

VESTA INSURANCE GROUP INC  
Form 10-Q  
November 14, 2002

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# 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 September 30, 2002**

**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.

The number of shares outstanding of the registrant's common stock,  
 \$.01 par value, as of November 12, 2002  
 36,443,294

**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)

	September 30, 2002	De
	-----	-----
	(unaudited)	
Assets:		
Fixed maturities available for sale - at fair value (cost: 2002 - \$861,576; 2001 - \$785,049)	\$ 875,581	
Equity securities-at fair value: (cost: 2002- \$29,228; 2001- \$32,298)	27,141	
Mortgage and collateral loans	38,735	
Policy loans	61,491	

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Short-term investments	71,338
Other invested assets	27,751
	-----
Total investments	1,102,037
Cash	32,745
Accrued investment income	13,420
Premiums in course of collection (net of allowances for losses of \$2,389 in 2002 and \$2,684 in 2001)	167,238
Reinsurance balances receivable	347,198
Reinsurance recoverable on paid losses	40,127
Deferred policy acquisition costs	98,210
Property and equipment	18,527
Deferred income taxes	42,839
Goodwill and other intangible assets	138,186
Other assets	28,601
	-----
Total assets	\$ 2,029,128
	=====
Liabilities:	
Policy liabilities	\$ 680,446
Losses and loss adjustment expenses	342,210
Unearned premiums	301,245
Federal Home Loan Bank advances	167,300
Short term debt	30,184
Long term debt	66,798
Reinsurance balances payable	76,445
Other liabilities	96,804
	-----
Total liabilities	1,761,432
Commitments and contingencies: See Note B	
Deferrable Capital Securities	22,445
Stockholders' equity:	
Preferred stock, \$.01 par value, 5,000,000 shares authorized, issued: 2002 - 0 and 2001 - 0	--
Common stock, \$.01 par value, 100,000,000 shares authorized, issued: 2002 - 37,528,111 and 2001 - 36,994,464	375
Additional paid-in capital	248,313
Accumulated other comprehensive income, net of tax expense of \$6,417 and \$4,191 in 2002 and 2001, respectively	11,918
Retained earnings	8,787
Treasury stock (1,084,817 shares and 923,972 shares at cost at September 30, 2002 and December 31, 2001, respectively)	(7,540)
Unearned stock	(16,602)
	-----
Total stockholders' equity	245,251
	-----
Total liabilities, deferrable capital securities and stockholders' equity	\$ 2,029,128
	=====

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)

	<b>Three months ended</b>	
	<b>September 30,</b>	
	<b>2002</b>	<b>2001</b>
	-----	
	<b>(unaudited)</b>	
	-----	
Revenues:		
Net premiums written	\$ 149,913	\$ 80,152
Change in unearned premiums	(11,697)	(6,455)
	-----	
Net premiums earned	138,216	73,697
Policy fees	5,272	2,230
Agency fees and commissions	21,268	299
Net investment income	14,397	15,450
Realized gains (losses)	(1,233)	757
Other	2,990	2,884
	-----	
Total revenues	180,910	95,317
Expenses:		
Policyholder benefits	8,082	8,436
Losses and loss adjustment expenses incurred	87,524	43,896
Policy acquisition expenses	27,725	17,506
Litigation settlement and arbitration award charge	23,600	30,000
Operating expenses	49,215	17,575
Interest on debt	3,576	4,054
Gain on debt extinguishment	(2,998)	(1,400)
Goodwill and other intangible amortization	84	935
	-----	
Total expenses	196,808	121,002
Income loss from continuing operations before taxes, minority interest, and deferrable capital securities	(15,898)	(25,685)
Income tax benefit	(5,565)	(9,020)
Minority interest, net of tax	300	200
Deferrable capital security distributions, net of tax	322	387
	-----	
Net loss from continuing operations	(10,955)	(17,252)
Loss from discontinued operations, net of tax	(655)	(19,800)
	-----	
Net loss	(11,610)	(37,052)
Preferred stock dividend	--	--
Gain on redemption of preferred securities, net of tax	--	5,099
	-----	
Net loss available to common shareholders	\$ (11,610)	\$ (31,953)
	=====	
Net loss from continuing operations per share - Basic	\$ (0.32)	\$ (0.57)
	=====	
Net loss available to common shareholders per share - Basic	\$ (0.34)	\$ (1.00)
	=====	
Net loss from continuing operations per share - Diluted	\$ (0.32)	\$ (0.57)
	=====	
Net loss available to common shareholders per share - Diluted	\$ (0.34)	\$ (1.00)

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Statements of Comprehensive Income		
Net income (loss)	\$ (11,610)	\$ (37,052)
Other comprehensive income, net of tax:		
Unrealized holding (losses) gains on available-for-sale securities net of tax of \$2,035, \$4,224, \$1,970, and \$8,270, respectively	3,780	7,845
Less realized (losses) gains on available-for-sale securities net of tax of \$432, \$265, \$258, and \$1,745, respectively	(801)	492
	4,581	7,353
Gain on redemption of preferred securities, net of tax of \$2,746, \$113 and \$2,746 respectively	--	5,099
Comprehensive (loss) income	\$ (7,029)	\$ (24,600)

See accompanying Notes to Consolidated Financial Statements

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

	Nine months ended S 2002
	(unaudited)
Operating Activities:	
Net loss	\$ (21,333)
Adjustments to reconcile net loss to cash provided by (used in) operations	
Changes in:	
Loss and LAE reserves, and future policy liabilities	44,949
Unearned premium reserves	85,635
Reinsurance balances receivable	(2,931)
Premiums in course of collection	(117,469)
Reinsurance recoverable on paid losses	(2,292)
Reinsurance balances payable	59,981
Other assets and liabilities	58,487
Policy acquisition costs deferred	(103,646)
Policy acquisition costs amortized	73,737
Realized gains	(737)
Amortization and depreciation	3,648
Gain on extinguishment of debt	(4,398)
Net cash provided by (used in) operations	73,631
Investing Activities:	
Investments sold, matured, and called:	
Fixed maturities available for sale	283,813
Equity securities	6,697

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Investments acquired:	
Fixed maturities available for sale	(335,983)
Equity securities	(6,001)
Net decrease in other invested assets	27,946
Net cash received (paid) for acquisition	7,020
Net (increase) decrease in short-term investments	(30,140)
Additions to property and equipment	(1,712)
	-----
Net cash (used in) provided from investing activities	(48,360)
Financing Activities:	
Net change in FHLB borrowings	(1,314)
Change in long and short-term debt	(4,779)
Net deposits and withdrawals from insurance liabilities	(6,315)
Issuance of common stock	--
Acquisition of common stock	(949)
Dividends paid	(2,748)
	-----
Net cash provided by (used in) financing activities	(16,105)
Increase in cash	9,166
Cash at beginning of period	23,579
	-----
Cash at end of period	\$ 32,745
	=====

See accompanying Notes to Consolidated Financial Statements

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**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 financial statements have been prepared in conformity with accounting principles generally accepted in the United States and, in the opinion of management, reflect all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of results for such periods. The results of operations and cash flows for any interim period are not necessarily indicative of results for the full year. These financial statements should be read in conjunction with the financial statements and related notes which have been issued by the Company and filed with the Securities and Exchange Commission.

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

*New Accounting Standards:* In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, "Business Combinations." SFAS No. 141 address financial accounting and reporting for business combinations. The standard eliminates the pooling of interests method of accounting for business combinations and requires that all intangible assets be accounted for separately from goodwill. Vesta has applied the requirements of SFAS No. 141 to all acquisitions after July 1, 2001, as required, and will account for future acquisitions in accordance with the new guidance.

