

VESTA INSURANCE GROUP INC
Form 10-Q
August 13, 2003

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2003

OR

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

**For the transition period from
to
Commission file number 1-12338**

VESTA INSURANCE GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State of other jurisdiction of
incorporation or organization)

63-1097283
(I.R.S. Employer
Identification No.)

3760 River Run Drive
Birmingham, Alabama
(Address of principal executive offices)

35243
(Zip Code)

(205) 970-7000
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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 the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

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The number of shares outstanding of the registrant's common stock,
\$.01 par value, as of August 12, 2003
36,678,060

Vesta Insurance Group, Inc.

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Part I
Item 1. Financial Statements
Vesta Insurance Group, Inc.
Consolidated Balance Sheets
(amounts in thousands, except share and per share data)

	June 30, 2003	December 31, 2002
	(unaudited)	
Assets:		
Fixed maturities available for sale - at fair value (cost: 2003 - \$845,717; 2002 - \$829,982)	\$ 884,135	\$ 863,695
Equity securities-at fair value: (cost: 2003- \$28,829; 2002- \$26,072)	31,514	27,055
Mortgage loans	9,124	12,124
Policy loans	61,181	61,278
Short-term investments	21,360	9,679
Other invested assets	41,437	36,759
	<hr/>	<hr/>
Total investments	1,048,751	1,010,590
Cash	55,939	140,593
Accrued investment income	14,283	11,866
Premiums in course of collection (net of allowances for losses of \$897 in 2003 and 2002)	143,696	128,799
Reinsurance balances receivable	363,985	355,054
Reinsurance recoverable on paid losses	81,255	79,334

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	June 30,	December 31,
Deferred policy acquisition costs	76,721	71,752
Property and equipment	20,237	22,123
Deferred income taxes	45,434	46,176
Assets held for sale	11,323	9,598
Goodwill	142,296	129,656
Other intangible assets	5,046	5,214
Other assets	26,041	32,103
	<u> </u>	<u> </u>
Total assets	\$ 2,035,007	\$ 2,042,858
	<u> </u>	<u> </u>
Liabilities:		
Policy liabilities	\$ 672,593	\$ 678,419
Losses and loss adjustment expenses	337,571	322,320
Unearned premiums	345,084	306,782
Federal Home Loan Bank advances	163,422	176,793
Reinsurance balances payable	76,220	100,860
Short term debt	29,843	30,000
Long term debt	55,800	55,795
Liabilities held for sale	6,160	5,632
Other liabilities	95,196	107,951
	<u> </u>	<u> </u>
Total liabilities	1,781,889	1,784,552
Commitments and contingencies: See Note B		
Deferrable Capital Securities	22,445	22,445
Stockholders' equity:		
Preferred stock, \$.01 par value, 5,000,000 shares authorized, issued:		
2003 - 0 and 2002 - 0	--	--
Common stock, \$.01 par value, 100,000,000 shares authorized, issued:		
2003 and 2002 - 38,143,037	381	381
Additional paid-in capital	248,372	248,372
Accumulated other comprehensive income, (net of tax expense		
of \$10,122 and \$8,131 in 2003 and 2002, respectively)	19,179	15,101
Retained earnings	(12,408)	(2,698)
Treasury stock (2,464,977 shares at cost at June 30, 2003 and		
December 31, 2002)	(18,250)	(18,250)
Unearned stock	(6,601)	(7,045)
	<u> </u>	<u> </u>
Total stockholders' equity	230,673	235,861
	<u> </u>	<u> </u>
Total liabilities, deferrable capital securities		
and stockholders' equity	\$ 2,035,007	\$ 2,042,858
	<u> </u>	<u> </u>

See accompanying Notes to Consolidated Financial Statements

Vesta Insurance Group, Inc.
Consolidated Statements of Operations and Comprehensive Income
Statements of Operations
(amounts in thousands, except per share data)

Three months ended		Six months ended	
June 30,		June 30,	
2003	2002	2003	2002

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	Three months ended		Six months ended	
	(unaudited)		(unaudited)	
Revenues:				
Net premiums written	\$ 129,868	\$ 149,396	\$ 260,814	\$ 293,999
Change in unearned premiums	(6,408)	(27,212)	(19,861)	(66,518)
Net premiums earned	123,460	122,184	240,953	227,481
Policy fees	9,073	5,505	16,711	8,923
Agency fees and commissions	16,854	13,353	37,731	31,733
Net investment income	9,871	13,691	21,486	27,259
Realized gains (losses)	2,111	(589)	5,618	496
Other	1,859	2,389	3,802	4,524
Total revenues	163,228	156,533	326,301	300,416
Expenses:				
Policyholder benefits	5,214	6,923	10,304	14,751
Losses and loss adjustment expenses incurred	93,589	83,526	173,095	153,531
Policy acquisition expenses	23,476	24,215	45,259	43,726
Operating expenses	43,317	38,892	88,955	79,486
Interest on debt	3,153	3,895	6,311	7,846
Gain on debt extinguishment	--	--	--	(1,380)
Other intangible amortization	84	84	168	168
Total expenses	168,833	157,535	324,092	298,128
(Loss) income from continuing operations before income taxes, minority interest, and deferrable capital securities	(5,605)	(1,002)	2,209	2,288
Income tax (benefit) expense	(1,961)	(350)	772	800
Minority interest, net of tax	93	597	379	1,021
Deferrable capital security distributions, net of tax	311	322	622	451
Net (loss) income from continuing operations	(4,048)	(1,571)	436	16
Loss from discontinued operations, net of tax	(7,553)	(9,912)	(8,361)	(9,750)
Net loss	(11,601)	(11,483)	(7,925)	(9,734)
Gain on redemption of preferred securities, net of tax	--	--	--	210
Net loss available to common shareholders	\$ (11,601)	\$ (11,483)	\$ (7,925)	\$ (9,524)
Net (loss) income from continuing operations per share - Basic	\$ (0.12)	\$ (0.05)	\$ 0.01	\$ 0.00
Net loss available to common shareholders per share - Basic	\$ (0.33)	\$ (0.34)	\$ (0.23)	\$ (0.29)
Net (loss) income from continuing operations per share - Diluted	\$ (0.12)	\$ (0.05)	\$ 0.01	\$ 0.00
Net loss available to common shareholders per share - Diluted	\$ (0.33)	\$ (0.34)	\$ (0.23)	\$ (0.29)

Statements of Comprehensive Income (Loss)

Net loss	\$ (11,601)	\$ (11,483)	\$ (7,925)	\$ (9,734)
Other comprehensive income, net of tax:				
Unrealized holding (losses) gains on available-for-sale securities net of tax of \$3,303, \$2,875, \$4,162 and \$(67), respectively	6,134	5,340	7,730	(125)
Less realized (losses) gains on available-for-sale securities net of tax of \$739, \$(206), \$1,966 and \$174, respectively	1,372	(383)	3,652	322
	4,762	5,723	4,078	(447)
Gain on redemption of preferred securities, net of tax of \$0, \$0, \$0 and \$113 respectively	--	--	--	210

Statements of Comprehensive Income (Loss)

Comprehensive loss	\$ (6,839)	\$ (5,760)	\$ (3,847)	\$ (9,971)

See accompanying Notes to Consolidated Financial Statements

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Vesta Insurance Group, Inc.
Consolidated Statement of Cash Flows
(amounts in thousands)

	Six months ended June 30,	
	2003	2002
	(unaudited)	
Operating Activities:		
Net income	\$ (7,925)	\$ (9,734)
Adjustments to reconcile net loss to cash provided by (used in) operations		
Changes in:		
Loss and LAE reserves, and future policy liabilities	13,009	28,709
Unearned premium reserves	38,302	78,305
Reinsurance balances receivable	(21,567)	9,671
Premiums in course of collection	(14,897)	(86,126)
Reinsurance recoverable on paid losses	(1,921)	2,965
Reinsurance balances payable	(24,640)	42,900
Other assets and liabilities	1,341	31,109
Policy acquisition costs deferred	(50,128)	(81,868)
Policy acquisition costs amortized	45,259	46,012
Realized gains	(5,618)	(496)
Amortization and depreciation	3,455	2,539
Gain on extinguishment of debt	--	(897)
Net cash provided by (used in) operations	(25,330)	63,089
Investing Activities:		
Investments sold:		
Fixed maturities available for sale	83,881	170,873
Equity securities	5,811	4,655
Investments acquired:		
Fixed maturities available for sale	(236,268)	(230,991)
Equity securities	(6,029)	(5,241)
Maturities, paydowns, calls and other		
Fixed maturities available for sale	130,479	53,121
Net decrease in other invested assets	2,284	18,585
Net cash received (paid) for acquisition	(17,200)	9,006
Net increase in short-term investments	(11,681)	(61,166)
Assets held for sale	4,102	--
Additions to property and equipment	(2,127)	(407)
Disposal of property and equipment	495	83
Net cash used in investing activities	(46,253)	(41,482)
Financing Activities:		
Net change in FHLB borrowings	(13,371)	4,691
Change in long and short-term debt	(152)	(990)
Repayment of acquisition contingent consideration	(4,483)	--

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	Six months ended June 30,	
Net deposits and withdrawals from insurance liabilities	6,718	(9,535)
Acquisition of common stock	--	(949)
Dividends paid	(1,783)	(1,837)
	<hr/>	<hr/>
Net cash used in financing activities	(13,071)	(8,620)
(Decrease) increase in cash	(84,654)	12,987
Cash at beginning of period	140,593	23,579
	<hr/>	<hr/>
Cash at end of period	\$ 55,939	\$ 36,566

See accompanying Notes to Consolidated Financial Statements

Vesta Insurance Group, Inc. Notes to Consolidated Financial Statements (amounts in thousands except per share amounts)

Note A-Significant Accounting Policies

Basis of Presentation: The accompanying unaudited interim consolidated financial statements of Vesta Insurance Group, Inc. (the "Company") have been prepared in conformity with accounting principles generally accepted in the United States for interim financial information and with the instructions of Form 10-Q and Article 10 of Regulation S-X. These financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals and other adjustments, such as impairments) considered necessary for a fair presentation have been included. The results of operations and cash flows for any interim period are not necessarily indicative of results for the full year.

Reclassifications: Certain amounts in the financial statements presented have been reclassified from amounts previously reported in order to be comparable between periods. These reclassifications have no effect on previously reported stockholders' equity or net income loss during the periods involved.

New Accounting Standards: Effective July 1, 2002, Vesta adopted Statement of Financial Accounting Standards No. 145 (SFAS No. 145) "Rescission of FASB Statement No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections", which had been issued by the Financial Accounting Standards Board "FASB" in April 2002. SFAS No. 145 rescinds SFAS No. 4, which required all gains and losses from extinguishments of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. In connection with our adoption of SFAS No. 145, we have reclassified gains on the extinguishment of debt from extraordinary gain on debt extinguishment to other expense. These reclassifications decreased total expenses by \$1.4 million for the six months ended June 30, 2002.

In November 2002, the FASB issued FASB Interpretation No. ("FIN") 45, "Guarantor's Accounting and Disclosures Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 clarifies the requirements of SFAS No. 5, "Accounting for Contingencies," related to a guarantors accounting for, and disclosures of, the issuance of certain types of guarantees. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 15, 2002 and have been included in the Notes to the consolidated financial statements included herein. The impact on the Company's financial statements from the application of the recognition and measurement provisions of FIN No. 45 is dependent on the level of guarantees issued or modified in 2003 and thereafter. No guaranties were issued or modified during the six months ended June 30, 2003, which were impacted by the provisions of FIN No. 45.

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities" which clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements." This Interpretation provides guidance on the identification and consolidation of variable interest entities ("VIEs"), whereby control is achieved through means other than through voting rights. The effective date of FIN 46 is for the first fiscal quarter beginning after June 15, 2003. Management believes the adoption of FIN 46 will not have a material impact on the Company's financial position, results of operations or cash flows.

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In May 2002, the Derivatives Implementation Group of the FASB exposed for comment issue No. B36, "Bifurcation of Embedded Credit Derivatives" ("DIG B36"). DIG B36 would require the bifurcation of potential embedded derivatives within modified coinsurance and funds withheld coinsurance arrangements in which the terms require the future payment of a principal amount plus a return based on a specified proportion of the ceding company's return on either its general account assets or a specified block of those assets. The proposed effective date of the implementation guidance in DIG B36 is for the first fiscal quarter beginning after June 15, 2003 and would be applied on a prospective basis. The Company is currently evaluating the impact of this pronouncement.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). SFAS 150 establishes how an issuer classifies and measures certain free standing financial instruments with characteristics of both liabilities and equity and requires that such instruments be classified as liabilities. SFAS 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003 for those existing financial instruments subject to the provisions of SFAS No. 150. The Company has not entered into any financial instruments within the scope of SFAS 150 since May 31, 2003. Management has determined that the Company's Deferrable Capital Securities are subject to the provisions of SFAS No. 150. The transition provisions of SFAS No. 150 require that upon adoption of SFAS No. 150 on July 1, 2003, the Company's Deferrable Capital Securities would be reclassified as a liability from its current mezzanine debt classification. The dividends paid to the holders of the Deferrable Capital Securities will be classified as interest expense on a prospective basis.

