

MEADOWBROOK INSURANCE GROUP INC

Form 10-Q

August 09, 2007

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

**Form 10-Q**

- þ** **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarter ended June 30, 2007**
- or**
- o** **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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate number of shares of the Registrant's Common Stock, \$.01 par value, outstanding on August 1, 2007 was 36,967,887.



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| <u>Certification Pursuant to Section 906, signed by Karen M. Spaun, Senior Vice President and Chief Financial Officer</u> |             |

Table of Contents**PART 1 FINANCIAL INFORMATION****ITEM 1 FINANCIAL STATEMENTS****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF INCOME**

|  | <b>For the Six Months<br/>Ended June 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                                  | <b>2006</b> |
|  | <b>(Unaudited)</b>                           |             |
|  | <b>(In thousands, except share data)</b>     |             |
| <b>Revenues</b>                                    |  |             |
| Premiums earned                                    |  |             |
| Gross  | \$ 166,814                                   | \$ 163,394  |
| Ceded  | (34,419)                                     | (35,756)    |
| Net earned premiums                                | 132,395                                      | 127,638     |
| Net commissions and fees                           | 22,294                                       | 21,987      |
| Net investment income                              | 12,385                                       | 10,619      |
| Net realized gains                                 | 14   | 18          |
| Total revenues                                     | 167,088                                      | 160,262     |
| <b>Expenses</b>                                    |  |             |
| Losses and loss adjustment expenses                | 101,382                                      | 107,819     |
| Reinsurance recoveries                             | (25,029)                                     | (33,630)    |
| Net losses and loss adjustment expenses            | 76,353                                       | 74,189      |
| Salaries and employee benefits                     | 26,432                                       | 27,214      |
| Policy acquisition and other underwriting expenses | 26,812                                       | 24,604      |
| Other administrative expenses                      | 14,992                                       | 14,927      |
| Amortization expense                               | 687  | 307         |
| Interest expense                                   | 3,154  | 2,887       |
| Total expenses                                     | 148,430                                      | 144,128     |
| Income before taxes and equity earnings            | 18,658                                       | 16,134      |
| Federal and state income tax expense               | 5,610  | 5,159       |
| Equity earnings of affiliates                      | 61   | 25          |
| Net income   | \$ 13,109                                    | \$ 11,000   |

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|  |    |            |            |
|--|----|------------|------------|
| Earnings Per Share                       |    |            |            |
| Basic                                    | \$ | 0.44       | \$ 0.38    |
| Diluted                                  | \$ | 0.44       | \$ 0.37    |
| Weighted average number of common shares |    |            |            |
| Basic                                    |    | 29,822,086 | 28,842,427 |
| Diluted                                  |    | 29,876,480 | 29,579,217 |

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

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF INCOME**

|  | <b>For the Three Months<br/>Ended June 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                                    | <b>2006</b> |
|  | <b>(Unaudited)</b>                             |             |
|  | <b>(In thousands, except share data)</b>       |             |
| <b>Revenues</b>                                    |  |             |
| Premiums earned                                    |  |             |
| Gross  | \$ 85,263                                      | \$ 81,703   |
| Ceded  | (18,072)                                       | (17,189)    |
| Net earned premiums                                | 67,191   | 64,514      |
| Net commissions and fees                           | 10,743   | 10,698      |
| Net investment income                              | 6,229  | 5,380       |
| Net realized gains                                 | 20   | 25          |
| Total revenues                                     | 84,183   | 80,617      |
| <b>Expenses</b>                                    |  |             |
| Losses and loss adjustment expenses                | 51,380   | 57,935      |
| Reinsurance recoveries                             | (11,673)                                       | (20,789)    |
| Net losses and loss adjustment expenses            | 39,707   | 37,146      |
| Salaries and employee benefits                     | 12,900   | 13,846      |
| Policy acquisition and other underwriting expenses | 13,169   | 13,180      |
| Other administrative expenses                      | 7,598  | 7,133       |
| Amortization expense                               | 543  | 142         |
| Interest expense                                   | 1,667  | 1,499       |
| Total expenses                                     | 75,584   | 72,946      |
| Income before taxes and equity earnings            | 8,599  | 7,671       |
| Federal and state income tax expense               | 2,461  | 2,312       |
| Equity earnings of affiliates                      | 48   | 16          |
| Net income   | \$ 6,186                                       | \$ 5,375    |
| <b>Earnings Per Share</b>                          |  |             |
| Basic  | \$ 0.20  | \$ 0.19     |
| Diluted  | \$ 0.20  | \$ 0.18     |
| Weighted average number of common shares           |  |             |
| Basic  | 30,294,628                                     | 28,820,862  |
| Diluted  | 30,350,553                                     | 29,571,925  |

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



Table of Contents**MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

|  | <b>For the Six Months Ended<br/>June 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                                  | <b>2006</b> |
|  | <b>(Unaudited)</b>                           |             |
|  | <b>(In thousands)</b>                        |             |
| Net income   | \$ 13,109                                    | \$ 11,000   |
| Other comprehensive income, net of tax:                            |  |             |
| Unrealized losses on securities                                    | (4,176)                                      | (5,245)     |
| Net deferred derivative gain hedging activity                      | 113  | 431         |
| Less: reclassification adjustment for gains included in net income | 21   | 19          |
| Other comprehensive loss, net of tax                               | (4,042)                                      | (4,795)     |
| Comprehensive income   | \$ 9,067                                     | \$ 6,205    |

**MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

|  | <b>For the Three Months Ended<br/>June 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                                    | <b>2006</b> |
|  | <b>(Unaudited)</b>                             |             |
|  | <b>(In thousands)</b>                          |             |
| Net income   | \$ 6,186                                       | \$ 5,375    |
| Other comprehensive income, net of tax:                            |  |             |
| Unrealized losses on securities                                    | (4,556)  | (2,216)     |
| Net deferred derivative gain hedging activity                      | 189  | 179         |
| Less: reclassification adjustment for gains included in net income | 3  |             |
| Other comprehensive loss, net of tax                               | (4,364)  | (2,037)     |
| Comprehensive income   | \$ 1,822                                       | \$ 3,338    |

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

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED BALANCE SHEETS**

|  | <b>June 30,<br/>2007</b>                 | <b>December 31,<br/>2006</b> |
|--|--|------------------------------|
|  | <b>(Unaudited)</b>                       |                              |
|  | <b>(In thousands, except share data)</b> |                              |
| <b>ASSETS</b>  |  |                              |
| Investments  |  |                              |
| Debt securities available for sale, at fair value (amortized cost of \$523,567 and \$486,213)                            | \$ 515,688                               | \$ 484,724                   |
| Cash and cash equivalents  | 26,377                                   | 42,876                       |
| Accrued investment income  | 6,035                                    | 5,884                        |
| Premiums and agent balances receivable, net  | 97,192                                   | 85,578                       |
| Reinsurance recoverable on:  |  |                              |
| Paid losses  | 6,771                                    | 4,257                        |
| Unpaid losses  | 200,214                                  | 198,422                      |
| Prepaid reinsurance premiums   | 15,869                                   | 20,425                       |
| Deferred policy acquisition costs  | 27,670                                   | 27,902                       |
| Deferred federal income taxes  | 18,503                                   | 15,732                       |
| Goodwill   | 43,497                                   | 31,502                       |
| Other assets   | 59,926                                   | 51,698                       |
| <b>Total assets</b>  | <b>\$ 1,017,742</b>                      | <b>\$ 969,000</b>            |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |  |                              |
| Liabilities  |  |                              |
| Losses and loss adjustment expenses  | \$ 523,258                               | \$ 501,077                   |
| Unearned premiums  | 145,265                                  | 144,575                      |
| Debt   | 22,025                                   | 7,000                        |
| Debentures   | 55,930                                   | 55,930                       |
| Accounts payable and accrued expenses  | 26,161                                   | 25,384                       |
| Reinsurance funds held and balances payable  | 9,745                                    | 15,124                       |
| Payable to insurance companies   | 4,913                                    | 5,442                        |
| Other liabilities  | 11,122                                   | 12,775                       |
| <b>Total liabilities</b>   | <b>798,419</b>                           | <b>767,307</b>               |
| Shareholders Equity  |  |                              |
| Common stock, \$0.01 stated value; authorized 75,000,000 shares; 30,529,260 and 29,107,818 shares issued and outstanding | 305                                      | 291                          |
| Additional paid-in capital   | 135,376                                  | 126,828                      |
| Retained earnings  | 89,391                                   | 76,282                       |
| Note receivable from officer   | (870)                                    | (871)                        |

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|  |              |            |
|--|--------------|------------|
| Accumulated other comprehensive loss       | (4,879)      | (837)      |
| Total shareholders' equity                 | 219,323      | 201,693    |
| Total liabilities and shareholders' equity | \$ 1,017,742 | \$ 969,000 |

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

**Table of Contents****MEADOWBROOK INSURANCE GROUP, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | <b>For the Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|
|   | <b>2007</b>                                  | <b>2006</b> |
|   | <b>(Unaudited)</b>                           |             |
|   | <b>(In thousands)</b>                        |             |
| <b>Cash Flows From Operating Activities</b>                                       |  |             |
| Net income  | \$ 13,109                                    | \$ 11,000   |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |             |
| Amortization of other intangible assets   | 687  | 307         |
| Amortization of deferred debenture issuance costs                                 | 118  | 118         |
| Depreciation of furniture, equipment, and building                                | 1,525  | 1,122       |
| Net accretion of discount and premiums on bonds                                   | 1,389  | 1,266       |
| Loss on sale of investments, net  | 32   | 30          |
| Gain on sale of fixed assets  | (44)   | (44)        |
| Stock-based employee compensation   | 2  | 114         |
| Incremental tax benefits from stock options exercised                             | (623)  | (301)       |
| Long-term incentive plan expense  | 119  | 393         |
| Deferred income tax expense   | (595)  | (319)       |
| Changes in operating assets and liabilities:                                      |  |             |
| Decrease (increase) in:   |  |             |
| Premiums and agent balances receivable  | (7,740)                                      | (14,702)    |
| Reinsurance recoverable on paid and unpaid losses                                 | (4,306)                                      | (4,066)     |
| Prepaid reinsurance premiums  | 4,556  | 1,070       |
| Deferred policy acquisition costs   | 232  | 494         |
| Other assets  | 1,740  | 423         |
| Increase (decrease) in:   |  |             |
| Losses and loss adjustment expenses   | 22,181                                       | 25,892      |
| Unearned premiums   | 690  | (122)       |
| Payable to insurance companies  | (528)  | (3,378)     |
| Reinsurance funds held and balances payable                                       | (5,379)                                      | (28)        |
| Other liabilities   | (4,928)                                      | (2,219)     |
| Total adjustments   | 9,128  | 6,050       |
| Net cash provided by operating activities   | 22,237                                       | 17,050      |
| <b>Cash Flows From Investing Activities</b>                                       |  |             |
| Purchase of debt securities available for sale                                    | (125,019)                                    | (112,107)   |
| Proceeds from sales and maturities of debt securities available for sale          | 87,244                                       | 56,614      |
| Capital expenditures  | (1,710)                                      | (2,980)     |
| Purchase of books of business   | (75)   | (120)       |
| Acquisition of U.S Specialty Underwriters, Inc.                                   | (12,644)                                     |             |

|   |           |           |
|---|-----------|-----------|
| Other investing activities  | (214)     | 288       |
| Net cash used in investing activities   | (52,418)  | (58,305)  |
| <b>Cash Flows From Financing Activities</b>   |           |           |
| Proceeds from lines of credit   | 19,025    | 10,078    |
| Payment of lines of credit  | (4,000)   | (5,178)   |
| Book overdraft  | 361       | 421       |
| Stock options exercised   | (340)     | 202       |
| Cash payment for payroll taxes associated with long-term incentive plan net stock issuance  | (1,841)   |           |
| Incremental tax benefits from stock options exercised                                       | 623       | 301       |
| Other financing activities  | (146)     | (137)     |
| Net cash provided by financing activities   | 13,682    | 5,687     |
| Net decrease in cash and cash equivalents   | (16,499)  | (35,568)  |
| Cash and cash equivalents, beginning of period  | 42,876    | 58,038    |
| Cash and cash equivalents, end of period  | \$ 26,377 | \$ 22,470 |
| <b>Supplemental Disclosure of Non-Cash Investing and Financing Activities:</b>              |           |           |
| Common stock portion of purchase price for acquisition of U.S. Specialty Underwriters, Inc. | \$ 10,000 | \$        |

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

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**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), its wholly owned subsidiary Star Insurance Company (Star), and Star's wholly owned subsidiaries, Savers Property and Casualty Insurance Company, Williamsburg National Insurance Company, and Ameritrust Insurance Corporation (which are collectively referred to as the Insurance Company Subsidiaries), and Preferred Insurance Company, Ltd. The consolidated financial statements also include Meadowbrook, Inc., Crest Financial Corporation, and their subsidiaries.

Pursuant to Financial Accounting Standards Board Interpretation Number (FIN) 46(R), the Company does not consolidate its subsidiaries, Meadowbrook Capital Trust I and II (the Trusts), as they are not variable interest entities and the Company is not the primary beneficiary of the Trusts. The consolidated financial statements, however, include the equity earnings of the Trusts. In addition and in accordance with FIN 46(R), the Company does not consolidate its subsidiary American Indemnity Insurance Company, Ltd. (American Indemnity). While the Company and its subsidiary Star are the common shareholders, they are not the primary beneficiaries of American Indemnity. The consolidated financial statements, however, include the equity earnings of American Indemnity.

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 requires management to make estimates. Actual results could differ from those estimates. The results of operations for the three months and six months ended June 30, 2007, 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, 2006.

The Company's consolidated statement of comprehensive income for the three months and six months ended June 30, 2006 previously reported, had a computational error. Comprehensive income for the three months and six months ended June 30, 2006, was overstated by \$179,000 and \$431,000, respectively. The consolidated statements of comprehensive income for 2007 for the 2006 comparative periods have been restated for this computational error.

***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.

For the six months ending June 30, 2007, total assumed written premiums were \$33.1 million, of which \$29.2 million, relates to assumed business the Company manages directly, and therefore, no estimation is involved. The remaining

\$3.9 million of assumed written premiums includes \$3.1 million related to residual markets.

For the three months ending June 30, 2007, total assumed written premiums were \$9.7 million, of which \$7.5 million, relates to assumed business the Company manages directly. The remaining \$2.2 million of assumed written premiums includes \$2.0 million related to residual markets.

Assumed premium estimates are specifically related 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 the NCCI to participating companies on a two quarter lag. To accommodate this lag, the Company estimates premium and loss activity based on historical and market based results. Historically, the

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

Company has not experienced any material difficulties or disputes in collecting balances from NCCI; and therefore, no provision for doubtful accounts is recorded related to the assumed premium estimate.

In addition, certain premiums are subject to retrospective premium adjustments. Premium is recognized over the term of the insurance contract.

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

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.

The Company reviews, on an ongoing basis, the collectibility of its receivables and establishes an allowance for estimated uncollectible accounts.

