

Edgar Filing: AMERICAN SAFETY INSURANCE HOLDINGS LTD - Form 10-Q

AMERICAN SAFETY INSURANCE HOLDINGS LTD  
Form 10-Q  
August 14, 2006

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
30, 2006 OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
\_\_\_\_\_ TO \_\_\_\_\_.

Commission File Number 1-14795

AMERICAN SAFETY INSURANCE HOLDINGS, LTD.  
(Exact name of Registrant as specified in its charter)

Bermuda  
(State or other jurisdiction  
of incorporation)

44 Church Street  
P.O. Box HM2064  
Hamilton HM HX, Bermuda  
(Address, zip code of principal executive offices)

(441) 296-8560  
(Registrant's telephone number, including area code)

Indicate by check mark whether 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 such shorter period that registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

The aggregate number of shares outstanding of Registrant's common stock, \$0.01 par value, on August 14, 2006: \_\_\_\_\_

AMERICAN SAFETY INSURANCE HOLDINGS, LTD.

FORM 10-Q

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

American Safety Insurance Holdings, Ltd. and Subsidiaries  
Consolidated Balance Sheets

|  | December 31,<br>2005 |          |
|--|----------------------|----------|
| Assets                                       |                      | (U       |
| Investments:                                 |                      |          |
| Fixed maturity securities available for sale | \$ 364,856,826       | \$ 42    |
| Common stock, at fair value                  | 21,706,103           | 2        |
| Preferred stock, at fair value               | 3,607,000            |          |
| Short-term investments                       | <u>25,326,648</u>    | <u>2</u> |
| Total investments                            | 415,496,577          | 47       |
| Cash and cash equivalents                    | 23,289,927           | 2        |
| Accrued investment income                    | 4,037,573            |          |
| Premiums receivable                          | 17,315,778           | 2        |
| Ceded unearned premium                       | 29,880,672           | 3        |
| Reinsurance recoverable                      | 173,490,056          | 17       |
| Deferred income taxes                        | 11,933,791           | 1        |
| Deferred policy acquisition costs            | 10,628,874           | 1        |
| Property, plant and equipment                | 4,489,608            |          |
| Other assets                                 | <u>6,572,007</u>     |          |
| Total assets                                 | \$ 697,134,863       | \$ 77    |
|  | =====                | =====    |

See accompanying notes to consolidated financial statements (unaudited).

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|   | December 31,<br>2005 | (U    |
|---|----------------------|-------|
| Liabilities and Shareholders' Equity  |                      |       |
| Liabilities:  |                      |       |
| Unpaid losses and loss adjustment expenses  | \$ 394,872,581       | \$ 41 |
| Unearned premiums   | 100,241,061          | 10    |
| Ceded premiums payable  | 16,505,732           | 1     |
| Accounts payable and accrued expenses   | 13,066,758           | 1     |
| Loan payable  | 37,810,099           | 3     |
| Funds held  | 11,190,989           | 1     |
| Minority Interest   | <u>5,012,396</u>     |       |
| Total liabilities   | 578,699,616          | 60    |
| Shareholders' equity:   |                      |       |
| Preferred stock, \$0.01 par value; authorized 5,000,000 shares; no shares issued and outstanding  | -                    |       |
| Common stock, \$0.01 par value; authorized 15,000,000 shares; issued and outstanding at December 31, 2005, 6,753,731 and June 30, 2006, 10,045,966 shares | 67,537               |       |
| Additional paid-in capital  | 49,460,019           | 9     |
| Retained earnings   | 70,457,352           | 7     |
| Accumulated other comprehensive income, net   | <u>(1,549,661)</u>   | (     |
| Total shareholders' equity  | <u>118,435,247</u>   | 16    |
| Total liabilities and shareholders' equity  | \$ 697,134,863       | \$77  |
|   | =====                | ===== |

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries  
Consolidated Statements of Earnings  
(unaudited)

|                                     | Three Months Ended<br>June 30, |                     | Six M<br>J        |
|-------------------------------------|--------------------------------|---------------------|-------------------|
|                                     | 2005                           | 2006                | 2005              |
| Revenues:                           |                                |                     |                   |
| Direct premiums earned              | \$ 59,076,332                  | \$ 54,038,204       | \$ 114,321,73     |
| Assumed premiums earned             | -                              | -                   | 6,66              |
| Ceded premiums earned               | <u>(24,541,747)</u>            | <u>(17,962,376)</u> | <u>(45,173,19</u> |
| Net premiums earned                 | 34,534,585                     | 36,075,828          | 69,155,19         |
| Net investment income               | 3,427,475                      | 4,794,702           | 6,583,85          |
| Net realized gains (losses)         | (96,697)                       | (3,169)             | (44,46            |
| Real estate income                  | 691,078                        | -                   | 3,000,07          |
| Other income                        | <u>33,807</u>                  | <u>23,193</u>       | <u>35,74</u>      |
| Total revenues                      | 38,590,248                     | 40,890,554          | 78,730,42         |
|                                     | =====                          | =====               | =====             |
| Expenses:                           |                                |                     |                   |
| Losses and loss adjustment expenses | 21,507,779                     | 21,387,969          | 42,288,82         |
| Acquisition expenses                | 6,883,652                      | 6,431,653           | 14,010,03         |
| Payroll and related expenses        | 3,181,498                      | 3,991,686           | 6,148,48          |
| Real estate expenses                | 423,933                        | 102,461             | 2,688,46          |
| Other expenses                      | 2,948,367                      | 2,951,627           | 5,197,87          |
| Interest expense                    | 262,961                        | 837,623             | 529,64            |

