements reflect all normal recurring adjustments necessary to present a fair statement of the results for the interim period. Preparation of financial statements under generally accepted accounting principles (GAAP) requires management to make estimates. Actual results could differ from those estimates. The results of operations for the three months ended March 31, 2010 are not necessarily indicative of the results expected for the full year.

These financial statements and the notes thereto should be read in conjunction with the Company's audited financial statements and accompanying notes included in its Annual Report on Form 10-K, as filed with the United States Securities and Exchange Commission, for the year ended December 31, 2009.

Revenue Recognition

Premiums written, which include direct, assumed and ceded 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.

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

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

estimate of the Company's obligation to continue to provide services in the future.

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

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Earnings Per Share***

For the three months ended March 31, 2010, there were no outstanding options that have been excluded from the diluted earnings per share. Outstanding options of 1,500 for the three months ended March 31, 2009 have been excluded from the diluted earnings per share, as they were anti-dilutive. There were no shares issuable pursuant to stock options included in diluted earnings per share for the three months ended March 31, 2010 and 2009.

Shares related to the Company's Long Term Incentive Plan (LTIP) included in diluted earnings per share were 204,788 and 17,828 for the three months ended March 31, 2010 and 2009, respectively.

Shares issued pursuant to a restricted stock award granted on February 23, 2010 were 202,500 out of the 2002 Stock Option Plan. Shares retired for tax withholding were 4,928 resulting in a net issuance of 197,572 which are included in our weighted average number of common shares for the three months ended March 31, 2010.

Income Taxes

As of March 31, 2010 and December 31, 2009, the Company did not have any unrecognized tax benefits.

Interest costs and penalties related to income taxes are classified as interest expense and other administrative expenses, respectively. As of March 31, 2010 and December 31, 2009, the Company had no accrued interest or penalties related to uncertain tax positions.

Reclassifications and redefining segment reporting:

During the three months ended March 31, 2010, the Company made certain reclassifications to the expense classifications in the Consolidated Statement of Income. These reclassifications were made to enable the user of the financial statements to calculate the GAAP combined ratio directly from the Consolidated Statement of Income. The reclassifications were the result of a comprehensive cost allocation study that allowed us to align the underlying internal salary and administrative costs with the underlying function of those costs. Previously, internal salary and administrative costs were charged to the Insurance Company Subsidiaries based upon an estimated management fee and later eliminated during consolidation. Under this new methodology, the actual costs are reimbursed by the Insurance Company Subsidiaries and the expenses are eliminated as a reimbursement of costs. As such, the nature of the costs retain their underlying function in the consolidation process. The Consolidated Statement of Income for the three months ended March 31, 2009 has been reclassified to conform to this revised presentation.

The following table sets forth the reclassification of expense line items for the three months ended March 31, 2009 (in thousands):

	As Reported	Reclassification	Reclassified
Losses and loss adjustment expenses	\$ 88,698	\$ 5,108	\$ 93,806
Reinsurance recoverables	(18,911)		(18,911)
Net losses and loss adjustment expenses	69,787	5,108	74,895

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Salaries and employee benefits	19,827	(19,827)	
Policy acquisition and other underwriting expenses	23,969	15,024	38,993
Other administrative expenses	10,393	(10,393)	
General selling and administrative expenses		8,166	8,166
General corporate expenses		1,922	1,922
Amortization expense	1,508		1,508
Interest expense	2,782		2,782
Total expenses	\$ 128,266	\$	\$ 128,266

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In addition, as part of this study, the Company re-evaluated its operating segments. As a result of this re-evaluation, the Company concluded that the previously reported Agency Operations segment should no longer be considered a separate segment of the Company as Agency Operations now represents less than 2% of the Company's consolidated revenues and less than 1% of the Company's consolidated pre-tax profits. As such, the Company will only report one operating segment—Specialty Insurance Operations.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) 810, *Consolidation* (previously SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*). ASC 810, contains consolidation guidance applicable to variable interest entities. The guidance further requires enhanced disclosures, including disclosure of significant judgments and assumptions as to whether a variable interest entity must be consolidated, and how involvement with the variable interest entity affects a company's financial statements. The guidance is effective for annual periods beginning after November 15, 2009. The Company adopted ASC 810 in the first quarter of 2010. The adoption of ASC 810 did not have a material impact on its financial condition or results of operations.

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06 *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. Effective for interim and annual reporting periods beginning after December 15, 2009, ASU 2010-06 requires additional disclosures for financial instrument transfers in and out of Levels 1 and 2; and clarifies existing disclosure requirements around the level of disaggregation and for the inputs and valuation techniques. These additional disclosures are provided in Note 5 *Fair Value Measurements*.

Effective for fiscal years beginning after December 15, 2010, ASU 2010-06 requires additional disclosures for activity in Level 3 fair value measurements. The adoption of this guidance is not expected to have a significant impact on our disclosures.

NOTE 2 Restricted Stock Awards

On February 23, 2010, the Company issued 202,500 restricted stock awards (RSAs), to eight executives of the Company, out of its 2002 Amended and Restated Stock Option Plan (the Plan). The RSAs vest over a four year period. The first twenty percent vested on February 23, 2010 and the remaining eighty percent will vest annually on a straight line basis over the requisite service period, which ends February 23, 2014. The unvested RSAs 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. In accordance with Accounting Standard Codification (ASC) 718, *Compensation—Stock Compensation*, the Company recorded approximately \$310,000 of compensation expense for the three months ended March 31, 2010.

NOTE 3 Debt

Credit Facilities

On July 31, 2008, the Company executed \$100 million in senior credit facilities (the Credit Facilities). The Credit Facilities included a \$65.0 million term loan facility, which was fully funded upon the closing of its Merger with

ProCentury and a \$35.0 million revolving credit facility, which was partially funded upon closing of the Merger. As of March 31, 2010, the outstanding balance on its term loan facility was \$47.1 million. The Company did not have an outstanding balance on its revolving credit facility as of March 31, 2010. The undrawn portion of the revolving credit facility is available to finance working capital and for general corporate purposes, including but not limited to, surplus contributions to its Insurance Company Subsidiaries to support premium growth or strategic acquisitions. At December 31, 2009, the Company had an outstanding balance of \$49.9 million on its term loan and did not have an outstanding balance on its revolving credit facility.

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The principal amount outstanding under the Credit Facilities provides for interest at LIBOR, plus the applicable margin, or at the Company's option, the base rate. The base rate is defined as the higher of the lending bank's prime rate or the Federal Funds rate, plus 0.50%, plus the applicable margin. The applicable margin is determined by the consolidated indebtedness to consolidated total capital ratio. In addition, the Credit Facilities provide for an unused facility fee ranging between twenty basis points and forty basis points, based on our consolidated leverage ratio as defined by the Credit Facilities. At March 31, 2010, the interest rate on the Company's term loan was 5.95%, which consisted of a fixed rate of 3.95%, as described in Note 6 *Derivative Instruments*, plus an applicable margin of 2.00%.