Realized gains or losses on sale of investments are determined on the basis of specific costs of the investments. Dividend income is recognized when declared and interest income is recognized when earned. Discount or premium on debt securities purchased at other than par value is amortized using the effective yield method. Investments with other than temporary declines in fair value are written down to their estimated net fair value and the related realized losses are recognized in income.

***Earnings Per Share***

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

Outstanding options of 98,807 and 129,731 for the six months ended June 30, 2007 and 2006, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive. Shares issuable pursuant to stock options included in diluted earnings per share were 39,510 and 288,765 for the six months ended June 30, 2007 and 2006, respectively. Shares related to the Company's Long Term Incentive Plan (LTIP) included in diluted earnings per share were 14,884 and 448,024 for the six months ended June 30, 2007 and 2006, respectively.

Outstanding options of 93,807 and 129,731 for the three months ended June 30, 2007 and 2006, respectively, have been excluded from the diluted earnings per share, as they were anti-dilutive. Shares issuable pursuant to stock options included in diluted earnings per share were 39,941 and 308,400 for the three months ended June 30, 2007 and 2006, respectively. Shares related to the Company's LTIP included in diluted earnings per share were 15,983 and 442,663 for the three months ended June 30, 2007 and 2006, respectively.

***Recent Accounting Pronouncements***



In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 157, *Fair Value Measurements*, which becomes effective for fiscal years beginning after November 15, 2007. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The Company will evaluate the impact of SFAS No. 157, but believes the adoption of SFAS No. 157 will not have a material impact on its consolidated financial statements.

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

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. SFAS No. 159 will permit entities the option to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis as of specified election dates. This election is irrevocable. The objective of SFAS No. 159 is to improve financial reporting and reduce the volatility in reported earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is in the process of evaluating the potential impact SFAS No. 159 will have on its consolidated financial statements.

**NOTE 2 Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan**

***Stock Options***

Effective January 1, 2006, the Company adopted SFAS No. 123(R), *Share-Based Payment*, using the modified prospective application transition method. The Company previously adopted the requirements of recording stock options consistent with SFAS 123 and accounting for the change in accounting principle using the prospective method in accordance with SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123*. Under the prospective method, stock-based compensation expense was recognized for awards granted after the beginning of the fiscal year in which the change is made, or January 1, 2003. Upon implementation of SFAS No. 148 in 2003, the Company recognized stock-based compensation expense for awards granted after January 1, 2003.

Prior to the adoption of SFAS No. 148, the Company applied the intrinsic value-based provisions set forth in APB Opinion No. 25. Under the intrinsic value method, compensation expense is determined on the measurement date, which is the first date when both the number of shares the employee is entitled to receive, and the exercise price are known. Compensation expense, if any, resulting from stock options granted by the Company was determined based upon the difference between the exercise price and the fair market value of the underlying common stock at the date of grant. The Company's Stock Option Plan requires the exercise price of the grants to be at the current fair market value of the underlying common stock.

Upon adoption of SFAS No. 123(R), the Company was required to recognize as an expense in the financial statements all share-based payments to employees based on their fair values. SFAS No. 123(R) requires forfeitures to be estimated in calculating the expense relating to the share-based payments, as opposed to recognizing any forfeitures and the corresponding reduction in expense as they occur. In addition, SFAS No. 123(R) requires any tax savings resulting from tax deductions in excess of compensation expense be reflected in the financial statements as a cash inflow from financing activities, rather than as an operating cash flow as in prior periods. The pro forma disclosures previously permitted under SFAS 123, are no longer an alternative to financial statement recognition. As indicated, the Company adopted the requirements of SFAS 123(R) using the modified prospective application transition method. The prospective method requires compensation expense to be recorded for all unvested stock options and restricted stock, based upon the previously disclosed SFAS 123 methodology and amounts.

The Company, through its 1995 and 2002 Amended and Restated Stock Option Plans (the Plans), may grant options to key executives and other members of management of the Company and its subsidiaries in amounts not to exceed 2,000,000 shares of the Company's common stock allocated for each plan. The Plans are administered by the Compensation Committee (the Committee) of the Board of Directors. Option shares may be exercised subject to the

terms of the Plans and the terms prescribed by the Committee at the time of grant. Currently, the Plans options have either five or ten-year terms and are exercisable and vest in equal increments over the option term. The Company has not issued any new stock options to employees since 2003.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

The following is a summary of the Company's stock option activity and related information for the six months ended June 30, 2007:

|                                     | <b>Options</b> | <b>Weighted-Average Exercise Price</b> |
|-------------------------------------|----------------|--|
| Outstanding as of December 31, 2006 | 391,678        | \$ 7.38                                |
| Exercised                           | (200,926)      | \$ 2.75                                |
| Forfeited                           | (15,052)       | \$ 21.68                               |
| Outstanding as of June 30, 2007     | 175,700        | \$ 11.45                               |
| Exercisable as of June 30, 2007     | 149,830        | \$ 11.30                               |

The following table summarizes information about stock options outstanding at June 30, 2007:

| <b>Range of Exercise Prices</b> | <b>Options Outstanding</b> |  |  | <b>Options Exercisable</b> |  |
|---------------------------------|----------------------------|--|--|----------------------------|--|
|                                 | <b>Options</b>             | <b>Weighted-Average Remaining Life (Years)</b> | <b>Weighted-Average Exercise Price</b> | <b>Options</b>             | <b>Weighted-Average Exercise Price</b> |
| \$2.173 to \$3.507              | 75,393                     | 0.9  | \$ 2.17                                | 75,393                     | \$ 2.17                                |
| \$6.48                          | 1,500                      | 2.7  | \$ 6.48                                | 1,000                      | \$ 3.24                                |
| \$10.91 to \$24.6875            | 98,807                     | 1.2  | \$ 18.60                               | 73,437                     | \$ 23.47                               |
|                                 | 175,700                    | 1.1  | \$ 11.45                               | 149,830                    | \$ 11.30                               |

Compensation expense of \$2,000 and \$114,000 has been recorded in the six months ended June 30, 2007 and 2006 under SFAS 123(R), respectively. Compensation expense of \$17,000 has been recorded in the three months ended June 30, 2006 under SFAS 123(R). As of March 31, 2007, the Company has fully expensed all of its current outstanding stock options.

***Long Term Incentive Plan***

In 2004, the Company adopted a Long Term Incentive Plan (the "LTIP"). The LTIP provides participants with the opportunity to earn cash and stock awards based upon the achievement of specified financial goals over a three-year performance period with the first performance period commencing January 1, 2004. At the end of a three-year performance period, and if the performance targets for that period are achieved, the Compensation Committee of the

Board of Directors shall determine the amount of LTIP awards that are payable to participants in the LTIP for the current performance period. One-half of any LTIP award will be payable in cash and one-half of the award will be payable in the form of a stock award. If the Company achieves the performance targets for the three-year performance period, payment of the cash portion of the award would be made in three annual installments, with the first payment being paid as of the end of the that performance period and the remaining two payments to be paid in the subsequent two years. Any unpaid portion of a cash award is subject to forfeiture if the participant voluntarily leaves the Company or is discharged for cause. The portion of the award to be paid in the form of stock will be issued as of the end of that performance period. The number of shares of Company's common stock subject to the stock award shall equal the dollar amount of one-half of the LTIP award divided by the fair market value of Company's common stock on the first date of the beginning of the performance period. The stock awards shall be made subject to the terms and conditions of the LTIP and Plans. The Company accrues awards based upon the criteria set-forth and approved by the Compensation Committee of the Board of Directors, as included in the LTIP.

In 2006, the Company achieved its specified financial goals for the 2004-2006 plan years. On February 8, 2007, the Company's Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of the LTIP award for the 2004-2006 plan years, which included both a cash and stock award. The total

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cash distribution was \$2.5 million, of which \$823,000 was paid out in 2007 with the remainder to be paid out in 2008 and 2009. The stock portion of the LTIP award was valued at \$2.5 million, which resulted in the issuance of 579,496 shares of the Company's common stock. Of the 579,496 shares issued, 191,570 shares were retired for payment of the participant's associated withholding taxes related to the compensation recognized by the participant. The stock portion of the award was fully expensed as of December 31, 2006. The cash portion of the award is being expensed over a five-year period. In addition, the Company's Board of Directors and the Compensation Committee of the Board of Directors approved the new performance targets for the 2007-2009 plan years. The Company commenced accruing for the LTIP payout for the 2007-2009 plan years as of March 31, 2007.

At June 30, 2007, the Company had \$977,000 and \$119,000 accrued for the cash and stock award, respectively, for a total accrual of \$1.1 million under the LTIP. Of the \$1.1 million accrued for the LTIP, \$906,000 relates to the cash portion accrued for the 2004-2006 plan years under the LTIP. As previously indicated, the stock portion for the 2004-2006 plan years was fully expensed as of December 31, 2006. At December 31, 2006, the Company had \$1.4 million and \$2.5 million accrued for the cash and stock award, respectively, for a total accrual of \$2.5 million under the LTIP. Shares related to the Company's LTIP included in diluted earnings per share were 14,884 and 448,024 for the six months ended June 30, 2007 and 2006, respectively. For the three months ended June 30, 2007 and 2006, shares included in diluted earnings per share were 15,983 and 442,663, respectively.

***Deferred Compensation Plan***

In 2006, the Company adopted an Executive Nonqualified Excess Plan (the "Excess Plan"). The Excess Plan is intended to be a nonqualified deferred compensation plan that will comply with the provisions of Section 409A of the Internal Revenue Code. The Company adopted the Excess Plan to provide a means by which certain key management employees may elect to defer receipt of current compensation from the Company in order to provide retirement and other benefits, as provided for in the Excess Plan. In accordance with the Excess Plan, the assets of the Excess Plan are held in a rabbi trust. The Excess Plan is intended to be an unfunded plan maintained primarily for the purpose of providing deferred compensation benefits for eligible employees. At June 30, 2007 and 2006, the Company had \$531,000 and \$58,000 accrued for deferred compensation, respectively.

**NOTE 3 Reinsurance**

The Insurance Company Subsidiaries cede insurance to reinsurers under pro-rata and excess-of-loss contracts. These reinsurance arrangements diversify the Company's business and minimize its exposure to large losses or from hazards of an unusual nature. The ceding of insurance does not discharge the original insurer from its primary liability to its policyholder. In the event that all or any of the reinsuring companies are unable to meet their obligations, the Insurance Company Subsidiaries would be liable for such defaulted amounts. Therefore, the Company is subject to credit risk with respect to the obligations of its reinsurers. In order to minimize its exposure to significant losses from reinsurer insolvencies, the Company evaluates the financial condition of its reinsurers and monitors the economic characteristics of the reinsurers on an ongoing basis. The Company also assumes insurance from other domestic insurers and reinsurers. Based upon management's evaluation, they have concluded the reinsurance agreements entered into by the Company transfer both significant timing and underwriting risk to the reinsurer and, accordingly, are accounted for as reinsurance under the provisions of SFAS No. 113 Accounting and Reporting for Reinsurance for Short-Duration and Long-Duration Contracts.

Intercompany pooling agreements are commonly entered into between affiliated insurance companies, so as to allow the companies to utilize the capital and surplus of all of the companies, rather than each individual company. Under pooling arrangements, companies share in the insurance business that is underwritten and allocate the combined premium, losses and related expenses between the companies within the pooling arrangement. The Insurance Company Subsidiaries utilize an Inter-Company Reinsurance Agreement (the Pooling Agreement ). This Pooling Agreement includes Star, Ameritrust Insurance Corporation ( Ameritrust ), Savers Property and Casualty Insurance Company ( Savers ) and Williamsburg National Insurance Company ( Williamsburg ). Pursuant to the Pooling Agreement, Savers, Ameritrust and Williamsburg have agreed to cede to Star and Star

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has agreed to reinsure 100% of the liabilities and expenses of Savers, Ameritrust and Williamsburg, relating to all insurance and reinsurance policies issued by them. In return, Star agreed to cede and Savers, Ameritrust and Williamsburg have agreed to reinsure Star for their respective percentages of the liabilities and expenses of Star. Annually, the Company examines the Pooling Agreement for any changes to the ceded percentage for the liabilities and expenses. Any changes to the Pooling Agreement must be submitted to the applicable regulatory authorities for approval.

At June 30, 2007 and December 31, 2006, the Company had reinsurance recoverables for paid and unpaid losses of \$207.0 million and \$202.7 million, respectively.

In regard to the Company's excess-of-loss reinsurance, the Company manages its credit risk on reinsurance recoverables by reviewing the financial stability, A.M. Best rating, capitalization, and credit worthiness of prospective and existing risk-sharing partners. The Company generally does not seek collateral where the reinsurer is rated A- or better by A.M. Best, has \$500 million or more in surplus, and is admitted in the state of Michigan. As of June 30, 2007, the largest unsecured reinsurance recoverable is due from an admitted reinsurer with an A A.M. Best rating and accounts for 44.1% of the total recoverable for paid and unpaid losses.

In regard to the Company's risk-sharing partners (client captive or rent-a-captive quota-share non-admitted reinsurers), the Company manages credit risk on reinsurance recoverables by reviewing the financial stability, capitalization, and credit worthiness of prospective or existing reinsurers or partners. The Company customarily collateralizes reinsurance balances due from non-admitted reinsurers through funds withheld trusts or stand-by letters of credit issued by highly rated banks.

To date, the Company has not, in the aggregate, experienced material difficulties in collecting reinsurance recoverables.

The Company has historically maintained an allowance for the potential exposure to uncollectibility of certain reinsurance balances. At the end of each quarter, an analysis of these exposures is conducted to determine the potential exposure to uncollectibility. The following table sets forth the Company's exposure to uncollectible reinsurance and related allowances as of June 30, 2007 and December 31, 2006 (in thousands):

|                              | June 30, 2007             |                    |           | December 31, 2006         |                    |           |
|------------------------------|---------------------------|--------------------|-----------|---------------------------|--------------------|-----------|
|                              | Non<br>Risk<br>Sharing(1) | Risk<br>Sharing(2) | Total     | Non<br>Risk<br>Sharing(1) | Risk<br>Sharing(2) | Total     |
| Gross exposure               | \$ 6,770                  | \$ 7,396           | \$ 14,166 | \$ 6,863                  | \$ 7,952           | \$ 14,815 |
| Collateral or other security | (5)                       | (3,317)            | (3,322)   | (170)                     | (3,453)            | (3,623)   |
| Allowance                    | (6,684)                   | (2,928)            | (9,612)   | (6,777)                   | (2,954)            | (9,731)   |
| Net exposure                 | \$ 81                     | \$ 1,151           | \$ 1,232  | \$ (84)                   | \$ 1,545           | \$ 1,461  |



- (1) Balances related to three unaffiliated insurance companies, which are under regulatory liquidation or control, for which allowances have been established; all other admitted reinsurers have an A.M. Best rating of A- or better.
- (2) Balances related to risk-sharing partners, which have either captive or rent-a-captive quota-share reinsurance contracts with the Company.

While management believes the above allowances to be adequate, no assurance can be given, however, regarding the future ability of any of the Company's risk-sharing partners to meet their obligations.

