MEADOWBROOK INSURANCE GROUP INC
Form 10-Q
November 10, 2014

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

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2014
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number 1-14094

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

Michigan	38-2626206
(State of Incorporation)	(IRS Employer Identification No.)

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

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

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

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

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

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

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

The aggregate number of shares of the Registrant's Common Stock, $.01 par value, outstanding on November 3, 2014, was 50,093,690.

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PART I – FINANCIAL INFORMATION

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PART 1 - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF INCOME

For the Three Months Ended September 30,

	2014	2013
	(Unaudited)	
	(In thousands, except share data)	
Revenues		
Premiums earned		
Gross	$200,822	$260,273
Ceded	(39,073)	(79,217)
Net earned premiums	161,749	181,056
Net commissions and fees	11,960	10,458
Net investment income	11,087	11,695
Realized gains:		
Total other-than-temporary impairments on securities	-	-
Portion of loss recognized in other comprehensive income	-	-
Net other-than-temporary impairments on securities recognized in earnings	-	-
Net realized gains excluding other-than-temporary impairments on securities	2,973	675
Net realized gains	2,973	675
Total revenues	187,769	203,884
Expenses		
Losses and loss adjustment expenses	141,753	197,314
Reinsurance recoveries	(35,095)	(65,067)
Net losses and loss adjustment expenses	106,658	132,247
Policy acquisition and other underwriting expenses	60,816	54,228
General, selling and administrative expenses	9,949	7,026
General corporate expenses	1,372	1,025
Amortization expense	1,011	1,037
Interest expense	3,506	3,581
Total expenses	183,312	199,144
Income before taxes and equity earnings	4,457	4,740
Federal and state income tax expense	445	356
Equity earnings of affiliates, net of tax	953	1,164
Equity earnings of unconsolidated subsidiaries, net of tax	2	(32)
Net income	$4,967	$5,516
Earnings Per Share		
Basic	$0.09	$0.11
Diluted	$0.09	$0.11
Weighted average number of common shares		
Basic	50,092,755	49,887,200

Diluted	50,092,755	49,933,540
Dividends paid per common share	$0.02	$0.02

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

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MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF INCOME

For the Nine Months Ended September 30,

	2014	2013
	(Unaudited) (In thousands, except share data)	
Revenues		
Premiums earned		
Gross	$630,275	$789,468
Ceded	(141,864)	(262,043)
Net earned premiums	488,411	527,425
Net commissions and fees	33,349	28,631
Net investment income	33,557	34,603
Realized gains:		
Total other-than-temporary impairments on securities	-	-
Portion of loss recognized in other comprehensive income	-	-
Net other-than-temporary impairments on securities recognized in earnings	-	-
Net realized gains excluding other-than-temporary impairments on securities	9,252	3,860
Net realized gains	9,252	3,860
Total revenues	564,569	594,519
Expenses		
Losses and loss adjustment expenses	423,991	590,095
Reinsurance recoveries	(104,483)	(190,661)
Net losses and loss adjustment expenses	319,508	399,434
Policy acquisition and other underwriting expenses	179,373	163,283
General, selling and administrative expenses	25,196	18,950
General corporate expenses	4,420	3,301
Amortization expense	2,959	3,146
Goodwill impairment expense	-	115,397
Interest expense	10,440	9,431
Total expenses	541,896	712,942
Income (loss) before taxes and equity earnings	22,673	(118,423)
Federal and state income tax expense (benefit)	4,474	(15,412)
Equity earnings of affiliates, net of tax	2,870	2,547
Equity earnings of unconsolidated subsidiaries, net of tax	18	4
Net income (loss)	$21,087	$(100,460)
Earnings (Losses) Per Share		
Basic	$0.42	$(2.01)
Diluted	$0.42	$(2.01)
Weighted average number of common shares		
Basic	50,054,031	49,866,326
Diluted	50,054,031	49,866,326
Dividends paid per common share	$0.06	$0.06

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

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MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Three Months Ended September 30,

