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

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 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	**63-1097283**
(State of other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
3760 River Run Drive	**35243**
Birmingham, Alabama	*(Zip Code)*
(Address of principal executive offices)	

(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. |X| 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 August 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)

	June 30, 2002 (unaudited)	De
Assets:		
Fixed maturities available for sale - at fair value (cost: 2002 - $804,136; 2001 - $785,049)	$ 819,879	
Equity securities-at fair value: (cost: 2002- $29,040; 2001- $32,298)	28,471	
Mortgage and collateral loans	42,385	
Policy loans	62,778	
Short-term investments	102,364	
Other invested assets	32,175	
Total investments	1,088,052	
Cash	36,566	

Accrued investment income	18,004
Premiums in course of collection (net of allowances for losses of $2,462 in 2002 and $2,684 in 2001)	135,895
Reinsurance balances receivable	334,596
Reinsurance recoverable on paid losses	82,070
Deferred policy acquisition costs	94,688
Property and equipment	21,592
Deferred income taxes	41,797
Goodwill and other intangible assets	134,738
Other assets	48,810
Total assets	$ 2,036,808
Liabilities:	
Policy liabilities	$ 681,222
Losses and loss adjustment expenses	320,202
Unearned premiums	293,915
Federal Home Loan Bank advances	173,305
Short term debt	28,974
Long term debt	74,794
Reinsurance balances payable	59,364
Other liabilities	130,409
Total liabilities	1,762,185
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 $3,951 and $4,191 in 2002 and 2001, respectively	7,337
Retained earnings	21,308
Treasury stock (1,054,717 shares and 923,972 shares at cost at March 31, 2002 and December 31, 2001, respectively)	(7,540)
Unearned stock	(17,615)
Total stockholders' equity	252,178
Total liabilities, deferrable capital securities and stockholders' equity	$ 2,036,808

See accompanying Notes to Consolidated Financial Statements

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Vesta Insurance Group, Inc.

Consolidated Statements of Operations and Comprehensive Incom

Statements of Operations
(amounts in thousands except per share data)

	Three months ended June 30, 2002	Three months ended June 30, 2001
	(unaudited)	
Revenues:		
Net premiums written	$ 155,853	$ 74,255
Change in unearned premiums	(27,212)	(64)
Net premiums earned	128,641	74,191
Policy fees	5,505	1,728
Agency fees and commissions	20,731	356
Net investment income	13,799	17,110
Realized gains (losses)	(589)	2,522
Other	3,799	2,240
Total revenues	171,886	98,147
Expenses:		
Policyholder benefits	11,104	8,938
Losses and loss adjustment expenses incurred	84,236	39,071
Policy acquisition expenses	24,738	16,975
Operating expenses	49,521	15,236
Interest on debt	3,895	4,487
Goodwill and other intangible amortization	84	969
Total expenses	173,578	85,676
Income (loss) from continuing operations before taxes, minority interest, and deferrable capital securities	(1,692)	12,471
Income tax expense (benefit)	(592)	4,341
Minority interest, net of tax	597	532
Deferrable capital security distributions, net of tax	322	383
Net income (loss) from continuing operations	(2,019)	7,215
Loss from discontinued operations, net of tax	(9,464)	(163)
Extraordinary gain on debt extinguishments, net of tax		--
Net income (loss)	(11,483)	7,052
Preferred stock dividend	--	--
Gain on redemption of preferred securities, net of tax	--	--
Net income (loss) available to common shareholders	$ (11,483)	$ 7,052
Net income (loss) from continuing operations per share - Basic	$ (0.06)	$ 0.30
Net income (loss) available to common shareholders per share - Basic	$ (0.34)	$ 0.30
Net income (loss) from continuing operations per share - Diluted	$ (0.06)	$ 0.30
Net income (loss) available to common shareholders per share - Diluted	$ (0.34)	$ 0.29

Statements of Comprehensive Income

Net income (loss)	$ (11,483)	$ 7,052
Other comprehensive income, net of tax:		
Unrealized holding (losses) gains on available-for-sale securities net of tax of $2,875, $2,380, $67, and $4,046, respectively	5,340	4,420
Less realized (losses) gains on available-for-sale securities net of tax		

of $206, $883, $174, and $1,480, respectively	(383)	1,639
	5,723	2,781
Gain on redemption of preferred securities, net of tax of $113 and $305, respectively.	--	--
Comprehensive (loss) income	$ (5,760)	$ 9,833