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." This statement addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. We adopted SFAS No. 142 effective January 1, 2002. See Note F for additional disclosures related to the adoption of SFAS No. 142.

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In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 is effective for fiscal years beginning after December 15, 2001 and was written to provide a single model for the disposal of long-lived assets. SFAS No. 144 supersedes SFAS No. 121 "Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, "Reporting the results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." Vesta adopted SFAS No. 144 effective January 1, 2002. Such adoption resulted in no material impact on Vesta's financial position, results of operations or cash flows.

In April 2002, the FASB issued SFAS 145, "Rescission of FASB Statement No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS 145 rescinds SFAS 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. As a result, the criteria in Accounting Principals Board Opinion 30, will now be used to classify those gains and losses. SFAS 64 amended SFAS 4, and is no longer necessary because SFAS 4 has been rescinded. SFAS 44 and the amended sections of SFAS 13 are not applicable to Vesta and therefore have no effect on Vesta's financial statements. SFAS 145 is effective for fiscal years beginning after May 15, 2002 with early application encouraged. Vesta adopted SFAS 145 on July 1, 2002. In connection with this adoption, we reclassified gains on the extinguishment of debt from extraordinary gain on debt extinguishment to other expense. These reclasses decreased other expense by \$3.0 million and \$4.4 million for the three and nine month periods ending September 30, 2002 and \$1.4 for the three and nine month periods ending September 30, 2001.

On July 31, 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early adoption encouraged. The adoption of this statement is not expected to have a material impact on Vesta's consolidated financial position or consolidated results of operations.

*Restricted Assets:* As part of a modified coinsurance agreement with Employers Reinsurance Corporation, American Founders is holding \$113.4 million of assets for the benefit of Employers, of which \$112.7 million are included in fixed maturities available for sale herein.

*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 income available to common shareholders and average shares outstanding for the three and nine months ending September 30, 2002 and 2001 are as follows:

	<b>Three months ended September 30,</b>	
	<b>2002</b>	<b>2001</b>
Net loss available to common shareholders	\$ (11,610)	\$ (31,953)
Preferred stock dividends on convertible preferred stock	--	--
Adjusted net income available to common shareholders	\$ (11,610)	\$ (31,953)
Weighted average shares outstanding-basic (1)	33,870	31,837
Stock options and restricted stock (2)	--	--
Weighted average shares outstanding-diluted (1)	33,870	31,837

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	<b>Nine months ended September 30,</b>	
	<b>2002</b>	<b>2001</b>
Net loss available to common shareholders	\$ (21,123)	\$ (22,430)

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Preferred stock dividends on convertible preferred stock	--	163
Adjusted net income (loss) available to common shareholders	\$ (21,123)	\$ (22,267)
Weighted average shares outstanding-basic (1)	33,659	24,848
Stock options and restricted stock (2)	--	--
Weighted average shares outstanding-diluted (1)	33,659	24,848

(1) Reflects weighted averages. At September 30, 2002, Vesta had 36.4 million shares outstanding and zero shares of convertible preferred stock outstanding. Weighted average shares outstanding for earnings per share purposes do not include shares held by the Agent's Stock Incentive Plan Trust that have not been allocated to participants.

(2) 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 average shares outstanding calculation. Potentially dilutive securities for the three months ended September 30, 2002 and 2001 are .5 million shares and for the nine months ending September 30, 2002 and 2001 are .5 million shares.

Earnings per share for discontinued operations and extraordinary gains for the three and nine months ended September 30, 2002 and 2001 are as follows:

	2002		2001	
	3 month	9 month	3 month	9 month
Basic Earnings per share:				
Discontinued Operations	\$ (0.02)	\$ (0.30)	\$ (0.62)	\$ (0.80)
Diluted Earnings per share:				
Discontinued Operations	\$ (0.02)	\$ (0.30)	\$ (0.62)	\$ (0.80)

### Note B-Commitments and Contingencies

#### *Securities Litigation*

On October 26, 2001, Vesta executed a definitive agreement to settle the securities litigation that had been pending since June 1998 against Vesta and certain current and former officers and directors. On December 10, 2001, the Court approved settlement of the consolidated class action securities litigation in U.S. District Court in Alabama as to Vesta and its officers and directors for a total of \$61 million in cash. A related derivative action lawsuit in the Circuit Court of Jefferson County, Alabama was also dismissed with prejudice. Vesta funded \$21.0 million towards the settlement and the Company's excess directors and officers liability carriers funded the remaining \$40.0 million. Vesta used its line of credit to finance its portion of the settlement and recorded a pre-tax one-time charge of approximately \$30 million against earnings to cover Vesta's contribution to the settlement and other expenses incurred. However, in the fourth quarter of 2001, the company reduced the charge by \$5 million as a result of recording amounts due the company from various insurance carriers under its D&O coverage. This amount was paid to Vesta in the third quarter of 2002.

Vesta determined to participate in the funding of the settlement and to take the related one-time charge against earnings as a result of the Cincinnati Insurance Company's attempted rescission of their \$25 million directors and officers liability policy and denial of coverage. Vesta has sued Cincinnati in Alabama state court alleging that its actions were taken in bad faith and is vigorously pursuing that claim. The Cincinnati case is currently scheduled for trial in February, 2003.

#### *Indemnification Agreements and Liability Insurance*



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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 advancing 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.

### *Arbitration*

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 \$33.9 million at September 30, 2002. Additionally, we have previously collected approximately \$48.5 million from the drawdown of collateral on hand.

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NRMA Insurance Ltd. ("NRMA"), one of the participants in the 20% 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 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 is scheduled for May, 2003. 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. The Company was recently notified by the panel that it has 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 non-operating charge as a revision of our estimated reinsurance recoverable in the third quarter. This ruling does not set a binding precedent regarding the Company'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. The hearing on the remaining issues in the NRMA arbitration will be conducted in 2003. The hearing in the Dorinco arbitration is presently scheduled for December, 2003. While management continues to believe its interpretation of the treaty's terms and computations based thereon are correct, these matters are in arbitration and their ultimate outcome cannot be determined at this time.

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 claims are due under the terms of the treaty. In addition, during the fourth quarter, the treaty was terminated on a cut-off basis. Vesta is seeking recoupment of all improper claims payments and excessive expense allocations and charges from CIGNA. The arbitration was bifurcated into two phases with phase one 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 and phase two related to any issues between the parties after the Company conducts an audit of expenses related to the treaty. The phase one 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; and (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. The Phase II hearing has not yet been scheduled.

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.

During 1999, F&G Re (on behalf of USF&G), filed for arbitration under two aggregate stop loss reinsurance treaties whereby F&G Re assumed certain risk from Vesta. F&G Re sought to cancel the treaties and avoid its obligation. Vesta had recorded a reinsurance recoverable of \$30.0 million at March 31, 2002 related to these two treaties. The hearing in this arbitration began on February 11, 2002. The hearing was adjourned on February 15, 2002 and resumed on June 11, 2002, and the panel awarded Vesta \$15 million, plus interest of \$1.44 million. Accordingly, the Company recorded a pre-tax charge of approximately \$13.6 million in the 2nd quarter of 2002 as discontinued operations. The

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charge related to this award was recorded in our Assumed Reinsurance segment, which is reflected herein as a discontinued operation, consistent with the manner in which premiums and losses under these contracts were originally recorded.