The Company maintains an excess-of-loss reinsurance treaty designed to protect against large or unusual loss and loss adjustment expense activity. The Company determines the appropriate amount of reinsurance primarily based on the Company's evaluation of the risks accepted, but also considers analysis prepared by consultants and reinsurers and on market conditions including the availability and pricing of reinsurance. To date, there have been

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no material disputes with the Company's excess-of-loss reinsurers. No assurance can be given, however, regarding the future ability of any of the Company's excess-of-loss reinsurers to meet their obligations.

Under the workers' compensation reinsurance treaty, reinsurers are responsible for 100% of each loss in excess of \$350,000, up to \$5.0 million for each claimant, on losses occurring prior to April 1, 2005. The Company increased its retention from \$350,000 to \$750,000, for losses occurring on or after April 1, 2005 and to \$1.0 million for losses occurring on or after April 1, 2006. In addition, there is coverage for loss events involving more than one claimant up to \$50.0 million per occurrence in excess of retentions of \$1.0 million. In a loss event involving more than one claimant, the per claimant coverage is \$10.0 million in excess of retentions of \$1.0 million.

Under the core liability reinsurance treaty, the reinsurers are responsible for 100% of each loss in excess of \$350,000, up to \$2.0 million per occurrence on policies effective prior to June 1, 2005. The Company increased its retention from \$350,000 to \$500,000, for losses occurring on policies effective on or after June 1, 2005. The Company also purchased an additional \$3.0 million of reinsurance clash coverage in excess of the \$2.0 million to cover amounts that may be in excess of the \$2.0 million policy limit, such as expenses associated with the settlement of claims or awards in excess of policy limits. Reinsurance clash coverage reinsures a loss when two or more policies are involved in a common occurrence. Effective June 1, 2006, the Company purchased a \$5.0 million excess cover to support its umbrella business. This business had previously been reinsured through various semi-automatic agreements and will now be protected by one common treaty. The Company has no retention when the umbrella limit is in excess of the primary limit, but does warrant it will maintain a minimum liability of \$1.0 million if the primary limit does not respond or is exhausted.

The Company has a separate treaty to cover liability specifically related to commercial trucking, where reinsurers are responsible for 100% of each loss in excess of \$350,000, up to \$1.0 million for losses occurring prior to December 1, 2005. The Company increased its retention from \$350,000 to \$500,000 for losses occurring on or after December 1, 2005. In addition, the Company purchased an additional \$1.0 million of reinsurance clash coverage. The Company established a separate treaty to cover liability related to chemical distributors and repackagers, where reinsurers are responsible for 100% of each loss in excess of \$500,000, up to \$1.0 million, applied separately to general liability and auto liability. This treaty was terminated on a run-off basis on August 1, 2006. The exposures are covered under the core casualty treaty for policies effective August 1, 2006 and after. Additionally, the Company has a separate treaty structure to cover liability related to agricultural business. The reinsurer is responsible for 100% of each loss in excess of \$500,000, up to \$1.0 million for casualty losses and up to \$5.0 million, for property losses occurring on or after May 1, 2006. This treaty also provides an additional \$1.0 million of reinsurance clash coverage for the casualty lines.

Under the property reinsurance treaty, reinsurers are responsible for 100% of the amount of each loss in excess of \$500,000, up to \$5.0 million per location. In addition, there is coverage for loss events involving multiple locations up to \$20.0 million after the Company has incurred \$750,000 in loss.

On May 1, 2007, the Company renewed its existing reinsurance agreement that provides reinsurance coverage for policies written in the Company's public entity excess liability program. The agreement provides reinsurance coverage of \$4.0 million in excess of \$1.0 million for each occurrence in excess of the policyholder's self-insured retention.

In addition, the Company renewed its reinsurance agreement that provides \$10.0 million in excess of \$5.0 million for each occurrence, which is above the underlying \$5.0 million of coverage for the Company's public entity excess liability program. Under this agreement, reinsurers are responsible for 100% of each loss in excess of \$5.0 million for all lines, except workers' compensation, which is covered by the Company's core catastrophic workers' compensation

treaty structure up to \$50.0 million per occurrence.

Additionally, certain small programs have separate reinsurance treaties in place, which limit the Company's exposure to \$350,000 or less.

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Facultative reinsurance is purchased for property values in excess of \$5.0 million, casualty limits in excess of \$2.0 million, or for coverage not covered by a treaty.

**NOTE 4 Debt**

***Lines of Credit***

In April 2007, the Company executed an amendment to its current revolving credit agreement with its bank. The amendments included an extension of the term to September 30, 2010, an increase to the available borrowings up to \$35.0 million, and a reduction of the variable interest rate basis to a range between 75 to 175 basis points above LIBOR. The Company uses the revolving line of credit to meet short-term working capital needs. Under the revolving line of credit, the Company and certain of its non-regulated subsidiaries pledged security interests in certain property and assets of the Company and named subsidiaries.

At June 30, 2007 and December 31, 2006, the Company had an outstanding balance of \$22.0 million and \$7.0 million on the revolving line of credit, respectively.

The revolving line of credit provides for interest at a variable rate based, at the Company's option, upon either a prime based rate or LIBOR-based rate. In addition, the revolving line of credit also provides for an unused facility fee. On prime based borrowings, the applicable margin ranges from 75 to 25 basis points below prime. On LIBOR-based borrowings, the applicable margin ranges from 75 to 175 basis points above LIBOR. The margin for all loans is dependent on the sum of non-regulated earnings before interest, taxes, depreciation, amortization, and non-cash impairment charges related to intangible assets for the preceding four quarters, plus dividends paid or payable to the Company from subsidiaries during such period ( Adjusted EBITDA ). At June 30, 2007, the weighted average interest rate for LIBOR-based borrowings outstanding was 6.4%.

Debt covenants consist of: (1) maintenance of the ratio of Adjusted EBITDA to interest expense of 2.0 to 1.0, (2) minimum net worth of \$130.0 million and increasing annually commencing June 30, 2005, by fifty percent of the prior year's positive net income, (3) minimum A.M. Best rating of B, and (4) minimum Risk Based Capital Ratio for Star of 1.75 to 1.00. As of June 30, 2007, the Company was in compliance with these covenants.

***Senior Debentures***

In April 2004, the Company issued senior debentures in the amount of \$13.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.0%, which is non-deferrable. At June 30, 2007, the interest rate was 9.36%. The senior debentures are callable by the Company at par after five years from the date of issuance. Associated with this transaction, the Company incurred \$390,000 of commissions paid to the placement agents. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

In May 2004, the Company issued senior debentures in the amount of \$12.0 million. The senior debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.2%, which is non-deferrable. At June 30, 2007, the interest rate was 9.56%. The senior debentures are callable by the Company at par after five years from the date of issuance. Associated with this transaction, the Company incurred \$360,000 of commissions paid to the placement agents. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are

being amortized over seven years as a component of interest expense.

The Company contributed \$9.9 million of the proceeds to its Insurance Company Subsidiaries and the remaining proceeds were used for general corporate purposes.

***Junior Subordinated Debentures***

In September 2005, Meadowbrook Capital Trust II (the Trust II ), an unconsolidated subsidiary trust of the Company, issued \$20.0 million of mandatorily redeemable trust preferred securities ( TPS ) to a trust formed by an

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institutional investor. Contemporaneously, the Company issued \$20.6 million in junior subordinated debentures, which includes the Company's investment in the trust of \$620,000. These debentures have financial terms similar to those of the TPS, which includes the deferral of interest payments at any time, or from time-to-time, for a period not exceeding five years, provided there is no event of default. These debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 3.58%. At June 30, 2007, the interest rate was 8.94%. These debentures are callable by the Company at par beginning in October 2010.

The Company received \$19.4 million in net proceeds, after the deduction of approximately \$600,000 of commissions paid to the placement agents in the transaction. These issuance costs have been capitalized and are included in other assets on the balance sheet, which will be amortized over seven years as a component of interest expense.

The Company contributed \$10.0 million of the proceeds from the issuance of these debentures to its Insurance Company Subsidiaries and the remaining proceeds were used for general corporate purposes.

In September 2003, Meadowbrook Capital Trust (the Trust), an unconsolidated subsidiary trust of the Company, issued \$10.0 million of mandatorily redeemable TPS to a trust formed by an institutional investor. Contemporaneously, the Company issued \$10.3 million in junior subordinated debentures, which includes the Company's investment in the trust of \$310,000. These debentures have financial terms similar to those of the TPS, which includes the deferral of interest payments at any time, or from time-to-time, for a period not exceeding five years, provided there is no event of default. These debentures mature in thirty years and provide for interest at the three-month LIBOR, plus 4.05%. At June 30, 2007, the interest rate was 9.40%. These debentures are callable by the Company at par beginning in October 2008.

The Company received \$9.7 million in net proceeds, after the deduction of approximately \$300,000 of commissions paid to the placement agents in the transaction. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense.

The Company contributed \$6.3 million of the proceeds from the issuance of these debentures to its Insurance Company Subsidiaries and the remaining proceeds were used for general corporate purposes.

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 TPS.

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.

The seven year amortization period in regard to the issuance costs represents management's best estimate of the estimated useful life of the bonds related to both the senior debentures and junior subordinated debentures described above.

**NOTE 5 Derivative Instruments**

In October 2005, the Company entered into two interest rate swap transactions to mitigate its interest rate risk on \$5.0 million and \$20.0 million of the Company's senior debentures and trust preferred securities, respectively. The

Company accrues for these transactions in accordance with SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities, as subsequently amended. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges under SFAS No. 133. In accordance with SFAS No. 133, 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 being accrued and is recognized as an adjustment to interest expense.

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The first interest rate swap transaction, which relates to \$5.0 million of the Company's \$12.0 million issuance of senior debentures, has an effective date of October 6, 2005 and ending date of May 24, 2009. The Company is required to make certain quarterly fixed rate payments calculated on a notional amount of \$5.0 million, non-amortizing, based on a fixed annual interest rate of 8.925%. The counterparty is obligated to make quarterly floating rate payments to the Company, referencing the same notional amount, based on the three-month LIBOR, plus 4.20%.

The second interest rate swap transaction, which relates to \$20.0 million of the Company's \$20.0 million issuance of trust preferred securities, has an effective date of October 6, 2005 and ending date of September 16, 2010. The Company is required to make quarterly fixed rate payments calculated on a notional amount of \$20.0 million, non-amortizing, based on a fixed annual interest rate of 8.34%. The counterparty is obligated to make quarterly floating rate payments to the Company, referencing the same notional amount, based on the three-month LIBOR, plus 3.58%.

In relation to the above interest rate swaps, the net interest income received for the six months ended June 30, 2007, was approximately \$76,000. The net interest expense incurred for the six months ended June 30, 2006, was approximately \$9,000. For the three months ended June 30, 2007 and 2006, the net interest income received was approximately \$38,000 and \$9,000, respectively. The total fair value of the interest rate swaps as of June 30, 2007 and December 31, 2006, was approximately \$373,000 and \$200,000, respectively. Accumulated other comprehensive income at June 30, 2007 and December 31, 2006, included the accumulated income on the cash flow hedge, net of taxes, of \$243,000 and \$130,000, respectively.

In July 2005, the Company made a \$2.5 million loan, at an effective interest rate equal to the three-month LIBOR, plus 5.2%, to an unaffiliated insurance agency. In December 2005, the Company loaned an additional \$3.5 million to the same agency. The original \$2.5 million demand note was replaced with a \$6.0 million convertible note. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. 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 then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible at the option of the Company based upon a pre-determined formula, beginning in 2008. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At June 30, 2007, the estimated fair value of the derivative was not material to the financial statements.

**NOTE 6 Shareholders Equity**

At June 30, 2007, shareholders' equity was \$219.3 million, or a book value of \$7.18 per common share, compared to \$201.7 million, or a book value of \$6.93 per common share, at December 31, 2006.

In October 2005, the Company's Board of Directors authorized management to purchase up to 1,000,000 shares of its common stock in market transactions for a period not to exceed twenty-four months. For the six months ended June 30, 2007 and for the year ended December 31, 2006, the Company did not repurchase any common stock. As of June 30, 2007, the cumulative amount the Company repurchased and retired under the current share repurchase plan was 63,000 shares of common stock for a total cost of approximately \$372,000. As of June 30, 2007, the Company has available up to 937,000 shares remaining to be purchased.



On February 8, 2007, the Company's Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of the Company's LTIP award for the 2004-2006 plan years, which included both a cash and stock award. The stock portion of the LTIP award was valued at \$2.5 million, which resulted in the issuance of 579,496 shares of the Company's common stock. Of the 579,496 shares issued, 191,570 shares were retired for payment of the participant's associated withholding taxes related to the compensation recognized by the participant. Refer to Note 2 ~ *Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan* for

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further detail. The retirement of the shares for the associated withholding taxes reduced the Company's paid in capital by \$1.8 million.

In April 2007, the Company purchased the business of U.S. Specialty Underwriters, Inc. for a purchase price of \$23.0 million. This purchased price was comprised of \$13.0 million in cash and \$10.0 million in the Company's common stock. Total additional shares issued for the \$10.0 million portion of the purchase price were 907,935 shares.

**NOTE 7 Regulatory Matters and Rating Agencies**

A significant portion of the Company's consolidated assets represent assets of the Insurance Company Subsidiaries. The State of Michigan Office of Financial and Insurance Services (OFIS), restricts the amount of funds that may be transferred to the holding company in the form of dividends, loans or advances. These restrictions in general, are as follows: the maximum discretionary dividend that may be declared, based on data from the preceding calendar year, is the greater of each insurance company's net income (excluding realized capital gains) or ten percent of the insurance company's surplus (excluding unrealized gains). These dividends are further limited by a clause in the Michigan law that prohibits an insurer from declaring dividends, except from surplus earnings of the company. Earned surplus balances are calculated on a quarterly basis. Since Star is the parent insurance company, its maximum dividend calculation represents the combined Insurance Company Subsidiaries' surplus. At June 30, 2007, Star's earned surplus position was positive \$26.3 million. At December 31, 2006, Star had positive earned surplus of \$13.2 million. As of June 30, 2007, Star may pay a dividend of up to \$16.5 million without the prior approval of OFIS, which is ten percent of statutory surplus as of year end 2006. No statutory dividends were paid during 2006 or during the six months ended June 30, 2007.

Insurance operations are subject to various leverage tests (e.g. premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. The Company's targets for gross and net written premium to statutory surplus are 2.8 to 1.0 and 2.25 to 1.0, respectively. As of June 30, 2007, on a statutory combined basis, the gross and net premium leverage ratios were 1.9 to 1.0 and 1.6 to 1.0, respectively.

The National Association of Insurance Commissioners (NAIC) has adopted a risk-based capital (RBC) formula to be applied to all property and casualty insurance companies. The formula measures required capital and surplus based on an insurance company's products and investment portfolio and is used as a tool to evaluate the capital of regulated companies. The RBC formula is used by state insurance regulators to monitor trends in statutory capital and surplus for the purpose of initiating regulatory action. In general, an insurance company must submit a calculation of its RBC formula to the insurance department of its state of domicile as of the end of the previous calendar year. These laws require increasing degrees of regulatory oversight and intervention as an insurance company's RBC declines. The level of regulatory oversight ranges from requiring the insurance company to inform and obtain approval from the domiciliary insurance commissioner of a comprehensive financial plan for increasing its RBC to mandatory regulatory intervention requiring an insurance company to be placed under regulatory control in a rehabilitation or liquidation proceeding.