See accompanying Notes to Consolidated Financial Statements

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

	Six months ended 2002
	(unaudited)
Operating Activities:	
Net income (loss)	$ (9,734)
Adjustments to reconcile net income to cash used in operations	
Changes in:	
Loss and LAE reserves, and future policy liabilities	23,717
Unearned premium reserves	78,305
Reinsurance balances receivable	9,671
Premiums in course of collection	(86,126)
Reinsurance recoverable on paid losses	2,965
Reinsurance balances payable	42,900
Other assets and liabilities	36,101
Policy acquisition costs deferred	(81,868)
Policy acquisition costs amortized	46,012
Realized gains	(496)
Amortization and depreciation	2,539
Extraordinary gain	(897)
Net cash provided by (used in) operations	63,089
Investing Activities:	
Investments sold, matured, and called:	
Fixed maturities available for sale	223,994
Equity securities	4,655
Investments acquired:	
Fixed maturities available for sale	(230,991)
Equity securities	(5,241)
Net increase (decrease) in other invested assets	18,585
Net cash received for acquisition	9,006
Net increase in short-term investments	(61,166)
Additions to property and equipment	(324)

Net cash (used in) provided from investing activities	(41,482)
Financing Activities:	
Net change in FHLB borrowings	4,691
Change in long and short-term debt	(990)
Net deposits and withdrawals from insurance liabilities	(9,535)
Issuance of common stock	--
Acquisition of common stock	(949)
Dividends paid	(1,837)
Net cash provided by (used in) financing activities	(8,620)
Increase in cash	12,987
Cash at beginning of period	23,579
Cash at end of period	$ 36,566

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 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 of 2001, the Financial Accounting Standards Board 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.

In October of 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 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. The adoption of SFAS 145 will likely require Vesta to reclass any previous gains and losses on the extinguishments of debt as these items will no longer be considered extraordinary as defined by APB 30.

Restricted Assets. As part of a modified coinsurance agreement with Employers Reinsurance Corporation, American Founders is holding $113.0 million of assets for the benefit of Employers, of which $111.8 million are included in fixed maturities available for sale herein.

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.

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 six months ending June 30, 2002 and 2001 are as follows:

	Three months ended June 30, 2002	2001
Net (loss) income available to common shareholders	$ (11,483)	$ 7,052
Preferred stock dividends on convertible preferred stock	--	--
Adjusted net income (loss) available to common shareholders	$ (11,483)	$ 7,052
Weighted average shares outstanding-basic (1)	33,780	23,784
Stock options and restricted stock (2)	--	498
Weighted average convertible preferred stock (1)	--	--
Weighted average shares outstanding-diluted (1)	33,780	24,282

	Six months ended June 30, 2002	2001
Net (loss) income available to common shareholders	$ (9,524)	$ 10,089
Preferred stock dividends on convertible preferred stock	--	163
Adjusted net income (loss) available to common shareholders	$ (9,524)	$ 10,252

Weighted average shares outstanding-basic (1)	33,394	21,334
Stock options and restricted stock (2)	--	452
Weighted average convertible preferred stock (1)	--	945
Weighted average shares outstanding-diluted (1)	33,394	22,731

(1) Reflects weighted averages. At June 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 month and six month period ending June 30, 2002 are .4 million shares and .5 million shares respectively.

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

	2002		2001	
	3 month	6 month	3 month	6 month
Basic Earnings per share:				
Discontinued Operations	$ (0.28)	$ (0.28)	$ (0.01)	$ (0.01)
Extraordinary Gain	--	$ 0.03	--	--
Diluted Earnings per share:				
Discontinued Operations	$ (0.28)	$ (0.28)	$ (0.01)	$ (0.01)
Extraordinary Gain	--	$ 0.03	--	--

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 $25 million against earnings to cover Vesta's contribution to the settlement and other expenses incurred. We have now filed a claim with two of our upper level excess D & O insurers for their part of the settlement and related expenses. We have recorded a receivable of $5.4 million, which represents the amount currently due from those two excess D&O insurers.