Restricted Assets: As part of a modified coinsurance agreement with Employers Reinsurance Corporation, American Founders is holding \$167.5 million of assets for the benefit of Employers, of which \$165.7 million are included in fixed maturities available for sale herein. Additionally, we have pledged investments having a market value of \$169.5 million to the Federal Home Loan Bank.

Income per Share. Basic EPS is computed by dividing income available to common shareholders by the weighted average common shares outstanding for the period. Diluted EPS is calculated by adding to shares outstanding the additional net effect of potentially dilutive securities or contracts which could be exercised or converted into common shares except when the additional shares would produce anti-dilutive results.

Reconciliation of net loss available to common shareholders and average shares outstanding for the three and six months ending June 30, 2003 and 2002 are as follows:

	Three months ended June 30, 2003	2002
Net loss available to common shareholders	\$ (11,601)	\$ (11,483)
Weighted average shares outstanding-basic	34,896	33,780
Stock options and restricted stock *	--	--
Weighted average shares outstanding-diluted	34,896	33,780
	Six months ended June 30, 2003	2002
Net loss available to common shareholders	\$ (7,925)	\$ (9,524)
Weighted average shares outstanding-basic	34,880	33,394
Stock options and restricted stock *	--	--
Weighted average shares outstanding-diluted	34,880	33,394

*

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Under the provisions of SFAS No. 128, "Earnings Per Share", contingently issuable shares that would have the effect of being anti-dilutive are excluded for the diluted average shares outstanding calculation. Potentially dilutive securities for the three-month and six-month periods ending June 30, 2003 are 44 thousand and 47 thousand, respectively. Potentially dilutive securities for the three-month and six-month periods ending June 30, 2002 are 446 thousand and 526 thousand, respectively.

Earnings per share for discontinued operations for the three and six months ended June 30, 2003 and 2002 are as follows:

	2003		2002	
	3 month	6 month	3 month	6 month
Basic loss per share:				
Discontinued Operations	\$ (0.21)	\$ (0.24)	\$ (0.29)	\$ (0.29)
Diluted loss per share:				
Discontinued Operations	\$ (0.21)	\$ (0.24)	\$ (0.29)	\$ (0.29)

Stock-Based Compensation: In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure. This statement is effective for 2003 and amends SFAS No. 123, "Accounting for Stock-Based Compensation," by providing alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 requires additional disclosures related to the effect of stock-based compensation on reported results. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic-value-based method of accounting for stock-based compensation and has adopted only the disclosure requirements of SFAS No. 123. The following table illustrates the effect on net loss if the fair-value-based method had been applied to all outstanding and unvested awards in each period.

	2003		2002	
	3 month	6 month	3 month	6 month
Net loss as reported	\$(11,601)	\$(7,925)	\$(11,483)	\$(9,524)
Add: Stock-based employee compensation expense included in net income, net of tax	145	289	372	744
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of tax	(255)	(509)	(481)	(962)
Pro forma net loss	\$(11,711)	\$(8,145)	\$(11,592)	\$(9,742)
Net loss available to common shareholders per share - basic				
As reported	\$ (0.33)	\$ (0.23)	\$ (0.34)	\$ (0.29)
Pro forma	\$ (0.34)	\$ (0.23)	\$ (0.34)	\$ (0.29)
Net loss available to common shareholders per share - diluted				
As reported	\$ (0.33)	\$ (0.23)	\$ (0.34)	\$ (0.29)
Pro forma	\$ (0.34)	\$ (0.23)	\$ (0.34)	\$ (0.29)

Note B-Commitments and Contingencies

Securities Litigation

In 2001, Vesta settled a securities class action that had been pending since 1998. In connection with that settlement, the issuer of our primary directors' and officers' insurance policy, which was intended to cover the initial \$25 million of settlement costs and related expenses, denied coverage and refused to fund its share of the settlement costs. We sued that insurer in Alabama state court alleging that its action was taken in bad faith. In February 2003, we settled that claim and collected \$16 million in cash, which was reflected in the 2002 consolidated financial statements.

Health insurance related lawsuits

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Vesta and two former officers of Vesta are defendants in a lawsuit styled *James H. Cashion, Jr. d/b/a American Health Underwriters v. Vesta Insurance Group, Inc., et al*, Plaintiff, a former general agent of our subsidiary States General Life Insurance Company, which we purchased in 2001, alleges that the defendants engaged in an actionable civil conspiracy to tortiously interfere with his agency contracts. The civil conspiracy claim is premised, in part, on certain payments made to these two former officers of Vesta by another agent who replaced Mr. Cashion. The plaintiff is seeking actual and punitive damages. Vesta denies tortiously interfering with plaintiff's agency contract, believes the claims asserted against it have no merit, and is vigorously defending this lawsuit. In the opinion of management, resolution of this lawsuit is not expected to have a material adverse effect on our financial position.

During the second quarter of 2003, we entered into a settlement and release agreement with Jimmy Walker, a former agent of States General. Pursuant to this settlement and release agreement, we voluntarily dismissed the arbitration and litigation that we had earlier commenced against Mr. Walker and released him from his obligation to repay certain indebtedness owed to under a series of promissory notes representing amounts Mr. Walker borrowed from us in connection with his agency activities. Pursuant to this settlement agreement, Mr. Walker unconditionally assigned to us certain commissions to which he would otherwise be entitled under his former agent's agreement with States General and released us from any claims that he could assert against us arising from such agent's agreement. At June 30, 2003, the net realizable amount of the assigned commissions to the Company was \$1.3 million and is recorded as a component of other invested assets on the accompanying interim consolidated balance sheet.

Life insurance related lawsuits

Our subsidiary, American Founders, is a defendant in a lawsuit brought by a judgment creditor of IFS Holdings, Inc. - the former holder of American Founders' series A and C preferred stock - alleging that American Founders redeemed its Series A and Series C preferred stock from IFS Holdings, Inc. for less than "reasonably equivalent value," and, therefore, engaged in a voidable fraudulent transfer. American Founders believes (i) that the redemption transaction was for reasonably equivalent value; and (ii) that the allegations brought against it in this lawsuit are without merit. We have vigorously defended this action. In the opinion of management, resolution of the lawsuit is not expected to have a material adverse effect on our financial position. However, depending upon the amount and timing, an unfavorable resolution of this matter could materially affect American Founders' future operations or cash flows in a particular period.

Indemnification Agreements and Liability Insurance

Pursuant to Delaware law and our by-laws, we are obligated to indemnify our current and former officers and directors for certain liabilities arising from their employment with or services to Vesta, provided that their conduct complied with certain requirements. Pursuant to these obligations, we have been funding costs of defense and other expenses on behalf of certain current and former officers and directors, subject to an undertaking from such individuals to repay any amounts advanced in the event a court determines that they are not entitled to indemnification.

Reinsurance Arbitration/Litigation

As discussed in previous SEC filings, in 1998 we corrected our accounting for assumed reinsurance business through restatement of our previously issued financial statements. Similar corrections were made on a statutory accounting basis through recording cumulative adjustments in Vesta Fire's 1997 statutory financial statements. The impact of this correction has been reflected in amounts ceded under our 20 percent whole account quota share treaty which was terminated on June 30, 1998 on a run-off basis. We believe such treatment is appropriate under the terms of this treaty and have calculated the quarterly reinsurance billings presented to the three treaty participants accordingly. The aggregate amount included herein as recoverable from such reinsurers totaled \$33.4 million at June 30, 2003. Additionally, we have previously collected approximately \$48.5 million from the drawdown of collateral on hand. Such amount, net of related expenses, has been reflected in the 2002 financial statements.

NRMA Insurance Ltd. ("NRMA"), one of the participants in the 20 percent whole account quota share treaty, filed a lawsuit in the United States District Court for the Northern District of Alabama contesting our billings. NRMA sought rescission of the treaty and a temporary restraining order preventing us from drawing down approximately \$34.5 million of collateral. We filed a demand for arbitration as provided for in the treaty and also filed a motion to compel arbitration which was granted in the United States District Court action. Vesta reached an agreement with NRMA to collect the \$34.5 million of collateral in exchange for posting a \$25 million letter of credit in favor of NRMA to fund any amounts NRMA may recover as a result of the arbitration. We also filed for arbitration against Alfa Mutual Insurance Company and Dorinco Reinsurance Company, the other two participants on the treaty. All those arbitrations are in the discovery stages. Additionally, Alfa filed a Motion for Declaratory Judgment asking the arbitration panel to order that there is no enforceable agreement between Alfa and Vesta or alternatively, that there is no coverage for developmental losses under the treaty. After a hearing in June 2002, the arbitration panel denied Alfa's motion. The hearing on the merits of the arbitration with Alfa was scheduled for May 2003. However, on April 21, 2003, Alfa filed a lawsuit against Vesta Fire in state court in Montgomery, Alabama seeking a declaration from the Court on certain procedural and organizational matters and requesting that the Court stay the arbitration proceedings during the pendency of the litigation in state court in Alabama. On April 24, 2003, the Court issued a temporary restraining order staying the proceedings in the ongoing arbitration in order to maintain the status quo until the merits of Alfa's petition can be heard and determined, which is currently scheduled for September 24, 2003. The lawsuit filed by Alfa will delay

indefinitely the Alfa arbitration proceedings but is not currently expected to delay proceedings in the other two arbitrations. On June 19, 2002, the panel in the NRMA arbitration issued an order to bifurcate the arbitration, and scheduled a hearing for the week of October 28, 2002 to decide the issue of coverage for developmental losses under the treaty. On September 6, 2002, the panel notified the parties that it would make such determination on this specific issue on the papers and filings submitted by the parties without the necessity of a live hearing. On November 6, 2002, the Company was notified by the panel that it ruled that the treaty does not apply to loss occurrences prior to July 1, 1997. As a result, Vesta recorded a \$23.6 million pre-tax charge as a revision of our estimated reinsurance recoverable in the third quarter of 2002. This ruling does not set a binding precedent regarding Vesta's other arbitrations and, accordingly, we have not recorded any change in our estimate of our recoverable from the other treaty participants as a result of this ruling. In February 2003, Vesta filed a petition to vacate the NRMA panel ruling in the U.S. District Court for

the Northern District of Alabama. On April 8, 2003, the Court ruled that since the arbitration proceedings have not been fully exhausted, it was dismissing Vesta's petition without prejudice of the parties to seek the Court's review of any final arbitration award. The hearing in the NRMA arbitration is currently scheduled to begin on October 20, 2003, and is estimated to take approximately two weeks. On December 16, 2002, Dorinco filed a motion seeking an order that the treaty does not cover developmental losses. On May 1, 2003, the panel in the Dorinco arbitration ruled that Dorinco is not responsible for losses on any policy or any other insurance or reinsurance contract terminated prior to July 1, 1997 and that the arbitration will continue with respect to losses whenever occurring, on policies or any other insurance or reinsurance contract in force at July 1, 1997. The hearing in the Dorinco arbitration is currently scheduled to begin on December 1, 2003, and is estimated to take approximately two weeks. Based on a current estimate of the impact of this ruling and the ruling previously received from the NRMA panel, we currently believe our estimated recoverable is appropriate. However, we are continuing to evaluate the effects of complying with these rulings and our estimate may change in the future as a result of this evaluation.

While management continues to believe its interpretation of the treaty's terms and computations based thereon are correct, these matters are being contested in these arbitration proceedings and their ultimate outcome cannot be determined at this time. If rescission on all three treaties was awarded by three separate arbitration panels, we would incur a pre-tax charge of approximately \$57.0 million.

If the amounts recoverable under the relevant treaties are ultimately determined to be materially less than the amounts that we have reported as recoverable, we may incur a significant, material, and adverse impact on our financial condition and results of operations.