### *Other Litigation*

On January 14, 2002, the Company's subsidiary, American Founders, was notified of a lawsuit in Texas naming it as a defendant and brought by a creditor of the former parent of the subsidiary. This lawsuit (subsequently identified as the Blitz lawsuit) alleges, among other things, that American Founders redeemed its Series A and Series C preferred stock issues at less than "reasonably equivalent value". American Founders believes that the allegations brought against it in this lawsuit are without merit and intends to mount a vigorous defense in this action. In the opinion of management, resolution of the Blitz lawsuit is not expected to have a material adverse effect on the financial position of the Company. However, depending on the amount and timing, an unfavorable resolution of this matter could materially affect American Founders' future operations or cash flows in a particular period.

Vesta Fire owns approximately 72% of the voting securities of American Founders, and Ken Phillips and Wayne Schreck (the "Minority Shareholders") collectively own approximately 28% of voting securities of American Founders. Vesta Fire, on the one hand, and the Minority Shareholders, on the other hand, are parties to an Investor Rights Agreement (the "IRA") which provides, among other things, that the Minority Shareholders may deliver an "offer notice" offering to sell their securities in American Founders to Vesta Fire and, if Vesta Fire declines to accept the offer, the Minority Shareholders may then sell the offered securities to a third party or, in the alternative, purchase Vesta Fire's securities on "substantially equivalent terms." The Minority Shareholders have delivered an offer notice to Vesta Fire which fails to provide one fixed price for American Founders securities that is applicable to both Vesta Fire and the Minority Shareholders, and further purports to require significant extraneous payments to the Minority Shareholders under their employment contracts to which they are not otherwise entitled and which are unrelated to the value of their American Founders securities. On September 4, 2002, Vesta Fire filed a Petition and Application for Temporary Injunction in District Court for Collin County, Texas against the Minority Shareholders seeking to void or, in the alternative, reform the offensive terms of their "Offer Notice." On October 15, 2002, the court granted a temporary injunction enjoining the Minority Shareholders from selling their securities to a third party or demanding the purchase of Vesta Fire's securities in American Founders, and set the matter for trial on February 17, 2003.

The Minority Shareholders filed an answer, cross-claim against American Founders and counterclaim against Vesta Fire on November 4, 2002. The cross-claim against American Founders alleges breach of the Minority Shareholders' employment contracts. The counter claim against Vesta Fire alleges negligent misrepresentation and fraud in connection with Vesta Fire's initial investment of \$25 million in American Founders on June 30, 2000. The Minority Shareholders seek unspecified damages and rescission of Vesta's investment in American Founders. In the opinion of management, the Minority Shareholders' claims against both American Founders and Vesta Fire are without merit and will not have any material adverse effect on either American Founders or Vesta Fire.

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.

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### *Non-Performing Loans*

Our life insurance subsidiary, American Founders, invested in approximately \$42 million in loans to certain borrowers in 1998 and 1999. These loans were generally structured to pay scheduled principal and interest payments on a quarterly basis over a seven year term and were secured by the stock of privately held companies. Management of American Founders wrote off approximately \$8.0 million of these loans in the fourth quarter of 2001 and \$1.25 million in the third quarter of 2002 following the bankruptcy of an affiliate of one of these privately held companies, which reduced American Founders' aggregate carrying value of these loans at September 30, 2002 to \$26.0 million.

The \$26.0 million balance of the loans owed are collateralized by pledges of stock in privately held companies which own real estate located in Mexico. These loans have not performed since September 30, 2001. Although management believes that the collateral underlying these loans is adequate and currently believes that American Founders will ultimately collect all amounts owed under these loans, it is possible that management's view of these loans' collectibility could change as they proceed to enforce American Founders' rights under the loan documents, including taking control of the pledged stock of these privately held companies and exercising that control in order to realize cash proceeds from

the Mexican real estate held by them.

### **Note C-Segment Information**

We operate several segments, which are distinguishable by their product offerings. The accounting policies of the operating segments are the same as used in preparing the consolidated financial statements. Segment pre-tax income is generally income before income tax, and minority interest, if any. Premiums, policy fees, other income, loss and benefit expenses, and amortization of deferred acquisition costs are attributed directly to each operating segment. Operating expenses are allocated to the segments in a manner which most appropriately reflects the operations of that 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.

A brief description of each segment is as follows:

#### **Standard Property-Casualty**

The standard property-casualty segment primarily consists of the marketing and distribution of personal lines insurance products including residential property and private passenger auto coverages. Vesta's products are distributed primarily through approximately 1,500 independent agencies in 24 states. Our standard personal auto line targets drivers over age thirty-five with above average driving records and our residential property products cover the full range of homes.

#### **Life and Health Insurance**

On June 30, 2000, we entered the life and annuity business through an investment in American Founders Financial Corporation, a holding company for two life insurance companies domiciled in Texas and we entered the health insurance business through the acquisition of Aegis Financial Corporation in December 2000. American Founders and Aegis have approximately \$2.5 billion (face value) of life and annuity products in force and approximately \$22.6 million of health insurance premiums in force at September 30, 2002. American Founders markets traditional life products, universal life products, fixed-rate annuities, pension contracts and related products through independent agents throughout the majority of the United States. Aegis Financial markets health insurance products through captive agents throughout the United States.

#### **Specialty Underwriting**

Specialty underwriting includes our fronting operations and any underwriting risk retained from premiums written through our non-standard auto agencies. In fronting arrangements, we write targeted property-casualty insurance coverages and reinsure a substantial portion 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 the amount of underwriting risk to retain, based on market conditions, and the prospective results of the underlying business. Our decision on how much underwriting risk to retain is dependent on the current rating environment and the reinsurance terms offered by reinsurers.

#### **Agency**

The agency segment consists of our retail agency and wholesale operations. The primary sources of revenue are commissions and fees collected by retailers and fees and commissions collected by wholesalers. These revenue streams are not underwriting risk-bearing.

#### **Corporate and Other**

Our corporate and other segment primarily consists of unallocated net investment income, unallocated interest expense, and certain overhead expenses not directly associated with a particular segment.

A summary of segment results for the three months ended September 30, 2002 and 2001 is as follows:

	<b>Standard Property- Casualty</b>	<b>Life and Health Insurance</b>	<b>Specialty Underwriting</b>	<b>Agency</b>	<b>C a</b>
<b>2002</b>					
Revenues:			(in thousands)		
Premiums earned	\$ 88,694	\$ 7,537	\$ 41,985		
Agency fees and commissions	--	--	--	\$ 26,745	
Net investment income	--	9,827	--	--	
Policy fees	1,345	798	3,129	--	
Realized gains (losses)	--	(1,092)	--	--	
Other	122	367	1,369	--	
Total revenues	90,161	17,437	46,483	26,745	
Expenses:					
Loss, LAE and policyholder benefits	61,446	8,082	26,078	--	
Policy acquisition costs	19,881	1,534	11,787	--	
Loss due to arbitration award	--	--	--	--	
Operating expenses	10,551	3,470	6,064	22,922	
Interest on debt	--	1,592	--	287	
Gain on extinguishment of debt	--	--	--	--	
Intangible asset amortization	--	--	--	--	
Total expenses	91,878	14,678	43,929	23,209	
Pre-tax income (loss) from continuing operations	\$ (1,717)	\$ 2,759	\$ 2,554	\$ 3,536	
Operating segment assets:					
Investments and other assets	\$ 363,522	\$ 890,477	\$ 168,999	\$ 60,981	
Deferred acquisition costs	59,352	25,730	13,128	--	
	\$ 422,874	\$ 916,207	\$ 182,127	\$ 60,981	
<b>2001</b>					
Revenues:			(in thousands)		
Premiums earned	\$ 63,890	\$ 7,365	\$ 2,442		
Agency fees and commissions	--	--	--	\$ 299	
Net investment income	--	10,348	--	49	
Policy fees	1,254	976	--	--	
Realized gains (losses)	--	860	--	--	
Other	166	314	1346	--	
Total revenues	65,310	19,863	3,788	348	