The debt covenants applicable to the Credit Facilities consist of: (1) minimum consolidated net worth starting at eighty percent of pro forma consolidated net worth after giving effect to the acquisition of ProCentury, with quarterly increases thereafter, (2) minimum Risk Based Capital Ratio for Star and Century Surety of 1.75 to 1.00, (3) maximum permitted consolidated leverage ratio of 0.35 to 1.00, (4) minimum consolidated debt service coverage ratio of 1.25 to 1.00, and (5) minimum A.M. Best Company rating of B++. As of March 31, 2010, the Company was in compliance with these debt covenants.

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 March 31, 2010(1)	Principal Amount
2003	Junior subordinated debentures	2008	2033	Three-month LIBOR, plus 4.05%	4.34%	\$ 10,310
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.00%	4.25%	13,000
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.20%	4.45%	12,000
2005	Junior subordinated debentures	2010	2035	Three-month LIBOR, plus 3.58%	3.84%	20,620
	Junior subordinated debentures(2)	2007	2032	Three-month LIBOR, plus 4.00%	4.25%	15,000
	Junior subordinated debentures(2)	2008	2033	Three-month LIBOR, plus 4.10%	4.35%	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 (the Merger) on July 31, 2008.

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

The issuance costs associated with these debentures have been capitalized and are included in other assets on the balance sheet. As of June 30, 2007, these issuance costs were being amortized over a seven year period as a component of interest expense. The seven year amortization period represented management's best estimate of the estimated useful life of the bonds related to both the senior debentures and junior subordinated debentures. Beginning July 1, 2007, the Company reevaluated its best estimate and determined a five year amortization period

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to be a more accurate representation of the estimated useful life. Therefore, this change in amortization period from seven years to five years has been applied prospectively beginning July 1, 2007.

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, respectively.

In relation to the junior subordinated debentures acquired in conjunction with the ProCentury Merger, 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 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 both Trusts will be distributed by the Trusts to the holders of the trust preferred securities.

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

NOTE 4 Investments

The estimated fair value of investments in securities is determined based on published market quotations and broker/dealer quotations. The cost or amortized cost, gross unrealized gains, losses, non-credit other than temporary impairments (OTTI) and estimated fair value of investments in securities classified as available for sale at March 31, 2010 and December 31, 2009 were as follows (in thousands):

	Cost or Amortized Cost	March 31, 2010 Gross Unrealized		Non-Credit OTTI(1)	Estimated Fair Value
		Gains	Losses		
Debt Securities:					
U.S. Government and agencies	\$ 24,155	\$ 1,052	\$ (28)	\$	\$ 25,179
Obligations of states and political subs	507,498	21,148	(650)		527,996
Corporate securities	304,773	12,829	(769)	(12)	316,821
Redeemable preferred stocks	2,689	1,916			4,605
Residential mortgage-backed securities	200,933	12,486	(78)	(558)	212,783
Commercial mortgage-backed securities	29,896	769	(362)		30,303
Other asset-backed securities	23,452	1,255	(154)	(828)	23,725
Total debt securities available for sale	1,093,396	51,455	(2,041)	(1,398)	1,141,412

Equity Securities:

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Perpetual preferred stock	12,005	1,997	(69)		13,933
Common stock	14,788	987	(476)		15,299
Total equity securities available for sale	26,793	2,984	(545)		29,232
Total securities available for sale	\$ 1,120,189	\$ 54,439	\$ (2,586)	\$ (1,398)	\$ 1,170,644

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	Cost or Amortized Cost	December 31, 2009 Gross Unrealized			Estimated Fair Value
		Gains	Losses	Non-Credit OTTI(1)	
Debt Securities:					
U.S. Government and agencies	\$ 26,177	\$ 1,037	\$ (60)	\$	\$ 27,154
Obligations of states and political subs	499,384	21,566	(816)		520,134
Corporate securities	257,187	10,872	(892)	(22)	267,145
Redeemable preferred stocks	2,689	1,349	(38)		4,000
Residential mortgage-backed securities	214,562	11,379	(114)	(615)	225,212
Commercial mortgage-backed securities	24,015	292	(579)		23,728
Other asset-backed securities	21,440	983	(181)	(1,061)	21,181
Total debt securities available for sale	1,045,454	47,478	(2,680)	(1,698)	1,088,554
Equity Securities:					
Perpetual preferred stock	12,131	1,350	(168)		13,313
Common stock	14,788	691	(450)		15,029
Total equity securities available for sale	26,919	2,041	(618)		28,342
Total securities available for sale	\$ 1,072,373	\$ 49,519	\$ (3,298)	\$ (1,698)	\$ 1,116,896

(1) Includes unrealized gains (losses) related to securities with non-credit OTTI.

Gross unrealized gains, losses, and non-credit OTTI on available for sale securities as of March 31, 2010 and December 31, 2009 were as follows (in thousands):

	March 31, 2010	December 31, 2009
Unrealized gains	\$ 54,439	\$ 49,519
Unrealized losses	(2,586)	(3,298)
Non-credit OTTI(1)	(1,398)	(1,698)
Net unrealized gains	50,455	44,523
Deferred federal income tax expense	(17,659)	(15,583)
Valuation allowance adjustment on deferred income taxes	1,185	694
Net unrealized gains on investments, net of deferred federal income taxes	\$ 33,981	\$ 29,634

(1) Includes unrealized gains (losses) related to securities with non-credit OTTI.

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Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Net realized (losses) gains on securities, including OTTI, for the three months ended March 31, 2010 and 2009 were as follows (in thousands):

	For the Three Months Ended March 31, 2010 2009	
Realized (losses) gains:		
Debt securities:		
Gross realized gains	\$ 148	\$ 56
Gross realized losses	(314)	(1,752)
Total debt securities	(166)	(1,696)
Equity Securities:		
Gross realized gains	10	
Gross realized losses		(317)
Total equity securities	10	(317)
Net realized losses	\$ (156)	\$ (2,013)
OTTI included in realized losses on securities above	\$ (305)	\$ (2,051)

Proceeds from the sales of fixed maturity securities available for sale were \$416,000 for the three months ended March 31, 2010. There were no sales of fixed maturity securities available for sale for the three months ended March 31, 2009.

At March 31, 2010, 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 Estimated Fair	
	Amortized Cost	Value
Due in one year or less	\$ 35,960	\$ 37,014
Due after one year through five years	183,629	193,353
Due after five years through ten years	458,040	478,977
Due after ten years	161,486	165,255

Mortgage-backed securities, collateralized obligations and other asset-backed securities	254,281	266,813
	\$ 1,093,396	\$ 1,141,412

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Net investment income for the three months ended March 31, 2010 and 2009 was as follows (in thousands):

	For the Three Months Ended March 31,	
	2010	2009
Net Investment Income Earned From:		
Debt securities	\$ 12,580	\$ 11,725
Equity Securities	536	523
Cash and cash equivalents	184	377
Total gross investment income	13,300	12,625
Less investment expenses	271	283
Net investment income	\$ 13,029	\$ 12,342

Other Than Temporary Impairments of Securities and Unrealized Losses on Investments

At March 31, 2010 and December 31, 2009, the Company had 107 and 127 securities that were in an unrealized loss position, respectively. Of the securities held at March 31, 2010, twenty-seven had an aggregate \$18.9 million and \$1.8 million fair value and unrealized loss, respectively, and have been in an unrealized loss position for more than twelve months. Of the securities held at December 31, 2009, forty-one had an aggregate \$30.0 million and \$2.3 million fair value and unrealized loss, respectively, and have been in an unrealized loss position for more than twelve months.