We are in arbitration with CIGNA Property and Casualty Insurance Company (now ACE USA) under a personal lines insurance quota share reinsurance agreement, whereby we assumed certain risks from CIGNA. During September 2000, CIGNA filed for arbitration under the reinsurance agreement, seeking payment of the balances that CIGNA claimed were due under the terms of the treaty. At that time, the treaty was terminated on a cut-off basis. In the pending arbitration Vesta is seeking, among other things, recoupment of all believed improper excessive expense allocations and charges from CIGNA. The arbitration was bifurcated into two phases with Phase I concentrating on the interpretation of the intent of the parties related to the expense reimbursement provisions of the treaty at the time it was entered. Phase II, which is ongoing, relates to any remaining issues between the parties, including those that exist with regard to an audit of expenses ceded to the treaty. The Phase I hearing was held in February 2002 and the panel ruled that (i) the Company is responsible for the payment of ceding commissions provided for in the treaty and should pay any outstanding billings for commissions and paid claims, plus interest; (ii) the Company may proceed with an audit of expenses ceded to the treaty; and (iii) the parties should identify any further issues to be brought before the arbitration panel for phase two of the hearing. Vesta is presently conducting its expense audit as permitted by the panel. During the course of preparing for and conducting the expense audit, the Company determined that it should revise its estimated reinsurance receivable and record during the second quarter of 2003 a pre-tax valuation allowance of \$9.4 million and recorded the valuation allowance as a component of discontinued operations. Management intends to continue to proceed with the presentation of our case to the arbitration panel and believes that the resolution of this arbitration will not have any adverse financial impact on the Company. The Phase II hearing has not yet been scheduled.

Muhl vs. Vesta is a case pending in the supreme Court of the State of New York, County of New York, brought by the Liquidator of Midland Insurance Company ("Midland"), claiming recoveries under two alleged retrocession agreements (Pool I and Pool III) between Midland and Interstate Fire Insurance Company, Vesta's predecessor in interest. The Liquidator's claims against Vesta under Pool I and Pool III have been severed.

Third party auditors hired by Vesta have identified coverage issues that cast doubt on the validity of a number of claims. In addition, there is no actual retrocessional agreement that evidences the terms and conditions of Pool III which involves 71% or more of the incurred losses at issue. Although there are other tangential documents that the Liquidator may attempt to rely on to prove liability under Pool III, we believe that the Liquidator will not be able to establish liability for any portion of the Pool III claims. We also believe that a number of the losses allegedly incurred in connection with Pool I may be avoided on specific coverage grounds. We are defending this matter vigorously and are reasonably optimistic regarding the ultimate outcome, although an adverse ruling in this case could have a material effect on our financial condition.

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Nichols vs. Vesta Fire Insurance Corporation is a lawsuit brought by the Liquidator of Delta America Re Insurance Company in Kentucky state court to recover losses alleged under reinsurance contracts entered into in the 1970's. Vesta removed the action to federal court and successfully moved to compel arbitration. Each party has selected a party arbitrator but as yet there is no neutral umpire. There has been no discovery as yet and no organizational meeting of the panel.

Vesta vs. New Cap Re is an arbitration against an Australian reinsurer, to collect reinsurance recoverables pursuant to two accident year excess of loss ratio reinsurance agreements. In the arbitration, New Cap Re challenged Vesta's earlier draw on a Letter of Credit for \$7.5 million which was held in connection with one of the two contracts. Shortly after the arbitration commenced, New Cap Re became the subject of insolvency proceedings in Australia and an ancillary proceeding in the U.S. Bankruptcy Court in New York. The Bankruptcy Court stayed all pending litigation and arbitration against New Cap Re, and we appealed that ruling to the Southern District of New York, and ultimately to the U.S. Court of Appeals for the Second Circuit which recently affirmed the Bankruptcy Court's stay of the arbitration against New Cap Re. Hence, our efforts to recover losses as well as New Cap Re's efforts to challenge the earlier draw on the \$7.5 million Letter of Credit by us are stayed.

On September 5, 2002, New Cap Re served us with an Application pursuant to Section 588FF of the Australian Corporations Act seeking an order directing us to pay New Cap Re and its liquidator \$1.0 million that Vesta allegedly received as an "unfair preference" and/or arising out of an "uncommercial transaction," as those terms are defined by the Corporations Act. We filed a Notice of Appearance on October 31, 2002. While management intends to vigorously defend this matter, given the preliminary nature of these proceedings, it is too early to evaluate the likelihood of success.

Other

Vesta, through its subsidiaries, is routinely a party to pending or threatened legal proceedings and arbitration relating to the regular conduct of its insurance business. These proceedings involve alleged breaches of contract, torts, including bad faith and fraud claims and miscellaneous other specified relief. Based upon information presently available, and in light of legal and other defenses available to Vesta and its subsidiaries, management does not consider liability from any threatened or pending litigation regarding routine matters to be material.

Credit Facilities

Effective February 1, 2003, we entered into a new revolving credit arrangement with First Commercial to replace the previous facility. The new facility is a \$30 million line secured by a pledge of 358,375 shares of common stock of Instant Insurance Holdings, Inc. (Instant), representing approximately 70% of Instant's issued and outstanding shares of capital stock as of December 31, 2002. The new facility bears interest at First Commercial's prime rate and will mature no earlier than June 30, 2005. As of June 30, 2003, we had drawn \$29.8 million available under this Agreement.

This new credit agreement contains covenants which require us to maintain (i) consolidated GAAP net income (excluding realized gains and losses) of at least \$15 million for any calendar year, beginning in 2003, (ii) Consolidated debt to capital ratio of no more than 39%, (iii) an A.M. Best rating of "B" or better, (iv) consolidated GAAP net worth of at least \$208 million, (v) an interest coverage ratio of not less than 1.5 to 1 and (vi) risk-based capital of not less than 150% of the NAIC's authorized control level. As of June 30, 2003, we were in compliance with all quarterly covenants. However, based on our results through the first six months of 2003, we believe that uncertainty exists regarding our ability to meet certain of the First Commercial credit arrangement covenants at December 31, 2003. Furthermore, current dividend levels from Vesta Fire and J. Gordon Gaines would not be sufficient to repay the anticipated outstanding balance of this credit facility at the year-end covenant measurement date without seeking prior approval. Although management believes the Company would be able to secure waivers on any covenant violations, the failure to obtain such waivers of the potential covenant violations or refinance the credit facility on similar terms could have a material adverse impact on our financial condition.

Note C-Segment Information

We report financial results according to five business segments, which are distinguished by their product offerings or business activities. The accounting policies of the operating segments are described in Note A in the Company's Annual Report on Form 10-K for the year-ended December 31, 2002. Segment pre-tax income (loss) is generally income from continuing operations before income taxes, minority interest and deferrable capital security distributions. Premiums, policy fees, other income, loss and benefit expenses, operating expenses and policy acquisition expenses are attributed directly to each operating segment. Net investment income and interest expense are allocated only to those segments for which such amounts are considered an integral part of the financial results for that segment.

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A brief description of each segment is as follows:

Standard property-casualty segment

The standard property-casualty segment consists of two principal lines of business: (1) underwriting residential property insurance in capacity constrained states; and (2) underwriting residential property and automobile insurance in states where we can profitably offer both products through independent agents. Vesta's insurance products are distributed primarily through approximately 2,475 independent agencies in 16 states. Our residential property lines target families (1) with multiple insurance policies; (2) who own more than one automobile; and (3) who live in a home valued between \$100,000 and \$250,000. Our standard personal auto line targets drivers over age thirty-five with above average driving records.

Life insurance segment

We provide a variety of life insurance products through American Founders Financial Corporation, a holding company for two life insurance companies domiciled in Texas. In 2000, we purchased a 72% interest in American Founders. On February 18, 2003, we purchased the remaining shares held by minority holders and now own 100% of American Founders. At June 30, 2003, American Founders had in force approximately \$1.8 billion (face value) of life and annuity products. American Founders markets traditional life products, universal life products, fixed-rate annuities, pension contracts and related products through independent agents located throughout the U.S. In the fourth quarter of 2002, we decided to exit the health insurance business line which was previously included in the life insurance segment. The results for the health insurance line have been reclassified to discontinued operations for all periods presented in this report. See Note F.

Non-standard underwriting segment

Our non-standard underwriting segment consists of two lines of business: (1) underwriting non-standard auto insurance products sold by our affiliated agency operations and (2) underwriting non-standard auto insurance sold by unaffiliated agencies. In each of these lines of business, we utilize quota share reinsurance to minimize our exposure to loss. The non-standard underwriting segment includes our fronting operations and any underwriting risk retained from premiums written through our non-standard auto agencies.

With respect to fronting arrangements, we write property-casualty insurance coverages and reinsure substantially all of the risks to reinsurers in exchange for fees. This business takes advantage of our certificates of authority granting us license to write insurance in many states. Income from fronting arrangements is primarily generated on a fee-for-service basis. For the premium written through our non-standard auto agencies, we determine, based upon market conditions and the prospective results of the underlying business, whether to keep 100% of the underwriting risk or reinsure this risk to various reinsurers. Our decision on how much underwriting risk to retain is dependent on the current rating environment and the amount of commissions offered by the reinsurers.

Non-standard agency segment

Our non-standard agency segment does not engage in underwriting activities. The primary focus of our agency segment is the distribution of non-standard auto insurance products for various retail and wholesale insurance carriers in exchange for commissions and fees. Our non-standard agencies primarily target (1) individuals specifically required by law to purchase auto insurance; (2) individuals with accidents or violations on their driving records; (3) new drivers; and (4) drivers of high-performance vehicles. Typically, non-standard auto insurance customers are considered higher-risk than standard customers, and premiums for non-standard insurance are generally more expensive.

Corporate and other segment

Our corporate and other segment consists primarily of (1) net income earned on investments; (2) interest expenses associated with corporate debt; (3) financial results for a small life insurance agency; and (4) overhead expenses not directly associated with any other business segment.

A summary of segment results for the three months ended June 30, 2003 and 2002 is as follows:

Standard Property-	Non-Standard	Non-Standard	Corporate	Eliminations	Total
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	Standard	Life					
	Casualty	Insurance	Underwriting	Agency	and Other		
2003	(in thousands)						
Revenues:							
Premiums earned	\$ 79,348	\$ 2,317	\$ 41,795	\$ --	\$ --	\$ --	\$ 123,460
Agency fees and commissions	--	--	--	33,936	--	(17,082)	16,854
Net investment income	--	7,078	--	--	2,793	--	9,871
Policy fees	2,892	632	5,549	--	--	--	9,073
Realized gains (losses)	--	242	--	--	1,869	--	2,111
Other	164	719	773	--	203	--	1,859
Total revenues	82,404	10,988	48,117	33,936	4,865	(17,082)	\$ 163,228
Expenses:							
Loss, LAE and policyholder benefits	64,997	5,214	28,592	--	--	--	98,803
Policy acquisition costs	17,785	41	12,091	--	--	(6,441)	23,476
Operating expenses	11,264	2,407	5,091	30,142	5,054	(10,641)	43,317
Interest on debt	--	1,436	--	332	1,385	--	3,153
Intangible asset amortization	--	--	--	--	84	--	84
Total expenses	94,046	9,098	45,774	30,474	6,523	(17,082)	168,833
Pre-tax income (loss)	\$ (11,642)	\$ 1,890	\$ 2,343	\$ 3,462	\$ (1,658)	\$ --	\$ (5,605)
Operating segment assets:							
Investments and other assets	\$ 439,319	\$ 874,829	\$ 159,796	\$ 139,579	\$ 261,438		
Deferred acquisition costs	42,909	20,142	13,670	--	--		
	\$ 482,228	\$ 894,971	\$ 173,466	\$ 139,579	\$ 261,438		

	Standard	Life					
	Property-Casualty	Insurance	Non-Standard Underwriting	Non-Standard Agency	Corporate and Other	Eliminations	Total
2002	(in thousands)						
Revenues:							
Premiums earned	\$ 79,142	\$ 2,476	\$ 40,566	\$ --	\$ --	\$ --	\$ 122,184
Agency fees and commissions	--	--	--	26,172	--	(12,819)	13,353
Net investment income	--	9,230	--	--	4,915	(454)	13,691
Policy fees	1,290	1,133	3,082	--	--	--	5,505
Realized gains (losses)	--	2,322	--	--	(2,911)	--	(589)
Other	225	320	1,628	--	216	--	2,389
Total revenues	80,657	15,481	45,276	26,172	2,220	(13,273)	\$ 156,533
Expenses:							
Loss, LAE and policyholder benefits	59,336	6,923	24,190	--	--	--	90,449
Policy acquisition costs	16,405	463	12,153	--	--	(4,806)	24,215
Operating expenses	9,735	2,646	5,757	22,671	6,096	(8,013)	38,892
Interest on debt	--	1,588	--	454	2,307	(454)	3,895
Intangible asset amortization	--	--	--	--	84	--	84