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 was recently rescheduled 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 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 $55.2 million at June 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 recently 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. The hearing on any issues remaining after the October 28, 2002 hearing will be conducted in October, 2003. The hearing in the Dorinco arbitration is presently scheduled for December, 2003. While management believes 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 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 to 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, 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.

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 following the bankruptcy of an affiliate of one of these privately held companies, which reduced American Founders' aggregate carrying value of these loans at June 30, 2002 and December 31, 2001 to $27.1 million.

The $27.1 million balance of the loans 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 of American Founders 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 June 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 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 June 30, 2002 and 2001 is as follows:

2002	**Standard Property-Casualty**	**Life and Health Insurance**	**Specialty Underwriting**	**Agency**	**C a**
Revenues:			(in thousands)		
Premiums earned	$ 80,513	$ 7,562	$ 40,566		
Agency fees and commissions	--	--	--	$ 26,172	
Net investment income	--	9,338	--	--	
Policy fees	1,290	1,133	3,082	--	
Realized gains (losses)	--	2,322	--	--	
Other	225	320	1,628		
Total revenues	82,028	20,675	45,276	26,172	
Expenses:					
Loss, LAE and policyholder benefits	60,046	11,104	24,190	--	
Policy acquisition costs	16,717	1,309	12,153	--	
Operating expenses	10,092	3,551	5,757	22,671	
Interest on debt	--	1,588	--	454	
Goodwill and other intangible amortization	--	--	--	--	
Total expenses	86,855	17,552	42,100	23,125	
Pre-tax income (loss) from					

continuing operations	$(4,827)	$ 3,123	$ 3,176	$ 3,047
Operating segment assets:				
Investments and other assets	$ 359,554	$ 916,598	$ 149,657	$ 66,192
Deferred acquisition costs	57,720	24,782	1,517	10,669
	$ 417,274	$ 941,380	$ 151,174	$ 76,861

2001	**Standard Property-Casualty**	**Life and Health Insurance**	**Specialty Underwriting**	**Agency**	**C a**
Revenues:			(in thousands)		
Premiums earned	$ 64,706	$ 7,482	$ 2,003		
Agency fees and commissions	--	--	--	$ 356	
Net investment income	--	11,010	--	103	
Policy fees	676	1,052	--	--	
Realized gains	--	797	--	--	
Other	420	183	961	--	
Total revenues	65,802	20,524	2,964	459	
Expenses:					
Loss, LAE and policyholder benefits	37,573	8,938	1,498	--	
Policy acquisition costs	14,519	2,035	421	--	
Operating expenses	8,043	2,806	96	1,438	
Interest on debt	--	2,198	--	--	
Goodwill and other intangible amortization	--	--	--	--	
Total expenses	60,135	15,977	2,015	1,438	
Pre-tax income (loss) from continuing operations	$ 5,667	$ 4,547	$ 949	$ (979)	
Operating segment assets:					
Investments and other assets	$ 333,458	$ 925,653	$ 11,493	$ 24,135	
Deferred acquisition costs	32,140	1,573	253	--	
	$ 365,598	$ 927,226	$ 11,746	$ 24,135	

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

2002	**Standard Property-Casualty**	**Life and Health Insurance**	**Specialty Underwriting**	**Agency**	**C a**
Revenues:			(in thousands)		
Premiums earned	$ 148,356	$ 15,636	$ 76,440		
Agency fees and commissions	--	--	--	$ 49,760	
Net investment income	--	18,757	--	--	
Policy fees	2,592	2,116	4,215	--	

Realized gains (losses)	--	3,263	--	--
Other	225	657	3,236	
Total revenues	151,173	40,429	83,891	49,760
Expenses:				
Loss, LAE and policyholder benefits	107,125	21,749	47,805	--
Policy acquisition costs	32,132	3,058	21,471	--
Operating expenses	19,264	6,837	9,053	43,407
Interest on debt	--	3,164	--	574
Goodwill and other intangible amortization	--	--	--	--
Total expenses	158,521	34,808	78,329	43,981
Pre-tax income (loss) from continuing operations	$ (7,348)	$ 5,621	$ 5,562	$ 5,779