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

When assessing the Company's intent to sell a debt security and if it is more likely than not we 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 our security portfolio, sale of securities to meet cash flow needs and sales of securities to capitalize on favorable pricing, are evaluated. In order to determine the amount of the credit loss for a debt security, the Company calculates the recovery value by performing a discounted cash flow analysis based on the current cash flows and future cash flows expected to be recovered. The discount rate is the effective interest rate implicit in the underlying

debt security upon issuance. The effective interest rate is the original yield or the coupon if the debt security was previously impaired. If an OTTI exists and there is not sufficient cash flows or other information to determine a recovery value of the security, the Company concludes that the entire OTTI is credit-related and the amortized cost for the security is written down to current fair value with a corresponding charge to realized loss in the Consolidated Statements of Income.

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Historical and implied volatility of the security;

Length of time and extent to which the fair value has been less than amortized cost;

Conditions specifically related to the security such as default rates, loss severities, loan to value ratios, current levels of subordination, third party guarantees, and vintage;

Specific conditions in an industry or geographic area;

Any changes to the rating of the security by a rating agency;

Failure, if any, of the issuer of the security to make scheduled payments; and

Recoveries or additional declines in fair value subsequent to the balance sheet date.

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

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

After the Company's review of its investment portfolio in relation to this policy, the Company recorded a credit OTTI loss of \$305,000 for the three months ended March 31, 2010, of which no non-credit related OTTI losses were recognized in other comprehensive income. For the three months ended March 31, 2009, the Company recorded an OTTI loss of \$2.1 million.

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 for the periods ended (in thousands):

	March 31, 2010					
	Less Than 12 months		Greater Than 12 months		Total	
	Fair Value of Investments	Gross Unrealized Losses with Non-Credit OTTI	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses and Non-Credit OTTI	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses and Non-Credit OTTI
Debt Securities:						
U.S. Government and agencies Obligations of states and political subs	\$ 3,467	\$ (28)	\$	\$	\$ 3,467	\$ (28)
Corporate securities	53,135	(498)	6,327	(152)	59,462	(650)
Redeemable preferred stocks	60,590	(781)			60,590	(781)
Residential mortgage-backed securities	5,791	(63)	4,613	(573)	10,404	(636)
Commercial mortgage-backed securities	7,184	(46)	281	(316)	7,465	(362)
Other asset-backed securities	2,389	(743)	1,119	(239)	3,508	(982)
Total debt securities	132,556	(2,159)	12,340	(1,280)	144,896	(3,439)
Equity Securities:						
Perpetual preferred stock			1,440	(69)	1,440	(69)
Common stock			5,084	(476)	5,084	(476)
Total equity securities			6,524	(545)	6,524	(545)
Total securities	\$ 132,556	\$ (2,159)	\$ 18,864	\$ (1,825)	\$ 151,420	\$ (3,984)

	December 31, 2009					
	Less Than 12 months		Greater Than 12 months		Total	
	Fair Value of Investments	Gross Unrealized Losses	Fair Value of Investments	Gross Unrealized Losses	Fair Value of Investments	Gross Unrealized Losses

	with Unrealized Losses	Losses and Non-Credit OTTI	with Unrealized Losses	Losses and Non-Credit OTTI	with Unrealized Losses	Losses and Non-Credit OTTI
Debt Securities:						
U.S. Government and agencies Obligations of states and political subs	\$ 3,546	\$ (60)	\$	\$	\$ 3,546	\$ (60)
Corporate securities	53,577	(640)	7,115	(176)	60,692	(816)
Redeemable preferred stocks	55,276	(912)	199	(2)	55,475	(914)
Residential mortgage-backed securities			721	(38)	721	(38)
Commercial mortgage-backed securities	5,971	(79)	4,596	(650)	10,567	(729)
Other asset-backed securities	3,286	(20)	8,109	(559)	11,395	(579)
	3,177	(972)	1,354	(270)	4,531	(1,242)
Total debt securities	124,833	(2,683)	22,094	(1,695)	146,927	(4,378)
Equity Securities:						
Perpetual preferred stock	103	(24)	2,862	(144)	2,965	(168)
Common stock			5,074	(450)	5,074	(450)
Total equity securities	103	(24)	7,936	(594)	8,039	(618)
Total securities	\$ 124,936	\$ (2,707)	\$ 30,030	\$ (2,289)	\$ 154,966	\$ (4,996)

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

Balance as of January 1, 2010	\$ (547)
Additional credit impairments on:	
Previously impaired securities	(245)
Securities for which an impairment was not previously recognized	
Reductions	
Balance as of March 31, 2010	\$ (792)

NOTE 5 Fair Value Measurements

The Company's available for sale investment portfolio consists primarily of debt securities. The change in fair value of these investments is recorded as a component of other comprehensive income. In addition, the Company has eight interest rate swaps that are designated as cash flow hedges. The Company records these interest rate swap transactions at fair value on the balance sheet and the effective portion of the changes in fair value are accounted for within other comprehensive income.

Fair value measurement accounting 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 participants' assumptions (unobservable inputs). The hierarchy level assigned to each security in the Company's available for sale portfolio is based upon its assessment of the transparency and reliability of the inputs used in the valuation as of the measurement date. The three hierarchy levels are defined as follows:

Level 1 Observable unadjusted quoted prices in active markets for identical securities.

The fair value measurements of exchange-traded preferred and common equities, and mutual funds were based on Level 1 inputs, or quoted market prices in active markets.

The fair value measurements of a slight portion of the Company's fixed income securities, comprising 2.9% of the fair value of the total fixed income portfolio, were based on Level 1 inputs.

Level 2 Observable inputs other than quoted prices in active markets for identical securities, including: quoted prices in active markets for similar securities; quoted prices for identical or similar securities in markets that are not active; inputs other than quoted prices that are observable for the security (e.g., interest rates, yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, credit risks, default rates); and inputs derived from or corroborated by observable market data by correlation or other means.

The fair value measurements of substantially all of the Company's fixed income securities, comprising 96.7% of the fair value of the total fixed income portfolio, were based on Level 2 inputs.

The fair values of the Company's interest rate swaps were based on Level 2 inputs.

Level 3 Unobservable inputs, including the reporting entity's own data (e.g., cash flow estimates), as long as there are no contrary data indicating market participants would use different assumptions.

The fair value measurements for eighteen securities, comprising 0.4% of the fair value of the total fixed income portfolio, were based on Level 3 inputs, due to the limited availability of corroborating market data. Inputs for valuation of these securities included benchmark yields, broker quotes, and models based on cash flows and other inputs.

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The fair values of securities were based on market values obtained from an independent pricing service that were evaluated using pricing models that vary by asset class and incorporate available trade, bid, and other market information and price quotes from well established independent broker-dealers. The independent pricing service monitors market indicators, industry and economic events, and for broker-quoted only securities, obtains quotes from market makers or broker-dealers that it recognizes to be market participants.