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Total expenses	Standard 85,476	11,620	42,100	23,125	8,487	(13,273)	157,535
Pre-tax income (loss)	\$ (4,819)	\$ 3,861	\$ 3,176	\$ 3,047	\$ (6,267)	\$ --	\$ (1,002)
Operating segment assets:							
Investments and other assets	\$ 359,554	\$ 916,598	\$ 149,657	\$ 66,192	\$ 353,141		
Deferred acquisition costs	57,720	24,782	1,517	10,669	--		
	<u>\$ 417,274</u>	<u>\$ 941,380</u>	<u>\$ 151,174</u>	<u>\$ 76,861</u>	<u>\$ 353,141</u>		

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A summary of segment results for the six months ended June 30, 2003 and 2002 is as follows:

	Standard Property- Casualty	Life Insurance	Non-Standard Underwriting	Non-Standard Agency	Corporate and Other	Eliminations	Total
2003	(in thousands)						
Revenues:							
Premiums earned	\$ 155,760	\$ 4,727	\$ 80,466				\$ 240,953
Agency fees and commissions	--	--	--	\$ 72,858		\$ (35,127)	37,731
Net investment income	--	14,773	--	--	\$ 6,713	--	21,486
Policy fees	4,954	1,125	10,632	--	--	--	16,711
Realized gains (losses)	--	232	--	--	5,386	--	5,618
Other	406	1,361	1,685	--	350	--	3,802
Total revenues	<u>161,120</u>	<u>22,218</u>	<u>92,783</u>	<u>72,858</u>	<u>12,449</u>	<u>(35,127)</u>	<u>\$ 326,301</u>
Expenses:							
Loss, LAE and policyholder benefits	117,991	10,304	55,104	--	--	--	183,399
Policy acquisition costs	36,413	409	23,324	--	--	(14,887)	45,259
Operating expenses	22,269	4,859	8,998	64,111	8,958	(20,240)	88,955
Interest on debt	--	2,889	--	332	3,090	--	6,311
Gain on extinguishment of debt	--	--	--	--	--	--	--
Intangible asset amortization	--	--	--	--	168	--	168
Total expenses	<u>176,673</u>	<u>18,461</u>	<u>87,426</u>	<u>64,443</u>	<u>12,216</u>	<u>(35,127)</u>	<u>324,092</u>
Pre-tax income (loss)	<u>\$ (15,553)</u>	<u>\$ 3,757</u>	<u>\$ 5,357</u>	<u>\$ 8,415</u>	<u>\$ 233</u>	<u>\$ --</u>	<u>\$ 2,209</u>

Standard Property- Casualty	Life Insurance	Non-Standard Underwriting	Non-Standard Agency	Corporate and Other	Eliminations	Total
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2002	Standard			(in thousands)			
Revenues:							
Premiums earned	\$ 145,508	\$ 5,533	\$ 76,440				\$ 227,481
Agency fees and commissions	--	--	--	\$ 58,734		\$ (27,001)	31,733
Net investment income	--	18,536	--	--	\$ 9,297	(574)	27,259
Policy fees	2,592	2,116	4,215	--	--	--	8,923
Realized gains (losses)	--	3,263	--	--	(2,767)	--	496
Other	225	657	3,236	--	406	--	4,524
Total revenues	148,325	30,105	83,891	58,734	6,936	(27,575)	\$ 300,416
Expenses:							
Loss, LAE and policyholder benefits	105,726	14,751	47,805	--	--	--	168,282
Policy acquisition costs	31,469	800	21,471	--	--	(10,014)	43,726
Operating expenses	18,621	5,104	9,053	52,381	11,314	(16,987)	79,486
Interest on debt	--	3,164	--	574	4,682	(574)	7,846
Gain on extinguishment of debt	--	--	--	--	(1,380)	--	(1,380)
Intangible asset amortization	--	--	--	--	168	--	168
Total expenses	155,816	23,819	78,329	52,955	14,784	(27,575)	298,128
Pre-tax income (loss)	\$ (7,491)	\$ 6,286	\$ 5,562	\$ 5,779	\$ (7,848)	\$ --	\$ 2,288

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Note D-Stock & Debt Transactions

In the first quarter of 2002, we issued 533,647 shares of common stock in exchange for \$4.6 million face amount of our 8.75% Senior Notes and \$.8 million face amount of our 8.5% Deferrable Capital Securities. In connection with this transaction we recorded a pre-tax gain on extinguishment of debt of \$1.4 million in other expense and an after tax gain on redemption of preferred securities of \$.2 million.

Note E-Acquisitions and Dispositions

In February 2003, we completed the acquisition of the approximate 27% remaining ownership from the minority owners of American Founders Financial Corporation. The purchase price for this acquisition was \$12.9 million. The transaction has been accounted for as a purchase. Summarized below is a preliminary allocation of 100% of the assets and liabilities of American Founders (in thousands and unaudited):

Assets acquired:	
Invested assets	\$ 723,738
Deferred policy acquisition costs	17,666
Other assets	152,684
Goodwill	10,760
	<u> </u>
Total assets	\$ 904,848
	<u> </u>
Liabilities acquired:	
Future policy benefits	\$ 661,432
Other liabilities	185,719
	<u> </u>
Total liabilities	\$ 847,151
	<u> </u>

During the second quarter of 2003, the Company acquired the 20% minority interest in InsureOne Independent Insurance Agency, LLC for \$11.2 million. The transaction has been accounted for as a purchase and resulted in an increase to goodwill of \$9.1 million.

In June 2003, the Company executed a definitive stock purchase agreement for the sale of all common stock of Aegis Financial Corporation (Aegis) and its subsidiary States General Life Insurance Company (States General). The sales price is equal to the statutory surplus of States General and Aegis, adjusted for any fair value adjustments on investment securities held by Aegis and States General. Consummation of the

transaction, which is subject to regulatory approval, is expected to occur during the third quarter. The sales price is expected to be approximately \$5.0 million. The assets and liabilities of Aegis and States General are reflected as held for sale on the accompanying June 30, 2003 balance sheet.

In the second quarter of 2003, the Company settled certain contingent consideration provisions related to prior period standard property-casualty acquisitions. The result of the settlement of the contingent consideration provisions was an increase of goodwill of \$3.5 million.

In January of 2002, the Company completed three acquisitions: (1) the acquisition of certain assets of InsureOne Agency and the renewal rights to a book of non-standard automobile business; (2) acquisition of the non-standard automobile related assets of Harbor Insurance Group; and (3) purchase of the common stock of Old American Investments. The combined purchase price for these transactions was \$35.1 million, with \$16.6 million due at closing and \$18.5 million due upon the occurrence of certain future events. In 2003, the Company paid \$2.0 million in contingent consideration and settled the remaining \$16.5 million through an agreement by which the Company is required to make scheduled payments through August 2005. The balance of the contingent consideration liability at June 30, 2003 is \$12.0 million and is reflected as a component of other liabilities on the accompanying consolidated balance sheet.

Note F-Discontinued Operations

In the fourth quarter of 2002, we made the decision to exit the health insurance and consulting business lines. Accordingly, our health insurance and consulting lines results for 2002 have been reclassified in our financial statements as part of discontinued operations and are classified as operations held for sale. For the three and six months ended June 30, 2003, we recorded a pre-tax loss for our health operations and our consulting business of \$1.0 million and \$2.5 million, respectively.

Previously, in 2000 and 1999, we exited the reinsurance assumed and commercial lines businesses, respectively. As a result, the reporting for these business lines is included in discontinued operations in our financial statements. At the time we made the decision to exit each of these business lines, we estimated the reserves required to fulfill our expected future obligations with respect to these discontinued operations. However, we continue to monitor our recorded estimates with respect to ultimate settlement on an ongoing basis.

Based upon available information, we believe the recorded reserves for discontinued operations at June 30, 2003 are adequate. However, we will continue to monitor these reserves and their related claims activity and experience. Further adjustments to our estimates could be necessary as we continue to run off the remaining outstanding claims.

For the three and six months ended June 30, 2003, we recorded a pre-tax loss for reinsurance assumed and commercial lines businesses of \$10.7 million and \$10.4 million, respectively. These losses are primarily related to the recording, during the second quarter of 2003, of a pre-tax valuation allowance of \$9.4 million on the CIGNA Property and Casualty Insurance Company arbitration reinsurance assumed receivables. See Note B to the interim consolidated financial statements.

The Company's 2002 results have been reclassified to reflect the losses from discontinued operations.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with management's discussion and analysis of the financial condition and results of operations and all of the other information, including the discussion of Vesta's critical accounting policies, appearing in Vesta's 2002 Annual Report as filed with the Securities and Exchange Commission on Form 10-K and with the financial statements included therein and the notes thereto.

Results of Operations

Overview

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Vesta conducts business in three areas of the personal insurance industry: (1) standard property and casualty insurance; (2) non-standard automobile insurance; and (3) life insurance. Our consolidated revenue is derived principally from risk-bearing premiums, commissions and fees, investment income and investment gains and losses. Our consolidated expenses consist primarily of payments for claims and expenses associated with underwriting activities, agents' commissions and operations.

We report financial information according to five business segments: (1) standard property-casualty insurance; (2) non-standard agency; (3) non-standard underwriting; (4) life insurance; and (5) corporate and other. Since 1999, we have discontinued a number of business lines. We have segregated the reporting for these discontinued operations in our financial statements.

Since 2000, we have pursued a strategy to diversify into various segments of the personal insurance markets. While we have experienced significant and profitable growth in various personal lines businesses since 2000, we have also experienced significant declines in our property and casualty subsidiaries' statutory capital and surplus during the same period. These declines in capital and surplus are primarily attributable to lower than expected arbitration awards and changes in estimates of disputed reinsurance recoverable balances, reserve strengthening in our discontinued commercial and assumed reinsurance segments and increased policy acquisitions costs associated with significant premium growth. This decline in statutory surplus coupled with significant growth in premium written is the primary reason that A.M. Best Company recently adjusted the financial strength ratings of our property and casualty insurance subsidiaries from B+ (Very Good) to B (Fair). Through the first half of 2003, our business has not experienced a significant negative impact from this adjustment. However, the adjustment could lead to significant deterioration in selected portions of our standard property and casualty premium volume and adversely impact the financial results of this segment going forward, the degree to which management is unable to quantify.

In an effort to strengthen our statutory capital position, we have undertaken an evaluation of a possible sale or divestiture of our life and health business as well as portions our property and casualty business.

Standard property-casualty and non-standard underwriting

The financial results of our property-casualty underwriting activities (including our standard property-casualty segment and the non-standard underwriting segment) primarily depend upon two variables: (1) the amount of premiums we collect, which is dependent upon rates and volume; and (2) the costs we incur to adjust and pay claims submitted by individuals we have insured.

Subject to competitive and market trends and regulatory approval, premium rates are generally within our control, and we continuously monitor and seek to adjust rates as appropriate. During the first six months of 2003, we implemented 5 rate increases in our standard automobile business line in the states of North Carolina, Ohio, West Virginia and Tennessee, which represented an average premium increase of approximately 6.8%. In the first six months of 2003, we also implemented 11 rate increases in our standard residential property line in the states of West Virginia, Ohio, Pennsylvania, Tennessee and South Carolina, which represented an average premium increase of approximately 11.6%. In our non-standard underwriting segment, we enacted 7 rate increases in the states of Florida, Illinois, Indiana, Missouri, New Mexico and South Carolina for an average increase of 2.2%. With respect to volume, our ability to increase written premium in our property-casualty underwriting activities is largely dependent upon our surplus leverage ratio, which reflects our underwriting operations' net written premiums relative to statutory surplus at the end of a period. As of December 31, 2002, our surplus leverage ratio did not indicate capacity for significant growth in our net premiums written, and, in March of 2003, we commenced an evaluation of a possible sale or divestiture of a portion of our property and casualty business in an effort to maximize shareholder value and strengthen our statutory capital position.

The costs we incur to adjust and pay claims, known as loss and loss adjustment expenses, are largely beyond our control and depend primarily upon the frequency and/or severity of claims made by our policyholders. One measure of performance in the insurance industry is the "loss ratio," which is the ratio of (i) the sum of loss and loss adjustment expenses; to (ii) the sum of earned premiums and policy fees. Our loss ratio will generally increase or decrease according to the frequency and/or severity of claims made by our policyholders.

Another key performance measure for insurance companies is the "combined ratio." The combined ratio compares (i) the sum of loss, loss adjustment expenses, operating expenses and policy acquisition expenses; to (ii) total earned premiums and policy fees. A combined ratio of less than 100% indicates underwriting profitability, without regard to investment income earned from investing the premium received.

Non-standard agency

The financial results of our agency activities primarily depend upon the amount of fees and commissions we can collect from the sale of insurance products and the expenses we incur to conduct our day-to-day operations. Although we expect the minimum commissions and policy fees that we earn under a typical agency contract to be relatively stable, we expect to earn a substantial amount of additional "profit sharing" commissions in excess of the contractual minimums. These profit sharing commissions are dependent upon whether the non-standard auto policies that we produce for other insurers result in a level of losses in relation to written premium (i.e., loss ratios) below the levels stated in our agency contracts. Accordingly, the frequency and severity of claims made on the policies our agencies produce may impact our profit sharing commissions.