	2014	2013
	(Unaudited)	
	(In thousands)	
Net income	$4,967	$5,516
Other comprehensive income, net of tax:		
Unrealized (losses) gains on securities	(932)	3,243
Unrealized gains (losses) in affiliates and unconsolidated subsidiaries	41	(316)
Increase on non-credit other-than-temporary impairments on securities	-	-
Net deferred derivative gains - hedging activity	232	140
Less reclassification adjustment for investment gains included in net income	(1,933)	(457)
Other comprehensive (losses) gains, net of tax	(2,592)	2,610
Comprehensive income	$2,375	$8,126

MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Nine Months Ended September 30,

	2014	2013
	(Unaudited)	
	(In thousands)	
Net income (loss)	$21,087	$(100,460)
Other comprehensive income (loss), net of tax:		
Unrealized gains (losses) on securities	22,819	(32,026)
Unrealized gains (losses) in affiliates and unconsolidated subsidiaries	159	(254)
Increase on non-credit other-than-temporary impairments on securities	-	-
Net deferred derivative (losses) gains - hedging activity	(973)	3,178
Less reclassification adjustment for investment gains included in net income	(6,014)	(2,534)
Other comprehensive gains (losses), net of tax	15,991	(31,636)
Comprehensive income (loss)	$37,078	$(132,096)

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

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MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED BALANCE SHEETS

	September 30, 2014 (Unaudited)	December 31, 2013
	(In thousands, except share data)	
ASSETS		
Investments		
Debt securities available for sale, at fair value (amortized cost of $1,445,409 and $1,455,754 in 2014 and 2013, respectively)	$1,480,162	$1,463,046
Equity securities available for sale, at fair value (cost of $94,158 and $95,346 in 2014 and 2013, respectively)	106,870	109,982
Cash and cash equivalents	106,084	94,776
Accrued investment income	14,759	14,266
Premiums and agent balances receivable (net allowance of $5,410 and $5,094 in 2014 and 2013 respectively)	188,995	214,144
Reinsurance recoverable on:		
Paid losses	8,358	14,453
Unpaid losses	537,879	505,431
Prepaid reinsurance premiums	34,620	63,908
Deferred policy acquisition costs	65,128	62,773
Deferred income taxes, net	28,520	41,435
Goodwill	6,857	5,644
Other intangible assets	22,911	24,509
Other assets	138,290	147,475
Total assets	$2,739,433	$2,761,842
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Losses and loss adjustment expenses	$1,616,674	$1,616,521
Unearned premiums	302,569	354,367
Debt	152,373	160,723
Debentures	80,930	80,930
Accounts payable and accrued expenses	42,246	29,712
Funds held and reinsurance balances payable	29,857	29,320
Payable to insurance companies	41,832	45,625
Other liabilities	24,848	31,231
Total liabilities	2,291,329	2,348,429
Shareholders' Equity		
Common stock, $0.01 par value; authorized 75,000,000 shares; 50,093,690 and 49,887,200 shares issued and outstanding	501	499
Additional paid-in capital	277,007	276,410
Retained earnings	138,976	120,894
Note receivable from officer	(690)	(709)
Accumulated other comprehensive income	32,310	16,319
Total shareholders' equity	448,104	413,413

Total liabilities and shareholders' equity	$2,739,433	$2,761,842

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

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

	Common Stock	Additional Paid-In Capital	Retained Earnings	Note Receivable from Officer	Accumulated Other Comprehensive Income	Total Shareholders' Equity
	(Unaudited, In thousands)					
Balances December 31, 2013	$499	$276,410	$120,894	$ (709)	$ 16,319	$ 413,413
Net income	-	-	21,087	-	-	21,087
Dividends declared	-	-	(3,005)	-	-	(3,005)
Change in unrealized gain or loss on available for sale securities, net of tax	-	-	-	-	16,600	16,600
Change in valuation allowance on deferred tax assets	-	-	-	-	205	205
Net deferred derivative loss - hedging activity	-	-	-	-	(973)	(973)
Stock award, net of tax	2	92	-	-	-	94
Long term incentive plan; stock award for 2013 and 2014 plan years	-	505	-	-	-	505
Change in investment of affiliates, net of tax	-	-	-	-	174	174
Change in investment of unconsolidated subsidiaries	-	-	-	-	(15)	(15)
Note receivable from officer	-	-	-	19	-	19
Balances September 30, 2014	$501	$277,007	$138,976	$ (690)	$ 32,310	$ 448,104