At December 31, 2006, each of our Insurance Company Subsidiaries was in excess of any minimum threshold at which corrective action would be required.

In April 2007, the Company received an upgrade of its financial strength rating by A.M. Best Company to A- (Excellent), from B++ (Very Good) for its Insurance Company Subsidiaries.

**NOTE 8** **Segment Information**

The Company defines its operations as specialty risk management operations and agency operations based upon differences in products and services. The separate financial information of these segments is consistent with the way results are regularly evaluated by management in deciding how to allocate resources and in assessing

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performance. Intersegment revenue is eliminated upon consolidation. It would be impracticable for the Company to determine the allocation of assets between the two segments.

***Specialty Risk Management Operations***

The specialty risk management operations segment, which includes insurance company specialty programs and fee-for-service specialty programs, focuses on specialty or niche insurance business. Specialty risk management operations provide services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention, and reinsurance placement, along with various types of property and casualty insurance coverage, including workers compensation, commercial multiple peril, general liability, commercial auto liability, and inland marine. Insurance coverage is provided primarily to associations or similar groups of members and to specified classes of business of the Company's agent-partners. The Company recognizes revenue related to the services and coverages the specialty risk management operations provides within seven categories: net earned premiums, management fees, claims fees, loss control fees, reinsurance placement, investment income, and net realized gains (losses).

***Agency Operations***

The Company earns commissions through the operation of its retail property and casualty insurance agencies located in Michigan, California, and Florida. The agency operations produce commercial, personal lines, life, and accident and health insurance, for more than fifty unaffiliated insurance carriers. The agency produces an immaterial amount of business for its affiliated Insurance Company Subsidiaries.

The following tables set forth the segment results (in thousands):

|                           | <b>For the Six Months<br/>Ended June 30,</b> |             |
|---------------------------|--|-------------|
|                           | <b>2007</b>                                  | <b>2006</b> |
| Revenues                  |  |             |
| Net earned premiums       | \$ 132,395                                   | \$ 127,638  |
| Management fees           | 10,287                                       | 9,621       |
| Claims fees               | 4,451  | 4,451       |
| Loss control fees         | 1,143  | 1,131       |
| Reinsurance placement     | 418  | 561         |
| Investment income         | 11,921                                       | 10,170      |
| Net realized gains        | 14   | 18          |
| Specialty risk management | 160,629                                      | 153,590     |
| Agency operations         | 6,745  | 7,139       |
| Miscellaneous income(2)   | 464  | 449         |
| Intersegment revenue      | (750)  | (916)       |
| Consolidated revenue      | \$ 167,088                                   | \$ 160,262  |

|                             |           |           |
|-----------------------------|-----------|-----------|
| Pre-tax income:             |           |           |
| Specialty risk management   | \$ 22,020 | \$ 18,632 |
| Agency operations(1)        | 1,868     | 2,265     |
| Non-allocated expenses      | (5,230)   | (4,763)   |
| Consolidated pre-tax income | \$ 18,658 | \$ 16,134 |

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

|                             | <b>For the Three Months<br/>Ended June 30,</b> |             |
|-----------------------------|--|-------------|
|                             | <b>2007</b>                                    | <b>2006</b> |
| Revenues                    |  |             |
| Net earned premiums         | \$ 67,191                                      | \$ 64,514   |
| Management fees             | 5,412  | 5,090       |
| Claims fees                 | 2,247  | 2,351       |
| Loss control fees           | 544  | 593         |
| Reinsurance placement       | 85   | 143         |
| Investment income           | 5,991  | 5,140       |
| Net realized gains          | 20   | 25          |
| Specialty risk management   | 81,490   | 77,856      |
| Agency operations           | 2,860  | 2,878       |
| Miscellaneous income(2)     | 238  | 240         |
| Intersegment revenue        | (405)  | (357)       |
| Consolidated revenue        | \$ 84,183                                      | \$ 80,617   |
| Pre-tax income:             |  |             |
| Specialty risk management   | \$ 10,768                                      | \$ 9,334    |
| Agency operations(1)        | 574  | 614         |
| Non-allocated expenses      | (2,743)  | (2,277)     |
| Consolidated pre-tax income | \$ 8,599                                       | \$ 7,671    |

(1) The Company's agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate overhead allocation excludes those expenses specific to the holding company. For the six months ended June 30, 2007 and 2006, the allocation of corporate overhead to the agency operations segment was \$1.2 million and \$1.6 million, respectively. For the three months ended June 30, 2007 and 2006, the allocation of corporate overhead to the agency operations segment was \$528,000 and \$771,000, respectively.

(2) The miscellaneous income included in the revenue relates to miscellaneous interest income within the holding company.

The following table sets forth the non-allocated expenses included in pre-tax income (in thousands):

**For the Six Months  
Ended June 30,**  
**2007**      **2006**

|                          |            |            |
|--------------------------|------------|------------|
| Holding company expenses | \$ (1,389) | \$ (1,569) |
| Amortization             | (687)      | (307)      |
| Interest expense         | (3,154)    | (2,887)    |
|                          | \$ (5,230) | \$ (4,763) |

**For the Three Months  
Ended June 30,  
2007                      2006**

|                          |            |            |
|--------------------------|------------|------------|
| Holding company expenses | \$ (533)   | \$ (636)   |
| Amortization             | (543)      | (142)      |
| Interest expense         | (1,667)    | (1,499)    |
|                          | \$ (2,743) | \$ (2,277) |

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

**NOTE 9 Income Taxes**

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting and reporting for uncertain tax positions. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition, measurement, and presentation of uncertain tax positions taken or expected to be taken in an income tax return. The Company adopted the provisions of FIN 48 as of January 1, 2007.

As a result of the adoption of FIN 48, the Company identified, evaluated and measured the amount of income tax benefits to be recognized for all income tax positions. The net tax assets recognized under FIN 48 did not differ from the net tax assets recognized prior to adoption, and, therefore, the Company did not record an adjustment.

Interest costs and penalties related to income taxes are classified as interest expense and other administrative expenses, respectively. As of June 30, 2007 and December 31, 2006, the Company had no amounts of accrued interest or penalties related to uncertain tax positions.

The Company and its subsidiaries are subject to U.S. federal income tax as well as to income tax of multiple state jurisdictions. Tax returns for all years after 2002 are subject to future examination by tax authorities.

**NOTE 10 Commitments and Contingencies**

The Company and its subsidiaries are subject at times to various claims, lawsuits and proceedings relating principally to alleged errors or omissions in the placement of insurance, claims administration, consulting services and other business transactions arising in the ordinary course of business. Where appropriate, the Company vigorously defends such claims, lawsuits and proceedings. Some of these claims, lawsuits and proceedings seek damages, including consequential, exemplary or punitive damages, in amounts that could, if awarded, be significant. Most of the claims, lawsuits and proceedings arising in the ordinary course of business are covered by errors and omissions insurance or other appropriate insurance. In terms of deductibles associated with such insurance, the Company has established provisions against these items, which are believed to be adequate in light of current information and legal advice. In accordance with SFAS No. 5, *Accounting for Contingencies*, 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 its 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 11 Subsequent Events**

On July 19, 2007, the Company completed a secondary offering of 5,500,000 additional shares of its common stock at a price of \$9.65 per share. In addition, the underwriters for the offering exercised their over-allotment option of 937,500 additional shares. The Company received total gross proceeds of \$62.1 million. Including the underwriting



discount associated with the offering and other estimated expenses, the Company received total net proceeds of approximately \$58.6 million. These net proceeds will be utilized to support organic growth within its underwriting operations, fund potential select acquisitions and for other general corporate purposes. Upon receipt of the net proceeds, the Company did reduce its \$22.0 million line of credit balance to zero.

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**ITEM 2**

**MANAGEMENTS DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**For the Periods ended June 30, 2007 and 2006**

***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 collectibility 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.*

**Description of Business**

We are a publicly traded specialty risk management organization offering a full range of insurance products and services, focused on niche and specialty program business, which we believe is under served by the standard insurance market. Program business refers to an aggregation of individually underwritten risks that have some unique characteristic and are distributed through a select group of focused general agencies, retail agencies and program administrators. We perform the majority of underwriting and claims services associated with these programs. We also provide property and casualty insurance coverage and services through programs and alternative risk management solutions for agents, professional and trade associations, public entities and small to medium-sized insureds. In addition, we also operate as an insurance agency representing unaffiliated insurance companies in placing insurance coverages for policyholders. We define our business segments as specialty risk management operations and agency operations.

**Critical Accounting Estimates**

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 13, 2007, are those that we consider to be our critical accounting estimates. As of the three months and six months ended June 30, 2007, there have been no material changes in our critical accounting estimates.

**RESULTS OF OPERATIONS FOR THE SIX MONTHS ENDED JUNE 30, 2007 AND 2006**

**Executive Overview**

For the first half of 2007, we experienced an improvement in our overall results in comparison to prior year. This improvement continues to reflect our selective growth, as well as our adherence to strict corporate

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underwriting guidelines and price adequacy. We continue to be committed to strong underwriting discipline and growth within our profitable programs. Our generally accepted accounting principles ( GAAP ) combined ratio for the six months ended June 30, 2007 was 96.8%, in comparison to 2006 at 96.7%. We continue to experience solid growth in our fee-based operations. After tax net operating income, excluding amortization, increased 21.1% to \$13.5 million, or \$0.45 per diluted share, compared to \$11.2 million, or \$0.38 per diluted share in 2006.

Gross written premium increased \$4.2 million, or 2.6%, for the first half of 2007 to \$167.5 million, compared to \$163.3 million. Our existing underwritten business was up \$8.9 million, or 5.8% in comparison to 2006. This growth included business from new programs implemented in 2006. The growth in existing business was slightly offset by a reduction in residual market premiums that are assigned to us as a result of a decrease in the estimate of the overall size of the residual market. We continue to follow pricing guidelines mandated by our corporate underwriting guidelines. Overall, our rate change for the first half of the year was slightly down. We anticipate it will remain slightly down for the remainder of the year. We continue to be selective on new program implementation by focusing only on those programs that meet our underwriting guidelines and have a proven history of profitability.

In April 2007, we received an upgrade of our financial strength rating by A.M. Best Company to A- (Excellent), from B++ (Very Good) for our Insurance Company Subsidiaries. We worked diligently towards achieving this upgrade and were very pleased with the decision. This rating upgrade validates our commitment to create value through excellent underwriting and consistent operating performance. We are well positioned to attract additional solid underwriting prospects from new and existing insurance programs and should realize significant cost savings in the future.

In April 2007, we entered into an Asset Purchase Agreement ( Agreement ) to acquire the business of U.S. Specialty Underwriters, Inc. ( USSU ) for a purchase price of \$23.0 million. We simultaneously closed on the acquisition on the same date. The purchase price was comprised of \$13.0 million in cash and \$10.0 million in our common stock. The total shares issued for the \$10.0 million portion of the purchase price was 907,935 shares. Under the terms of the Agreement, we acquired the excess workers compensation business and other related assets. In addition, we entered into a Management Agreement with the shareholder of USSU. Under the terms and conditions of the Management Agreement, the shareholder is responsible for the day to day administration and management of the acquired business. The shareholder's consideration for the performance of its duties shall be in the form of a Management Fee payable by us based on a share of net income before interest, taxes, depreciation, and amortization. In addition, we can terminate the Management Agreement in the future, at our discretion, based on a multiple of the Management Fee calculated for the trailing twelve months and subject to the terms and conditions of the Agreement. USSU is based in Cleveland, Ohio, and is a specialty program manager that produces fee based income by underwriting excess workers compensation coverage for a select group of insurance companies.

In July 2007, we completed an offering of 6,437,500 additional shares of newly issued common stock at \$9.65 per share. The gross proceeds of the offering were \$62.1 million. The net proceeds were \$58.6 million. The net proceeds from the offering will be utilized to support organic growth within our underwriting operations, fund potential select acquisitions, and for other general corporate purposes. Upon receipt of the net proceeds, we reduced our \$22.0 million line of credit balance to zero.

## **Results of Operations**

Net income for the six months ended June 30, 2007, was \$13.1 million, or \$0.44 per dilutive share, compared to net income of \$11.0 million, or \$0.37 per dilutive share, for the comparable period of 2006. This improvement reflects growth in net investment income from positive operating cash flows and an increase in margins on our gross commissions and fee revenue, partially offset by amortization of intangibles and interest expense associated with the recent acquisition of USSU. In addition, this increase was the result of our selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy.

Revenues for the six months ended June 30, 2007, increased \$6.8 million, or 4.3%, to \$167.1 million, from \$160.3 million for the comparable period in 2006. This increase reflects a \$4.8 million, or 3.7%, increase in net earned premiums. The increase in net earned premiums is the result of selective growth consistent with our

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corporate underwriting guidelines and our controls over price adequacy, partially offset by a reduction in residual market premiums that are assigned to us as a result of a decrease in the estimate of the overall size of the residual market. In addition, the increase in revenue reflects a \$1.8 million increase in investment income, primarily the result of an increase in average invested assets due to positive cash flow and a slight increase in yield.

*Specialty Risk Management Operations*

The following table sets forth the revenues and results from operations for our specialty risk management operations (in thousands):

|                                      | <b>For the Six Months<br/>Ended June 30,</b> |             |
|--------------------------------------|--|-------------|
|                                      | <b>2007</b>                                  | <b>2006</b> |
| Revenue:                             |  |             |
| Net earned premiums                  | \$ 132,395                                   | \$ 127,638  |
| Management fees                      | 10,287                                       | 9,621       |
| Claims fees                          | 4,451  | 4,451       |
| Loss control fees                    | 1,143  | 1,131       |
| Reinsurance placement                | 418  | 561         |
| Investment income                    | 11,921                                       | 10,170      |
| Net realized gains                   | 14   | 18          |
| Total revenue                        | \$ 160,629                                   | \$ 153,590  |
| Pre-tax income                       |  |             |
| Specialty risk management operations | \$ 22,020                                    | \$ 18,632   |

Revenues from specialty risk management operations increased \$7.0 million, or 4.6%, to \$160.6 million for the six months ended June 30, 2007, from \$153.6 million for the comparable period in 2006.

Net earned premiums increased \$4.8 million, or 3.7%, to \$132.4 million in the six months ended June 30, 2007, from \$127.6 million in the comparable period in 2006. As previously indicated, this increase is the result of selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy, partially offset by the reduction in residual market premiums and mandatory rate decreases in the Nevada, Florida and Massachusetts workers' compensation lines of business.

Management fees increased \$666,000, or 6.9%, to \$10.3 million for the six months ended June 30, 2007, from \$9.6 million for the comparable period in 2006. This increase is related to fees received as a result of our acquisition of USSU. Total fees received for the six months ended June 30, 2007 as a result of this acquisition were \$809,000. Slightly offsetting these fees was a slight decrease in fees related to a New England-based program.