Life insurance

The financial results of our life insurance operations primarily depend upon (1) the amount we collect as premium; (2) the amount of investment income earned on invested premium; and (3) the benefits we pay to insureds upon their death. Unlike the standard property-casualty reporting segments, we include the investment income earned on invested premium in the results for our life insurance segment. The greatest variable in our revenue in the life segment is the amount of income we can earn on invested assets, which is dependent upon general interest rates and market conditions. The greatest variable in our expense from period to period is the mortality rate of our insureds, as mortality rates in excess of our actuarially predicted levels will adversely impact financial results in any given period.

Corporate and other

The financial results of our corporate and other segment reflect other revenue and expenses that are not allocated to any particular segment, including (i) investment income related to our property-casualty underwriting operations; (ii) corporate interest expense; (iii) general corporate operating expenses; and (iv) realized gains and losses and gains from repurchases of our own debt securities at a discount.

In addition to the above-mentioned factors, our financial results may also be impacted by such items as weather-related events including hurricanes and tornadoes and changes in regulations governing the insurance industry. Also, our ability to effectively compete in the insurance markets we serve is influenced by the financial strength ratings assigned to our companies by A.M. Best.

Comparison of Second Quarter 2003 to Second Quarter 2002

For the quarter ended June 30, 2003, we reported a net loss available to common shareholders of \$11.6 million, or \$0.33 loss per diluted share, compared with a net loss available to shareholders of \$11.5 million, or \$0.34 loss per diluted share, reported for the previous year.

The primary factors that impacted our financial results in the second quarter of 2003 were as follows:

- Our combined ratio in the standard property-casualty segment was 114.1%. The 114.1% combined ratio was primarily impacted by \$20.0 million of catastrophe losses, including \$17.3 million from the severe Texas hail storms in April.
- A decline in market interest rates and a higher level of prepayments on our mortgage-backed securities adversely impacted net investment income. The weighted average yield (excluding realized and unrealized gains) decreased from 3.81% for the quarter ended June 30, 2002 to 2.48% for the quarter ended June 30, 2003.
- During the quarter ended June 30, 2003, the Company recorded a pre-tax valuation allowance of \$9.4 million related to the CIGNA Property & Casualty Insurance Company arbitration reinsurance assumed receivable.

For a depiction of the various components of revenue, expense and financial results for each of our business segments for the quarter ending June 30, 2003, refer to Note C included in this report.

Standard property-casualty segment

In our standard property-casualty segment, we underwrite or sell personal automobile and residential property insurance through approximately 2,475 independent insurance sales agencies. In the second quarter of 2003, the standard property-casualty segment generated approximately \$82.4 million in revenue, or approximately 50.5% of consolidated revenue.

For the quarter ended June 30, 2003, net premiums written in our standard property-casualty lines decreased by \$22.0 million (down 21.3%), to \$81.5 million from \$103.5 million in the second quarter of 2002. Net premiums earned during the three months ended June 30, 2003 for standard property-casualty lines increased by \$.2 million, or 0.3%, to \$79.3 million from \$79.1 million in 2002. The decrease in net premiums written is primarily attributable to the Texas residential property 50% quota share reinsurance treaty entered into in December of 2002, as well as decreased writings in the Midwest and Mid-Atlantic regions in connection with our decision to terminate agents and withdraw from certain states. The increase in net premiums earned for the standard property-casualty segment was primarily due to increases in premiums written in

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prior periods being earned in the current period offset by \$1.7 million of catastrophe reinstatement coverage premiums stemming from the April hail storms.

Although we expect our net written premium to continue to decrease in 2003 on a net basis, we have implemented rate increases to address emerging loss trends and to protect our net written premium relative to expenses, or underwriting margin. During the first six months of 2003, we implemented 5 rate increases in our standard automobile business line in the states of North Carolina, Ohio, West Virginia and Tennessee, which represented an average premium increase of approximately 6.8%. We also implemented 11 rate increases in our standard residential property line in the states of West Virginia, Ohio, Pennsylvania, Tennessee and South Carolina, which represented an average increase of approximately 11.6%.

Loss and loss adjustment expenses (LAE) for standard property casualty lines for the period ended June 30, 2003 increased by \$5.7 million, or 9.6%, to \$65.0 million from \$59.3 million in the prior year. The increase in loss and loss adjustment expenses incurred was primarily attributable to a \$13.8 million increase in catastrophe losses in the current quarter offset by favorable non-catastrophe underwriting results. As a result, the loss ratio for standard property-casualty segment was 79.0% compared with 73.8% at June 30, 2002.

For the quarter ended June 30, 2003, policy acquisition expenses increased by \$1.4 million, or 8.5% to \$17.8 million from \$16.4 million for the same period of the prior year. Policy acquisition costs as a percentage of total revenues for the quarter ended June 30, 2003 was 21.6% as compared to 20.3% for the same period in the prior year. This increase is attributable to a higher level of ceded premiums for reinsurance on which we do not receive a ceding commission.

Operating expenses increased \$1.6 million, or 16.5%, to \$11.3 million during the three months ended June 30, 2003 from \$9.7 million for the same period in the prior year. This increase is attributable to increased operating expenses stemming from our premium growth in 2002. This increase has stabilized over the previous quarters.

Non-standard agency segment

Our non-standard agency segment does not retain any underwriting risk. Rather, the primary focus of our agency segment is the distribution of non-standard auto insurance products for various insurance carriers in exchange for commissions and fees. Since our entry into the non-standard auto business in late 2000, revenue for our agency segment has increased significantly. In the second quarter of 2003, our non-standard agency segment generated approximately \$33.9 million of commission and fees-based revenue, or 18.8% of aggregate revenue, before eliminations.

For the quarter ended June 30, 2003, fees and commissions in our agency segment increased by \$7.8 million due to increased sales of non-standard products. Our agency segment pre-tax income increased \$0.4 million, or 13.3%, to \$3.4 million for the three-months ended June 30, 2003 compared to \$3.0 million for 2002.

Non-standard underwriting segment

Our non-standard underwriting segment can be separated into two lines of business: (1) underwriting non-standard auto insurance products sold by our affiliated agency operations and (2) underwriting non-standard auto insurance sold by unaffiliated agencies. In each of these business lines, we utilize quota share reinsurance to minimize our exposure to loss. Under a quota share contract, reinsurers share losses and certain allocated expenses in the same percentage as they share in premiums.

Since entering the non-standard auto business in late 2000, our revenue has increased significantly. In the second quarter of 2003, our non-standard underwriting segment generated approximately \$41.8 million of revenue, representing approximately 29.5% of consolidated revenue.

For the quarter ended June 30, 2003, net premiums written for non-standard lines increased by \$2.6 million, or 6.0%, to \$46.0 million from \$43.4 million in 2002. For the same period, net premiums earned for non-standard lines increased by \$1.2 million, or 3.0%, to \$41.8 million from \$40.6 million. The increase in net premiums written and net premiums earned was primarily attributable to new business produced by our

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affiliated agency operations, which acquired several agencies in late 2001 and early 2002.

Of our total non-standard net written premiums of \$46.0 million during the second quarter of 2003, the net premiums written on policies produced by our affiliated agencies were approximately \$38.9 million. The largest component of our net premiums written on policies sold by affiliated agencies was approximately \$16.9 million net premium written through InsureOne, our affiliated agency operation based in Chicago, Illinois. Until December 1, 2002, we bore 100% of the underwriting risk on these policies. Effective December 1, 2002, we entered into a contract to cede 40% of the premiums and losses on the InsureOne business to third party reinsurers pursuant to a quota share reinsurance contract. Although the volume of policies sold by affiliated agencies other than InsureOne and unaffiliated agencies have continued to increase during the first half of 2003, we expect the rate of growth of our total non-standard underwriting net written premiums will decrease in second half of 2003 as a result of the InsureOne quota share reinsurance contract.

Of our total net non-standard written premiums of \$46.0 million during the second quarter of 2003, net written premiums produced by unaffiliated agencies was approximately \$7.1 million, with approximately \$20.9 million of gross written premium ceded to third party reinsurers. For the quarter ended June 30, 2003, we also collected "issuing carrier" or "fronting" fees of approximately \$.8 million, down from \$1.6 million in 2002. The decrease in fronting fees was primarily attributable to a decrease in the fronting fees earned in relation to a program in California to \$.6 million in the second quarter of 2003, compared with \$1.2 million in the same period in 2002.

Although we expect our net written premium will decrease in the latter half of 2003 as compared to the prior year levels as a result of the quota share reinsurance contract placed on the Insure One business, we have implemented rate increases to address emerging loss trends and to protect our underwriting margin. During the first six months of 2003, we implemented 7 rate increases in our non-standard underwriting segment in the states of Florida, Illinois, Indiana, Missouri, New Mexico and South Carolina, which represented an average premium increase of approximately 2.2%.

Loss and loss adjustment expenses for the non-standard underwriting segment increased by \$4.4 million, or 18.2%, in the second quarter of 2003, to \$28.6 million from \$24.2 million in 2002. The loss ratio for our non-standard underwriting segment at June 30, 2003 was 60.4%, compared with 55.4% at June 30, 2002. The increase in the loss and loss adjustment expense ratio was primarily attributable to a maturity of the book of business.

For the quarter ended June 30, 2003 policy acquisition expenses decreased \$62 thousand to \$12.1 million from \$12.2 million in 2002. Policy acquisition expenses as a percentage of earned premiums and policy fees decreased to 25.5% for the quarter ended June 30, 2003 from 27.8% in 2002, primarily attributable to higher contingent commissions earned during the current quarter as compared to prior year.

Life insurance segment

We provide a variety of life insurance products through American Founders Financial Corporation, a holding company for two life insurance companies domiciled in Texas. American Founders' business is driven primarily by the acquisitions of closed blocks of life insurance policies and, to a lesser extent, by marketing and distributing its fixed annuity products. Our life insurance products are sold through marketing firms, financial institutions and 1,000 independent agents located throughout 37 states and the District of Columbia. At June 30, 2003, American Founders had approximately \$1.8 billion (face value) of life and annuity products in force, and approximately \$737.1 million in invested assets.

In the second quarter, our life insurance segment generated approximately \$11.0 million in revenue, or approximately 6.7% of consolidated revenue.

Life insurance fees decreased to \$.6 million from \$1.1 million in the prior year as a result of increased reinsurance. Investment income decreased \$2.2 million from the prior year due to increased reinsurance, higher volumes of paydowns on our mortgage-backed securities, an overall decline in market interest rates during 2002 and a reduction in invested assets from \$851.4 million as of June 30, 2002 to \$737.1 as of June 30, 2003. The weighted average yield on invested assets for 2003 (excluding realized and unrealized gains/losses) was 4.9% compared with 6.1% for the prior year period.

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For the period ended June 30, 2003, net investment income related to our property-casualty underwriting operations decreased by \$2.1 million to \$2.8 million from \$4.9 million in 2002. The decrease in investment income was primarily attributable to a decline in overall market interest rates and a higher level of prepayments on our mortgage-backed securities, partially offset by increased average invested assets. The weighted average yield on invested assets for the quarter ended June 30, 2003 (excluding realized and unrealized gains/losses) was 3.72% compared with 6.1% for the prior year period.

Our overall interest expense includes interest payable on our 8.75% senior debentures due in 2025 and borrowings and our commercial credit borrowings. Interest expense decreased by \$.9 million compared with 2002, primarily due to debt repurchased in 2002.

In 2003, operating expenses decreased by \$1.0 million from the prior year primarily due to decreased compensation costs and the termination of an operating lease.

Discontinued operations

In the fourth quarter of 2002, we made the decision to exit the health insurance and consulting business lines. Accordingly, our health insurance and consulting lines results for 2002 have been reclassified in our financial statements as part of discontinued operations and are classified as operations held for sale. For the quarter ended June 30, 2003, we recorded a pre-tax loss of \$1.0 million for our health operations and our consulting business.

Previously, in 2000 and 1999, we exited the reinsurance assumed and commercial lines businesses, respectively. As a result, the reporting for these business lines is included in discontinued operations in our financial statements. At the time we made the decision to exit each of these business lines, we estimated the reserves required to fulfill our expected future obligations with respect to these discontinued operations. However, we continue to monitor our recorded estimates with respect to ultimate settlement on an ongoing basis.

Based upon available information, we believe the recorded reserves for discontinued operations at June 30, 2003 is adequate. However, we will continue to monitor these reserves and their related claims activity and experience. Further adjustments to our estimates could be necessary as we continue to run off the remaining outstanding claims.