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

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MEADOWBROOK INSURANCE GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30,

	2014	2013
	(Unaudited)	
	(In thousands)	
Cash Flows From Operating Activities		
Net income (loss)	$21,087	$(100,460)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Amortization of other intangible assets	2,959	3,146
Amortization of deferred debenture issuance costs	-	73
Impairment of goodwill	-	115,397
Depreciation of furniture, equipment, and building	3,217	3,479
Net amortization of discount and premiums on bonds	9,685	8,453
Accretion of issued debt/original issue discount	1,149	784
Amortization of capitalized convertible note fees	327	223
Gain on sale of investments	(9,159)	(3,898)
Gain on sale of fixed assets	(231)	(66)
Long-term incentive plan expense	538	324
Stock award	118	274
Equity earnings of affiliates, net of taxes	(2,870)	(2,547)
Equity earnings of unconsolidated subsidiaries, net of tax	(18)	(4)
Deferred income tax expense (benefit)	4,612	(7,870)
Write-off of book of business	52	-
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Premiums and agent balances receivable	25,208	(16,679)
Reinsurance recoverable on paid and unpaid losses	(26,353)	(108,321)
Prepaid reinsurance premiums	29,288	50,493
Deferred policy acquisition costs	(2,355)	(14,815)
Other assets	8,406	(24,147)
Increase (decrease) in:		
Losses and loss adjustment expenses	153	123,411
Unearned premiums	(51,798)	(30,690)
Payable to insurance companies	(3,793)	26,099
Funds held and reinsurance balances payable	537	(11,845)
Other liabilities	(7,600)	8,122
Total adjustments	(17,928)	119,396
Net cash provided by operating activities	3,159	18,936
Cash Flows From Investing Activities		
Purchase of debt securities available for sale	(63,765)	(400,212)
Proceeds from sales and maturities of debt securities available for sale	77,450	145,606
Purchase of equity securities available for sale	(27,619)	(98,385)
Proceeds from sales of equity securities available for sale	37,157	18,285
Capital expenditures	(1,316)	(1,363)
Other investing activities	6	(680)
Net cash provided by (used in) investing activities	21,913	(336,749)
Cash Flows From Financing Activities		

Payments on term loan and revolving credit facility	(9,500)	(4,500)
Proceeds from convertible senior notes	-	96,324
Payments for convertible senior notes hedge	-	(12,942)
Proceeds from issuance of warrants	-	3,023
Book overdrafts	(1,278)	188
Dividends paid on common stock	(3,005)	(2,993)
Other financing activities	19	22
Net cash (used in) provided by financing activities	(13,764)	79,122
Net increase (decrease) in cash and cash equivalents	11,308	(238,691)
Cash and cash equivalents, beginning of period	94,776	342,124
Cash and cash equivalents, end of period	$106,084	$103,433
Supplemental Disclosure of Cash Flow Information:		
Interest paid	$5,077	$8,092
Net income taxes (rececived) paid (1)	$(5,136)	$1,165
Supplemental Disclosure of Non-Cash Investing and Financing Activities:		
Stock-based employee compensation	$118	$274

(1) Tax return refunds were received in first quarter of 2014 and 2013 for $8,886 and $3,067, respectively.

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

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MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
NOTE 1 – Summary of Significant Accounting Policies

Basis of Presentation and Management Representation

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

In the opinion of management, the consolidated financial statements reflect all normal recurring adjustments necessary to present a fair statement of the results for the interim period. Preparation of financial statements under generally accepted accounting principles ("GAAP") requires management to make estimates. Actual results could differ from those estimates. The results of operations for the three months and nine months ended September 30, 2014 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 fiscal year ended December 31, 2013.