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 March 31, 2010 (in thousands):

	March 31, 2010 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)
Debt Securities:				
U.S. Government and agencies	\$ 25,179	\$	\$ 25,179	\$
Obligations of states and political subs	527,996		527,996	
Corporate securities	316,821		315,669	1,152
Redeemable preferred stocks	4,605	4,605		
Residential mortgage-backed securities	212,783		212,782	1
Commercial mortgage-backed securities	30,303		30,303	
Other asset-backed securities	23,725		20,247	3,478
Total debt securities available for sale	1,141,412	4,605	1,132,176	4,631
Equity Securities:				
Perpetual preferred stock	13,933	13,933		
Common stock	15,299	15,299		
Total equity securities available for sale	29,232	29,232		
Total securities available for sale	\$ 1,170,644	\$ 33,837	\$ 1,132,176	\$ 4,631
Derivatives - interest rate swaps	\$ 6,202		\$ 6,202	

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table presents changes in Level 3 available for sale investments measured at fair value on a recurring basis as of March 31, 2010 (in thousands):

	Fair Value Measurement Using Significant Unobservable Inputs - Level 3
Balance as of January 1, 2010	\$ 4,161
Total gains or losses (realized/unrealized):	
Included in earnings	(27)
Included in other comprehensive income	45
Purchases, issuances and settlements	420
Transfers in and out of Level 3	32
Balance as of March 31, 2010	\$ 4,631

Total credit losses for the period that are included in earnings attributable to the change in unrealized losses on Level 3 assets still held at the reporting date amounted to \$47,000.

The Company's policy on recognizing transfers between hierarchy levels is determined at the end of the reporting period. During the quarter ended March 31, 2010, there were no transfers in or out of level 1 securities, and no transfers into level 2 securities. There was one structured security that was transferred out of level 2 and into level 3, because it was determined that its fair value could no longer be based on a non-binding quote from a well established independent broker-dealer. There were no securities transferred out of level 3.

NOTE 6 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):

Expiration	Fixed	Fixed Amount at March 31,
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Effective Date	Date	Debt Instrument	Counterparty Interest Rate Terms	Rate	2010
10/6/2005	9/16/2010	Junior subordinated debentures	Three-month LIBOR, plus 3.58%	8.340%	\$ 20,000
4/23/2008	5/24/2011	Senior debentures	Three-month LIBOR, plus 4.20%	7.720%	7,000
4/23/2008	6/30/2013	Junior subordinated debentures	Three-month LIBOR, plus 4.05%	8.020%	10,000
4/29/2008	4/29/2013	Senior debentures	Three-month LIBOR, plus 4.00%	7.940%	13,000
7/31/2008	7/31/2013	Term loan(1)	Three-month LIBOR	3.950%	47,063
8/15/2008	8/15/2013	Junior subordinated debentures(2)	Three-month LIBOR	3.780%	10,000
9/4/2008	9/4/2013	Junior subordinated debentures(2)	Three-month LIBOR	3.790%	15,000

(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 agreement.

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MEADOWBROOK INSURANCE GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

In relation to the above interest rate swaps, the net interest expense incurred for the three months ended March 31, 2010, was approximately \$1.2 million. The net interest expense incurred for the three months ended March 31, 2009, was approximately \$798,000.

As of March 31, 2010 and December 31, 2009, the total fair value of the interest rate swaps was approximately (\$6.2 million) and (\$5.9 million), respectively. Accumulated other comprehensive income at March 31, 2010 and December 31, 2009, included accumulated loss on the cash flow hedge, net of taxes, of approximately \$4.0 million and \$3.9 million, respectively.

In December 2005, the Company entered into a \$6.0 million convertible note receivable with an unaffiliated insurance agency. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due 90 days after the receipt of the agency's 2013 audited financial statements. This agency has been a producer for the Company for over ten years. As security for the loan, the borrower granted the Company a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and executed a personal guaranty. This note is convertible at the option of the Company based upon a pre-determined formula.

NOTE 7 Shareholders Equity

At March 31, 2010, shareholders' equity was \$511.5 million, or a book value of \$9.43 per common share, compared to \$502.9 million, or a book value of \$9.06 per common share, at December 31, 2009.

At the Company's Board of Directors meeting on February 12, 2010, the Board authorized 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. This share repurchase plan replaced the existing share repurchase plan authorized in July 2008. For the three months ended March 31, 2010, the Company purchased and retired approximately 1.5 million shares of common stock for a total cost of approximately \$11.0 million. There were no share repurchases in the three months ended March 31, 2009.

For the three months ended March 31, 2010, the Company had \$1.6 million of cash dividends payable on April 5, 2010. For the three months ended March 31, 2009, cash dividends paid to common shareholders totaled \$1.1 million. On April 30, 2010, the Company's Board of Directors declared a quarterly dividend of \$0.03 per common share. The dividend is payable on June 1, 2010, to shareholders of record as of May 14, 2010.

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

NOTE 8 Commitments and Contingencies

The Company, and its subsidiaries, are subject at times to various claims, lawsuits and proceedings relating principally to alleged errors or omissions in the placement of insurance, claims administration, consulting services and other business transactions arising in the ordinary course of business. Where appropriate, the Company vigorously defends such claims, lawsuits and proceedings. Some of these claims, lawsuits and proceedings seek damages, including consequential, exemplary or punitive damages, in amounts that could, if awarded, be significant. Most of the claims, lawsuits and proceedings arising in the ordinary course of business are covered by errors and omissions insurance or other appropriate insurance. In terms of deductibles associated with such insurance, the

Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Company has established provisions against these items, which are believed to be adequate in light of current information and legal advice. In accordance with accounting guidance, if it is probable that an asset has been impaired or a liability has been incurred as of the date of the financial statements and the amount of loss is estimable; an accrual for the costs to resolve these claims is recorded by the Company in the accompanying consolidated balance sheets. Period expenses related to the defense of such claims are included in other operating expenses in the accompanying consolidated statements of income. Management, with the assistance of outside counsel, adjusts such provisions according to new developments or changes in the strategy in dealing with such matters. On the basis of current information, the Company does not expect the outcome of the claims, lawsuits and proceedings to which the Company is subject to, either individually, or in the aggregate, will have a material adverse effect on the Company's financial condition. However, it is possible that future results of operations or cash flows for any particular quarter or annual period could be materially affected by an unfavorable resolution of any such matters.

NOTE 9 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 options or 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 ended March 31 (in thousands, except per share amounts):

	2010	2009
Net income, as reported	\$ 16,434	\$ 13,540
Common shares:		
Basic		
Weighted average shares outstanding	55,272,310	57,392,499
Diluted		
Weighted average shares outstanding	55,272,310	57,392,499
Dilutive effect of:		
Share awards under long term incentive plan	204,788	17,828
Total	55,477,098	57,410,327
Net income per common share		
Basic	\$ 0.30	\$ 0.24
Diluted	\$ 0.30	\$ 0.24