For the quarter ended June 30, 2003, we recorded a pre-tax loss of \$10.7 million for reinsurance assumed and commercial lines businesses primarily related to the recording, during the second quarter of 2003, of a pre-tax valuation allowance of \$9.4 million on the CIGNA Property and Casualty Insurance Company arbitration reinsurance assumed receivables. See Note B to the interim consolidated financial statements.

The Company's 2002 results have been reclassified to reflect the losses from discontinued operations.

Income taxes

For the period ended June 30, 2003, we recorded an income tax benefit of \$2.0 million, compared with an income tax benefit of \$.3 million recorded in the prior year. Our effective tax rate of 35% in 2003 was consistent with our effective tax rate in the prior year.

Comparison of Six Months Ended June 30, 2003 with Six Months Ended June 30, 2002

For the six month period ended June 30, 2003, we reported net loss available to common shareholders of \$7.9 million, or \$0.23 loss per diluted share, compared with net loss available to shareholders of \$9.5 million, or \$0.29 loss per diluted share, reported for the previous year.

The primary factors that impacted our financial results in the six month period of 2003 were as follows:

- Our combined ratio in the standard property-casualty segment was 109.6%. The combined ratio of 109.6% was primarily driven by \$23.3 million of losses, loss adjustment expenses and additional catastrophe coverage premiums resulting from various catastrophes occurring during the first half of 2003, including \$17.3 million related to a series of April hail storms in Texas and the Southeastern United States.
- Net investment income have been adversely impacted by higher levels of prepayments on our mortgage-backed securities and an overall decline in market rates. The weighted average yield (excluding realized and unrealized gains) decreased from 4.70% for the six months ended June 30, 2002 to 3.32% for the six months ended June 30, 2003.
- Operating results from our non-standard agency segment continue to improve as we expand our agency operations. Pre-tax income from our non-standard agency was \$8.4 million for the six months ended June 30, 2003.
- During the quarter ended June 30, 2003, the Company recorded a pre-tax valuation allowance of \$9.4 million related to the CIGNA Property & Casualty Insurance Company arbitration reinsurance assumed receivable.

Standard property-casualty segment

In the six months ended June 30, 2003, the standard property-casualty segment generated approximately \$161.1 million in revenue, or approximately 49.4% of consolidated revenue.

For the six months ended June 30, 2003, net premiums written in our standard property-casualty lines decreased by \$36.7 million, or 18.4%, to \$163.1 million from \$199.8 million in the prior year period. Net premiums earned for standard property-casualty lines increased by \$10.3 million in 2003, up 7.0%, to \$155.8 million from \$145.5 million in 2002. The decrease in net premiums written is primarily attributable to the Texas residential property 50% quota share reinsurance treaty entered into in December of 2002 as well as decreased writings in the Midwest and Mid-Atlantic regions in connection with our decision to terminate agents and withdraw from certain states. The increase in net premiums earned for the standard property-casualty segment was primarily due to increases in premiums written in prior periods being earned in the current period.

Although we expect our net written premium will decrease in 2003 on a net basis as a result of the Texas residential property 50% quota share, we have implemented rate increases to address emerging loss trends and to protect our net written premium relative to expenses, or underwriting margin. During the first six months of 2003, we implemented 5 rate increases in our standard automobile business line in the states of North Carolina, Ohio, West Virginia and Tennessee, which represented an average premium increase of approximately 6.8%. We also implemented 11 rate increases in our standard residential property line in the states of West Virginia, Ohio, Pennsylvania, Tennessee and South Carolina, which represented an average increase of approximately 11.6%.

Loss and loss adjustment expenses for standard property casualty lines for the period ended June 30, 2003 increased by \$12.3 million, or 11.6%, to \$118.0 million from \$105.7 million in the prior year. The increase in loss and loss adjustment expenses incurred was primarily attributable to a \$15.4 million increase in catastrophe losses in the first half of 2003 as compared to the first half of 2002 off-set by favorable non-catastrophe underwriting results. As a result, the loss ratio for standard property-casualty segment was 73.2% for the first half of 2003 compared with 71.3% for the first half of 2002.

For the quarter ended June 30, 2003, policy acquisition expenses increased by \$4.9 million, or 15.7%, to \$36.4 million from \$31.5 million for the same period of the prior year. Policy acquisition costs as a percentage of total revenues for the six months ended June 30, 2003 was 22.6% as compared to 21.2% for the same period in the prior year. This increase is attributable to higher level of ceded premiums for reinsurance on which we do not receive a ceding commission.

Operating expenses increased \$3.7 million, or 19.9%, to \$22.3 million during the six months ended June 30, 2003 from \$18.6 million for the same period in the prior year. This increase is attributable to increased operating expenses stemming from our premium growth.

Non-standard agency segment

In the first six months of 2003, our non-standard agency segment generated approximately \$72.9 million of commission and fees-based revenue, or approximately 20.2% of aggregate revenue, before eliminations.

For the six months ended June 30, 2003, fees and commissions in our agency segment increased by \$14.1 million, reflecting the continued growth in this segment since our entry in late 2000. Our agency segment continued to improve its financial performance in the first half of 2003, achieving pre-tax income of approximately \$8.4 million compared with \$5.8 million during the first six months of 2002.

Non-standard underwriting segment

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Since entering the non-standard auto business in late 2000, our revenue has increased significantly. For the six months ended June 30, 2003, our non-standard underwriting segment generated approximately \$92.8 million of revenue, representing approximately 28.4% of consolidated revenue.

For the six months ended June 30, 2003, net premiums written for non-standard lines increased by \$4.3 million, or 4.9%, to \$93.0 million from \$88.7 million in 2002. For the same period, net premiums earned for non-standard lines increased by \$4.1 million to \$80.5 million from \$76.4 million. The increase in net premiums written and net premiums earned was primarily attributable to new business produced by our affiliated agency operations, which acquired several agencies in late 2001 and early 2002 which have continued to experience premium growth.

Of our total non-standard net written premiums of \$93.0 million during the six months ended June 30, 2003, the net premiums written on policies produced by our affiliated agencies was approximately \$77.1 million. The largest component of our net premiums written on policies sold by affiliated agencies was approximately \$39.2 million net premium written through InsureOne, our affiliated agency operation based in Chicago, Illinois. Until December 1, 2002, we bore 100% of the underwriting risk on these policies. Effective December 1, 2002, we entered into a contract to cede 40% of the premiums and losses on the InsureOne business to third party reinsurers pursuant to a quota share reinsurance contract. Although the volume of policies sold by affiliated agencies other than InsureOne have continued to increase during the first half of 2003, we expect our total non-standard underwriting net written premiums will decrease in the second half of 2003 as a result of the InsureOne quota share reinsurance contract.

Of our total non-standard net written premiums of \$93.0 million during the six month period ended June 30, 2003, net written premiums produced by unaffiliated agencies was approximately \$15.9 million, with approximately \$44.7 million of gross written premium ceded to third party reinsurers. For the quarter ended June 30, 2003, we also collected "issuing carrier" or "fronting" fees of approximately \$1.7 million, down from \$3.2 million in 2002. The decrease in fronting fees was primarily attributable to a decrease in the fronting fees earned in relation to a program in California to \$1.2 million during the first six months of 2003, compared with \$2.3 million in the prior year.

Although we expect our net written premium will decrease in the latter half of 2003 as compared to the prior year as a result of the quota share reinsurance contract placed on the Insure One business, we have implemented rate increases to address emerging loss trends and to protect our underwriting margin. During the first six months of 2003, we implemented 7 rate increases in our non-standard underwriting segment in the states of Florida, Illinois, Indiana, Missouri, New Mexico and South Carolina, which represented an average premium increase of approximately 2.2%.

Loss and loss adjustment expenses during the first half of 2003 for the non-standard underwriting segment increased by \$7.3 million, or 15.3%, in 2003, to \$55.1 million from \$47.8 million in 2002. The increase in loss and loss adjustment expenses incurred was primarily attributable to the increase in earned premium produced by affiliated agencies acquired in our agency segment during 2002. The loss ratio for our non-standard underwriting segment at June 30, 2003 was 60.5%, compared with 59.3% at June 30, 2002. The increase in the loss and loss adjustment expense ratio was primarily attributable to unfavorable loss ratios on premium produced by affiliated agencies acquired in our non-standard agency segment during 2002.

Consistent with the corresponding increase in earned premium, policy acquisition expenses for the period ended June 30, 2003 increased by \$1.9 million from the same period of the prior year.

Life insurance segment

In the first six months of 2003, our life insurance segment generated approximately \$22.2 million in revenue, or approximately 6.8% of consolidated revenue.

Life insurance policy fees decreased to \$1.1 million from \$2.1 million in the prior year as a result of increased reinsurance. Investment income decreased \$3.8 million from the prior year due to increased reinsurance, higher volumes of paydowns on our mortgage-backed securities, a decline in market interest rates during 2003 and a reduction in invested assets from \$851.4 million as of June 30, 2002 to \$737.1 million as of June 30, 2003. The weighted average yield on invested assets for the six months ended June 30, 2003 (excluding realized and unrealized gains and losses) was 5.1% compared with 6.0% for the prior year period.

Corporate and other segment

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For the six month period ended June 30, 2003, net investment income related to our property-casualty underwriting operations decreased by \$2.6 million to \$6.7 million from \$9.3 million in 2002. The decrease in investment income was primarily attributable to a decline in overall market interest rates and a higher level of prepayments on our mortgage-backed securities, partially offset by increased average invested assets. The weighted average yield on invested assets for the six months ended June 30, 2003 (excluding realized and unrealized gains and losses) was 4.05% compared with 6.4% for the prior year period.

Our overall interest expense includes interest payable on our 8.75% senior debentures due in 2025 and our commercial credit borrowings. Interest expense decreased by \$1.6 million compared with 2002, primarily due to debt repurchased in 2002.

In 2003, operating expenses decreased by \$2.4 million from the prior year primarily due to decreased compensation costs and the termination of an operating lease.

Discontinued operations

In the fourth quarter of 2002, we made the decision to exit the health insurance and consulting business lines. Accordingly, our health insurance and consulting lines results for 2002 have been reclassified in our financial statements as part of discontinued operations and are classified as operations held for sale. For the period ended June 30, 2003, we recorded a pre-tax loss of \$2.5 million for our health operations and \$.6 million from our consulting business.

Previously, in 2000 and 1999, we exited the reinsurance assumed and commercial lines businesses, respectively. As a result, the reporting for these business lines is included in discontinued operations in our financial statements. At the time we made the decision to exit each of these business lines, we estimated the reserves required to fulfill our expected future obligations with respect to these discontinued operations. However, we continue to monitor our recorded estimates with respect to ultimate settlement on an ongoing basis.

Based upon available information, we believe the recorded reserves for discontinued operations at June 30, 2003 is adequate. However, we will continue to monitor these reserves and their related claims activity and experience. Further adjustments to our estimates could be necessary as we continue to run off the remaining outstanding claims.

For the six months ended June 30, 2003, we recorded a pre-tax loss of \$10.4 million. This loss is primarily related to the recording, during the second quarter of 2003, of a valuation allowance of \$9.4 million on the CIGNA Property and Casualty Insurance Company reinsurance receivables. See Note B to the interim consolidated financial statements.

Income taxes

For the period ended June 30, 2003 and 2002, we recorded an income tax expense of \$.8 million. Our effective tax rate of 35% in 2003 was consistent with our effective tax rate in the prior year.

Liquidity and Capital Resources

Liquidity and Capital Resources - Holding Company

Vesta is a holding company whose principal asset is its investment in the capital stock of the companies constituting the Vesta Insurance Group. The principal uses of funds at the holding company level are to pay (1) operating expenses; (2) principal and interest on outstanding indebtedness and deferrable capital securities; and (3) dividends to stockholders as declared by the Board of Directors.

Vesta's principal source of liquidity and capital resources to meet its holding company obligations is dividends paid by our subsidiaries. Many of our subsidiaries are insurance companies that are individually supervised by various state insurance regulators, and other unregulated companies that we own, such as Instant Insurance Holdings, Inc., are owned indirectly through a regulated insurance company. Given our organizational structure, we rely on two subsidiaries to pay dividends to our holding company or otherwise fund the obligations of our holding company on its behalf - Vesta Fire Insurance Corporation, an Illinois domiciled insurer, and J. Gordon Gaines, Inc., a Delaware business corporation.