Revenue Recognition

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

Assumed premium estimates include business where the company accepts a portion of the risk from a ceding carrier as well as the mandatory assumed pool business from the National Council on Compensation Insurance ("NCCI"), or residual market business.

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MEADOWBROOK INSURANCE GROUP, INC.
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(Unaudited)

Effective July 1, 2013, the Insurance Company Subsidiaries entered into an agreement with State National Insurance Company, National Specialty Insurance Company and United Specialty Insurance Company (collectively, "SNIC"), whereby certain business from our Insurance Company Subsidiaries is written directly with SNIC and 100% assumed collectively by our Insurance Company Subsidiaries. Our Insurance Company Subsidiaries pay SNIC a 5.5% policy issuance fee, which is reflected as assumed commission expense on the applicable Insurance Company Subsidiaries' financial statements. For the three months and nine months ended September 30, 2014, our Insurance Company Subsidiaries collectively assumed $79.3 million and $214.4 million, respectively, in gross written premium from SNIC. The impact of the SNIC policy issuance fee on the Company's expense ratio was 2.3% and 2.2% for the three months and nine months ended September 30, 2014, respectively.

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

Commission income, which includes reinsurance placement, is recorded on the later of the effective date or the billing date of the policies on which they were earned. Commission income is reported net of any sub-producer commission expense. Commission adjustments that occur subsequent to the issuance of the policy because of cancellation typically are recognized when the policy is effectively cancelled. Profit sharing commissions from unaffiliated insurance carriers are recognized when determinable, which is when such commissions are received.

Income Taxes

As of September 30, 2014 and December 31, 2013, the Company did not have any unrecognized tax benefits. As of September 30, 2014 and December 31, 2013, the Company had no accrued interest or penalties related to uncertain tax positions.

Recent Accounting Pronouncements

Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive

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

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MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 2 – Investments

The cost or amortized cost, gross unrealized gains, losses, non-credit other-than-temporary impairments (“OTTI”) and estimated fair value of investments in securities classified as available for sale at September 30, 2014 and December 31, 2013 were as follows (in thousands):

	September 30, 2014				
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Non-Credit OTTI	Estimated Fair Value
Debt Securities:					
U.S. Government and agencies	$24,442	$503	$(118)	$ -	$24,827
Obligations of states and political subs	703,170	27,283	(3,838)	-	726,615
Corporate securities	571,926	15,343	(4,367)	-	582,902
Residential mortgage-backed securities	104,563	1,887	(2,384)	-	104,066
Commercial mortgage-backed securities	21,592	318	(429)	-	21,481
Other asset-backed securities	19,716	567	(12)	-	20,271
Total debt securities available for sale	1,445,409	45,901	(11,148)	-	1,480,162
Equity Securities:					
Common stock	94,158	14,033	(1,321)	-	106,870
Total equity securities available for sale	94,158	14,033	(1,321)	-	106,870
Total securities available for sale	$1,539,567	$59,934	$(12,469)	$ -	$1,587,032

	December 31, 2013				
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Non-Credit OTTI	Estimated Fair Value
Debt Securities:					
U.S. Government and agencies	$24,985	$572	$(188)	$ -	$25,369
Obligations of states and political subs	730,004	25,509	(20,121)	-	735,392
Corporate securities	534,913	15,529	(11,935)	-	538,507
Residential mortgage-backed securities	118,930	2,191	(4,737)	-	116,384
Commercial mortgage-backed securities	26,719	617	(868)	-	26,468
Other asset-backed securities	20,203	763	(40)	-	20,926
Total debt securities available for sale	1,455,754	45,181	(37,889)	-	1,463,046
Equity Securities:					
Perpetual preferred stock	71	147	-	-	218
Common stock	95,275	14,933	(444)	-	109,764
Total equity securities available for sale	95,346	15,080	(444)	-	109,982
Total securities available for sale	$1,551,100	$60,261	$(38,333)	$ -	$1,573,028