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Expenses:				
Loss, LAE and policyholder benefits	41,896	8,436	2,000	--
Policy acquisition costs	14,519	2,401	586	--
Litigate settlement charge	--	--	--	--
Operating expenses	7,738	3,248	54	1,573
Interest on debt	--	2,067	--	--
Gain on extinguishment of debt	--	--	--	--
Goodwill and other intangible amortization	--	--	--	--
	-----	-----	-----	-----
Total expenses	64,153	16,152	2,640	1,573
Pre-tax income (loss) from continuing operations				
	\$ 1,157	\$ 3,711	\$ 1,148	\$ (1,225)
	=====	=====	=====	=====
Operating segment assets:				
Investments and other assets	\$ 323,819	\$ 940,395	\$ 35,876	\$ 21,320
Deferred acquisition costs	30,485	20,955	434	--
	-----	-----	-----	-----
	\$ 354,304	\$ 961,350	\$ 36,310	\$ 21,320
	=====	=====	=====	=====

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A summary of segment results for the nine months ended September 30, 2002 and 2001 is as follows:

	<b>Standard Property- Casualty</b>	<b>Life and Health Insurance</b>	<b>Specialty Underwriting</b>	<b>Agency</b>	<b>C a</b>
	-----	-----	-----	-----	-----
<b>2002</b>					
Revenues:					
			(in thousands)		
Premiums earned	\$ 237,050	\$ 23,173	\$ 118,425		
Agency fees and commissions	--	--	--	\$ 76,505	
Net investment income	--	28,584	--	--	
Policy fees	3,937	2,914	7,344	--	
Realized gains (losses)	--	2,173	--	--	
Other	347	1,024	4,605	--	
	-----	-----	-----	-----	-----
Total revenues	241,334	57,868	130,374	76,505	
Expenses:					
Loss, LAE and policyholder benefits	168,571	29,831	73,883	--	
Policy acquisition costs	52,013	4,592	33,258	--	
Loss due to arbitration award	--	--	--	--	
Operating expenses	29,815	10,307	15,117	66,329	
Interest on debt	--	4,756	--	861	
Gain on debt extinguishment	--	--	--	--	
Intangible asset amortization	--	--	--	--	
	-----	-----	-----	-----	-----
Total expenses	250,399	49,486	122,258	67,190	
Pre-tax income (loss) from continuing operations					
	\$ (9,065)	\$ 8,382	\$ 8,116	\$ 9,315	
	=====	=====	=====	=====	=====

Standard Life and

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	Property- Casualty	Health Insurance	Specialty Underwriting	Agency
<b>2001</b>				
Revenues:			(in thousands)	
Premiums earned	\$ 185,443	\$ 22,312	\$ 5,528	
Agency fees and commissions	--	--	--	\$ 1,097
Net investment income	--	32,138	--	309
Policy fees	2,285	2,926	--	--
Realized gains	--	2,258	--	--
Other	586	549	3,150	--
<b>Total revenues</b>	<b>188,314</b>	<b>60,183</b>	<b>8,678</b>	<b>1,406</b>
Expenses:				
Loss, LAE and policyholder benefits	117,371	25,431	4,297	--
Policy acquisition costs	41,096	6,558	1,229	--
Litigation settlement charge	--	--	--	--
Operating expenses	22,143	9,815	211	4,400
Interest on debt	--	6,695	--	--
Interest on debt	--	6,695	--	--
Gain on debt extinguishment	--	--	--	--
Goodwill and other intangible amortization	--	--	--	--
<b>Total expenses</b>	<b>180,610</b>	<b>48,499</b>	<b>5,737</b>	<b>4,400</b>
Pre-tax income (loss) from continuing operations	\$ 7,704	\$ 11,684	\$ 2,941	\$ (2,994)

**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.

In the third quarter of 2002, we redeemed \$8.0 million face amount of our 8.75% Senior Notes for approximately \$5.0 million cash. In connection with this transaction, we recorded a pre-tax gain on extinguishment of debt of \$3.0 million in other expense.

**Note E-Acquisitions**

In January 2002, we completed three acquisitions. We acquired certain assets of InsureOne Agency and the renewal rights to a book of non-standard automobile business, the non-standard automobile related assets of Harbor Insurance Group, and the common stock of Old American Investments. Combined purchase prices are estimated to be \$22.3 million with \$15.3 million due at closing and \$7.0 million due upon the occurrence of certain future events. The transactions have been accounted for as purchases. Summarized below is an initial allocation of assets and liabilities acquired (in thousands except per share amounts and unaudited):

Assets acquired:	
Cash	\$ 27,716
Property, Plant & Equipment	3,148
Other assets	29,572
Goodwill and other	
Intangible assets	24,913
<b>Total assets</b>	<b>\$ 85,349</b>

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Liabilities acquired:	
Unearned premiums	35,731
Other liabilities	27,321
	-----
Total liabilities	\$ 63,052
	=====

On August 1, 2002, our subsidiary Instant Insurance Holdings, Inc. ("Instant") acquired a 100% interest in Driver's Choice Insurance Services, LLC. The transaction has been accounted for as a purchase. Summarized below is an initial allocation of assets and liabilities acquired (in thousands except per share amounts and unaudited):

Assets acquired:	
Cash	\$ (59)
Other assets	1,088
Goodwill and other intangibles	1,800
	-----
Total assets	\$ 2,829
	=====

Liabilities acquired:	
Payables and other liabilities	1,898
	-----
Total liabilities	\$ 1,898
	=====

### Note F-Goodwill and Other Intangible Assets

In June, 2001, the FASB issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and other Intangible Assets," having a required effective date for fiscal years beginning after December 15, 2001. Under the new rules, Goodwill and other intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

We adopted the new rules on accounting for goodwill and other intangible assets effective January 1, 2002. Application of the non-amortization provisions of SFAS No. 142 is expected to result in an increase in net income of approximately \$2.6 million during 2002.

In connection with the transitional goodwill impairment evaluation, SFAS 142 required the Company to perform an assessment of whether there is an indication that goodwill is impaired as of the date of adoption. To accomplish this the Company identified its reporting units and determined the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of the date of adoption. The Company then had up to six months from the date of adoption to determine the fair value of each reporting unit and compare it to the reporting unit's carrying amount. To the extent a reporting unit's carrying amount exceeds its fair value, an indication exists that the reporting unit's goodwill may be impaired and the Company must perform the second step of the transitional impairment test. In the second step of the analysis, the Company must compare the implied fair value of the reporting unit's goodwill, determined by allocating the reporting unit's fair value to all of its assets (recognized and unrecognized) and liabilities in a manner similar to a purchase price allocation in accordance with SFAS 141, to its carrying amount, both of which would be measured as of the date of adoption.

The Company has completed the first step of the analysis and there is no indication of a goodwill impairment.