Claim fees remained flat for the six months ended June 30, 2007, compared to 2006.

Net investment income increased \$1.7 million, or 17.2%, to \$11.9 million in 2007, from \$10.2 million in 2006. Average invested assets increased \$69.3 million, or 14.9%, to \$534.8 million in 2007, from \$465.5 million in 2006. The increase in average invested assets reflects cash flows from continued favorable underwriting results and an increase in the duration of our reserves. The increase in the duration of our reserves reflects the impact of growth in

our excess liability business, which was implemented at the end of 2003. This type of business has a longer duration than the average reserves on our other programs and is now a larger proportion of reserves. The average investment yield for June 30, 2007, was 4.63%, compared to 4.56% for the comparable period in 2006. The current pre-tax book yield was 4.44%. The current after-tax book yield for the six months ended June 30, 2007 was 3.40%, compared to 3.26% for the comparable period in 2006. This increase is primarily the result of the shift in our investment portfolio to tax-exempt investments. The duration of the investment portfolio is 4.2 years.

Specialty risk management operations generated pre-tax income of \$22.0 million for the six months ended June 30, 2007, compared to pre-tax income of \$18.6 million for the comparable period in 2006. This increase in pre-tax income reflects growth in net investment income from positive operating cash flows and an increase in the pre-

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tax margin on our gross managed and intercompany fee revenue. The GAAP combined ratio was 96.8% for the six months ended June 30, 2007, compared to 96.7% for the same period in 2006.

Net loss and loss adjustment expenses ( LAE ) increased \$2.2 million, or 2.9%, to \$76.4 million for the six months ended June 30, 2007, from \$74.2 million for the same period in 2006. Our loss and LAE ratio improved 0.3 percentage points to 62.7% for the six months ended June 30, 2007, from 63.0% for the same period in 2006. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. This improvement reflects the impact of favorable development of prior accident year reserves of 0.7 percentage points of December 31, 2006 reserves, offset by prior year reinsurance premium adjustments related to an inception to date reconciliation project completed in conjunction with the implementation of a new automated reinsurance system. In addition, a slightly more competitive insurance market resulted in a small increase in the loss ratio. The favorable development primarily reflects favorable claim settlements in the professional liability and workers compensation lines of business. Offsetting these improvements was unfavorable development within the general liability and auto liability lines of business. The unfavorable development within the general liability line of business reflects a claim reserving process change for an excess liability program. The unfavorable development within the auto liability line of business was primarily the result of unexpected case reserve increases within our California-based energy program. Additional discussion of our reserve activity is described below within the Other Items ~ Reserves section.

Our expense ratio for the six months ended June 30, 2007 was 34.1%, compared to 33.7% for the same period in 2006. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. The slight increase in the expense ratio in comparison to 2006 is primarily the result of an increase in insurance related assessments. This was partially offset by an increase in ceding commissions, also impacted by shifts in the mix of business.

*Agency Operations*

The following table sets forth the revenues and results from operations for our agency operations (in thousands):

|                   | <b>For the Six Months<br/>Ended June 30,</b> |             |
|-------------------|--|-------------|
|                   | <b>2007</b>                                  | <b>2006</b> |
| Net commission    | \$ 6,745                                     | \$ 7,139    |
| Pre-tax income(1) | \$ 1,868                                     | \$ 2,265    |

- (1) Our agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate overhead allocation excludes those expenses specific to the holding company. For the six months ended June 30, 2007 and 2006, the allocation of corporate overhead to the agency operations segment was \$1.2 million and \$1.6 million, respectively.

Revenue from agency operations, which consists primarily of agency commission revenue, decreased \$394,000, or 5.5%, to \$6.7 million for the six months ended June 30, 2007, from \$7.1 million for the comparable period in 2006. This decrease is primarily the result of a reduction in premium on client renewals due to a more competitive pricing environment primarily on our larger Michigan accounts.



Agency operations generated pre-tax income, after the allocation of corporate overhead, of \$1.9 million for the six months ended June 30, 2007, compared to \$2.3 million for the comparable period in 2006. The decrease in the pre-tax income is primarily attributable to the decrease in agency commission revenue mentioned above.

### **Other Items**

#### **Reserves**

At June 30, 2007, our best estimate for the ultimate liability for loss and LAE reserves, net of reinsurance recoverables, was \$323.0 million. We established a reasonable range of reserves of approximately \$299.1 million to

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\$344.7 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):

| <b>Line of Business</b>                     | <b>Minimum Reserve Range</b> | <b>Maximum Reserve Range</b> | <b>Selected Reserves</b> |
|---|------------------------------|------------------------------|--------------------------|
| Workers Compensation(1)                     | \$ 153,864                   | \$ 170,184                   | \$ 163,842               |
| Commercial Multiple Peril/General Liability | 68,541                       | 85,108                       | 76,120                   |
| Commercial Automobile                       | 59,198                       | 67,080                       | 63,342                   |
| Other                                       | 17,512                       | 22,357                       | 19,740                   |
| Total Net Reserves                          | \$ 299,115                   | \$ 344,729                   | \$ 323,044               |

(1) Includes Residual Markets

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

The key assumptions used in our selection of ultimate reserves included the underlying actuarial methodologies, a review of current pricing and underwriting initiatives, an evaluation of reinsurance costs and retention levels, and a detailed claims analysis with an emphasis on how aggressive claims handling may be impacting the paid and incurred loss data trends embedded in the traditional actuarial methods. With respect to the ultimate estimates for losses and LAE, the key assumptions remained consistent for the six months ended June 30, 2007 and the year ended December 31, 2006.

For the six months ended June 30, 2007, we reported a decrease in net ultimate loss estimates for accident years 2006 and prior of \$2.1 million, or 0.7% of \$302.7 million of net loss and LAE reserves at December 31, 2006. The decrease in net ultimate loss estimates reflected revisions in the estimated reserves as a result of actual claims activity in calendar year 2007 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 2006 and for the six months ended June 30, 2007. The major components of this change in ultimate loss estimates are as follows (in thousands):

| <b>Line of Business</b> | <b>Reserves at</b>       |                     | <b>Incurred Losses</b> |                       |                     | <b>Paid Losses</b> |                   |                      | <b>Reserves at</b> |
|-------------------------|--------------------------|---------------------|------------------------|-----------------------|---------------------|--------------------|-------------------|----------------------|--------------------|
|                         | <b>December 31, 2006</b> | <b>Current Year</b> | <b>Prior Years</b>     | <b>Total Incurred</b> | <b>Current Year</b> | <b>Prior Years</b> | <b>Total Paid</b> | <b>June 30, 2007</b> |                    |

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|   |            |           |            |           |          |           |           |            |
|---|------------|-----------|------------|-----------|----------|-----------|-----------|------------|
| Workers Compensation                        | \$ 137,113 | \$ 28,796 | \$ (5,553) | \$ 23,243 | \$ 544   | \$ 21,370 | \$ 21,914 | \$ 138,442 |
| Residual Markets                            | 26,098     | 5,241     | (2,135)    | 3,106     | 1,994    | 1,810     | 3,804     | 25,400     |
| Commercial Multiple Peril/General Liability | 63,056     | 13,747    | 7,520      | 21,267    | (168)    | 8,371     | 8,203     | 76,120     |
| Commercial Automobile                       | 54,642     | 22,675    | 1,638      | 24,313    | 3,399    | 12,214    | 15,613    | 63,342     |
| Other                                       | 21,746     | 8,040     | (3,616)    | 4,424     | 1,492    | 4,938     | 6,430     | 19,740     |
| Net Reserves                                | 302,655    | \$ 78,499 | \$ (2,146) | \$ 76,353 | \$ 7,261 | \$ 48,703 | \$ 55,964 | 323,044    |
| Reinsurance Recoverable                     | 198,422    |           |            |           |          |           |           | 200,214    |
| Consolidated                                | \$ 501,077 |           |            |           |          |           |           | \$ 523,258 |

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| <b>Line of Business</b>                     | <b>Reserves at<br/>December 31,<br/>2006</b> | <b>Re-Estimated<br/>Reserves at<br/>June 30,<br/>2007 on Prior<br/>Years</b> | <b>Development<br/>as a Percentage<br/>of Prior Year<br/>Reserves</b> |
|---|--|--|---|
| Workers Compensation                        | \$ 137,113                                   | \$ 131,560   | (4.0)%  |
| Commercial Multiple Peril/General Liability | 63,056                                       | 70,576   | 11.9%   |
| Commercial Automobile                       | 54,642                                       | 56,280   | 3.0%  |
| Other                                       | 21,746                                       | 18,130   | (16.6)%   |
| Sub-total                                   | 276,557                                      | 276,546  | 0.0%  |
| Residual Markets                            | 26,098                                       | 23,963   | (8.2)%  |
| Total Net Reserves                          | \$ 302,655                                   | \$ 300,509   | (0.7)%  |

*Workers Compensation Excluding Residual Markets* The projected net ultimate loss estimate for the workers compensation line of business excluding residual markets decreased \$5.6 million, or 4.0% of net workers compensation reserves. This net overall decrease primarily reflects decreases of \$608,000, \$1.8 million, \$1.3 million, \$580,000 and \$808,000 in accident years 2006, 2005, 2004, 2003 and 2000, respectively. These decreases reflect better than expected experience for many of our workers compensation programs, including a Nevada, Florida, New England, and a countrywide association program. The anticipated average severity on reported claims in the prior actuarial projections was better than expected and, therefore, ultimate loss estimates were reduced. The change in ultimate loss estimates for all other accident years was insignificant.

*Commercial Multiple Peril/General Liability* The commercial multiple peril and general liability line of business had an increase in net ultimate loss estimates of \$7.5 million, or 11.9% of net commercial multiple peril and general liability reserves. The net increase reflects increases of \$1.4 million, \$1.0 million, and \$4.6 million in the ultimate loss estimates for accident years 2006, 2005 and 2004, which were primarily due to larger than expected claim emergence in a Florida-based program. This emergence reflects greater than expected claim activity within an excess liability program, primarily in the 2004 accident year. While this program had unfavorable development in prior accident year reserves, the current and inception to date underwriting profits remain positive and within our corporate guidelines for return on surplus. The change in ultimate loss estimates for all other accident years was insignificant.

*Commercial Automobile* The projected net ultimate loss estimate for the commercial automobile line of business increased \$1.6 million, or 3.0% of net commercial automobile reserves. This net overall increase reflects increases of \$1.7 million and \$1.3 million in accident years 2005 and 2004, respectively. These increases primarily reflect higher than expected emergence of claim activity in a Florida-based and California-based program. These increases were offset by decreases of \$707,000 and \$253,000 in accident years 2006 and 2001, respectively. The decreases in these accident years reflect favorable development within a California-based program and a Florida-based 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 \$3.6 million, or 16.6% of net reserves. This net decrease reflects decreases of \$970,000, \$1.3 million, \$761,000, and \$360,000, in the net ultimate loss estimate for accident years 2006, 2005, 2004 and 2003, respectively. These decreases were due to better than expected case reserve development during the calendar year in a medical malpractice program. The change in ultimate loss estimates for all other accident years was insignificant.

*Residual Markets* The workers compensation residual market line of business had a decrease in net ultimate loss estimates of \$2.1 million, or 8.2% of net reserves. This decrease reflects reductions of \$1.5 million, \$939,000, and \$326,000 in accident years 2005, 2004 and 2003, respectively. Offsetting these decreases was an increase of \$648,000 in accident year 2006. 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 quarter. The change in ultimate loss estimates for all other accident years was insignificant.

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### **Salary and Employee Benefits and Other Administrative Expenses**

Salary and employee benefits for the six months ended June 30, 2007, decreased \$782,000, or 2.9%, to \$26.4 million, from \$27.2 million for the comparable period in 2006. This decrease primarily reflects a decrease in variable compensation and health benefit costs, offset by merit increases. The decrease in variable compensation reflects the increase in our targeted return on equity. Overall, our headcount remained flat.

Other administrative expenses remained relatively flat in comparison to 2006. Other administrative expenses increased in comparison to 2006 as a result of our acquisition of USSU, primarily due to the management fee associated with this acquisition. Offsetting the increases related to USSU were decreases related to policyholder dividends, as well as various decreases in other general operating expenses in comparison to 2006.

Salary and employee benefits and other administrative expenses include both corporate overhead and the holding company expenses included in the non-allocated expenses of our segment information.

### **Amortization Expense**

Amortization expense for the six months ended June 30, 2007, increased \$380,000, or 123.8%, to \$687,000, from \$307,000 for the comparable period in 2006. Amortization expense primarily relates to the customer relationships acquired with the Florida-based agency operation in 2005 and the acquisition of USSU. The increase in amortization expense is related to our acquisition of USSU.

### **Interest Expense**

Interest expense for the six months ended June 30, 2007, increased \$267,000, or 9.2%, to \$3.2 million, from \$2.9 million for the comparable period in 2006. The increase in interest expense reflects an increase in the outstanding balance on our line of credit associated with borrowings to fund the cash portion of the USSU acquisition. 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 line of credit. The average outstanding balance on our line of credit during the six months ending June 30, 2007, was \$15.0 million, compared to \$10.0 million for the same period in 2006. The average interest rate, excluding the debentures, was approximately 6.7% in 2007, compared to 6.6% in 2006.

### **Income Taxes**

Income tax expense, which includes both federal and state taxes, for the six months ended June 30, 2007, was \$5.6 million, or 30.0% of income before taxes. For the same period last year, we reflected an income tax expense of \$5.2 million, or 32.0% of income before taxes. The decrease in our tax rate from 2006 to 2007 primarily reflects a higher level of tax exempt securities in our investment portfolio, slightly offset by a higher level of income within our fee-based operations, which are taxed at a 35% rate. Our tax exempt securities as a percentage of total invested assets were 45.3% and 43.3% at June 30, 2007 and 2006, respectively.

### **Other than Temporary Impairments**

Our policy for the valuation of temporarily impaired securities is to determine impairment based on analysis of the following factors: (1) rating downgrade or other credit event (e.g., failure to pay interest when due); (2) financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology or discontinuance of a business segment; (3) prospects for the issuer's industry segment; and (4) our intent and ability to retain the investment for a period of time sufficient to allow for

anticipated recovery in market value. We evaluate our investments in securities to determine other than temporary impairment, no less than quarterly. Investments that are deemed other than temporarily impaired are written down to their estimated net fair value and the related losses recognized in operations.

At June 30, 2007, we had 357 securities that were in an unrealized loss position. These investments all had unrealized losses of less than ten percent. At June 30, 2007, 203 of those investments, with an aggregate \$189.6 million and \$5.6 million fair value and unrealized loss, respectively, have been in an unrealized loss position for more than eighteen months. Positive evidence considered in reaching our conclusion that the

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investments in an unrealized loss position are not other than temporarily impaired consisted of: 1) there were no specific events which caused concerns; 2) there were no past due interest payments; 3) there has been a rise in market prices; 4) our ability and intent to retain the investment for a sufficient amount of time to allow an anticipated recovery in value; and 5) changes in market value were considered normal in relation to overall fluctuations in interest rates.