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MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Gross unrealized gains, losses, and non-credit OTTI on available for sale securities as of September 30, 2014 and December 31, 2013 were as follows (in thousands):

	September 30, 2014	December 31, 2013
Unrealized gains	$ 59,934	$ 60,261
Unrealized losses	(12,469)	(38,333)
Non-credit OTTI	-	-
Net unrealized gains	47,465	21,928
Deferred federal income tax expense	(16,612)	(7,675)
Net unrealized gains on investments, net of deferred federal income taxes	$ 30,853	$ 14,253

Net realized gains (losses including OTTI) on securities, for the three months and nine months ended September 30, 2014 and 2013 were as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Realized gains (losses):				
Debt securities:				
Gross realized gains	$857	$87	$1,193	$1,617
Gross realized losses	(383)	(40)	(383)	(211)
Total debt securities	474	47	810	1,406
Equity securities:				
Gross realized gains	2,328	656	8,357	2,502
Gross realized losses	(4)	-	(8)	(10)
Total equity securities	2,324	656	8,349	2,492
Net realized gains	$2,798	$703	$9,159	$3,898
OTTI included in realized losses on securities above	$-	$-	$-	$-

Proceeds from the sales of debt and equity securities available for sale were $31.8 million and $12.8 million for the three months ended September 30, 2014 and 2013, respectively. Proceeds from the sales of debt and equity securities available for sale were $62.9 million and $88.9 million for the nine months ended September 30, 2014 and 2013, respectively.

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MEADOWBROOK INSURANCE GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

At September 30, 2014, the amortized cost and estimated fair value of available for sale debt securities by contractual maturity are shown below. Expected maturities may differ from contractual maturities, because certain borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands):

	Available for Sale	
	Amortized Cost	Estimated Fair Value
Due in one year or less	$41,384	$41,962
Due after one year through five years	535,460	558,383
Due after five years through ten years	601,630	611,530
Due after ten years	121,064	122,469
Mortgage-backed securities, collateralized obligations and asset-backed securities	145,871	145,818
	$1,445,409	$1,480,162

Net investment income for the three months and nine months ended September 30, 2014 and 2013 was as follows (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
Net Investment Income Earned From:				
Debt securities	$10,515	$10,888	$31,746	$32,593
Equity securities	811	1,043	2,658	2,593
Cash and cash equivalents	171	165	400	558
Total gross investment income	11,497	12,096	34,804	35,744
Less investment expenses	410	401	1,247	1,141
Net investment income	$11,087	$11,695	$33,557	$34,603

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

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

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

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

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

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

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

The Company reviewed its investment portfolio in relation to its OTTI policy and determined the Company did not need to record a credit related OTTI loss, nor recognize a non-credit related OTTI loss in other comprehensive income for the three months and nine months ended September 30, 2014 or 2013.

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

	September 30, 2014								
	Less than 12 months			Greater than 12 months			Total		
	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses and Non-Credit OTTI	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses and Non-Credit OTTI	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses and Non-Credit OTTI
Debt Securities:									
U.S. Government and agencies	-	$ -	$ -	3	$ 3,399	$ (118)	3	$ 3,399	$ (118)
Obligations of states and political subs	29	96,714	(1,407)	40	132,304	(2,431)	69	229,018	(3,838)
Corporate securities	93	197,177	(2,592)	23	60,425	(1,775)	116	257,602	(4,367)
Residential mortgage-backed securities	4	28,700	(814)	9	46,060	(1,570)	13	74,760	(2,384)
Commercial mortgage-backed securities	3	5,064	(159)	2	7,792	(270)	5	12,856	(429)
Other asset-backed securities	3	4,435	(12)	-	-	-	3	4,435	(12)
Total debt securities	132	332,090	(4,984)	77	249,980	(6,164)	209	582,070	(11,148)
Equity Securities:									
Common stock	22	19,027	(1,223)	3	1,390	(98)	25	20,417	(1,321)
Total equity securities	22	19,027	(1,223)	3	1,390	(98)	25	20,417	(1,321)
Total securities	154	$ 351,117	$ (6,207)	80	$ 251,370	$ (6,262)	234	$ 602,487	$ (12,469)