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

For the Periods ended March 31, 2010 and 2009

Forward-Looking Statements

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

Business Overview

We are a publicly traded specialty 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, wholesale program administrators and general agents, who value service, specialized knowledge, and focused expertise. Our primary focus is on niche or specialty products and program business and risk management solutions for our customers. The services and coverages we provide are tailored to meet specific requirements of defined client groups and their members, which may include specialty program underwriting; admitted and excess and surplus lines insurance products; alternative risk transfer solutions, and insurance administration services. Program business refers to an aggregation of individually underwritten risks that have some characteristic and/or are distributed through a select group of general agencies, retail agencies and program administrators. We provide various types of property and casualty insurance coverage, primarily to associations or similar groups of members and to the specified classes of business of our agents. With our specialty programs and products, we seek to combine profitable underwriting, investment returns and efficient capital management to deliver consistent long-term growth in shareholder value. We also earn commission revenue, which represents 1.8% of our total revenue, through the operation of its retail property and casualty insurance agencies, located in Michigan, California, and Florida. These agencies produce commercial, personal lines, life and accident and health insurance, with more than fifty unaffiliated insurance carriers. These agencies produce an immaterial amount of business for our affiliated Insurance Company Subsidiaries

Our programs are diversified geographically, by class and line of business, type of insured and distribution. In the workers' compensation line of business, we have a regional focus in California, New England, Florida, and Nevada. Within the commercial automobile and commercial multiple peril line of business, we have a regional focus in the Southeast and California. In the general liability line of business, we have a focus in Texas. Our fee-for-service

business is managed on a regional basis with an emphasis in the Midwest, New England, and Southeastern regions. Our corporate strategy emphasizes a regional focus and diverse sources of revenue between underwritten premiums, service fee revenue and commissions. This allows us to leverage our fixed costs over a larger revenue base and take advantage of new opportunities.

Table of Contents***Critical Accounting Policies***

In certain circumstances, we are required to make estimates and assumptions that affect amounts reported in our consolidated financial statements and related footnotes. We evaluate these estimates and assumptions on an on-going basis based on a variety of factors. There can be no assurance, however, that actual results will not be materially different than our estimates and assumptions, and that reported results of operation will not be affected by accounting adjustments needed to reflect changes in these estimates and assumptions. The accounting estimates and related risks described in our Annual Report on Form 10-K as filed with the United States Securities and Exchange Commission on March 15, 2010, are those that we consider to be our critical accounting estimates. For the three months ended March 31, 2010, there have been no material changes in regard to any of our critical accounting estimates.

Reclassifications and redefining segment reporting

During the three months ended March 31, 2010, we made certain reclassifications to the expense classifications in the Consolidated Statement of Income. These reclassifications enable the user of the financial statements to calculate the GAAP combined ratio directly from the Consolidated Statement of Income. The reclassifications were the result of a comprehensive cost allocation study that allowed us to align the underlying internal salary and administrative costs with the underlying function of those costs. Previously, internal salary and administrative costs were charged to the Insurance Company Subsidiaries based upon an estimated management fee and later eliminated during consolidation. Under this new methodology the actual costs are reimbursed by the Insurance Company Subsidiaries and the expenses are eliminated as a reimbursement of costs. As such, the nature of the costs retain their underlying function in the consolidation process. The Consolidated Statement of Income for the three months ended March 31, 2009 has been reclassified to conform to this revised presentation.

The following table sets forth the reclassification of expense line items for the three months ended March 31, 2009 (in thousands):

	As Reported	Reclassification	Reclassified
Losses and loss adjustment expenses	\$ 88,698	\$ 5,108	\$ 93,806
Reinsurance recoverables	(18,911)		(18,911)
Net losses and loss adjustment expenses	69,787	5,108	74,895
Salaries and employee benefits	19,827	(19,827)	
Policy acquisition and other underwriting expenses	23,969	15,024	38,993
Other administrative expenses	10,393	(10,393)	
General selling and administrative expenses		8,166	8,166
General corporate expenses		1,922	1,922
Amortization expense	1,508		1,508
Interest expense	2,782		2,782
Total expenses	\$ 128,266	\$	\$ 128,266

In addition, as part of the cost allocation analysis, we re-evaluated our operating segments. As a result of this re-evaluation, we concluded that the previously reported Agency Operations segment should no longer be considered a separate segment as Agency Operations now represents less than 2% of our consolidated revenues and less than 1%

of our consolidated pre-tax profits. As such, we will only report one operating segment Specialty Insurance Operations.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND 2009

Executive Overview

Our results for the first quarter of 2010 include the positive impact from continued selective growth, coupled with our adherence to strict corporate underwriting guidelines, as well as a focus on current accident year price

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adequacy, and the benefits derived from leveraging of fixed costs. Our generally accepted accounting principles (GAAP) combined ratio was 92.1% for the first quarter of 2010 compared to 88.2% for the comparable quarter in 2009. Net operating income increased \$484,000 from \$16.3 million for the first quarter of 2009 to \$16.8 million for the first quarter of 2010.

Gross written premium increased \$47.2 million, or 29.5%, to \$207.2 million, compared to \$160.0 million in 2009. This growth is largely from workers' compensation initiatives that were implemented in the second half of 2009 primarily in the Midwest and Western states, and the expansion of transportation business in the Southeast. We continue to focus on maintaining a diversified book of business, and equally as important, price adequacy. The majority of the new business we wrote in 2009 was roll-over business that had a proven, profitable track record, and we have been able to achieve rate increases on top of what had previously been charged.

Results of Operations

Net income for the three months ended March 31, 2010, was \$16.4 million, or \$0.30 per dilutive share, compared to net income of \$13.5 million, or \$0.24 per dilutive share, for the comparable period of 2009. Net operating income, a non-GAAP measure, increased \$484,000, or 3.0%, to \$16.8 million, or \$0.30 per dilutive share, compared to net operating income of \$16.3 million, or \$0.28 per dilutive share for the comparable period in 2009, with lower weighted average shares outstanding. Total weighted average shares outstanding for the three months ended March 31, 2010 were 55,477,098, compared to 57,410,327 for the comparable period in 2009. This decrease reflects the impact of our share repurchase program in which we repurchased 1,456,000 shares during the first quarter of 2010. We currently have approximately 3.5 million more shares within the plan available for repurchase.

Revenues

Revenues for the three months ended March 31, 2010, increased \$24.6 million, or 16.4%, to \$174.2 million, from \$149.6 million for the comparable period in 2009. This increase primarily reflects overall growth within our existing programs and new business that was implemented in 2009 and 2010.

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

	For the Three Months Ended March 31,	
	2010	2009
Revenue:		
Net earned premiums	\$ 151,441	\$ 129,038
Management administrative fees	4,956	5,250
Claims fees	1,746	1,966
Investment income	13,029	12,342
Commission revenue	3,166	3,021
Net realized losses	(134)	(1,992)
Total revenue	\$ 174,204	\$ 149,625

Net earned premiums increased \$22.4 million, or 17.4%, to \$151.4 million for the three months ended March 31, 2010, from \$129.0 million in the comparable period in 2009. This increase was primarily the result of growth within

our existing programs and the new business we began writing in 2009.

Management fees decreased \$0.3 million, or 5.6%, to \$5.0 million for the three months ended March 31, 2010, from \$5.3 million for the comparable period in 2009. This decrease primarily reflects the impact of a program we previously managed that decided to perform its own policy administration services, as well as a slight decrease in fees related to some of our self-insured programs, caused by a decrease in premium volume from continued competition and challenging economic conditions.

Claim fees decreased \$0.2 million, or 11.2%, to \$1.8 million for the three months ended March 31, 2010, from \$2.0 million for the comparable period in 2009. This decrease is primarily the result of the fact that the previously

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mentioned program is now administering their claims in house and an anticipated decrease resulting from the termination of one unprofitable program.