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During the nine months ended September 30, 2001, we recorded \$1.6 million in amortization of goodwill. The impact of amortization of goodwill on net income for the nine months ended September 30, 2001 was as follows (in thousands, except per share data):

	Nine months ended September 30, 2001 -----
Reported net loss	\$ (27,366)
Add back:	
Goodwill amortization, net of income taxes	1,580 -----
Net loss excluding goodwill amortization, net of income taxes	\$ (25,786) =====
 <b>Basic net income per common share</b>	
Reported net loss	\$ (1.10)
Add back:	
Goodwill amortization, net of income taxes	0.06 -----
Net loss excluding goodwill amortization, net of income taxes	\$ (1.04) =====
Weighted average number of common shares outstanding (basic)	24,848
 Diluted net income per common share	
Reported loss income	\$ (1.10)
Add back:	
Goodwill amortization, net of income taxes	0.06 -----
Net loss excluding goodwill amortization, net of income taxes	\$ (1.04) =====
Weighted average number of common shares outstanding (diluted)	24,848

The changes in the carrying amount of goodwill and other intangible assets for the year ended December 31, 2001 and for the nine months ended September 30, 2002 are as follows (in thousands):

Balance as of January 1, 2001	\$ 17,797
Goodwill and other intangible assets acquired	94,857
Amortization	(3,394) -----
Balance as of December 31, 2001	109,260
Goodwill and other intangible assets acquired	29,178
Amortization	(252)
Transitional impairment charge	-- -----
Balance as of September 30, 2002	\$ 138,186 =====

The \$138.2 million balance at September 30, 2002 consists of \$131.5 million of goodwill and \$6.7 million of intangible assets. Other intangible assets include brand name, trademark and the value of certain policy renewal rights.



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Amortization expense recorded on the intangible assets for each of the three-month periods ended September 30, 2002 and 2001 was \$.1 million and \$0, respectively. The estimated amortization expense for each of the five succeeding fiscal years is as follows (in thousands):

For the year ended December 31,

2002	\$ 336
2003	300
2004	250
2005	200
2006	200

### Note G-Subsequent Events

In October 2002, we redeemed \$8.0 face amount of our 8.75% Senior Notes for approximately \$4.1 million cash. In connection with this transaction, we will record in the fourth quarter, a pre-tax gain on extinguishments of debt of approximately \$3.9 million.

Subsequent to September 30, 2002, we were informed by A.M. Best that the financial strength ratings of American Founders Life Insurance Company and States General Life Insurance Company, our principal life and health insurance subsidiaries have been changed to B (Fair) and B-, respectively. Management expects the rating actions to cause minimal impact to the financial results of our life and health operations for the remainder of 2002 and 2003.

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## 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 2001 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

Vesta writes property-casualty insurance on selected personal lines risks only. Our standard property-casualty insurance and non-standard automobile insurance writings are balanced between risks of property damage (faster determination of ultimate loss but highly unpredictable) and casualty exposure (more predictable but takes longer to determine the ultimate loss). We also write life, annuity, and health insurance business. We are actively involved in the writing of insurance on our policies for the benefit of reinsurance companies, commonly referred to as servicing carrier or fronting, which generates fee-for-service income, and we also operate non-standard automobile retail agencies and MGA operations.

Our revenues from operations are derived primarily from net premiums earned on risks written by our insurance subsidiaries, commission and fees from our retail and MGA operations, investment income and investment gains or losses. Our expenses consist primarily of payments for claims and underwriting expenses, including agents' commissions, fees and operating expenses.

### *Comparison of Third Quarter 2002 to Third Quarter 2001*

Income available to common shareholders increased by \$20.4 million, to a \$11.6 million loss for the quarter ended September 30, 2002, from a \$32.0 million loss for the quarter ended September 30, 2001. This increase is the result of higher income from operations in the current quarter, a \$30.0 million charge in the prior quarter related to settlement of securities litigation and a \$30.0 million pretax charge for discontinued operations in the prior year quarter. On a diluted per share basis, net income available to common shareholders for the third quarter of 2002 was net loss of \$0.34 per share versus net loss of \$1.00 per share for the third quarter of 2001. In the third quarter of 2002, we recorded a \$23.6 million pre-tax non-operating charge as a revision of our estimated reinsurance recoverable under a whole account quota share reinsurance

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treaty. This treaty is the subject of an arbitration between our principal property-casualty operating company, Vesta Fire, and the treaty participants. See Note B to the consolidated financial statements for further discussion of this arbitration.

### *Standard Property-Casualty*

Net premiums written for standard property-casualty lines increased by \$27.2 million, or 38.8%, to \$97.2 million for the quarter ended September 30, 2002, from \$70.0 million for the quarter ended September 30, 2001. Net premiums earned for standard property-casualty lines increased \$24.8 million, or 38.8% to \$88.7 million for the quarter ended September 30, 2002, from \$63.9 million for the quarter ended September 30, 2001. The increase in net premiums written and net premiums earned is primarily attributable to increased writings in Texas, partially offset by decreases in other lines of business.

Loss and loss adjustment expenses ("LAE") for standard property-casualty lines increased by \$19.5 million, or 46.5%, to \$61.4 million for the quarter ended September 30, 2002, from \$41.9 million for the quarter ended September 30, 2001. The loss and LAE ratio for property-casualty lines for the quarter ended September 30, 2002 was 68.2% as compared to 64.3% at September 30, 2001. The increase in the loss and LAE incurred is due to the increase in earned premium. The increase in the loss and LAE ratio is primarily attributable to deteriorating underwriting results in the current period in certain components of our homeowners business, partially offset by improving results in our Texas operations. The deterioration in our underwriting results is being primarily driven by increases in severity of claims in certain states.

Policy acquisition expenses increased \$5.4 million for the quarter-to-quarter comparison, consistent with the increase in earned premium. Operating expenses increased by \$2.9 million, to \$10.6 million for the quarter ended September 30, 2002, as we incurred increased expenses from our growth in the Texas operations.

### *Life and Health Insurance*

American Founders and Aegis have approximately \$2.5 billion (face value) of life and annuity products in force and \$22.6 million of health insurance premiums in force at September 30, 2002. Life insurance premiums and policy fees were \$2.7 million for the quarter ended September 30, 2002 compared to \$2.4 million for the comparable prior period in 2001. The increase is attributable to the acquisition of Washington Life in August 2001. Health insurance premiums totaled \$5.6 million for the quarter ended September 30, 2002 versus \$5.0 million for the comparable prior period. Health insurance benefits incurred totaled \$3.0 million for the quarter and health insurance commission expense was \$1.2 million. Pre-tax operating income increased by \$.7 million primarily due to improved mortality in our acquired blocks, and better morbidity in our health insurance operations.

Subsequent to September 30, 2002, we were informed by A.M. Best that the financial strength ratings of American Founders Life Insurance Company and States General Life Insurance Company, our principal life and health insurance subsidiaries have been changed to B (Fair) and B-, respectively. Management expects the rating actions to cause minimal impact to the financial results of our life and health operations for the remainder of 2002 and 2003.

### *Specialty Underwriting*

Net premiums written for specialty underwriting increased by \$42.4 million to \$45.2 million for the quarter ended September 30, 2002, from \$2.8 million for the quarter ended September 30, 2001. Net premiums earned for specialty underwriting increased to \$42.0 million for the quarter ended September 30, 2002, from \$2.4 million for the quarter ended September 30, 2001. The increase in net premiums written and net premiums earned is primarily attributable to the acquisition of certain assets of Insure One and the related book of business from its affiliated insurance companies and increased retained amounts from other fronting programs. Fronting fees were consistent with the prior year period as ceded earned premium was consistent with the prior year.

Loss and loss adjustment expenses ("LAE") for specialty underwriting increased by \$24.1 million to \$26.1 million for the quarter ended September 30, 2002, from \$2.0 million for the quarter ended September 30, 2001. The loss and LAE ratio for the quarter ended September 30, 2002 was 57.8% as compared to 81.9% at September 30, 2001. The increase in the loss and LAE incurred and the decrease in the loss and LAE ratio is primarily attributable to the inclusion of underwriting results of the business produced by our affiliated agency, Insure One, which are better than the underwriting results from our traditional fronting programs.