	December 31, 2013								
	Less than 12 months			Greater than 12 months			Total		
	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses and Non-Credit OTTI	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses and Non-Credit OTTI	Number of Issues	Fair Value of Investments with Unrealized Losses	Gross Unrealized Losses and Non-Credit OTTI
Debt Securities:									
U.S. Government and agencies	5	$ 6,181	$ (91)	1	$ 903	$ (97)	6	$ 7,084	$ (188)
Obligations of states and political subs	103	285,264	(16,218)	16	43,811	(3,903)	119	329,075	(20,121)
Corporate securities	121	259,581	(10,663)	8	16,734	(1,272)	129	276,315	(11,935)
Residential mortgage-backed securities	13	72,458	(3,879)	1	8,095	(858)	14	80,553	(4,737)
	5	12,451	(868)	-	-	-	5	12,451	(868)

Commercial mortgage-backed securities									
Other asset-backed securities	4	8,522	(40)	-	-	-	4	8,522	(40)
Total debt securities	251	644,457	(31,759)	26	69,543	(6,130)	277	714,000	(37,889)
Equity Securities:									
Perpetual preferred stock	-	-	-	-	-	-	-	-	-
Common stock	15	12,112	(444)	-			15	12,112	(444)
Total equity securities	15	12,112	(444)	-	-	-	15	12,112	(444)
Total securities	266	$656,569	$(32,203)	26	$69,543	$(6,130)	292	$726,112	$(38,333)

NOTE 3 – Fair Value Measurements

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

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

Level 1 – Valuations that are based on unadjusted quoted prices in active markets for identical securities. The fair value of exchange-traded preferred and common equities, and mutual funds included in the Level 1 category were based on quoted prices that are readily and regularly available in an active market. The fair value measurements that were based on Level 1 inputs comprise 6.7% of the fair value of the total investment portfolio.

Level 2 – Valuations that are based on observable inputs (other than Level 1 prices) such as quoted prices for similar assets at the measurement date; quoted prices in markets that are not active; or other inputs that are observable, either directly or indirectly. The fair value of securities included in the Level 2 category were based on the market values obtained from a third party pricing service that were evaluated using pricing models that vary by asset class and incorporate available trade, bid and other observable market information. The third party pricing service monitors market indicators, as well as industry and economic events. The Level 2 category includes corporate bonds, government and agency bonds, asset-backed, residential mortgage-backed and commercial mortgage-backed securities and municipal bonds. The fair value measurements that were based on Level 2 inputs comprise 93.1% of the fair value of the total investment portfolio.

Level 3 – Valuations that are derived from techniques in which one or more of the significant inputs are unobservable and/or involve management judgment and/or are based on non-binding broker quotes. The fair value measurements that were based on Level 3 inputs comprise 0.2% of the fair value of the total investment portfolio.

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

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

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

The Level 3 securities consist of 15 securities totaling $3.2 million or 0.2% of the total investment portfolio. These primarily represent asset-backed securities and corporate debt securities that have a principal protection feature supported by a U.S. Treasury strip. To determine the fair value all 15 of these securities, the third party investment manager used benchmarking techniques based upon industry sector, rating and other factors.

Also included in Level 3 valuation is the conversion feature within the Notes (as defined in Note 5 ~ Derivative Instruments) and the Notes Hedges. The estimated fair values of both the conversion feature and the Notes Hedge are obtained from the third party financial institution counterparties valued using non-binding broker quotations and significant unobservable inputs.