Net investment income increased \$0.7 million, or 5.6%, to \$13.0 million in 2010 from \$12.3 million in 2009. This increase primarily reflects the increase in average invested assets from \$1.1 billion in 2009 to \$1.2 billion in 2010. This increase is the result of positive cash flows generated from operations that were primarily due to favorable underwriting results. The average investment yield for March 31, 2010 was 4.3% compared to 4.5% in 2009. The current pre-tax book yield was 4.4%. The current after-tax book yield was 3.3% compared to 3.3% in 2009. The effective duration of the investment portfolio is 5.2 years at March 31, 2010, compared to 4.6 years at March 31, 2009.

Expenses

Expenses increased \$22.8 million from \$128.3 million for the three months ended March 31, 2009 to \$151.1 million for the three months ended March 31, 2010. This increase is reflective of the growth in our underwriting operations.

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

	For the Three Months Ended March 31,	
	2010	2009
Expense:		
Net losses and loss adjustment expenses	\$ 87,480	\$ 74,895
Policy acquisition and other underwriting expenses	51,879	38,993
General selling & administrative expenses	5,906	8,166
General corporate expenses	1,977	1,922
Amortization expense	1,401	1,508
Interest expense	2,443	2,782
 Total expenses	 \$ 151,086	 \$ 128,266

Net loss and loss adjustment expenses (LAE) increased \$12.6 million, to \$87.5 million for the three months ended March 31, 2010, from \$74.9 million for the same period in 2009. Our loss and LAE ratio decreased 0.2 percentage points to 57.8% for the three months ended March 31, 2010, from 58.0% for the same period in 2009. The accident year loss and LAE ratio was 64.2% for the three months ended March 31, 2010 down from 64.5% in the comparable period in 2009. This decrease reflects the refinement of our costs allocation process between internal claims handling costs and policy administrative costs, offset by an increase in the 2010 accident year losses for the quarter, as a result of winter storm losses. Additional discussion of our reserve activity is described below within the *Other Items Reserves* section.

Policy acquisition and other underwriting expenses increased \$12.9 million, to \$51.9 million for the three months ended March 31, 2010 from \$39.0 million for the same period in 2009. Our expense ratio increased 4.1 percentage points to 34.3% for the three months ended March 31, 2010, from 30.2% for the same period in 2009. This increase reflects the above mentioned refinement in our internal costs allocation process between internal claims handling costs and policy administrative costs, as a well as the allocation between general administrative expenses and policy administrative costs. In addition, there was a slight increase in commission expense relating to new business added in

the second half of 2009 where the agent performs certain policy issuance activities. Lastly, the 2009 expense ratio had been favorably impacted by lower insurance related assessments, primarily related to premium tax credits received from 2008 premium tax returns, which lowered the expense ratio by 1.3 percentage points for the quarter ended March 31, 2009.

General selling & administrative expenses decreased \$2.3 million, to \$5.9 million for the three months ended March 31, 2010 from \$8.2 million for the same period in 2009. This decrease partially reflects the above mentioned refinement in our internal costs allocation process between policy acquisition costs and general administrative costs, as well as an overall decrease in costs such as technology, travel and related general costs.

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Amortization expense decreased \$0.1 million to \$1.4 million for the three months ended March 31, 2010 from \$1.5 million for the same period in 2009. This decrease reflects a decrease in the amortization relating to the USSU acquisition in 2007.

Interest expense for the three months ended March 31, 2010, decreased \$0.3 million, to \$2.5 million, from \$2.8 million for the comparable period in 2009. Interest expense is primarily attributable to our debentures, which are described within the *Liquidity and Capital Resources* section of Management's Discussion and Analysis, as well as our term loan. The overall decrease reflects the decline in the average outstanding balance on our term loan to \$49.8 million for the period ended March 31, 2010 from \$60.2 million for same period in 2009.

Federal income tax expense for the three months ended March 31, 2010 was \$7.5 million or 32.5% of income before taxes compared to \$7.5 million or 35.8% of income before taxes for the same period in 2009. Income tax expense on capital gains (losses) and the change in our valuation allowance for other than temporary impairments where there not any realized gains to offset the realized capital losses, was \$253,000 and \$518,000 for the three months ended March 31, 2010 and 2009, respectively. Excluding the impact of this deferred tax valuation, the effective income tax rate would have been 31.2% and 29.4% for the three months ended March 31, 2010 and 2009, respectively. This increase reflects a \$477,000 adjustment to our current tax expense relating to a return to provision analysis completed on the closing tax return of ProCentury. Excluding this adjustment, the effective tax rate on net operating income, a non-GAAP measure, for the three months ended March 31, 2010 would have been 29.2% compared to 29.4% for the same period in 2009.

Other Items**Equity earnings of affiliated, net of tax;**

In July 2009, our subsidiary, Star, purchased a 28.5% ownership interest in an insurance holding limited liability company for \$14.8 million in cash. We are not required to consolidate this investment as we are not the primary beneficiary of the business. Our ownership interest is significant, but is less than a majority ownership and, therefore, we are accounting for this investment under the equity method of accounting. Star will recognize 28.5% of the profits and losses as a result of this equity interest ownership. For the three months ended March 31, 2010, we recorded pre-tax and after-tax equity earnings of \$803,000 and \$522,000, or \$0.01 per share.

Reserves

At March 31, 2010, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was \$708.9 million. We established a reasonable range of reserves of approximately \$645.0 million to \$751.7 million. This range was established primarily by considering the various indications derived from standard actuarial techniques and other appropriate reserve considerations. The following table sets forth this range by line of business (in thousands):

Line of Business	Minimum Reserve Range	Maximum Reserve Range	Selected Reserves
Workers Compensation(1)	\$ 212,756	\$ 235,446	\$ 226,899
Commercial Multiple Peril/General Liability	296,892	364,164	337,189
Commercial Automobile	100,995	113,195	107,854
Other	34,392	38,944	36,982

Total Net Reserves	\$ 645,035	\$ 751,749	\$ 708,924
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(1) Includes Residual Markets

Reserves are reviewed and established by our internal actuaries for adequacy and peer reviewed by our independent 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

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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 three months ended March 31, 2010, and the year ended December 31, 2009.