2001	Standard Property-Casualty	Life and Health Insurance	Specialty Underwriting	Agency
			(in thousands)	
Revenues:				
Premiums earned	$ 121,553	$ 14,947	$ 3,086	
Agency fees and commissions	--	--	--	$ 798
Net investment income	--	21,790	--	260
Policy fees	1,031	1,950	--	--
Realized gains	--	1,398	--	--
Other	420	235	1,804	
Total revenues	123,004	40,320	4,890	1,058
Expenses:				
Loss, LAE and policyholder benefits	75,475	16,995	2,297	--
Policy acquisition costs	26,577	4,157	643	--
Operating expenses	14,405	6,567	157	2,827
Interest on debt	--	4,628	--	--
Goodwill and other intangible amortization	--	--	--	--
Total expenses	116,457	32,347	3,097	2,827
Pre-tax income (loss) from continuing operations	$ 6,547	$ 7,973	$ 1,793	$ (1,769)

Note D-Stock 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 an after tax extraordinary gain on extinguishment of debt of $.9 million and an after tax gain on redemption of preferred securities of $.2 million.

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
Propery, Plant & Equipment	3,148
Other assets	29,572
Goodwill and other Intangible assets	24,913
Total assets	$ 85,349
Liabilities acquired:	
Unearned premiums	35,731
Other liabilities	27,321
Total liabilities	$ 63,052

Note F-Goodwill and Other Intangible Assets

In June, 2001, the FASB issued Statement of Financial Accounting Standards 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.

During the six months ended June 30, 2001, we recorded $1.0 million in amortization of goodwill. The impact of amortization of goodwill on net income for the six months ended June 30, 2001 was as follows (in thousands, except per share data):

	Six months ended June 30, 2001

Reported net income	$ 9,687
Add back:	
Goodwill amortization, net of income taxes	972
Net income excluding goodwill amortization, net of income taxes	$ 10,659

Basic net income per common share

Reported net income	$ 0.45
Add back:	
Goodwill amortization, net of income taxes	0.05
Net income excluding goodwill amortization, net of income taxes	$ 0.50
Weighted average number of common shares outstanding (basic)	21,334

Diluted net income per common share

Reported net income	$ 0.44
Add back:	
Goodwill amortization, net of income taxes	0.04
Net income excluding goodwill amortization, net of income taxes	$ 0.48
Weighted average number of common shares outstanding (diluted)	22,731

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

Balance as of January 1, 2000	$ 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	25,646
Amortization	(168)
Transitional impairment charge	--
Balance as of June 30, 2002	$ 134,738

The $134.7 million balance at June 30, 2002 consists of $128.0 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.

Amortization expense recorded on the intangible assets for each of the three-month periods ended June 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

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 Second Quarter 2002 to Second Quarter 2001

Income available to common shareholders decreased by $18.6 million, to an $11.5 million loss for the quarter ended June 30, 2002, from $7.1 million of income for the quarter ended June 30, 2001. This decrease is the result of lower income from operations, increased catastrophe losses, and a $9.5 million after-tax charge for discontinued operations primarily related to our award in arbitration with F&G Re. On a diluted per share basis, net income available to common shareholders for the second quarter of 2002 was a net loss of $0.34 per share versus net income of $0.29 per share for the second quarter of 2001.

Standard Property-Casualty

Net premiums written for standard property-casualty lines increased by $40.1 million, or 61.9%, to $104.9 million for the quarter ended June 30, 2002, from $64.8 million for the quarter ended June 30, 2001. Net premiums earned for standard property-casualty lines increased $15.8 million, or 24.4% to $80.5 million for the quarter ended June 30, 2002, from $64.7 million for the quarter ended June 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 $22.4 million, or 59.6%, to $60.0 million for the quarter ended June 30, 2002, from $37.6 million for the quarter ended June 30, 2001. The loss and LAE ratio for property-casualty lines for the quarter ended June 30, 2002 was 74.1% as compared to 57.5% at June 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 versus our results in the prior year period, catastrophe losses in the current quarter of $6.2 million versus $.3 million in the prior year period, and our overall increase in earned premium. The deterioration in our underwriting results is being primarily driven by increases in severity of claims in certain states.

Policy acquisition expenses increased $2.2 million for the quarter-to-quarter comparison, consistent with the increase in earned premium. Operating expenses increased by $2.0 million, to $10.1 million for the quarter ended June 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 June 30, 2002. Life insurance premiums and policy fees were $5.1 million for the quarter ended June 30, 2002 compared to $3.5 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 $3.6 million for the quarter ended June 30, 2002 versus $3.5 million for the comparable prior period. Health insurance benefits incurred totaled $4.2 million for the quarter and health insurance commission expense was $1.0 million. Pre-tax income decreased by $.7 million primarily due to higher mortality in two older acquired blocks, lower than expected investment income, and adverse morbidity in our health insurance operations, partially offset by increased realized investment gains.