Dividends from Vesta Fire

Transactions between Vesta and its insurance subsidiaries, including the payment of dividends, are subject to certain limitations under the insurance laws of those subsidiaries' domiciliary states. The insurance laws of the state of Illinois, where Vesta Fire is domiciled, permit the payment of dividends out of unassigned surplus in any year which, together with other dividends or distributions made within the preceding 12 months, do not exceed the greater of 10% of statutory surplus as of the end of the preceding year or the net income for the preceding year, with larger dividends payable only after receipt of prior regulatory approval. The Illinois Insurance Department has indicated that these dividend

limitations prohibit the payment of dividends if the insurer has negative or zero "unassigned funds" at the end of the prior year, as reported on its statutorily required annual statement. Our lead insurance subsidiary, Vesta Fire, reported negative "unassigned funds" on its annual statement for 2002, and is expected to continue to report negative unassigned funds for the foreseeable future. Accordingly, we may not be able to declare and pay a dividend from our lead insurance company subsidiary for the foreseeable future without prior approval. There can be no assurance that Vesta Fire will be able to obtain the requisite regulatory approval for the payment of dividends.

Dividends from J. Gordon Gaines

J. Gordon Gaines, Inc. provides administrative services to all of our property - casualty insurance subsidiaries in exchange for fees pursuant to an administrative services agreement and, with respect to our Texas Select Lloyds Insurance Company, an attorney-in-fact agreement. These management agreements are subject to certain regulatory standards which generally require their terms and fees to be fair and reasonable. The Illinois or Texas Departments of Insurance may review these agreements from time to time to insure the reasonableness of their terms and fees, and it is possible that such terms and fees could be modified to reduce the amounts available to our holding company. Assuming these management agreements are not modified in a material respect, we believe that J. Gordon Gaines, Inc. will be able to pay dividends to our holding company, or otherwise fund the obligations of our holding company on its behalf, sufficient to fund our anticipated needs (including scheduled debt service) for at least the next twelve months.

Credit Facilities

Effective February 1, 2003, we entered into a new revolving credit arrangement with First Commercial to replace the previous facility. The new facility is a \$30 million line secured by a pledge of 358,375 shares of common stock of Instant Insurance Holdings, Inc. (Instant), representing approximately 70% of Instant's issued and outstanding shares of capital stock as of December 31, 2002. The new facility bears interest at First Commercial's prime rate and will mature no earlier than June 30, 2005. As of June 30, 2003, we had drawn \$29.8 million available under this Agreement.

This new credit agreement contains covenants which require us to maintain (i) consolidated GAAP net income (excluding realized gains and losses) of at least \$15 million for any calendar year, beginning in 2003, (ii) Consolidated debt to capital ratio of no more than 39%, (iii) an A.M. Best rating of "B" or better, (iv) consolidated GAAP net worth of at least \$208 million, (v) an interest coverage ratio of not less than 1.5 to 1 and (vi) risk-based capital of not less than 150% of the NAIC's authorized control level. As of June 30, 2003, we were in compliance with all quarterly covenants. However, based on our results through the first six months of 2003, we believe that uncertainty exists regarding our ability to meet certain of the First Commercial credit arrangement covenants at December 31, 2003. Furthermore, current dividend levels from Vesta Fire and J. Gordon Gaines would not be sufficient to repay the anticipated outstanding balance of this credit facility at the year-end covenant measurement date without seeking prior approval. Although management believes the Company would be able to secure waivers on any covenant violations, the failure to obtain such waivers of the potential covenant violations or refinance the credit facility on similar terms could have a material adverse impact on our financial condition.

Liquidity and Capital Resources - Subsidiary Operations

The principal sources of funds for our insurance subsidiaries are premiums, investment income and proceeds from the sale or maturity of invested assets. The principal uses of funds in our subsidiary operations are the payment of claims, operating expenses, commissions and the purchase of investments. Our subsidiaries also borrow funds from the Federal Home Loan Bank from time to time and invest the proceeds at higher interest rates.

Contingent Obligations

Our subsidiary operations are also involved in ongoing reinsurance recoverable disputes that could result in an obligation to repay certain amounts to reinsurers from whom we have collected funds. In connection with these disputes, our principal operating subsidiary, Vesta Fire, has obtained letters of credit for the benefit of reinsurers for which it is contingently liable. At June 30, 2003, Vesta Fire was contingently liable for \$33.7 million under the terms of letters of credit obtained in connection with these reinsurance disputes.

Additionally, we regularly obtain letters of credit or otherwise pledge securities for the benefit of ceding insurers in our nonstandard underwriting segment pursuant to reinsurance contracts. As of June 30, 2003, we had pledged approximately \$7.9 million in securities pursuant to these reinsurance contracts.

Inter-company obligations

In addition to the contractual obligations of our holding company to third parties, our holding company owes contractual obligations to certain of our subsidiaries that are eliminated in the consolidation of our financial statements. As of June 30, 2003, our insurance company subsidiaries held \$13.2 million face amount of our 8.75% Senior Debentures due 2025 and \$44.1 million face amount of our 12.5% Senior Notes due in December of 2005. Our holding company paid these subsidiaries approximately \$3.3 million in interest payments in 2003 which was eliminated in consolidation.

Cash Flows

As is typical in the insurance industry, we collect cash in the form of premiums and invest that cash until claims are paid. Cash collected from premiums and cash paid for claims are included in cash flow from operations, while the cash impact from our investing activities is included in cash flow from investing activities. In periods such as 2001 and 2000, when we were exiting certain lines of business such as commercial lines and reinsurance assumed lines, we funded the payout of commercial and reinsurance assumed claims through the liquidation of invested assets, consistent with the historical insurance business model. However, this generates cash outflows from operations that can be misleading.

On a consolidated basis, net cash provided by (used in) operations for the periods ended June 30, 2003 and 2002, was \$(25.3) million and \$63.0 million, respectively. Cash flow from operations was negative for the current period primarily due to cash outflows related to the payment of claims related to catastrophe losses and the funding of the unearned premium reserve on our 50% Texas quota share reinsurance contract. Net cash used in investing activities was \$46.3 million and \$41.5 million for the periods ended June 30, 2003 and 2002, respectively as we invested cash generated by our operations in prior periods. Net cash used in financing activities was \$13.1 million and \$8.6 million for the period ending June 30, 2003 and 2002, respectively. In 2003, repayments of outstanding Federal Home Loan Bank borrowings drove our financing activities.

New Accounting Pronouncements

Effective July 1, 2002, Vesta adopted Statement of Financial Accounting Standards No. 145 (SFAS No. 145) "Rescission of FASB Statement No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections", which had been issued by the Financial Accounting Standards Board "FASB" in April 2002. SFAS No. 145 rescinds SFAS No. 4, which required all gains and losses from extinguishments of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. In connection with our adoption of SFAS No. 145, we have reclassified gains on the extinguishment of debt from extraordinary gain on debt extinguishment to other expense. These reclassifications decreased total expenses by \$1.4 million for the six months ended June 30, 2002.

In November 2002, the FASB issued FASB Interpretation No. ("FIN") 45, "Guarantor's Accounting and Disclosures Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 clarifies the requirements of SFAS No. 5, "Accounting for Contingencies," related to a guarantors accounting for, and disclosures of, the issuance of certain types of guarantees. The disclosure requirements are effective for financial statements of interim and annual periods ending after December 15, 2002 and have been included in the Notes to the consolidated financial statements included herein. The impact on the Company's financial statements from the application of the recognition and measurement provisions of FIN No. 45 is dependent on the level of guarantees issued or modified in 2003 and thereafter. No guaranties were issued or modified during the six months ended June 30, 2003, which were impacted by the provisions of FIN No. 45.

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities" which clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements." This Interpretation provides guidance on the identification and consolidation of variable interest entities ("VIEs"), whereby control is achieved through means other than through voting rights. The effective date of FIN 46 is for the first fiscal quarter beginning after June 15, 2003. Management believes the adoption of FIN 46 will not have a material impact on the Company's financial position, results of operations or cash flows.

In May 2002, the Derivatives Implementation Group of the FASB exposed for comment issue No. B36, "Bifurcation of Embedded Credit Derivatives" ("DIG B36"). DIG B36 would require the bifurcation of potential embedded derivatives within modified coinsurance and funds withheld coinsurance arrangements in which the terms require the future payment of a principal amount plus a return based on a specified proportion of the ceding company's return on either its general account assets or a specified block of those assets. The proposed effective date of the implementation guidance in DIG B36 is for the first fiscal quarter beginning after June 15, 2003 and would be applied on a prospective basis. The Company is currently evaluating the impact of this pronouncement.

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In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" ("SFAS 150"). SFAS 150 establishes how an issuer classifies and measures certain free standing financial instruments with characteristics of both liabilities and equity and requires that such instruments be classified as liabilities. SFAS 150 was effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003 for those existing financial instruments subject to the provisions of SFAS No. 150. The Company has not entered into any financial instruments within the scope of SFAS 150 since May 31, 2003. Management has determined that the Company's Deferrable Capital Securities are subject to the provisions of SFAS No. 150. The transition provisions of SFAS No. 150 require that upon adoption of SFAS No. 150 on July 1, 2003, the Company's Deferrable Capital Securities would be reclassified as a liability from its current mezzanine debt classification. The dividends paid to the holders of the Deferrable Capital Securities will be classified as interest expense on a prospective basis.

Special Note Regarding Forward-Looking Statements

Any statement contained in this report which is not a historical fact, or which might otherwise be considered an opinion or projection concerning the Company or its business, whether express or implied, is meant as and should be considered a forward-looking statement as that term is defined in the Private Securities Litigation Reform Act of 1996. Forward-looking statements are based on assumptions and opinions concerning a variety of known and unknown risks, including but not necessarily limited to changes in market conditions, natural disasters and other catastrophic events, increased competition, changes in availability and cost of reinsurance, changes in governmental regulations, and general economic conditions, as well as other risks more completely described in our filings with the Securities and Exchange Commission, including our most recent Annual Report on Form 10-K. If any of these assumptions or opinions prove incorrect, any forward-looking statements made on the basis of such assumptions or opinions may also prove materially incorrect in one or more respects.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Vesta's principal assets are financial instruments, which are subject to the market risk of potential losses from adverse changes in market rates and prices. Our primary risk exposures are interest rate risk on fixed maturity investments, mortgages and collateral loans and annuity liabilities and equity price risk for stocks. Vesta manages its exposure to market risk by selecting investment assets with characteristics such as duration, yield and liquidity to reflect the underlying characteristics of the related insurance. There have been no material changes to the information about our market risk set forth in our Annual Report on Form 10-K for the year ended December 31, 2002.

Item 4. Controls and Procedures

Within 90 days prior to the date of this report, we carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, including the matters noted in the next paragraph, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information concerning Vesta and its consolidated subsidiaries required to be included in our periodic SEC reports.

Management, in consultation with the Company's independent accountants, identified deficiencies in our consolidation process, which constitute a "Reportable Condition" under standards established by the American Institute of Certified Public Accountants. Management, also in consultation with the Company's independent accountants, believes that this matter has not had any material impact on our consolidated financial statements. At the end of the second quarter, management implemented additional control procedures to address the identified deficiencies in the consolidation process. We believe the effect of the implementation of these additional control procedures will adequately address the previously identified deficiencies in design and operation.

PART II

Item 1. Legal Proceedings

Securities Litigation

In 2001, Vesta settled a securities class action that had been pending since 1998. In connection with that settlement, the issuer of our primary directors' and officers' insurance policy, which was intended to cover the initial \$25 million of settlement costs and related expenses, denied coverage and refused to fund its share of the settlement costs. We sued that insurer in Alabama state court alleging that its action was taken in bad faith. In February 2003, we settled that claim and collected \$16 million in cash, which was reflected in the 2002 consolidated financial statements.

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Health insurance related lawsuits

Vesta and two former officers of Vesta are defendants in a lawsuit styled *James H. Cashion, Jr. d/b/a American Health Underwriters v. Vesta Insurance Group, Inc., et al*, Plaintiff, a former general agent of our subsidiary States General Life Insurance Company, which we purchased in 2001, alleges that the defendants engaged in an actionable civil conspiracy to tortiously interfere with his agency contracts. The civil conspiracy claim is premised, in part, on certain payments made to these two former officers of Vesta by another agent who replaced Mr. Cashion. The plaintiff is seeking actual and punitive damages. Vesta denies tortiously interfering with plaintiff's agency contract, believes the claims asserted against it have no merit, and is vigorously defending this lawsuit. In the opinion of management, resolution of this lawsuit is not expected to have a material adverse effect on our financial position.