Policy acquisition expenses increased \$11.2 million for the quarter-to-quarter comparison, consistent with the increase in earned premium. Operating expenses increased by \$6.0 million, to \$6.1 million for the quarter ended September 30, 2002, as we incurred increased expenses from our increased operations.

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*Agency*

Our Agency operations increased its revenues by \$26.4 million to \$26.7 million as a result of acquisitions completed in the fourth quarter of 2001 and the first quarter of 2002. Operating expenses increased by \$21.3 million to \$22.9 million as we integrated the acquired operations with our existing operations.

*Net Investment Income*

Net investment income decreased by \$1.1 million, or 6.8%, to \$14.4 million for the quarter ended September 30, 2002, from \$15.5 million for the quarter ended September 30, 2001. The weighted average yield on invested assets (excluding realized and unrealized gains) was 5.19% for the quarter ended September 30, 2002, compared with 6.2% for the quarter ended September 30, 2001. The decrease in investment income is primarily attributable to a decrease in the weighted average yield as yields have generally declined in recent months, the investment of funds in our investment portfolio in new operating entities and a reduction in investment income from our non-performing collateral loan portfolio.

*Federal Income Taxes*

Federal income taxes increased by \$3.5 million to a \$5.6 million benefit for the quarter ended September 30, 2002 as a result of a loss in the current period compared to the prior period loss.

*Discontinued Operations*

In the second quarter of 2002, we received an award in our arbitration with F&G Re over two loss ratio contracts covering accident years 1996 and 1997. The award was for \$16.44 million. Accordingly, the Company has recorded a pre-tax charge of approximately \$13.6 million in the 2nd quarter of 2002 as discontinued operations. The charge related to this award was recorded in our Assumed Reinsurance segment, which is reflected herein as a discontinued operation, consistent with the manner in which premiums and losses under these contracts were originally recorded.

*Comparison of Nine Months Ended September 30, 2002 with Nine Months Ended September 30, 2001*

Income available to common shareholders increased by \$1.3 million, to a \$21.1 million loss for the nine months ended September 30, 2002, from a \$22.4 million loss for the nine months ended September 30, 2001. On a diluted per share basis, net income available to common shareholders for the first nine months of 2002 was a net loss of \$0.63 per share versus net loss of \$0.90 per share for the corresponding period of 2001. In the third quarter of 2002, we recorded a \$23.6 million pre-tax non-operating charge as a revision of our estimated reinsurance recoverable under a whole account quota share reinsurance treaty. This treaty is the subject of an arbitration between our principal property-casualty operating company, Vesta Fire, and the treaty participants. See Note B to the consolidated financial statements for further discussion of this arbitration.

*Standard Property-Casualty*

Net premiums written for standard property-casualty lines increased by \$112.8 million, or 60%, to \$299.8 million for the nine months ended September 30, 2002, from \$187.0 million for the nine months ended September 30, 2001. Net premiums earned for standard property-casualty lines increased \$51.7 million, or 27.8% to \$237.1 million for the nine months ended September 30, 2002, from \$185.4 million for the nine months ended September 30, 2001. The increase in net premiums written and net premiums earned is primarily attributable to the acquisition of Florida Select in April 2001, and increased writings in Texas, partially offset by decreases in other lines of business.

Loss and loss adjustment expenses ("LAE") for standard property-casualty lines increased by \$51.2 million, or 43.6%, to \$168.6 million for the nine months ended September 30, 2002, from \$117.4 million for the nine months ended September 30, 2001. The loss and LAE ratio for property-casualty lines for the nine months ended September 30, 2002 was 69.9% as compared to 62.5% at September 30, 2001. The increase in the loss and LAE incurred and the loss and LAE ratio is primarily attributable to deteriorating underwriting results in the current period in our automobile lines, storm losses in Texas, and an increase in earned premium. The deterioration in our underwriting results is being primarily driven by increases in frequency and severity of claims in certain states.

Policy acquisition expenses increased \$10.9 million for the nine months ended September 30, consistent with the increase in earned premium. Operating expenses increased by \$7.7 million, to \$29.8 million for the nine months ended September 30, 2002, as we incurred

increased expenses from our growth in the Texas operations.

#### *Life and Health Insurance*

American Founders and Aegis have approximately \$2.5 billion (face value) of life and annuity products in force and \$22.6 million of health insurance premiums in force at September 30, 2002. Life insurance premiums and policy fees were consistent with prior period as acquisitions have offset normal declines. Health insurance premiums totaled \$17.2 million for the nine months ended September 30, 2002 versus \$15.3 million for the comparable prior period. Health insurance benefits incurred totaled \$9.6 million for the nine months and health insurance commission expense was \$3.5 million. Pre-tax operating income decreased by \$3.1 million primarily due to higher mortality in certain acquired blocks, lower than expected investment income and adverse morbidity in our health insurance operations as compared to the prior year.

Subsequent to September 30, 2002, we were informed by A.M. Best that the financial strength ratings of American Founders Life Insurance Company and States General Life Insurance Company, our principal life and health insurance subsidiaries have been changed to B (Fair) and B-, respectively. Management expects the rating actions to cause minimal impact to the financial results of our life and health operations for the remainder of 2002 and 2003.

#### *Specialty Underwriting*

Net premiums written for specialty underwriting increased by \$127.6 million to \$133.9 million for the nine months ended September 30, 2002, from \$6.3 million for the nine months ended September 30, 2001. Net premiums earned for specialty underwriting increased to \$118.4 million for the nine months ended September 30, 2002, from \$5.5 million for the nine months ended September 30, 2001. The increase in net premiums written and net premiums earned is primarily attributable to the acquisition of certain assets of Insure One and the related book of business from its affiliated insurance companies and increased retained amounts from other fronting programs. Fronting fees increased \$1.5 million to \$4.6 million on higher ceded earned premium.

Loss and loss adjustment expenses ("LAE") for specialty underwriting increased by \$69.6 million to \$73.9 million for the nine months ended September 30, 2002, from \$4.3 million for the nine months ended September 30, 2001. The loss and LAE ratio for the nine months ended September 30, 2002 was 58.7% as compared to 77.7% at September 30, 2001. The increase in the loss and LAE incurred and the decrease in the loss and LAE ratio is primarily attributable to the inclusion of underwriting results of the business produced by our affiliated agency, Insure One, which are better than the underwriting results from our traditional fronting programs.

Policy acquisition expenses increased \$32.1 million for the nine month period comparison, consistent with the increase in earned premium. Operating expenses increased by \$14.9 million, to \$15.1 million for the quarter ended September 30, 2002, as we incurred increased expenses from our increased operations.

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#### *Agency*

Our Agency operations increased its revenues by \$75.1 million to \$76.5 million as a result of acquisitions completed in the fourth quarter of 2001 and the first quarter of 2002. Operating expenses increased by \$61.9 million to \$66.3 million as we integrated the acquired operations with our existing operations.

#### *Net Investment Income*

Net investment income decreased by \$6.3 million, or 13.0%, to \$41.9 million for the nine months ended September 30, 2002, from \$48.2 million for the nine months ended September 30, 2001. The weighted average yield on invested assets (excluding realized and unrealized gains) was 5.82% for the nine months ended September 30, 2002, compared with 6.3% for the nine months ended September 30, 2001. The decrease in investment income is primarily attributable to a decrease in the weighted average yield as yields have generally declined in recent months, the

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investment of funds in our investment portfolio in new operating entities and a reduction in investment income from our collateral loan portfolio.

### *Federal Income Taxes*

Federal income taxes decreased by \$2.0 million to \$4.8 million benefit for the nine months ended September 30, 2002 as a result of more income in the current period compared to the prior period.