Specialty Underwriting

Net premiums written for specialty underwriting increased by $41.4 million to $43.4 million for the quarter ended June 30, 2002, from $2.0 million for the quarter ended June 30, 2002. Net premiums earned for specialty underwriting increased to $40.6 million for the quarter ended June 30, 2002, from $2.0 million for the quarter ended June 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 $.7 million to $1.6 million on higher ceded earned premium.

Loss and loss adjustment expenses ("LAE") for specialty underwriting increased by $22.7 million to $24.2 million for the quarter ended June 30, 2002, from $1.5 million for the quarter ended June 30, 2001. The loss and LAE ratio for the quarter ended June 30, 2002 was 55.4% as compared to 74.8% at June 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 $11.7 million for the quarter-to-quarter comparison, consistent with the increase in earned premium. Operating expenses increased by $5.7 million, to $5.8 million for the quarter ended June 30, 2002, as we incurred increased expenses from our increased operations.

Agency

Our Agency operations increased its revenues by $25.8 million to $26.2 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 $22.7 million as we integrated the acquired operations with our existing operations.

Net Investment Income

Net investment income decreased by $3.3 million, or 19.3%, to $13.8 million for the quarter ended June 30, 2002, from $17.1 million for the quarter ended June 30, 2001. The weighted average yield on invested assets (excluding realized and unrealized gains) was 6.1% for the quarter ended June 30, 2002, compared with 6.7% for the quarter ended June 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 decreased by $4.9 million to a $.6 million benefit for the quarter ended June 30, 2002 as a result of a loss in the current period compared to the prior period income.

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 Six Months Ended June 30, 2002 with Six Months Ended June 30, 2001

Income available to common shareholders decreased by $19.6 million, to a $9.5 million loss for the six months ended June 30, 2002, from $10.1 million of income for the six months ended June 30, 2001. On a diluted per share basis, net income available to common shareholders for the first six months of 2002 was a net loss of $0.29 per share versus net income of $0.45 per share for the corresponding period of 2001.

Standard Property-Casualty

Net premiums written for standard property-casualty lines increased by $85.6 million, or 73.2%, to $202.6 million for the six months ended June 30, 2002, from $117.0 million for the six months ended June 30, 2001. Net premiums earned for standard property-casualty lines increased $26.8 million, or 22.0% to $148.4 million for the six months ended June 30, 2002, from $121.6 million for the six months ended June 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 $31.6 million, or 41.8%, to $107.1 million for the six months ended June 30, 2002, from $75.5 million for the six months ended June 30, 2001. The loss and LAE ratio for property-casualty lines for the six months ended June 30, 2002 was 71.0% as compared to 61.6% at June 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 $5.5 million for the six months ended June 30, consistent with the increase in earned premium. Operating expenses increased by $4.9 million, to $19.3 million for the six months ended June 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 June 30, 2002. Life insurance premiums and policy fees were $7.7 million for the six months ended June 30, 2002 compared to $6.6 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 $10.1 million for the six months ended June 30, 2002 versus $10.3 million for the comparable prior period. Health insurance benefits incurred totaled $7.0 million for the six months and health insurance commission expense was $1.3 million. Pre-tax income decreased by $2.5 million primarily due to higher mortality in two older acquired blocks and lower than expected investment income.

Specialty Underwriting

Net premiums written for specialty underwriting increased by $85.2 million to $88.7 million for the six months ended June 30, 2002, from $3.5 million for the six months ended June 30, 2002. Net premiums earned for specialty underwriting increased to $76.4 million for the six months ended June 30, 2002, from $3.1 million for the six months ended June 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 $1.4 million to $3.2 million on higher ceded earned premium.

Loss and loss adjustment expenses ("LAE") for specialty underwriting increased by $45.5 million to $47.8 million for the six months ended June 30, 2002, from $2.3 million for the six months ended June 30, 2001. The loss and LAE ratio for the six months ended June 30, 2002 was 59.3% as compared to 74.4% at June 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 $20.8 million for the six month period comparison, consistent with the increase in earned premium. Operating expenses increased by $8.9 million, to $9.1 million for the quarter ended June 30, 2002, as we incurred increased expenses from our increased operations.