For the three months ended March 31, 2010, we reported a decrease in net ultimate loss estimates for accident years 2009 and prior of \$9.7 million, or 1.4% of \$682.4 million of beginning net loss and LAE reserves at December 31, 2009. The change in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2010 that differed from the projected activity. There were no significant changes in the key assumptions utilized in the analysis and calculations of our reserves during 2009 and for the three months ended March 31, 2010. The major components of this change in ultimates are as follows (in thousands):

Line of Business	Reserves	Incurred Losses			Paid Losses			Reserves
	at December 31, 2009	Current Year	Prior Years	Total Incurred	Current Year	Prior Years	Total Paid	at March 31, 2010
Workers Compensation	\$ 185,729	\$ 36,525	\$ 1,476	\$ 38,001	\$ 1,080	\$ 16,665	\$ 17,745	\$ 205,985
Residual Markets	21,907	1,212	(1,274)	(62)	889	42	931	\$ 20,914
Commercial Multiple Peril/General Liability	333,688	26,144	(6,178)	19,966	487	15,978	16,465	\$ 337,189
Commercial Automobile	105,468	18,804	(1,860)	16,944	2,582	11,976	14,558	\$ 107,854
Other	35,584	14,502	(1,871)	12,631	2,472	8,760	11,233	\$ 36,982
Net Reserves	682,376	\$ 97,187	\$ (9,707)	\$ 87,480	\$ 7,510	\$ 53,421	\$ 60,932	708,924
Reinsurance Recoverable	266,801							269,524
Consolidated	\$ 949,177							\$ 978,448

Line of Business	Reserves at December 31, 2009	Total Re-estimated Reserves at March 31, 2010 on Prior Years	Development as a Percentage of Prior Year Reserves
	Workers Compensation	\$ 185,729	\$ 187,205
Commercial Multiple Peril/General Liability	333,688	327,510	-1.9%

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Commercial Automobile	105,468	103,608	-1.8%
Other	35,584	33,713	-5.3%
Sub-total	660,469	652,036	-1.3%
Residual Markets	21,907	20,633	-5.8%
Total Net Reserves	\$ 682,376	\$ 672,669	-1.4%

Workers Compensation Excluding Residual Markets The projected net ultimate loss estimate for the workers compensation line of business excluding residual markets increased \$1.5 million, or 0.8% of net workers compensation reserves. This net overall increase reflects increases of \$1.7 million and \$604,000 in the ultimate loss estimates for accident years 2009 and 2008, respectively. These increases were isolated to specific claim activity in certain specific programs. The change in ultimate loss estimates for all other accident years was insignificant.

Commercial Multiple Peril/General Liability The commercial multiple peril line and general liability line of business had a decrease in net ultimate loss estimates of \$6.2 million, or 1.9% of net commercial multiple peril and

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general liability reserves. The net decrease reflects decreases of \$1.8 million, \$2.7 million, and \$678,000 in the ultimate loss estimates for accident years 2008, 2007, 2006, respectively. The decreases in the net ultimate loss estimates for these accident years were due to better than expected claim emergence in several general liability programs and an excess liability program.

Commercial Automobile The projected net ultimate loss estimate for the commercial automobile line of business decreased \$1.9 million, or 1.8% of net commercial automobile reserves. This net overall decrease reflects decreases in the net ultimate loss estimate of \$1.1 million and \$853,000 for accident years 2009 and 2008, respectively. The decreases in the net ultimate loss estimates for these accident years were due to less than expected claim emergence in three west coast based programs. The decreases were offset by an increase of \$498,000 in accident year 2005. This increase in the net ultimate loss estimates for this accident year was due to greater than expected claim emergence in an excess liability program. The change in ultimate loss estimates for all other accident years was insignificant.

Other The projected net ultimate loss estimate for the other lines of business decreased \$1.9 million, or 5.3% of net reserves. This net decrease reflects a decrease of \$1.9 million in accident year 2009. This decrease is primarily due to better than expected case reserve development during the calendar year in a professional liability program. This decrease was offset by an increase in net ultimate loss estimate of \$475,000 in accident year 2008. This increase was due to greater than expected claim emergence in property lines of business. The change in ultimate loss estimates for all other accident years was insignificant.

Residual Markets The workers compensation residual market net reserves decreased by \$1.3 million, or 5.8% of net reserves. This decrease reflects a reduction of \$900,000 in accident year 2008. We record loss reserves as reported by the National Council on Compensation Insurance (NCCI), plus a provision for the reserves incurred but not yet analyzed and reported to us due to a two quarter lag in reporting. These changes reflect a difference between our estimate of the lag incurred but not reported and the amounts reported by the NCCI in the year. The change in ultimate loss estimates for all other accident years was insignificant.

Other Than Temporary Impairments

At March 31, 2010 and December 31, 2009, we had 107 and 127 securities that were in an unrealized loss position, respectively. Of the securities held at March 31, 2010, twenty seven securities had an aggregate \$18.9 million and \$1.8 million fair value and unrealized loss, respectively, and have been in an unrealized loss position for more than twelve months. Of the securities held at December 31, 2009, forty-one had an aggregate \$30.0 million and \$2.3 million fair value and unrealized loss, respectively, and have been in an unrealized loss position for more than twelve months.

During the quarter ended March 31, 2010, in accordance with to our OTTI policy, we recorded an OTTI credit loss of \$305,000. For the three months ended March 31, 2009 we recorded an OTTI loss of \$2.1 million.

Refer to Note 4 *Investments*, for additional information specific to OTTI and their fair value and amount of unrealized losses segregated by the time period the investment has been in an unrealized loss position.

LIQUIDITY AND CAPITAL RESOURCES

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

A significant portion of our consolidated assets represents assets of our Insurance Company Subsidiaries that may not be transferable to the holding company in the form of dividends, loans or advances in accordance with state insurance laws.. These laws generally specify that dividends can be paid only from unassigned surplus and only to the extent that all dividends in the current twelve months do not exceed the greater of 10% of total statutory surplus as of the end of the prior fiscal year or 100% of the statutory net income for the prior year, less any dividends paid in the prior twelve months. Using these criteria, the available ordinary dividend available to be paid from the Insurance

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Company Subsidiaries during 2010 is \$47.9 million without prior regulatory approval. In addition to ordinary dividends, the Insurance Company Subsidiaries have the capacity to pay \$51.5 million of extraordinary dividends in 2010, subject to prior regulatory approval. The Insurance Company Subsidiaries' ability to pay future dividends without advance regulatory approval is dependent upon maintaining a positive level of unassigned surplus, which in turn, is dependent upon the Insurance Company Subsidiaries generating net income. Total ordinary dividends paid from our Insurance Company Subsidiaries to our holding company were \$14.3 million and \$8.3 million for the three months ended March 31, 2010 and 2009, respectively. We remain well within our targets as they relate to our premium leverage ratios, even taking into consideration the dividends paid by our Insurance Company Subsidiaries. Our targets for gross and net written premium to statutory surplus are 2.75 to 1.0 and 2.25 to 1.0, respectively. As of March 31, 2010, on a trailing twelve month statutory consolidated basis, the gross and net premium leverage ratios were 2.1 to 1.0 and 1.8 to 1.0, respectively. The ordinary dividends paid in 2010 and 2009 we funded from current financial earnings.

We also generate operating cash flow from non-regulated subsidiaries in the form of commission revenue, outside management fees, and intercompany management fees. These sources of income are used to meet debt service, shareholders' dividends, and other operating expenses of the holding company and non-regulated subsidiaries. Earnings before interest, taxes, depreciation, and amortization from non-regulated subsidiaries were approximately \$3.3 million for the three months ended March 31, 2010.

We have a line of credit totaling \$35.0 million, which has no outstanding balance at March 31, 2010. The undrawn portion of the revolving credit facility is available to finance working capital and for general corporate purposes, including but not limited to, surplus contributions to our Insurance Company Subsidiaries to support premium growth or strategic acquisitions.

Cash flow provided by operations was \$44.7 million and \$23.3 million for the three months ended March 31, 2010 and 2009, respectively. The increase in cash flow from operations reflects growth in premiums written and the related underwriting profit. Our strong operating cash flows are also the result of our ability to match the duration of our invested assets and reserve duration as it relates to our incurred losses. We maintain a strong balance sheet with geographic spread of risks, high quality reinsurance, and a high quality investment portfolio.