### *Discontinued Operations*

In the second quarter of 2002, we received an award in our arbitration with F&G Re over two loss ratio contracts covering accident years 1996 and 1997. The award was for \$16.44 million. Accordingly, the Company has recorded a pre-tax charge of approximately \$13.6 million in the 2nd quarter of 2002 as discontinued operations. The charge related to this award was recorded in our Assumed Reinsurance segment, which is reflected herein as a discontinued operation, consistent with the manner in which premiums and losses under these contracts were originally recorded.

### **Liquidity and Capital Resources**

Vesta is a holding company whose principal asset is its investments in the capital stock of the companies constituting the Vesta Insurance Group, a group of wholly owned insurance companies including Vesta Fire Insurance Corporation and a majority ownership in a life insurance holding company which includes American Founders Life Insurance Company and a majority ownership in Instant Insurance Holdings, Inc. The insurance subsidiaries comprising the Vesta Group are individually supervised by various state insurance regulators, but given our organizational structure, Vesta Fire is our only operating subsidiary that can pay dividends directly to our holding company. Vesta Fire is an Illinois domestic insurance company.

### *Dividends and Management Fees*

The principal uses of funds at the holding company level are to pay operating expenses, principal and interest on outstanding indebtedness and deferrable capital securities and dividends to stockholders if declared by the Board of Directors. During the last three years, our insurance subsidiaries have produced operating results and paid management fees and dividends sufficient to fund our needs. As a holding company with no other business operations, we rely primarily on fees generated by our management agreement with our insurance subsidiaries and dividend payments from Vesta Fire to meet our cash requirements (including our debt service) and to pay dividends to our stockholders.

Transactions between Vesta and its insurance subsidiaries, including the payment of dividends and management fees to Vesta by such subsidiaries, 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 earned 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. On October 29, 2001, the Illinois Insurance Department published a Company Bulletin that indicates that the Department interprets these dividend limitations to 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 2001. 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.

We believe that the Illinois Insurance Department's willingness to approve the payment of a dividend by Vesta Fire to our holding company will depend on a variety of factors, such as the impact to the holding company if the dividend is not paid and the impact to Vesta Fire if the dividend is paid. For example, the payment of a dividend may cause non-compliance with the Illinois Department of Insurance's "reserve reconciliation test," which requires Vesta Fire to maintain a minimum amount of liquid, high quality assets. At September 30, 2002, Vesta Fire's qualifying assets exceeded its minimum by approximately \$8.8 million. If the payment of a dividend would jeopardize Vesta Fire's ability to comply with this reserve reconciliation test, then the Illinois Department of Insurance may not approve it. Accordingly, there can be no assurance that Vesta Fire will be able to obtain the requisite regulatory approval for the payment of dividends. In the second quarter of 2002, we applied for and received approval for a dividend of \$10.0 million.

We rely primarily on fees earned under several management agreements with our insurance company subsidiaries to meet our cash requirements (including debt service) and to pay dividends to our stockholders. Management agreements are subject to certain regulatory standards which generally require its terms and fees to be fair and reasonable. These management agreements may be reviewed 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 these management agreements will provide us with funds sufficient to meet our anticipated needs (including debt service) for at least the next twelve months.

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*Credit Facilities*

On March 3, 2000, we established a revolving credit facility with First Commercial Bank, Birmingham, Alabama ("First Commercial"). In May, 2001 we increased the amounts available and increased the term of the credit facility to the following:

- a \$15 million unsecured line which bears interest at First Commercial's prime rate +1/4%;
- an additional \$15 million line which bears interest at First Commercial's prime rate, secured by a pledge of the revenues received under the management contract between our wholly owned management company, J. Gordon Gaines, Inc., and our operating insurance subsidiaries.

Each of these credit facilities mature on April 30, 2003. As of September 30, 2002, the principal amount outstanding under these credit facilities was approximately \$30.0 million. Effective as of March 30, 2002, each of these credit agreements were amended to restructure the financial covenants contained therein. The amended covenants require us to maintain certain minimum (i) consolidated net income, (ii) consolidated debt to capital ratios, (iii) credit ratings, (iv) GAAP net worth, (v) interest coverage ratio and (vi) risk based capital. As of September 30, 2002, we were in compliance with all of these covenants.

*Contingent Obligations*

As part of its ongoing reinsurance recoverable arbitrations, we have obtained letters of credit for the benefit of certain parties. Our principal operating subsidiary, Vesta Fire is contingently liable under the terms of these letters of credit. For our reinsurance arbitrations, we have obtained letters of credit totaling \$33.7 million for which we are contingently liable.

Additionally, as part of our specialty lines underwriting retained, we have obtained letters of credit or other pledges of securities totaling \$29.2 million securing our obligations under the various reinsurance agreements.

*Cash Flows*

The principal sources of funds for our insurance subsidiaries are premiums, investment income and proceeds from the sale or maturity of invested assets. Such funds are used principally for the payment of claims, operating expenses, commissions and the purchase of investments. 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 is included in cash flow from operations, while the cash impact from our investing activities is included in cash flow from investing activities.

On a consolidated basis, net cash provided by (used in) operations for the quarter ended September 30, 2002 and 2001, was \$73.6 million and \$(34.5) million, respectively as our increased written premium generated a significant amount of operating cash flow. Net cash (used in) provided by investing activities was \$(48.3) million and \$2.6 million for the quarter ended September 30, 2002 and 2001, respectively as we invested excess cash generated from operations in our investment portfolio. Net cash (used in) provided by financing activities was \$(16.1) million and \$51.9 million for the quarter ending September 30, 2002 and 2001.

*New Accounting Pronouncements*

In June 2001, the FASB issued SFAS No. 141, "Business Combinations." SFAS No. 141 address financial accounting and reporting for business combinations. The standard eliminates the pooling of interests method of accounting for business combinations except for qualifying business combinations and requires that all intangible assets be accounted for separately from goodwill. Vesta has applied the requirements of SFAS No. 141 to all acquisitions after July 1, 2001, as required, and will account for future acquisitions in accordance with the new guidance.

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." This statement addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. This statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements.

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Vesta adopted the provisions of SFAS No. 142 effective January 1, 2002. Additionally, SFAS No. 142 requires that goodwill be tested annually for impairment and the initial goodwill impairment test is required to be completed within six months of adoption. Application of the non-amortization provisions of SFAS No. 142 is expected to result in increase in net income of approximately \$2.6 million in fiscal year 2002.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 is effective for fiscal years beginning after December 15, 2001 and was written to provide a single model for the disposal of long-lived assets. SFAS No. 144 supersedes SFAS No. 121 "Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of" and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, "Reporting the results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions." Vesta adopted SFAS No. 144 effective January 1, 2002. Such adoption resulted in no material impact on Vesta's financial position, results of operations or cash flows.

In April 2002, the FASB issued SFAS 145, "Rescission of FASB Statement No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS 145 rescinds SFAS 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. As a result, the criteria in Accounting Principles Board Opinion 30, will now be used to classify those gains and losses. SFAS 64 amended SFAS 4, and is no longer necessary because SFAS 4 has been rescinded. SFAS 44 and the amended sections of SFAS 13 are not applicable to Vesta and therefore have no effect on Vesta's financial statements. SFAS 145 is effective for fiscal years beginning after May 15, 2002 with early application encouraged. Vesta adopted SFAS 145 on July 1, 2002. In connection with this adoption, we reclassified gains on the extinguishment of debt from extraordinary gain on debt extinguishment to other expense. These reclasses decreased other expense by \$3.0 million and \$4.4 million for the three and nine month periods ending September 30, 2002.

On July 31, 2002, the FASB issued Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities. This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early adoption encouraged. The adoption of this statement is not expected to have a material impact on Vesta's consolidated financial position or consolidated results of operations.