During the second quarter of 2003, we entered into a settlement and release agreement with Jimmy Walker, a former agent of States General. Pursuant to this settlement and release agreement, we voluntarily dismissed the arbitration and litigation that we had earlier commenced against Mr. Walker and released him from his obligation to repay certain indebtedness owed to under a series of promissory notes representing amounts Mr. Walker borrowed from us in connection with his agency activities. Pursuant to this settlement agreement, Mr. Walker unconditionally assigned to us certain commissions to which he would otherwise be entitled under his former agent's agreement with States General and released us from any claims that he could assert against us arising from such agent's agreement. At June 30, 2003, the net realizable amount of the assigned commissions to the Company was \$1.3 million and is recorded as a component of other invested assets on the accompanying interim consolidated balance sheet.

Life insurance related lawsuits

Our subsidiary, American Founders, is a defendant in a lawsuit brought by a judgment creditor of IFS Holdings, Inc. - the former holder of American Founders' series A and C preferred stock - alleging that American Founders redeemed its Series A and Series C preferred stock from IFS Holdings, Inc. for less than "reasonably equivalent value," and, therefore, engaged in a voidable fraudulent transfer. American Founders believes (i) that the redemption transaction was for reasonably equivalent value; and (ii) that the allegations brought against it in this lawsuit are without merit. We have vigorously defended this action. In the opinion of management, resolution of the lawsuit is not expected to have a material adverse effect on our financial position. However, depending upon the amount and timing, an unfavorable resolution of this matter could materially affect American Founders' future operations or cash flows in a particular period.

Indemnification Agreements and Liability Insurance

Pursuant to Delaware law and our by-laws, we are obligated to indemnify our current and former officers and directors for certain liabilities arising from their employment with or services to Vesta, provided that their conduct complied with certain requirements. Pursuant to these obligations, we have been funding costs of defense and other expenses on behalf of certain current and former officers and directors, subject to an undertaking from such individuals to repay any amounts advanced in the event a court determines that they are not entitled to indemnification.

Reinsurance Arbitration/Litigation

As discussed in previous SEC filings, in 1998 we corrected our accounting for assumed reinsurance business through restatement of our previously issued financial statements. Similar corrections were made on a statutory accounting basis through recording cumulative adjustments in Vesta Fire's 1997 statutory financial statements. The impact of this correction has been reflected in amounts ceded under our 20 percent whole account quota share treaty which was terminated on June 30, 1998 on a run-off basis. We believe such treatment is appropriate under the terms of this treaty and have calculated the quarterly reinsurance billings presented to the three treaty participants accordingly. The aggregate amount included herein as recoverable from such reinsurers totaled \$33.4 million at June 30, 2003. Additionally, we have previously collected approximately \$48.5 million from the drawdown of collateral on hand. Such amount, net of related expenses, has been reflected in the 2002 financial statements.

NRMA Insurance Ltd. ("NRMA"), one of the participants in the 20 percent whole account quota share treaty, filed a lawsuit in the United States District Court for the Northern District of Alabama contesting our billings. NRMA sought rescission of the treaty and a temporary restraining order preventing us from drawing down approximately \$34.5 million of collateral. We filed a demand for arbitration as provided for in the treaty and also filed a motion to compel arbitration which was granted in the United States District Court action. Vesta reached an agreement with NRMA to collect the \$34.5 million of collateral in exchange for posting a \$25 million letter of credit in favor of NRMA to fund any amounts NRMA may recover as a result of the arbitration. We also filed for arbitration against Alfa Mutual Insurance Company and Dorinco Reinsurance Company, the other two participants on the treaty. All those arbitrations are in the discovery stages. Additionally, Alfa filed a Motion for Declaratory Judgment asking the arbitration panel to order that there is no enforceable agreement between Alfa and Vesta or alternatively, that there is no coverage for developmental losses under the treaty. After a hearing in June 2002, the arbitration panel denied Alfa's motion. The hearing on the merits of the arbitration with Alfa was scheduled for May 2003. However, on April 21, 2003, Alfa filed a lawsuit against Vesta Fire in state court in Montgomery, Alabama seeking a declaration from the Court on certain procedural and organizational matters and requesting that the Court stay the arbitration proceedings during the pendency of the litigation in state court in Alabama. On April 24, 2003,

the Court issued a temporary restraining order staying the proceedings in the ongoing arbitration in order to maintain the status quo until the merits of Alfa's petition can be heard and determined, which is currently scheduled for September 24, 2003. The lawsuit filed by Alfa will delay indefinitely the Alfa arbitration proceedings but is not currently expected to delay proceedings in the other two arbitrations. On June 19, 2002, the panel in the NRMA arbitration issued an order to bifurcate the arbitration, and scheduled a hearing for the week of October 28, 2002 to decide the issue of coverage for developmental losses under the treaty. On September 6, 2002, the panel notified the parties that it would make such determination on this specific issue on the papers and filings submitted by the parties without the necessity of a live hearing. On November 6, 2002, the Company was notified by the panel that it ruled that the treaty does not apply to loss occurrences prior to July 1, 1997. As a result, Vesta recorded a \$23.6 million pre-tax charge as a revision of our estimated reinsurance recoverable in the third quarter of 2002. This ruling does not set a binding precedent regarding Vesta's other arbitrations and, accordingly, we have not recorded any change in our estimate of our recoverable from the other treaty participants as a result of this ruling. In February 2003, Vesta filed a petition to vacate the NRMA panel ruling in the U.S. District Court for

the Northern District of Alabama. On April 8, 2003, the Court ruled that since the arbitration proceedings have not been fully exhausted, it was dismissing Vesta's petition without prejudice of the parties to seek the Court's review of any final arbitration award. The hearing in the NRMA arbitration is currently scheduled to begin on October 20, 2003, and is estimated to take approximately two weeks. On December 16, 2002, Dorinco filed a motion seeking an order that the treaty does not cover developmental losses. On May 1, 2003, the panel in the Dorinco arbitration ruled that Dorinco is not responsible for losses on any policy or any other insurance or reinsurance contract terminated prior to July 1, 1997 and that the arbitration will continue with respect to losses whenever occurring, on policies or any other insurance or reinsurance contract in force at July 1, 1997. The hearing in the Dorinco arbitration is currently scheduled to begin on December 1, 2003, and is estimated to take approximately two weeks. Based on a current estimate of the impact of this ruling and the ruling previously received from the NRMA panel, we currently believe our estimated recoverable is appropriate. However, we are continuing to evaluate the effects of complying with these rulings and our estimate may change in the future as a result of this evaluation.

While management continues to believe its interpretation of the treaty's terms and computations based thereon are correct, these matters are being contested in these arbitration proceedings and their ultimate outcome cannot be determined at this time. If rescission on all three treaties was awarded by three separate arbitration panels, we would incur a pre-tax charge of approximately \$57.0 million.

If the amounts recoverable under the relevant treaties are ultimately determined to be materially less than the amounts that we have reported as recoverable, we may incur a significant, material, and adverse impact on our financial condition and results of operations.

We are in arbitration with CIGNA Property and Casualty Insurance Company (now ACE USA) under a personal lines insurance quota share reinsurance agreement, whereby we assumed certain risks from CIGNA. During September 2000, CIGNA filed for arbitration under the reinsurance agreement, seeking payment of the balances that CIGNA claimed were due under the terms of the treaty. At that time, the treaty was terminated on a cut-off basis. In the pending arbitration Vesta is seeking, among other things, recoupment of all believed improper excessive expense allocations and charges from CIGNA. The arbitration was bifurcated into two phases with Phase I concentrating on the interpretation of the intent of the parties related to the expense reimbursement provisions of the treaty at the time it was entered. Phase II, which is ongoing, relates to any remaining issues between the parties, including those that exist with regard to an audit of expenses ceded to the treaty. The Phase I hearing was held in February 2002 and the panel ruled that (i) the Company is responsible for the payment of ceding commissions provided for in the treaty and should pay any outstanding billings for commissions and paid claims, plus interest; (ii) the Company may proceed with an audit of expenses ceded to the treaty; and (iii) the parties should identify any further issues to be brought before the arbitration panel for phase two of the hearing. Vesta is presently conducting its expense audit as permitted by the panel. During the course of preparing for and conducting the expense audit, the Company determined that it should revise its estimated reinsurance receivable and record during the second quarter of 2003 a pre-tax valuation allowance of \$9.4 million and recorded the valuation allowance as a component of discontinued operations. Management intends to continue to proceed with the presentation of our case to the arbitration panel and believes that the resolution of this arbitration will not have any adverse financial impact on the Company. The Phase II hearing has not yet been scheduled.

Muhl vs. Vesta is a case pending in the supreme Court of the State of New York, County of New York, brought by the Liquidator of Midland Insurance Company ("Midland"), claiming recoveries under two alleged retrocession agreements (Pool I and Pool III) between Midland and Interstate Fire Insurance Company, Vesta's predecessor in interest. The Liquidator's claims against Vesta under Pool I and Pool III have been severed.

Third party auditors hired by Vesta have identified coverage issues that cast doubt on the validity of a number of claims. In addition, there is no actual retrocessional agreement that evidences the terms and conditions of Pool III which involves 71% or more of the incurred losses at issue. Although there are other tangential documents that the Liquidator may attempt to rely on to prove liability under Pool III, we believe that the Liquidator will not be able to establish liability for any portion of the Pool III claims. We also believe that a number of the losses allegedly

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incurred in connection with Pool I may be avoided on specific coverage grounds. We are defending this matter vigorously and are reasonably optimistic regarding the ultimate outcome, although an adverse ruling in this case could have a material effect on our financial condition.

Nichols vs. Vesta Fire Insurance Corporation is a lawsuit brought by the Liquidator of Delta America Re Insurance Company in Kentucky state court to recover losses alleged under reinsurance contracts entered into in the 1970's. Vesta removed the action to federal court and successfully moved to compel arbitration. Each party has selected a party arbitrator but as yet there is no neutral umpire. There has been no discovery as yet and no organizational meeting of the panel.

Vesta vs. New Cap Re is an arbitration against an Australian reinsurer, to collect reinsurance recoverables pursuant to two accident year excess of loss ratio reinsurance agreements. In the arbitration, New Cap Re challenged Vesta's earlier draw on a Letter of Credit for \$7.5 million which was held in connection with one of the two contracts. Shortly after the arbitration commenced, New Cap Re became the subject of insolvency proceedings in Australia and an ancillary proceeding in the U.S. Bankruptcy Court in New York. The Bankruptcy Court stayed all pending litigation and arbitration against New Cap Re, and we appealed that ruling to the Southern District of New York, and ultimately to the U.S. Court of Appeals for the Second Circuit which recently affirmed the Bankruptcy Court's stay of the arbitration against New Cap Re. Hence, our efforts to recover losses as well as New Cap Re's efforts to challenge the earlier draw on the \$7.5 million Letter of Credit by us are stayed.

On September 5, 2002, New Cap Re served us with an Application pursuant to Section 588FF of the Australian Corporations Act seeking an order directing us to pay New Cap Re and its liquidator \$1.0 million that Vesta allegedly received as an "unfair preference" and/or arising out of an "uncommercial transaction," as those terms are defined by the Corporations Act. We filed a Notice of Appearance on October 31, 2002. While management intends to vigorously defend this matter, given the preliminary nature of these proceedings, it is too early to evaluate the likelihood of success.

Other

Vesta, through its subsidiaries, is routinely a party to pending or threatened legal proceedings and arbitration relating to the regular conduct of its insurance business. These proceedings involve alleged breaches of contract, torts, including bad faith and fraud claims and miscellaneous other specified relief. Based upon information presently available, and in light of legal and other defenses available to Vesta and its subsidiaries, management does not consider liability from any threatened or pending litigation regarding routine matters to be material.

Item 2. Changes in Securities

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

At the annual meeting of stockholders held May 27, 2003, the following matters were submitted to a vote of stockholders (shares eligible to vote: 35,678,060).

1. Election of Directors

Messrs. Walter M. Beale, Jr. and Alan S. Farrior were elected to additional three year terms on the Board of Directors.

	For	Withheld
Beale	30,165,647	1,326,504

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	For	Withheld
Farrior	30,674,589	817,562

2. Ratification of Auditors

PricewaterhouseCoopers LLP was appointed as the principal independent auditor of the Company and its subsidiaries for the year ending December 31, 2003.

	For	Against	Abstain
PricewaterhouseCoopers LLP	30,715,164	529,406	247,581

Item 5. Other information

None.

Item 6. Exhibits and Reports on Form 8-K

a) EXHIBITS

- 10.25 Employment agreement between the registrant and Hopson B. Nance dated as of February 24, 2003.
- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

b) Reports on Form 8-K.

A current report was filed on Form 8-K on April 28, 2003 in connection with a press release.

Signatures

Pursuant to the requirements of the Securities Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Vesta Insurance Group, Inc.

Date: August 13, 2003

/s/ Hopson B. Nance

Hopson B. Nance
*Senior Vice President
and Chief Financial Officer
(and in his capacity as Principal Financial Officer)*