Agency

Our Agency operations increased its revenues by $49.0 million to $49.8 million as a result of acquisitions completed in the fourth quarter of 2001 and the first quarter of 2002. Operating expenses increased by $40.6 million to $43.4 million as we integrated the acquired operations with our existing operations.

Net Investment Income

Net investment income decreased by $5.2 million, or 15.9%, to $27.5 million for the six months ended June 30, 2002, from $32.7 million for the six months ended June 30, 2001. The weighted average yield on invested assets (excluding realized and unrealized gains) was 6.4% for the six months ended June 30, 2002, compared with 6.5% for the six months ended June 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 collateral loan portfolio.

Federal Income Taxes

Federal income taxes decreased by $3.6 million to $.3 million for the six months ended June 30, 2002 as a result of less 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 June 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 our management agreement with our insurance company subsidiaries to meet our cash requirements (including debt service) and to pay dividends to our stockholders. This management agreement, which provided approximately $25 million to our holding company in 2001, is subject to certain regulatory standards which generally require its terms and fees to be fair and reasonable. The Illinois Department of Insurance may review this agreement from time to time to insure the reasonableness of its 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 the management agreement is not modified in a material respect, we believe that this management agreement will provide us with funds sufficient to meet our anticipated needs (including debt service) for at least the next twelve months.

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 June 30, 2002, the principal amount outstanding under these credit facilities was approximately $28.9 million. Effective as of March 30, 2002, each of these credit agreements have been 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 June 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 June 30, 2002 and 2001, was $63.1 million and $(20.7) million, respectively as our increased written premium generated a significant amount of operating cash flow. Net cash (used in) provided by investing activities was $(41.5) million and $25.5 million for the quarter ended June 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 $(8.6) million and $58.2 million for the quarter ending June 30, 2002 and 2001.

New Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board 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 of 2001, the Financial Accounting Standards Board 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.

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 SAFS No. 142 is expected to result in increase in net income of approximately $2.6 million in fiscal year 2002.

In October of 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. The adoption of SFAS 145 will require Vesta to reclass any previous gains and losses on the extinguishments of debt as these items will no longer be considered extraordinary as defined by APB 30.

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.

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.

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 $25 million against earnings to cover Vesta's contribution to the settlement and other expenses incurred. We have now filed a claim with two of our upper level excess D & O insurers for their part of the settlement and related expenses. We have recorded a receivable of $5.4 million, which represents the amount currently due from those two excess D&O insurers.

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 was recently rescheduled 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 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 $55.2 million at June 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 recently 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. The hearing on any issues remaining after the October 28, 2002 hearing will be conducted in October, 2003. The hearing in the Dorinco arbitration is presently scheduled for December, 2003. While management believes 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 has recorded a pre-tax charge of approximately $13.6 million in the 2nd quarter of 2002 as discontinued operations.

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

Item 2. Changes in Securities

None.

Item 3. Defaults Upon Senior Securities

None.

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

At the annual meeting of stockholders held May 7, 2001, the following matters were submitted to a vote of stockholders. (Shares Eligible to Vote 36,473,394)

1. Election of Directors

Messrs. Norman W. Gayle, III and James E. Tait were elected to additional three year terms o

	For
Gayle	30,155,658
Tait	30,072,529

2. Election of Auditors

PricewaterhouseCoopers was appointed as the principal independent auditor of the Compa year ending December 31, 2002.

	For	Agains
PricewaterhouseCoopers LLP	30,914,389	920,97

Item 5. Other information

None.

Item 6. Exhibits and Reports on Form 8-K

a) EXHIBITS

b) Reports on Form 8-K.

A current report was filed on Form 8-K on May 6, 2002 in connection with a press release.

Signatures

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

Vesta Insurance Group, Inc.

Date: August 13, 2002

/s/ W. Perry Cronin

W. Perry Cronin
Senior Vice President
and Chief Financial Officer
(Principal Financial Officer)

Date: August 13, 2002

/s/ Hopson B. Nance

Hopson B. Nance
Vice President and Controller
(Principal Accounting Officer)

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