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### Market Risk of Financial Instruments

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, 2001.

### 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

None.

#### 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, 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.

In addition, there have been no significant changes in our internal controls or in other factors that could significantly affect those controls subsequent to the date of their last evaluation.

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## PART II

### Item 1. Legal Proceedings

#### *Securities Litigation*

On October 26, 2001, Vesta executed a definitive agreement to settle the securities litigation that had been pending since June 1998 against Vesta and certain current and former officers and directors. On December 10, 2001, the Court approved settlement of the consolidated class action securities litigation in U.S. District Court in Alabama as to Vesta and its officers and directors for a total of \$61 million in cash. A related derivative action lawsuit in the Circuit Court of Jefferson County, Alabama was also dismissed with prejudice. Vesta funded \$21.0 million towards the settlement and the Company's excess directors and officers liability carriers funded the remaining \$40.0 million. Vesta used its line of credit to finance its portion of the settlement and recorded a pre-tax one-time charge of approximately \$30 million against earnings to cover Vesta's contribution to the settlement and other expenses incurred. However, in the fourth quarter of 2001, the company reduced the charge by \$5 million as a result of recording amounts due the company from various insurance carriers under its D&O coverage. This amount was paid to Vesta in the third quarter of 2002.

Vesta determined to participate in the funding of the settlement and to take the related one-time charge against earnings as a result of the Cincinnati Insurance Company's attempted rescission of their \$25 million directors and officers liability policy and denial of coverage. Vesta has sued Cincinnati in Alabama state court alleging that its actions were taken in bad faith and is vigorously pursuing that claim. The Cincinnati case is currently scheduled for trial in February, 2003.

#### *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 advancing 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.

#### *Arbitration*

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



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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 \$33.9 million at September 30, 2002. Additionally, we have previously collected approximately \$48.5 million from the drawdown of collateral on hand.

NRMA Insurance Ltd. ("NRMA"), one of the participants in the 20% 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 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 is scheduled for May, 2003. 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. The Company was recently notified by the panel that it has 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 non-operating charge as a revision of our estimated reinsurance recoverable in the third quarter. This ruling does not set a binding precedent regarding the Company'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. The hearing on the remaining issues in the NRMA arbitration will be conducted in 2003. The hearing in the Dorinco arbitration is presently scheduled for December, 2003. While management continues to believe its interpretation of the treaty's terms and computations based thereon are correct, these matters are in arbitration and their ultimate outcome cannot be determined at this time.

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 claims are due under the terms of the treaty. In addition, during the fourth quarter, the treaty was terminated on a cut-off basis. Vesta is seeking recoupment of all improper claims payments and excessive expense allocations and charges from CIGNA. The arbitration was bifurcated into two phases with phase one 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 and phase two related to any issues between the parties after the Company conducts an audit of expenses related to the treaty. The phase one 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; and (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. The Phase II hearing has not yet been scheduled.

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.

During 1999, F&G Re (on behalf of USF&G), filed for arbitration under two aggregate stop loss reinsurance treaties whereby F&G Re assumed certain risk from Vesta. F&G Re sought to cancel the treaties and avoid its obligation. Vesta had recorded a reinsurance recoverable of \$30.0 million at March 31, 2002 related to these two treaties. The hearing in this arbitration began on February 11, 2002. The hearing was adjourned on February 15, 2002 and resumed on June 11, 2002, and the panel awarded Vesta \$15 million, plus interest of \$1.44 million. Accordingly, the Company recorded a pre-tax charge of approximately \$13.6 million in the 2nd quarter of 2002 as discontinued operations. The charge related to this award was recorded in our Assumed Reinsurance segment, which is reflected herein as a discontinued operation, consistent with the manner in which premiums and losses under these contracts were originally recorded.

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### *Other Litigation*

On January 14, 2002, the Company's subsidiary, American Founders, was notified of a lawsuit in Texas naming it as a defendant and brought by a creditor of the former parent of the subsidiary. This lawsuit (subsequently identified as the Blitz lawsuit) alleges, among other things, that American Founders redeemed its Series A and Series C preferred stock issues at less than "reasonably equivalent value". American Founders believes that the allegations brought against it in this lawsuit are without merit and intends to mount a vigorous defense in this action. In the opinion of management, resolution of the Blitz lawsuit is not expected to have a material adverse effect on the financial position of the

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Company. However, depending on the amount and timing, an unfavorable resolution of this matter could materially affect American Founders' future operations or cash flows in a particular period.

Vesta Fire owns approximately 72% of the voting securities of American Founders, and Ken Phillips and Wayne Schreck (the "Minority Shareholders") collectively own approximately 28% of voting securities of American Founders. Vesta Fire, on the one hand, and the Minority Shareholders, on the other hand, are parties to an Investor Rights Agreement (the "IRA") which provides, among other things, that the Minority Shareholders may deliver an "offer notice" offering to sell their securities in American Founders to Vesta Fire and, if Vesta Fire declines to accept the offer, the Minority Shareholders may then sell the offered securities to a third party or, in the alternative, purchase Vesta Fire's securities on "substantially equivalent terms." The Minority Shareholders have delivered an offer notice to Vesta Fire which fails to provide one fixed price for American Founders securities that is applicable to both Vesta Fire and the Minority Shareholders, and further purports to require significant extraneous payments to the Minority Shareholders under their employment contracts to which they are not otherwise entitled and which are unrelated to the value of their American Founders securities. On September 4, 2002, Vesta Fire filed a Petition and Application for Temporary Injunction in District Court for Collin County, Texas against the Minority Shareholders seeking to void or, in the alternative, reform the offensive terms of their "Offer Notice." On October 15, 2002, the court granted a temporary injunction enjoining the Minority Shareholders from selling their securities to a third party or demanding the purchase of Vesta Fire's securities in American Founders, and set the matter for trial on February 17, 2003.

The Minority Shareholders filed an answer, cross-claim against American Founders and counterclaim against Vesta Fire on November 4, 2002. The cross-claim against American Founders alleges breach of the Minority Shareholders' employment contracts. The counter claim against Vesta Fire alleges negligent misrepresentation and fraud in connection with Vesta Fire's initial investment of \$25 million in American Founders on June 30, 2000. The Minority Shareholders seek unspecified damages and rescission of Vesta's investment in American Founders. In the opinion of management, the Minority Shareholders' claims against both American Founders and Vesta Fire are without merit and will not have any material adverse effect on either American Founders or Vesta Fire.

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.

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### **Item 2. Changes in Securities**

None.

### **Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other information**

None.

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**Item 6. Exhibits and Reports on Form 8-K**

a) EXHIBITS

99.1 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

99.2 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

b) Reports on Form 8-K.

Current reports were filed on Form 8-K on July 19, 2002 and August 9, 2002 in connection with press releases.

A current report was filed on Form 8-K on August 14, 2002 in connection with the CEO and CFO second quarter financial certifications.

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**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: November 14, 2002

/s/ Hopson B. Nance

*Chief Financial Officer*  
*Financial Officer)*

By: Hopson B. Nance  
*Vice President, Controller and Interim*  
*(and in his capacity as Principal*

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**CERTIFICATIONS**

I, Norman W. Gayle, III, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Vesta Insurance Group, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

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3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

/s/ Norman W. Gayle

Norman W. Gayle, III  
*President and Chief Executive Officer*  
*(Principal Executive Officer)*

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I, Hopson B. Nance, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Vesta Insurance Group, Inc.;

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2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

*Chief Financial Officer*

/s/ Hopson B. Nance

Hopson B. Nance  
*Vice President, Controller and Interim*

*(Principal Financial Officer)*