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|                              |                     |                     |                    |
|------------------------------|---------------------|---------------------|--------------------|
| Minority interest            | <u>(48,616)</u>     | <u>(39,174)</u>     | <u>539,28</u>      |
| Total expenses               | <u>35,159,574</u>   | <u>35,663,845</u>   | <u>71,402,59</u>   |
| Earnings before income taxes | 3,430,674           | 5,226,709           | 7,327,82           |
| Income taxes                 | <u>291,920</u>      | <u>599,575</u>      | <u>542,72</u>      |
| Net earnings                 | \$ <u>3,138,754</u> | \$ <u>4,627,134</u> | \$ <u>6,785,09</u> |
|                              | =====               | =====               | =====              |
| Net earnings per share:      |                     |                     |                    |
| Basic                        | <u>\$0.47</u>       | <u>\$0.65</u>       | <u>\$ 1.0</u>      |
| Diluted                      | <u>\$0.44</u>       | <u>\$0.62</u>       | <u>\$0.94</u>      |
| outstanding:                 |                     |                     |                    |
| Basic                        | 6,718,269           | 7,106,393           | 6,754,67           |
|                              | =====               | =====               | =====              |
| Diluted                      | 7,118,651           | 7,498,006           | 7,197,09           |
|                              | =====               | =====               | =====              |

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries  
Consolidated Statements of Cash Flow  
(unaudited)

|  | 2005             | Six Months<br>June 3 |
|--|------------------|----------------------|
| Cash flow from operating activities:   |                  |                      |
| Net earnings   | \$6,785,097      |                      |
| Adjustments to reconcile net earnings to net cash provided<br>by operating activities: |                  |                      |
| Realized losses (gains) on investments   | 44,465           |                      |
| Depreciation expense   | 469,877          |                      |
| Stock based compensation expense   | -                |                      |
| Amortization of deferred acquisition costs, net  | 408,406          |                      |
| Amortization of premiums on investments  | 1,121,351        |                      |
| Deferred income taxes  | (454,458)        |                      |
| Change in:   |                  |                      |
| Accrued investment income  | (424,275)        |                      |
| Premiums receivable  | (464,619)        |                      |
| Reinsurance recoverable and ceded unearned premiums                                    | (19,416,618)     |                      |
| Funds held   | 1,230,834        |                      |
| Unpaid losses and loss adjustment expenses   | 32,912,804       |                      |
| Unearned premiums  | 6,074,856        |                      |
| Ceded premiums payable   | 999,178          |                      |
| Accounts payable and accrued expenses  | (699,066)        |                      |
| Other, net   | <u>2,319,056</u> |                      |
| Net cash provided by operating activities  | 30,906,888       |                      |
| Cash flow from investing activities:   |                  |                      |
| Purchases of fixed maturities  | (62,292,659)     |                      |
| Purchases of common stock  | (6,854,709)      |                      |
| Purchases of preferred stock   | -                |                      |

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|   |                  |
|---|------------------|
| Proceeds from sale of fixed maturities        | 27,364,190       |
| Proceeds from sale of equity investments      | 908,376          |
| Decrease (increase) in short-term investments | 9,404,848        |
| Decrease of investment in real estate         | 2,005,440        |
| Purchase of fixed assets, net                 | <u>(712,132)</u> |
| Net cash used in investing activities         | (30,176,646)     |

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries  
Consolidated Statements of Cash Flow (Continued)  
(unaudited)

|  |                    | Six Months<br><u>June 30</u> |
|--|--------------------|------------------------------|
|  | <u>2005</u>        |                              |
| Cash flow from financing activities:                 |                    |                              |
| Proceeds from issuance of common stock               | 772,210            |                              |
| Stock repurchase payments                            | (2,945,714)        |                              |
| Repayment of loan payable                            | (191,397)          |                              |
| Repayment of escrow deposits                         | (144,500)          |                              |
| Withdrawals of restricted cash                       | <u>144,500</u>     |                              |
| Net cash used in financing activities                | <u>(2,364,901)</u> |                              |
| Net increase (decrease) in cash and cash equivalents | (1,634,659)        |                              |
| Cash and cash equivalents at beginning of period     | <u>24,843,736</u>  |                              |
| Cash and cash equivalents at end of period           | \$23,209,077       |                              |
|  | =====              |                              |
| Supplemental disclosure of cash flow:                |                    |                              |
| Income taxes paid                                    | \$ 287,259         |                              |
|  | =====              |                              |
| Interest paid  | \$ 489,305         |                              |
|  | =====              |                              |