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

|  | Less than 12 Months   |                               | June 30, 2007<br>Greater than 12 Months                         |                               | Total   |                               |
|--|---|-------------------------------|---|-------------------------------|---|-------------------------------|
|  | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses |
| <b>Debt Securities:</b>                                |   |                               |   |                               |   |                               |
| Debt securities issued by U.S. government and agencies | \$ 10,469   | \$ (106)                      | \$ 16,047   | \$ (372)                      | \$ 26,516   | \$ (478)                      |
| Obligations of states and political subdivisions       | 114,710   | (2,182)                       | 80,955  | (2,062)                       | 195,665   | (4,244)                       |
| Corporate securities                                   | 13,947  | (395)                         | 47,918  | (1,429)                       | 61,865  | (1,824)                       |
| Mortgage and asset backed securities                   | 61,859  | (1,015)                       | 61,727  | (1,959)                       | 123,586   | (2,974)                       |
| Totals   | \$ 200,985  | \$ (3,698)                    | \$ 206,647  | \$ (5,822)                    | \$ 407,632  | \$ (9,520)                    |

|  | Less than 12 Months   |                               | December 31, 2006<br>Greater than 12 Months                     |                               | Total   |                               |
|--|---|-------------------------------|---|-------------------------------|---|-------------------------------|
|  | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses | Fair Value<br>of<br>Investments<br>with<br>Unrealized<br>Losses | Gross<br>Unrealized<br>Losses |
| <b>Debt Securities:</b>                                |   |                               |   |                               |   |                               |
| Debt securities issued by U.S. government and agencies | \$ 14,586   | \$ (61)                       | \$ 27,076   | \$ (460)                      | \$ 41,662   | \$ (521)                      |
| Obligations of states and political subdivisions       | 45,726  | (210)                         | 68,958  | (1,250)                       | 114,684   | (1,460)                       |
| Corporate securities                                   | 7,646   | (61)                          | 55,520  | (1,454)                       | 63,166  | (1,515)                       |
|  | 20,462  | (91)                          | 67,495  | (1,535)                       | 87,957  | (1,626)                       |



Mortgage and asset backed securities

|        |    |        |    |       |    |         |    |         |    |         |    |         |
|--------|----|--------|----|-------|----|---------|----|---------|----|---------|----|---------|
| Totals | \$ | 88,420 | \$ | (423) | \$ | 219,049 | \$ | (4,699) | \$ | 307,469 | \$ | (5,122) |
|--------|----|--------|----|-------|----|---------|----|---------|----|---------|----|---------|

As of June 30, 2007, gross unrealized gains and (losses) on securities were \$1.6 million and (\$9.5 million), respectively. As of December 31, 2006, gross unrealized gains and (losses) on securities were \$3.6 million and (\$5.1 million), respectively.

Our investment portfolio remains almost 100% in investment grade securities and we continue to invest in securities with minimum credit risk. While our investment portfolio includes investments in mortgage-backed and agency-backed securities, we have no exposure to sub-prime mortgages.

## RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED JUNE 30, 2007 AND 2006

### Results of Operations

Net income for the three months ended June 30, 2007, was \$6.2 million, or \$0.20 per dilutive share, compared to net income of \$5.4 million, or \$0.18 per dilutive share, for the comparable period of 2006. This improvement primarily reflects growth in net investment income, expansion of cash margins on our gross commissions and fee revenue, offset by a slightly more competitive insurance market and amortization of intangibles and interest expense associated with the acquisition of USSU.

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Revenues for the three months ended June 30, 2007, increased \$3.6 million, or 4.4%, to \$84.2 million, from \$80.6 million for the comparable period in 2006. This increase reflects a \$2.7 million, or 4.1%, increase in net earned premiums. The increase in net earned premiums is the result of selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy, partially offset by a reduction in residual market premiums that are assigned to us as a result of a decrease in the estimate of the overall size of the residual market. In addition, the increase in revenue reflects an \$849,000 increase in investment income, primarily the result of an increase in average invested assets due to positive cash flow and a slight increase in yield.

*Specialty Risk Management Operations*

The following table sets forth the revenues and results from operations for our specialty risk management operations (in thousands):

|                                      | <b>For the Three Months<br/>Ended June 30,</b> |             |
|--------------------------------------|--|-------------|
|                                      | <b>2007</b>                                    | <b>2006</b> |
| Revenue:                             |  |             |
| Net earned premiums                  | \$ 67,191                                      | \$ 64,514   |
| Management fees                      | 5,412  | 5,090       |
| Claims fees                          | 2,247  | 2,351       |
| Loss control fees                    | 544  | 593         |
| Reinsurance placement                | 85   | 143         |
| Investment income                    | 5,991  | 5,140       |
| Net realized gains                   | 20   | 25          |
| Total revenue                        | \$ 81,490                                      | \$ 77,856   |
| Pre-tax income                       |  |             |
| Specialty risk management operations | \$ 10,768                                      | \$ 9,334    |

Revenues from specialty risk management operations increased \$3.6 million, or 4.7%, to \$81.5 million for the three months ended June 30, 2007, from \$77.9 million for the comparable period in 2006.

Net earned premiums increased \$2.7 million, or 4.1%, to \$67.2 million in the three months ended June 30, 2007, from \$64.5 million in the comparable period in 2006. As previously indicated, this increase is the result of selective growth consistent with our corporate underwriting guidelines and our controls over price adequacy, partially offset by the reduction in residual market premiums and mandatory rate decreases in the Nevada, Florida and Massachusetts workers' compensation lines of business.

Management fees increased \$322,000, or 6.3%, to \$5.4 million for the three months ended June 30, 2007, from \$5.1 million for the comparable period in 2006. This increase is related to fees received as a result of our acquisition of USSU. Total fees received for the three months ended June 30, 2007 as a result of this acquisition were \$809,000. Slightly offsetting these fees was a slight decrease in fees related to a New England-based program, as well as the timing of anticipated profit sharing payments received in 2006 versus 2007.

Claim fees decreased \$104,000, or 4.4%, to \$2.2 million, from \$2.4 million for the comparable period in 2006.

Net investment income increased \$851,000, or 16.6%, to \$6.0 million in 2007, from \$5.1 million in 2006. Average invested assets increased \$78.2 million, or 16.7%, to \$547.5 million in 2007, from \$469.3 million in 2006. The increase in average invested assets reflects cash flows from continued favorable underwriting results and an increase in the duration of our reserves. The increase in the duration of our reserves reflects the impact of growth in our excess liability business, which was implemented at the end of 2003. This type of business has a longer duration than the average reserves on our other programs and is now a larger proportion of reserves. The average investment yield for June 30, 2007, was 4.55%, compared to 4.58% for the comparable period in 2006. The current pre-tax book yield was 4.44%. The current after-tax book yield for the three months ended June 30, 2007 was 3.40%, compared to

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3.26% for the comparable period in 2006. This increase is primarily the result of the shift in our investment portfolio to tax-exempt investments. The duration of the investment portfolio is 4.2 years.

Specialty risk management operations generated pre-tax income of \$10.8 million for the three months ended June 30, 2007, compared to pre-tax income of \$9.3 million for the comparable period in 2006. This increase in pre-tax income primarily reflects growth in net investment income, expansion of cash margins on our gross fee revenue, offset by a slightly more competitive insurance market. The GAAP combined ratio was 97.4% for the three months ended June 30, 2007, compared to 97.2% for the same period in 2006.

Net loss and loss adjustment expenses increased \$2.6 million, or 6.9%, to \$39.7 million for the three months ended June 30, 2007, from \$37.1 million for the same period in 2006. Our loss and LAE ratio increased 1.7 percentage points to 64.1% for the three months ended June 30, 2007, from 62.4% for the same period in 2006. This ratio is the unconsolidated net loss and LAE in relation to net earned premiums. The loss and LAE ratio for the quarter ended June 30, 2007 was impacted by prior year reinsurance premium adjustments related to inception to date reconciliations completed in conjunction with the implementation of a new reinsurance system, which added 0.9 percentage points to the loss and LAE ratio. In addition, a slightly more competitive insurance market resulted in a small increase in the loss ratio.

Our expense ratio decreased 1.5 percentage points to 33.3% for the three months ended June 30, 2007, from 34.8% for the same period in 2006. This ratio is the unconsolidated policy acquisition and other underwriting expenses in relation to net earned premiums. This decrease in the expense ratio in comparison to 2006 is primarily the result of an increase in ceding commissions. The increase in ceding commissions is the result of new quota share program business as well as shifts in the mix of business on existing programs, slightly offset by an increase in insurance related assessments.

*Agency Operations*

The following table sets forth the revenues and results from operations for our agency operations (in thousands):

|                   | <b>For the Three<br/>Months Ended<br/>June 30,</b> |             |
|-------------------|--|-------------|
|                   | <b>2007</b>  | <b>2006</b> |
| Net commission    | \$ 2,860   | \$ 2,878    |
| Pre-tax income(1) | \$ 574   | \$ 614      |

- (1) Our agency operations include an allocation of corporate overhead, which includes expenses associated with accounting, information services, legal, and other corporate services. The corporate overhead allocation excludes those expenses specific to the holding company. For the three months ended June 30, 2007 and 2006, the allocation of corporate overhead to the agency operations segment was \$528,000 and \$771,000, respectively.

Revenue from agency operations, which consists primarily of agency commission revenue, remained relatively flat in comparison to 2006.

Agency operations generated pre-tax income, after the allocation of corporate overhead, of \$574,000 for the three months ended June 30, 2007, compared to \$614,000 for the comparable period in 2006.

**Other Items**

**Reserves**

For the three months ended June 30, 2007, we reported an increase in net ultimate loss estimates for accident years 2006 and prior of \$83,000, or 0.03% of \$302.7 million of net loss and LAE reserves at December 31, 2006. There were no significant changes in the key assumptions utilized in the analysis and calculations of our reserves during 2007 and 2006.

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### **Salary and Employee Benefits and Other Administrative Expenses**

Salary and employee benefits for the three months ended June 30, 2007, decreased \$946,000, or 6.8%, to \$12.9 million, from \$13.8 million for the comparable period in 2006. This decrease primarily reflects a decrease in variable compensation and health benefit costs, offset by merit increases. The decrease in variable compensation reflects the increase in our targeted return on equity. Overall, our headcount remained flat.

Other administrative expenses increased \$465,000, or 6.5%, to \$7.6 million, from \$7.1 million for the comparable period in 2006. This increase is the result of our acquisition of USSU, primarily due to the management fee associated with this acquisition. Offsetting the increases related to USSU were various decreases in other general operating expenses in comparison to 2006.

Salary and employee benefits and other administrative expenses include both corporate overhead and the holding company expenses included in the non-allocated expenses of our segment information.

### **Amortization Expense**

Amortization expense for the three months ended June 30, 2007, increased \$401,000, or 282.4%, to \$543,000, from \$142,000 for the comparable period in 2006. Amortization expense primarily relates to the customer relationships acquired with the Florida based agency operation in 2005 and the acquisition of USSU. The increase in amortization expense is related to our acquisition of USSU.

### **Interest Expense**

Interest expense for the three months ended June 30, 2007, increased \$168,000, or 11.2%, to \$1.7 million, from \$1.5 million for the comparable period in 2006. The increase in interest expense reflects an increase in the outstanding balance on our line of credit associated with borrowings to fund the cash portion of the USSU acquisition. 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 current line of credit. The average outstanding balance on our line of credit during the three months ending June 30, 2007, was \$20.4 million, compared to \$10.1 million for the same period in 2006. The average interest rate, excluding the debentures, was approximately 6.4% in 2007, compared to 6.3% in 2006.

### **Income Taxes**

Income tax expense, which includes both federal and state taxes, for the three months ended June 30, 2007, was \$2.5 million, or 28.6% of income before taxes. For the same period last year, we reflected an income tax expense of \$2.3 million, or 30.1% of income before taxes. The decrease in our tax rate from 2006 to 2007 primarily reflects a higher level of tax exempt securities in our investment portfolio, slightly offset by a higher level of income within our fee-based operations, which are taxed at a 35% rate. Our tax exempt securities as a percentage of total invested assets were 45.3% and 43.3% at June 30, 2007 and 2006, respectively.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our principal sources of funds, which include both regulated and non-regulated cash flows, are insurance premiums, investment income, proceeds from the maturity and sale of invested assets, risk management fees, and agency commissions. Funds are primarily used for the payment of claims, commissions, salaries and employee benefits, other operating expenses, shareholders' dividends, share repurchases, and debt service. Our regulated sources of funds are insurance premiums, investment income, and proceeds from the maturity and sale of invested assets. These regulated

funds are used for the payment of claims, policy acquisition and other underwriting expenses, and taxes relating to the regulated portion of net income. Our non-regulated sources of funds are in the form of commission revenue, outside management fees, and intercompany management fees. Our capital resources include both non-regulated cash flow and excess capital in our Insurance Company Subsidiaries, which is defined as the dividend Star may issue without prior approval from our regulators. We review the excess capital in aggregate to determine the use of such capital. The general uses are as follows, contributions to our Insurance Company Subsidiaries to support premium growth, make select acquisitions, service debt, pay shareholders dividends,

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repurchase shares, investments in technology, or other expenses of the holding company. The following table illustrates net income, excluding interest, depreciation, and amortization, between our regulated and non-regulated subsidiaries, which reconciles to our consolidated statement of income and statement of cash flows (in thousands):

|  | <b>For the Six Months<br/>Ended June 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                                  | <b>2006</b> |
| Net income   | \$ 13,109                                    | \$ 11,000   |
| Insurance Company Subsidiaries:  |  |             |
| Net income   | \$ 11,071                                    | \$ 9,535    |
| Adjustments to reconcile net income to net cash provided by operating activities           | 158  | 1,057       |
| Changes in operating assets and liabilities  | 9,732  | 8,696       |
| Total adjustments  | 9,890  | 9,753       |
| Net cash provided by operating activities  | \$ 20,961                                    | \$ 19,288   |
| Fee-based Subsidiaries:  |  |             |
| Net income   | \$ 2,038                                     | \$ 1,465    |
| Depreciation   | 1,525  | 1,121       |
| Amortization   | 687  | 307         |
| Interest   | 3,154  | 2,887       |
| Net income, excluding interest, depreciation, and amortization                             | 7,404  | 5,780       |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities | 2,452  | 1,629       |
| Changes in operating assets and liabilities  | (3,214)                                      | (5,333)     |
| Total adjustments  | (762)  | (3,703)     |
| Depreciation   | (1,525)                                      | (1,121)     |
| Amortization   | (687)  | (307)       |
| Interest   | (3,154)                                      | (2,887)     |
| Net cash provided by (used in) operating activities  | \$ 1,276                                     | \$ (2,238)  |
| Consolidated total adjustments   | 9,128  | 6,050       |
| Consolidated net cash provided by operating activities                                     | \$ 22,237                                    | \$ 17,050   |



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|  | <b>For the Three Months<br/>Ended June 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                                    | <b>2006</b> |
| Net income   | \$ 6,186                                       | \$ 5,375    |
| Insurance Company Subsidiaries:  |  |             |
| Net income   | \$ 5,455                                       | \$ 4,952    |
| Adjustments to reconcile net income to net cash provided by operating activities           | (283)  | 723         |
| Changes in operating assets and liabilities  | (1,551)  | 740         |
| Total adjustments  | (1,834)  | 1,463       |
| Net cash provided by operating activities  | \$ 3,621                                       | \$ 6,415    |
| Fee-based Subsidiaries:  |  |             |
| Net income   | \$ 731   | \$ 423      |
| Depreciation   | 788  | 578         |
| Amortization   | 543  | 142         |
| Interest   | 1,667  | 1,499       |
| Net income, excluding interest, depreciation, and amortization                             | 3,729  | 2,642       |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities | 879  | 1,052       |
| Changes in operating assets and liabilities  | (146)  | (3,913)     |
| Total adjustments  | 733  | (2,861)     |
| Depreciation   | (788)  | (578)       |
| Amortization   | (543)  | (142)       |
| Interest   | (1,667)  | (1,499)     |
| Net cash provided by (used in) operating activities  | \$ 1,464                                       | \$ (2,438)  |
| Consolidated total adjustments   | (1,101)  | (1,398)     |
| Consolidated net cash provided by operating activities                                     | \$ 5,085                                       | \$ 3,977    |

Consolidated cash flow provided by operations for the six months ended June 30, 2007, was \$22.2 million, compared to consolidated cash flow provided by operations of \$17.0 million for the comparable period in 2006.