The following table presents the Company's assets and liabilities measured at fair value on a recurring basis, classified by the valuation hierarchy as of September 30, 2014 (in thousands):

		Fair Value Measurements Using		
	September 30, 2014	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
	Total	(Level 1)	(Level 2)	(Level 3)
Debt Securities:				
U.S. Government and agencies	$24,827	$-	$24,827	$ -
Obligations of states and political subs	726,615	-	726,615	-
Corporate securities	582,902	-	581,822	1,080
Residential mortgage-backed securities	104,066	-	104,066	-
Commercial mortgage-backed securities	21,481	-	21,481	-
Other asset-backed securities	20,271	-	18,126	2,145
Total debt securities available for sale	1,480,162	-	1,476,937	3,225
Equity Securities:				
Common stock	106,870	106,870	-	-
Total equity securities available for sale	106,870	106,870	-	-
Total securities available for sale	1,587,032	106,870	1,476,937	3,225
Derivatives:				
Derivatives - interest rate swaps	56	-	56	-
Cash conversion feature of cash convertible notes	(11,266)	-	-	(11,266)
Purchased cash convertible note hedge	11,266	-	-	11,266
Total derivatives	56	-	56	-

Total securities available for sale and derivatives	$1,587,088	$106,870	$1,476,993	$ 3,225

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The following table presents changes in Level 3 available for sale investments and derivatives measured at fair value on a recurring basis as of September 30, 2014 (in thousands):

	Commercial mortgage-backed and Other asset-backed securities	Corporate securities	Total
Balance as of December 31, 2013	$ 2,608	$ 889	$ 3,497
Total gains or losses (realized/unrealized):			
Included in earnings	367	24	391
Included in other comprehensive income	(194)	168	(26)
Purchases			-
Issuances			-
Settlements	(637)	-	(637)
Transfers in and out of Level 3	-	-	-
Balance as of September 30, 2014	$ 2,145	$ 1,080	$ 3,225

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

The Company's policy on recognizing transfers between hierarchy levels is applied at the end of each reporting period. There were no transfers between Levels 1, 2 and 3 for the three months and nine months ended September 30, 2014 and 2013, respectively.

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NOTE 4 – Debt

Credit Facilities

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

As of September 30, 2014, the outstanding balance on the Company's term loan facility was $18.0 million. Pursuant to the Second Amendment to Credit Agreement and Waiver, dated September 19, 2013 (the "Amendment"), the available borrowing under the revolving credit facility was reduced from $100.0 million to $30.0 million with further periodic reductions to $21.0 million as of March 31, 2016, less any optional reductions to the revolving commitments. The Amendment also established an amortization schedule for the revolving credit facility beginning on September 30, 2014. The Company has $15.0 million outstanding under its revolving credit facility and $0.1 million in letters of credit as of September 30, 2014. The undrawn portion of the revolving credit facility, which was $9.1 million as of September 30, 2014, is available to finance working capital and for other general corporate purposes, including but not limited to, surplus contributions to its Insurance Company Subsidiaries to support premium growth or strategic acquisitions.

The principal amount outstanding under the Credit Facilities provides for interest at either the Alternative Base Rate ("ABR") or the London interbank offered rate ("LIBOR"). ABR borrowings under the Credit Facilities will bear interest at the greatest of (a) the Administrative Agent's prime rate, (b) the federal funds effective rate plus 0.5%, and (c) the adjusted LIBOR for a one-month period plus 1.0%, in each case, plus a margin that is adjusted on the basis of the Company's consolidated leverage ratio. Eurodollar borrowings under the Credit Facilities will bear interest at the adjusted LIBOR for the interest period in effect plus a margin that is adjusted on the basis of the Company's consolidated leverage ratio. In addition, the Credit Facilities provide for an unused facility fee ranging between twenty-five basis points and thirty-seven and a half basis points, based on the Company's consolidated leverage ratio as defined by the Credit Facilities. At September 30, 2014, the interest rate on the Company's term loan was 2.75%, which consisted of a variable rate of 0.25%, plus an applicable margin of 2.50%. At September 30, 2014, the interest rate on the Company's revolving credit facility was approximately 0.23%, plus a 2.50% margin.