Other Items

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 6 *Derivative Instruments*, for additional information specific to our interest rate swaps.

Credit Facilities

On July 31, 2008, we executed \$100 million in senior credit facilities (the *Credit Facilities*). The *Credit Facilities* included a \$65.0 million term loan facility, which was fully funded upon the closing of our Merger with ProCentury and a \$35.0 million revolving credit facility, which was partially funded upon closing of the Merger. As of March 31, 2010, the outstanding balance on our term loan facility was \$47.1 million. We did not have an outstanding balance on our revolving credit facility as of March 31, 2010. The undrawn portion of the revolving credit facility is available to finance working capital and for general corporate purposes, including but not limited to, surplus contributions to our

Insurance Company Subsidiaries to support premium growth or strategic acquisitions. At December 31, 2009, we had an outstanding balance of \$49.9 million on our term loan and did not have an outstanding balance on our revolving credit facility. Refer to Note 3 *Debt*, for additional information specific to our credit facilities and debentures.

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Investment Portfolio

As of March 31, 2010 and December 31, 2009, the recorded values of our investment portfolio, including cash and cash equivalents, were \$1.2 billion.

In general, we believe our overall investment portfolio is conservatively invested. The effective duration of the investment portfolio at March 31, 2010 is 5.2 years, compared to 4.6 years at March 31, 2009. Our pre-tax book yield is 4.4%. The current after-tax yield is 3.3%, compared to 3.3% in 2009. Approximately 98.3% of our fixed income investment portfolio is investment grade.

Shareholders Equity

At March 31, 2010, shareholders equity was \$511.5 million, or a book value of \$9.43 per common share, compared to \$502.9 million, or a book value of \$9.06 per common share, at December 31, 2009.

At the Company's regularly scheduled Board of Directors meeting on February 12, 2010, the Board authorized 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. This share repurchase plan replaced the existing share repurchase plan authorized in July 2008. For the three months ended March 31, 2010, the Company purchased and retired 1.5 million shares of common stock for a total cost of approximately \$11.0 million. There were no share repurchases in the three months ended March 31, 2009.

For the three months ended March 31, 2010 we had \$1.6 million of cash dividends payable to our common shareholders on April 5, 2010. For the three months ended March 31, 2009 we paid cash dividends to our common shareholders totaled \$1.1 million. On April 30, 2010, our Board of Directors declared a quarterly dividend of \$0.03 per common share. The dividend is payable on June 1, 2010, to shareholders of record as of May 14, 2010.

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

Contractual Obligations and Commitments

For the three months ended March 31, 2010, there were no material changes in relation to our contractual obligations and commitments, outside of the ordinary course of our business.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) 810, *Consolidation* (previously SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*). ASC 810 contains consolidation guidance applicable to variable interest entities. The guidance further requires enhanced disclosures, including disclosure of significant judgments and assumptions as to whether a variable interest entity must be consolidated, and how involvement with the variable interest entity affects a company's financial statements. The guidance is effective for annual periods beginning after November 15, 2009. The Company adopted ASC 810 in the first quarter of 2010. The adoption of ASC 810 did not have a material impact on its financial condition or results of operations.

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. Effective for interim and annual reporting periods beginning after December 15, 2009, ASU 2010-06 requires additional disclosures for financial instrument transfers in and out of Levels 1 and 2; and clarifies existing disclosure requirements around the level of disaggregation and for the inputs and valuation techniques. These additional disclosures are provided in Note 5 *Fair Value Measurements*.

Effective for fiscal years beginning after December 15, 2010, ASU 2010-06 requires additional disclosures for activity in Level 3 fair value measurements. The adoption of this guidance is not expected to have a significant impact on our disclosures.

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 March 31, 2010. 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 is managed within the context of an asset and liability management strategy where the target duration for the fixed income portfolio is based on the estimate of the liability duration and takes into consideration our surplus. The investment policy guidelines provide for a fixed income portfolio duration of between three and a half and five and a half years. At March 31, 2010, our fixed income portfolio had a effective duration of 5.15, compared to 5.09 at December 31, 2009.

At March 31, 2010, the fair value of our investment portfolio, excluding cash and cash equivalents, was \$1.2 billion. Our market risk to the investment portfolio is primarily interest rate risk associated with debt securities. Our exposure to equity price risk is related to our investments in relatively small positions of preferred stocks and mutual funds with an emphasis on dividend income. These investments comprise 2.50% 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, 2009. 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 fair values to measure our potential loss of debt securities assuming an upward parallel shift in interest rates to measure the hypothetical change in fair values. The table below presents our model's estimate of changes in fair values given a change in interest rates. Dollar values are in thousands.

	Rates Down 100bps	Rates Unchanged	Rates Up 100bps
Fair Value	\$ 1,199,788	\$ 1,141,412	\$ 1,082,472
Yield to Maturity or Call	2.46%	3.45%	4.47%
Effective Duration	4.77	5.15	5.29

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 March 31, 2010 and December 31, 2009, we had debentures of \$80.9 million. At

this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$809,000.

Our term loan is subject to variable interest rates. Thus, our interest expense on our term loan is directly correlated to market interest rates. At March 31, 2010, we had an outstanding balance on our term loan of \$47.1 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$471,000. At December 31, 2009, we had an outstanding balance on our term loan of \$49.9 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$499,000.

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

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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 6 *Derivative Instruments* for further detail relating to our interest rate swap transactions.

In addition, our revolving line of credit under which we can borrow up to \$35.0 million is subject to variable interest rates. Thus, our interest expense on the revolving line of credit is directly correlated to market interest rates. At March 31, 2010 and December 31, 2009, we did not have an outstanding balance on our revolving line of credit.

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 March 31, 2010, 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 March 31, 2010, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

The information required by this item is included under Note 8 *Commitments and Contingencies* of the Notes to the Consolidated Financial Statements of the Company's Form 10-Q for the three months ended March 31, 2010, which is hereby incorporated by reference.

ITEM 1A. RISK FACTORS

There have been no material changes to the Risk Factors previously disclosed in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2009 and our other filings with the Securities and Exchange Commission.

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

On February 12, 2010, the Company's Board of Directors authorized management to purchase up to 5,000,000 shares of the Company's common stock in market transactions for a period not to exceed twenty-four months. This share repurchase plan replaced the existing share repurchase plan authorized in July 2008.

The following table represents information with respect to repurchases of the Company's common stock for the quarterly period ended March 31, 2010:

Period	Total Number of Shares	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that may yet be Repurchased Under the Plans or Programs
January 1 - January 31, 2010		\$		272,098
February 1 - February 28, 2010	350,000	\$ 6.98		4,650,000
March 1 - March 31, 2010	1,106,000	\$ 7.67		3,544,000
Total	1,456,000	\$ 7.51		

ITEM 6. EXHIBITS

The following documents are filed as part of this Report:

Exhibit No.	Description
10.1	Form of Restricted Stock Agreement in connection with restricted stock awards granted to Robert S. Cubbin, Karen M. Spaun, Michael G. Costello, Stephen A. Belden, and James M. Mahoney (incorporated by reference from Current Report on Form 8-K filed on March 1, 2010).
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.

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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: May 10, 2010

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