Regulated subsidiaries cash flow provided by operations for the six months ended June 30, 2007, was \$21.0 million, compared to \$19.3 million for the comparable period in 2006. This increase is the result of growth in our underwritten business and timing of premium collections, as well as an increase in investment income as a result of growth in our investment portfolio. Partially offsetting these improvements was an increase in paid losses and payments related to policy acquisition costs.

Non-regulated subsidiaries' cash flow provided by operations for the six months ended June 30, 2007, was \$1.3 million, compared to cash flow used in operations of \$2.2 million for the comparable period in 2006. The increase in cash flow from operations is primarily the result of income tax refunds received from our Insurance Company Subsidiaries through our Intercompany Tax Allocation Agreement, as well as a slight increase in fee-based revenues. This increase in cash flow was partially offset by variable compensation payments related to our long-term incentive plan, which were made in the first quarter of 2007 and related to 2006 performance and profitability.

We continue to anticipate a temporary increase in cash outflows related to our investments in technology as we enhance our operating systems and controls. We believe these temporary increases will not affect our liquidity, debt covenants, or other key financial measures.

**Table of Contents****Other Items****Long-term Debt**

The following table summarizes the principal amounts and variables associated with our long-term debt (in thousands):

| Year of Issuance | Description                    | Year Callable | Year Due | Interest Rate Terms           | Interest         |                  |
|------------------|--------------------------------|---------------|----------|-------------------------------|------------------|------------------|
|                  |                                |               |          |                               | Rate at 06/30/07 | Principal Amount |
| 2003             | Junior subordinated debentures | 2008          | 2033     | Three-month LIBOR, plus 4.05% | 9.40%            | \$ 10,310        |
| 2004             | Senior debentures              | 2009          | 2034     | Three-month LIBOR, plus 4.00% | 9.36%            | 13,000           |
| 2004             | Senior debentures              | 2009          | 2034     | Three-month LIBOR, plus 4.20% | 9.56%            | 12,000           |
| 2005             | Junior subordinated debentures | 2010          | 2035     | Three-month LIBOR, plus 3.58% | 8.94%            | 20,620           |
|                  |                                |               |          |                               | Total            | \$ 55,930        |

We received a total of \$53.3 million in net proceeds from the issuances of the above long-term debt, \$26.2 million of which was contributed to the surplus of our Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes. Associated with the issuance of the above long-term debt we incurred approximately \$1.7 million in issuance costs for commissions paid to the placement agents in the transactions. These issuance costs have been capitalized and are included in other assets on the balance sheet, which are being amortized over seven years as a component of interest expense. The seven year amortization period represents our best estimate of the estimated useful life of the bonds related to both the senior debentures and junior subordinated debentures.

**Interest Rate Swaps**

In October 2005, we entered into two interest rate swap transactions to mitigate our interest rate risk on \$5.0 million and \$20.0 million of our senior debentures and trust preferred securities, respectively. In accordance with Statement of Financial Accounting Standards ( SFAS ) No. 133 *Accounting for Derivative Instruments and Hedging Activities*, these interest rate swap transactions were recorded at fair value on the balance sheet and any changes in their fair value are accounted for within other comprehensive income. The interest differential to be paid or received is accrued and is recognized as an adjustment to interest expense.

The first interest rate swap transaction, which relates to \$5.0 million of our \$12.0 million issuance of senior debentures, has an effective date of October 6, 2005 and ending date of May 24, 2009. We are required to make certain quarterly fixed rate payments calculated on a notional amount of \$5.0 million, non-amortizing, based on a fixed annual interest rate of 8.925%. The counterparty is obligated to make quarterly floating rate payments to us referencing the same notional amount, based on the three-month LIBOR, plus 4.20%.

The second interest rate swap transaction, which relates to \$20.0 million of our \$20.0 million issuance of trust preferred securities, has an effective date of October 6, 2005 and ending date of September 16, 2010. We are required

to make quarterly fixed rate payments calculated on a notional amount of \$20.0 million, non-amortizing, based on a fixed annual interest rate of 8.34%. The counterparty is obligated to make quarterly floating rate payments to us referencing the same notional amount, based on the three-month LIBOR, plus 3.58%.

In relation to the above interest rate swaps, the net interest income received for the six months ended June 30, 2007, was approximately \$76,000. The net interest expense incurred for the six months ended June 30, 2006, was approximately \$9,000. For the three months ended June 30, 2007, the net interest income received was approximately \$38,000, compared to \$9,000 for the comparable period in 2006. The total fair value of the interest rate swaps as of June 30, 2007 and December 31, 2006, was approximately \$373,000 and \$200,000, respectively. Accumulated other comprehensive income at June 30, 2007 and December 31, 2006, included the accumulated income on the cash flow hedge, net of taxes, of \$243,000 and \$130,000, respectively.

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### ***Revolving Line of Credit***

In April 2007, we executed an amendment to our current revolving credit agreement with our bank. The amendments included an extension of the term to September 30, 2010, an increase to the available borrowings up to \$35.0 million, and a reduction of the variable interest rate basis to a range between 75 to 175 basis points above LIBOR. We use the revolving line of credit to meet short-term working capital needs. Under the revolving line of credit, we and certain of our non-regulated subsidiaries pledged security interests in certain property and assets of named subsidiaries.

At June 30, 2007 and December 31, 2006, we had an outstanding balance of \$22.0 million and \$7.0 million relating to our revolving line of credit, respectively.

The revolving line of credit provides for interest at a variable rate based, at our option, upon either a prime based rate or LIBOR-based rate. In addition, the revolving line of credit also provides for an unused facility fee. On prime based borrowings, the applicable margin ranges from 75 to 25 basis points below prime. On LIBOR-based borrowings, the applicable margin ranges from 75 to 175 basis points above LIBOR. The margin for all loans is dependent on the sum of non-regulated earnings before interest, taxes, depreciation, amortization, and non-cash impairment charges related to intangible assets for the preceding four quarters, plus dividends paid or payable to us from subsidiaries during such period ( Adjusted EBITDA ). As of June 30, 2007, the average interest rate for LIBOR-based borrowings was 6.4%.

Debt covenants consist of: (1) maintenance of the ratio of Adjusted EBITDA to interest expense of 2.0 to 1.0, (2) minimum net worth of \$130.0 million and increasing annually, commencing June 30, 2005, by fifty percent of the prior year's positive net income, (3) minimum A.M. Best rating of B , and (4) on an annual basis, a minimum Risk Based Capital Ratio for Star of 1.75 to 1.00. As of June 30, 2007, we were in compliance with these covenants.

### ***Shareholders' Equity***

At June 30, 2007, shareholders' equity was \$219.3 million, or \$7.18 per common share, compared to \$201.7 million, or \$6.93 per common share, at December 31, 2006.

On October 28, 2005, our Board of Directors authorized management to purchase up to 1,000,000 shares of our common stock in market transactions for a period not to exceed twenty-four months. For the six months ended June 30, 2007 and the year ended December 31, 2006, we did not repurchase any common stock. As of June 30, 2007, the cumulative amount we repurchased and retired under our current share repurchase plan was 63,000 shares of common stock for a total cost of approximately \$372,000. As of June 30, 2007, we have available up to 937,000 shares remaining to be purchased.

On February 8, 2007, our Board of Directors and the Compensation Committee of the Board of Directors approved the distribution of our LTIP award for the 2004-2006 plan years, which included both a cash and stock award. The stock portion of the LTIP award was valued at \$2.5 million, which resulted in the issuance of 579,496 shares of our common stock. Of the 579,496 shares issued, 191,570 shares were retired for payment of the participant's associated withholding taxes related to the compensation recognized by the participant. Refer to Note 2 ~ *Stock Options, Long Term Incentive Plan, and Deferred Compensation Plan* for further detail. The retirement of the shares for the associated withholding taxes reduced our paid in capital by \$1.8 million.

In April 2007, we purchased the business of USSU for a purchase price of \$23.0 million. This purchased price was comprised of \$13.0 million in cash and \$10.0 million in our common stock. Total additional shares issued for the \$10.0 million portion of the purchase price were 907,935 shares.

### ***Recent Acquisition***

As previously mentioned, we acquired the business of USSU, in April 2007, for a purchase price of \$23.0 million. Under the terms of the Agreement, we acquired the excess workers' compensation business and other related assets. USSU is based in Cleveland, Ohio, and is a specialty program manager that produces fee based income by underwriting excess workers' compensation coverage for a select group of insurance companies.

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In addition, we entered into a Management Agreement with the shareholder of USSU. Under the terms and conditions of the Management Agreement, the shareholder is responsible for the day to day administration and management of the acquired business. The shareholder's consideration for the performance of its duties shall be in the form of a Management Fee payable by us based on a share of net income before interest, taxes, depreciation, and amortization. In addition, we can terminate the Management Agreement in the future, at our discretion, based on a multiple of the Management Fee calculated for the trailing twelve months and subject to the terms and conditions of the Agreement.

Goodwill associated with this acquisition was approximately \$12.0 million. In addition, we recorded an increase to other intangible assets of approximately \$9.6 million. These other intangible assets related to customer relationships acquired with the acquisition. We determined that the estimated useful life of the other intangible assets to be approximately five years. As such, we will amortize the \$9.6 million in other intangible assets over a five year period.

**Adjusted Expense Ratio**

Included in our GAAP expense ratio is the impact of the margin associated with our fee-based operations. If the profit margin from our fee-for-service business is recognized as an offset to our underwriting expense, a more realistic picture of our operating efficiency emerges. The following table illustrates our adjusted expense ratio, which reflects the GAAP expense ratio of our insurance company subsidiaries, net of the pre-tax profit, excluding investment income, of our fee-for-service and agency subsidiaries (in thousands):

|   | <b>For the Six Months Ended<br/>June 30,</b> |             | <b>For the Three Months<br/>Ended June 30,</b> |             |
|---|--|-------------|--|-------------|
|   | <b>2007</b>                                  | <b>2006</b> | <b>2007</b>                                    | <b>2006</b> |
| Net earned premiums   | \$ 132,395                                   | \$ 127,638  | \$ 67,191                                      | \$ 64,514   |
| Less: Consolidated net loss and LAE                               | 76,353                                       | 74,189      | 39,707   | 37,146      |
| Intercompany claim fees   | 6,648  | 6,273       | 3,353  | 3,115       |
| Unconsolidated net loss and LAE                                   | 83,001                                       | 80,462      | 43,060   | 40,261      |
| Consolidated policy acquisition and other underwriting expenses   | 26,812                                       | 24,604      | 13,169   | 13,180      |
| Intercompany administrative and other underwriting fees           | 18,330                                       | 18,408      | 9,178  | 9,291       |
| Unconsolidated policy acquisition and other underwriting expenses | 45,142                                       | 43,012      | 22,347   | 22,471      |
| Underwriting income   | \$ 4,252                                     | \$ 4,164    | \$ 1,784                                       | \$ 1,782    |
| GAAP combined ratio as reported                                   | 96.8%  | 96.7%       | 97.4%  | 97.2%       |
| Specialty risk management operations pre-tax income               | \$ 22,020                                    | \$ 18,632   | \$ 10,768                                      | \$ 9,334    |
| Less: Underwriting income   | 4,252  | 4,164       | 1,784  | 1,782       |
| Net investment income and capital gains                           | 12,399                                       | 10,637      | 6,249  | 5,405       |
| Fee-based operations pre-tax income                               | 5,369  | 3,831       | 2,735  | 2,147       |
| Agency operations pre-tax income                                  | 1,868  | 2,265       | 574  | 614         |

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|   |              |              |              |              |
|---|--------------|--------------|--------------|--------------|
| Total fee-for-service pre-tax income                                      | \$ 7,237     | \$ 6,096     | \$ 3,309     | \$ 2,761     |
| GAAP expense ratio as reported  | 34.1%        | 33.7%        | 33.3%        | 34.8%        |
| Adjustment to include pre-tax income from total fee-for-service income(1) | 5.5%         | 4.8%         | 4.9%         | 4.3%         |
| <b>GAAP expense ratio as adjusted</b>                                     | <b>28.6%</b> | <b>28.9%</b> | <b>28.3%</b> | <b>30.6%</b> |
| GAAP loss and LAE ratio as reported                                       | 62.7%        | 63.0%        | 64.1%        | 62.4%        |
| GAAP combined ratio as adjusted   | 91.3%        | 92.0%        | 92.4%        | 93.0%        |



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|  | <b>For the Six Months<br/>Ended<br/>June 30,</b> |             | <b>For the Three Months<br/>Ended June 30,</b> |             |
|--|--|-------------|--|-------------|
|  | <b>2007</b>                                      | <b>2006</b> | <b>2007</b>                                    | <b>2006</b> |
| <b><u>Reconciliation of consolidated pre-tax income:</u></b> |  |             |  |             |
| Specialty risk management operations pre-tax income:         |  |             |  |             |
| Fee-based operations pre-tax income                          | \$ 5,369   | \$ 3,831    | \$ 2,735                                       | \$ 2,147    |
| Underwriting income  | 4,252  | 4,164       | 1,784  | 1,782       |
| Net investment income and capital gains                      | 12,399   | 10,637      | 6,249  | 5,405       |
| Total specialty risk management operations pre-tax income    | 22,020   | 18,632      | 10,768   | 9,334       |
| Agency operations pre-tax income                             | 1,868  | 2,265       | 574  | 614         |
| Less: Holding company expenses                               | 1,389  | 1,569       | 533  | 636         |
| Interest expense   | 3,154  | 2,887       | 1,667  | 1,499       |
| Amortization expense   | 687  | 307         | 543  | 142         |
| Consolidated pre-tax income                                  | \$ 18,658  | \$ 16,134   | \$ 8,599                                       | \$ 7,671    |

- (1) Adjustment to include pre-tax income from total fee-for-service income is calculated by dividing total fee-for-service income by net earned premiums.