Additionally, under the Amendment, the financial covenants applicable to the Credit Facilities were modified to consist of: (1) minimum consolidated net worth of the Company and its subsidiaries of $365,697,000 as of the effective date of the Amendment, with quarterly increases thereafter equal to the sum of (a) seventy-five percent of positive net income and (b) seventy-five percent of increases in shareholders' equity by reason of the issuance and sale of equity interests, if any, (2) minimum Risk Based Capital Ratio (as defined in the Amendment) for all material Insurance Company Subsidiaries of 1.75 times Company Action Level (as defined in the Amendment), (3) a maximum permitted consolidated leverage ratio of 0.35 to 1.00 at any time on or after September 30, 2014, (4) minimum consolidated fixed charge coverage ratio of 1.25 to 1.00, and (5) minimum A.M. Best rating of "B++" for all Insurance Company Subsidiaries. As of September 30, 2014, the Company was in compliance with these debt covenants.

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FHLBI

During 2011, certain of the Insurance Company Subsidiaries (Star, Williamsburg and Ameritrust) became members of the Federal Home Loan Bank of Indianapolis ("FHLBI"). As a member of the FHLBI, these subsidiaries have the ability to borrow on a collateralized basis at relatively low borrowing rates providing a source of liquidity. As of September 30, 2014 and 2013, the Company had borrowed $30.0 million from the FHLBI after pledging as collateral residential mortgage-backed securities ("RMBS") having a carrying value of $36.3 million, and making a FHLBI common stock investment of approximately $1.6 million. The Company has the ability to increase its borrowing capacity through purchasing additional investments in FHLBI and pledging additional securities. The Company retains all the rights regarding the collateralized RMBS.

Debentures

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

Year of Issuance	Description	Year Callable	Year Due	Interest Rate Terms	Interest Rate at September 30, 2014 (1)		Principal Amount
2003	Junior subordinated debentures	2008	2033	Three-month LIBOR, plus 4.05%	4.28	%	$ 10,310
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.00%	4.23	%	13,000
2004	Senior debentures	2009	2034	Three-month LIBOR, plus 4.20%	4.43	%	12,000
2005	Junior subordinated debentures	2010	2035	Three-month LIBOR, plus 3.58%	3.81	%	20,620
	Junior subordinated debentures (2)	2007	2032	Three-month LIBOR, plus 4.00%	4.23	%	15,000
	Junior subordinated debentures (2)	2008	2033	Three-month LIBOR, plus 4.10%	4.33	%	10,000
					Total		$ 80,930

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

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

Excluding the junior subordinated debentures acquired in conjunction with the ProCentury Merger, the Company received a total of $53.3 million in net proceeds from the issuances of the above long-term debt, of which $26.2 million was contributed to the surplus of its Insurance Company Subsidiaries and the remaining balance was used for general corporate purposes.

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

The junior subordinated debentures acquired in the ProCentury Merger were issued in conjunction with the issuance of $15.0 million and $10.0 million in floating rate trust preferred securities to a trust formed from the Company's unconsolidated trust, ProFinance Statutory Trust I and ProFinance Statutory Trust II.

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

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

Cash Convertible Senior Notes

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

Due to the bifurcation, the debt component reflects an original issue discount ("OID") of $12.9 million which will be amortized into interest expense over the term of the Notes. After considering the contractual interest payments and amortization of the OID, the Notes' effective interest rate is 7.4%.

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The following table shows the amounts recorded for the debt component of the Notes as of September 30, 2014 and December 31, 2013 (in thousands):

	September 30, 2014	December 31, 2013
Outstanding principal	$ 100,000	$ 100,000
Unamortized OID	(10,627)	(11,777)
Total debt component	$ 89,373	$ 88,223

Deferred issuance costs of $3.7 million will also be amortized into interest expense over the term of the Notes. Interest expense on the Notes, including amortization of deferred issuance costs, was $1.8 million and $1.7 million for the three months ended September 30, 2014 and 2013, respectively. Interest expense on the Notes, including amortization of deferred issuance costs, was $5.2 million and $3.7 million for the nine months ended September 30, 2014 and 2013, respectively.

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

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

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

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

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

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NOTE 5 – Derivative Instruments

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

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

Effective Date	Expiration Date	Debt Instrument