**Regulatory**

A significant portion of our consolidated assets represent assets of our Insurance Company Subsidiaries. The State of Michigan Office of Financial and Insurance Services ( OFIS ), restricts the amount of funds that may be transferred to us in the form of dividends, loans or advances. These restrictions in general, are as follows: the maximum discretionary dividend that may be declared, based on data from the preceding calendar year, is the greater of each insurance company s net income (excluding realized capital gains) or ten percent of the insurance company s surplus (excluding unrealized gains). These dividends are further limited by a clause in the Michigan law that prohibits an insurer from declaring dividends except out of surplus earnings of the company. Earned surplus balances are calculated on a quarterly basis. Since Star is the parent insurance company, its maximum dividend calculation represents the combined Insurance Company Subsidiaries surplus. At June 30, 2007, Star s earned surplus position was positive \$26.3 million. At December 31, 2006, Star had positive earned surplus of \$13.2 million. As of June 30, 2007, Star may pay a dividend of up to \$16. 5 million without the prior approval of OFIS, which is ten percent of statutory surplus as of year end 2006. No statutory dividends were paid during 2006 or during the six months ended June 30, 2007.

**Contractual Obligations and Commitments**

With the exception of our line of credit balance, there were no other material changes outside the ordinary course of our business in relation to our contractual obligations and commitments for the three months and six months ended June 30, 2007. In regard to our line of credit and as a result of our recent equity offering disclosed below in *Subsequent Events*, we utilized a portion of the net proceeds received from the equity offering to reduce our line of credit balance to zero.

## **Regulatory and Rating Issues**

The National Association of Insurance Commissioners ( NAIC ) has adopted a risk-based capital ( RBC ) formula to be applied to all property and casualty insurance companies. The formula measures required capital and surplus based on an insurance company s products and investment portfolio and is used as a tool to evaluate the capital of regulated companies. The RBC formula is used by state insurance regulators to monitor trends in statutory capital and surplus for the purpose of initiating regulatory action. In general, an insurance company must submit a calculation of its RBC formula to the insurance department of its state of domicile as of the end of the previous calendar year. These laws require increasing degrees of regulatory oversight and intervention as an insurance company s RBC declines. The level of regulatory oversight ranges from requiring the insurance company to inform

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and obtain approval from the domiciliary insurance commissioner of a comprehensive financial plan for increasing its RBC to mandatory regulatory intervention requiring an insurance company to be placed under regulatory control in a rehabilitation or liquidation proceeding.

At December 31, 2006, each of our Insurance Company Subsidiaries was in excess of any minimum threshold at which corrective action would be required.

Insurance operations are subject to various leverage tests (e.g. premium to statutory surplus ratios), which are evaluated by regulators and rating agencies. Our targets for gross and net written premium to statutory surplus are 2.8 to 1.0 and 2.25 to 1.0, respectively. As of June 30, 2007, on a statutory consolidated basis, gross and net premium leverage ratios were 1.9 to 1.0 and 1.6 to 1.0, respectively.

## **Reinsurance**

Intercompany pooling agreements are commonly entered into between affiliated insurance companies, so as to allow the companies to utilize the capital and surplus of all of the companies, rather than each individual company. Under pooling arrangements, companies share in the insurance business that is underwritten and allocate the combined premium, losses and related expenses between the companies within the pooling arrangement. The Insurance Company Subsidiaries entered into an Inter-Company Reinsurance Agreement (the Pooling Agreement). This Pooling Agreement includes Star, Ameritrust Insurance Corporation (Ameritrust), Savers Property and Casualty Insurance Company (Savers) and Williamsburg National Insurance Company (Williamsburg). Pursuant to the Pooling Agreement, Savers, Ameritrust and Williamsburg have agreed to cede to Star and Star has agreed to reinsure 100% of the liabilities and expenses of Savers, Ameritrust and Williamsburg, relating to all insurance and reinsurance policies issued by them. In return, Star agreed to cede and Savers, Ameritrust and Williamsburg have agreed to reinsure Star for their respective percentages of the liabilities and expenses of Star. Annually, we examine the Pooling Agreement for any changes to the ceded percentage for the liabilities and expenses. Any changes to the Pooling Agreement must be submitted to the applicable regulatory authorities for approval.

## **Convertible Note**

In July 2005, we made a \$2.5 million loan, at an effective interest rate equal to the three-month LIBOR, plus 5.2%, to an unaffiliated insurance agency. In December 2005, we loaned an additional \$3.5 million to the same agency. The original \$2.5 million demand note was replaced with a \$6.0 million convertible note. The effective interest rate of the convertible note is equal to the three-month LIBOR, plus 5.2% and is due December 20, 2010. This agency has been a producer for us for over ten years. As security for the loan, the borrower granted us a security interest in its accounts, cash, general intangibles, and other intangible property. Also, the shareholder then pledged 100% of the common shares of three insurance agencies, the common shares owned by the shareholder in another agency, and has executed a personal guaranty. This note is convertible upon our option based upon a pre-determined formula, beginning in 2008. The conversion feature of this note is considered an embedded derivative pursuant to SFAS No. 133, and therefore is accounted for separately from the note. At June 30, 2007, the estimated fair value of the derivative was not material to the financial statements.

## **Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, which becomes effective for fiscal years beginning after November 15, 2007. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. We will evaluate the impact of SFAS No. 157, but believe the adoption of SFAS No. 157 will not have a material impact on

our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. SFAS No. 159 will permit entities the option to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis as of specified election dates. This election is irrevocable. The objective of

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SFAS No. 159 is to improve financial reporting and reduce the volatility in reported earnings caused by measuring related assets and liabilities differently. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are in the process of evaluating the potential impact SFAS No. 159 will have on our consolidated financial statements.

## **Subsequent Events**

On July 19, 2007, we completed a secondary offering of 5,500,000 additional shares of our common stock at a price of \$9.65 per share. In addition, the underwriters for the offering exercised their over-allotment option of 937,500 additional shares. We received total gross proceeds of \$62.1 million. Including the underwriting discount associated with the offering and other estimated expenses, we received total net proceeds of approximately \$58.6 million. These net proceeds will be utilized to support organic growth within our underwriting operations, fund potential select acquisitions and for other general corporate purposes. Upon receipt of the net proceeds, we reduced our \$22.0 million line of credit balance to zero.

After consideration of the equity offering our pro forma shareholders' equity increased to \$277.9 million, or \$7.52 per common share. Our debt to equity ratio decreased to 20.1% after consideration of the pay down of our line of credit to zero.

## **ITEM 3. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***

Market risk is the risk of loss arising from adverse changes in market rates and prices, such as interest rates as well as other relevant market rate or price changes. The volatility and liquidity in the markets in which the underlying assets are traded directly influence market risk. The following is a discussion of our primary risk exposures and how those exposures are currently managed as of June 30, 2007. 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 June 30, 2007, our fixed income portfolio had a modified duration of 4.11, compared to 3.93 at December 31, 2006.

At June 30, 2007, the fair value of our investment portfolio was \$515.7 million. Our market risk to the investment portfolio is interest rate risk associated with debt securities. Our exposure to equity price risk is not significant. 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 return to profitability and 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, 2006. 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 in fair value 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 rounded and in thousands.

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|                           | <b>Rates Down<br/>100bps</b> | <b>Rates<br/>Unchanged</b> | <b>Rates Up<br/>100bps</b> |
|---------------------------|------------------------------|----------------------------|----------------------------|
| Market Value              | \$ 538,254                   | \$ 515,689                 | \$ 492,772                 |
| Yield to Maturity or Call | 3.87%                        | 4.87%                      | 5.87%                      |
| Effective Duration        | 4.09                         | 4.36                       | 4.54                       |

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 loss in fair values.

Our debentures are subject to variable interest rates. Thus, our interest expense on these debentures is directly correlated to market interest rates. At June 30, 2007 and December 31, 2006, we had debentures of \$55.9 million. At this level, a 100 basis point (1%) change in market rates would change annual interest expense by \$559,000.

In October 2005, we entered into two interest rate swap transactions to mitigate our interest rate risk on \$5.0 million and \$20.0 million of our senior debentures and trust preferred securities, respectively. We recognized these transactions in accordance with SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities*, as subsequently amended. These interest rate swap transactions have been designated as cash flow hedges and are deemed highly effective hedges under SFAS No. 133. In accordance with SFAS No. 133, these interest rate swap transactions are recorded at fair value on the balance sheet and the effective portion of any changes in fair value are accounted for within other comprehensive income. The interest differential to be paid or received is being accrued and is being recognized as an adjustment to interest expense.

In addition, our revolving line of credit under which we can borrow up to \$35.0 million is subject to variable interest rates. Thus, our interest expense on the revolving line of credit is directly correlated to market interest rates. At June 30, 2007, we had \$22.0 million outstanding on this revolving line of credit. At this level, a 100 basis point (1%) change in market rates would have changed interest expense by \$220,000. At December 31, 2006, we had \$7.0 million outstanding. At this level, a 100 basis point (1%) change in market rates would have changed interest expense by \$70,000.

**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 management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. There are inherent limitations to the effectiveness of any control system. A control system, no matter how well conceived and operated, can provide only reasonable assurance that its objectives are met. No evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

As of June 30, 2007, 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.



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**Changes in Internal Control over Financial Reporting**

There were no significant changes in our internal control over financial reporting during the three month period ended June 30, 2007, which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

The information required by this item is included under Note 10 *Commitments and Contingencies* of the Notes to the Consolidated Financial Statements of the Company's Form 10-Q for the six months ended June 30, 2007, which is hereby incorporated by reference.

**ITEM 1A. RISK FACTORS**

The discussion appearing under the caption **RISK FACTORS** of the Company's Prospectus Supplement filed with the Securities and Exchange Commission (the **Commission**) on July 19, 2007, which forms a part of the Registration Statement on Form S-3 which was declared effective by the Commission on July 6, 2007 (Registration #333-143244) is incorporated herein by reference.

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

In October 2005, the Company's Board of Directors authorized management to repurchase up to 1,000,000 shares, or approximately 3%, of its common stock in market transactions for a period not to exceed twenty-four months.

For the three months ended June 30, 2007, the Company did not purchase and retire any shares of common stock. The maximum number of shares that may yet be repurchased under the Company's current share repurchase plan is 937,000 shares, as reported in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

On May 9, 2007, the Company held its Annual Meeting of Shareholders ( **Annual Meeting** ) to consider and act upon the following proposals:

- (1) The election of four members to the Board of Directors of the Company;
- (2) Ratification of the appointment of the Company's independent registered public accounting firm, Ernst & Young LLP; and
- (3) Amend the Company's Articles of Incorporation to increase the number of authorized shares of Common Stock from 50,000,000 to 75,000,000.

The following directors stood for election at the Annual Meeting: (1) Merton J. Segal; (2) Joseph S. Dresner; (3) David K. Page; and (4) Herbert Tyner. The shareholders re-elected the directors at the Annual Meeting and therefore, each shall continue in office. The vote tabulation for each director was: (1) Merton J. Segal 25,517,316 in favor and 1,305,308 withheld; (2) Joseph S. Dresner 25,915,504 in favor and 907,120 withheld; (3) David K. Page 25,499,516 in favor and 1,323,108 withheld; and (4) Herbert Tyner 25,499,516 in favor and 1,323,108 withheld. Other directors continuing in office after the meeting were as follows: Robert S. Cubbin, Hugh W. Greenberg, Florine

Mark, Robert H. Naftaly, Robert W. Sturgis, and Bruce E. Thal.

**Table of Contents****PART II OTHER INFORMATION**

The shareholders ratified the appointment of Ernst & Young LLP by a vote of 26,799,926 in favor, 11,928 against and 10,770 abstained.

The shareholders approved the amendment to the Company's Articles of Incorporation to increase the number of authorized shares of Common Stock from 50,000,000 to 75,000,000 by a vote of 24,853,785 in favor, 1,936,756 against and 32,083 abstained.

**ITEM 6. EXHIBITS**

The following documents are filed as part of this Report:

| <b>Exhibit<br/>No.</b> | <b>Description</b> |
|------------------------|--------------------|
|------------------------|--------------------|

- |      |  |
|------|--|
| 3.1  | Amended and Restated Articles of Incorporation of the Company.   |
| 10.1 | Fourth Amendment to Credit Agreement between Meadowbrook Insurance Group, Inc., Meadowbrook, Inc., Crest Financial Corporation, and LaSalle Bank Midwest National Association, dated as of April 10, 2007 (incorporated by reference to Exhibit 10.1 from Current Report on Form 8-K filed on April 12, 2007). |
| 10.2 | First Amendment to Promissory Note between Meadowbrook Insurance Group, Inc. and LaSalle Bank Midwest National Association, dated as of April 10, 2007 (incorporated by reference to Exhibit 10.2 from Current Report on Form 8-K filed on April 12, 2007).  |
| 10.3 | Asset Purchase Agreement, dated April 16, 2007 (incorporated by reference to Exhibit 10.1 from Current Report on Form 8-K filed on April 18, 2007).  |
| 10.4 | Management Fee Agreement, dated April 16, 2007 (incorporated by reference to Exhibit 10.2 from Current Report on Form 8-K filed on April 18, 2007).  |
| 10.5 | Underwriting Agreement, dated July 18, 2007, among Meadowbrook Insurance Group, Inc., certain of its shareholders and KeyBanc Capital Markets Inc. (incorporated by reference to Exhibit 1.1 from Current Report on Form 8-K filed on July 23, 2007).  |
| 10.6 | At-Will Employment and Severance Agreement by and among Meadowbrook, Inc., Meadowbrook Insurance Group, Inc. and James M. Mahoney, dated August 1, 2007.   |
| 10.7 | At-Will Employment and Severance Agreement by and among Meadowbrook, Inc., Meadowbrook Insurance Group, Inc. and Joseph E. Mattingly, dated August 1, 2007.  |
| 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: August 9, 2007

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**EXHIBIT INDEX**

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| 10.3                   | Asset Purchase Agreement, dated April 16, 2007 (incorporated by reference to Exhibit 10.1 from Current Report on Form 8-K filed on April 18, 2007).  |
| 10.4                   | Management Fee Agreement, dated April 16, 2007 (incorporated by reference to Exhibit 10.2 from Current Report on Form 8-K filed on April 18, 2007).  |
| 10.5                   | Underwriting Agreement, dated July 18, 2007, among Meadowbrook Insurance Group, Inc., certain of its shareholders and KeyBanc Capital Markets Inc. (incorporated by reference to Exhibit 1.1 from Current Report on Form 8-K filed on July 23, 2007).  |
| 10.6                   | At-Will Employment and Severance Agreement by and among Meadowbrook, Inc., Meadowbrook Insurance Group, Inc. and James M. Mahoney, dated August 1, 2007.   |
| 10.7                   | At-Will Employment and Severance Agreement by and among Meadowbrook, Inc., Meadowbrook Insurance Group, Inc. and Joseph E. Mattingly, dated August 1, 2007.  |
| 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.  |