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries  
Consolidated Statements of Comprehensive Income  
(unaudited)

|  | Three Months Ended |              | Si        |
|--|--------------------|--------------|-----------|
|  | <u>June 30,</u>    |              |           |
|  | <u>2005</u>        | <u>2006</u>  | <u>20</u> |
| Net earnings   | \$ 3,138,754       | \$ 4,627,134 | \$ 6,78   |
| Other comprehensive income before income taxes:  |                    |              |           |
| Unrealized gains (losses) on securities available<br>for sale, net of minority interest of \$288,541 and<br>\$(167,259) for the three months ended June 30, 2005 |                    |              |           |

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|  |                       |                      |                  |
|--|-----------------------|----------------------|------------------|
| and 2006, respectively, and \$75,870 and \$(406,535) for the six months ended June 30, 2005 and 2006, respectively.  | 5,068,766             | (4,071,054)          | 40               |
| Unrealized gains (losses) on hedging transactions  | (167,696)             | 31,686               | 11               |
| Reclassification adjustment for realized (gains) and losses included in net earnings   | <u>96,697</u>         | <u>3,169</u>         | <u>4</u>         |
| Total other comprehensive income (loss) before taxes   | 4,997,767             | (4,036,199)          | 56               |
| Income tax expense (benefit) related to items of other comprehensive income, net of minority interest of \$109,733 and \$(57,869) for the three months ended June 30, 2005 and 2006 respectively, and \$108,370 and \$(139,221) for the six months ended June 30, 2005 and 2006, respectively. | <u>1,134,646</u>      | <u>(864,677)</u>     | <u>202</u>       |
| Other comprehensive income (loss) net of income taxes  | <u>3,863,131</u>      | <u>(3,171,522)</u>   | <u>363</u>       |
| Total comprehensive income   | \$ 7,001,875<br>===== | \$1,455,612<br>===== | \$7,148<br>===== |

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries

### Notes to Consolidated Financial Statements

June 30, 2006  
(unaudited)

#### **Note 1 - Basis of Presentation**

The accompanying consolidated financial statements of American Safety Insurance Holdings, Ltd. and its subsidiaries and American Safety Risk Retention Group, Inc. ("American Safety RRG"), a non-sub subsidiary (collectively, the "Company"), are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to use the best information available, in recording transactions resulting from business operations. Changes in estimates and/or actuarial determinations subject to future changes in assumptions, deferred income taxes, and the liabilities for unpaid losses and loss adjustment expenses. If actual results available (or actual amounts are determinable), the recorded estimates may be revised and management believes that these estimates are adequate, such estimates may change in the future.

The results of operations for the six months ended June 30, 2006 may not be indicative of the results for the fiscal year ending December 31, 2006. These unaudited interim consolidated financial statements are presented in conjunction with the financial statements and notes included in the audited consolidated financial statements of the Company for the fiscal year ended December 31, 2005.

The unaudited interim consolidated financial statements include the accounts of American Safety Insurance Holdings, Ltd. and American Safety RRG. All significant intercompany balances have been eliminated. In the accompanying financial statements, the presentation. See Note 5 for additional information. Prior years have been reclassified to conform with the presentation.

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### Note 2 - Accounting Pronouncements

During the last two years, the Financial Accounting Standard Board (FASB) has issued with various effective dates.

In November 2005, the FASB issued Staff Position Number FAS 115-1, The Meaning of Other-than-Temporary Impairment and Its Application to Certain Investments ("FSP 115-1"). FSP 115-1 addresses the determination of whether an impairment is other than temporary, and the measurement of an impairment. It also addresses the measurement of an impairment subsequent to the recognition of another-than-temporary impairment and requires recognition of losses that have not been recognized as other-than-temporary impairments. The guidance in FSP 115-1, Accounting for Certain Investments in Debt and Equity Securities, and was effective January 1, 2006. The pronouncement did not have a material impact on the Company's financial statement.

In April 2006, the FASB issued a Staff Position Number FIN 46(R)-6, Determining the Value of a Financial Instrument (FSP 46R-6). FSP 46R-6 responds to the need for guidance on how to determine the fair value of a financial instrument that has been identified and evaluated in order to apply FIN 46(R) and is effective for fiscal periods beginning after December 15, 2006. The pronouncement will have no impact on the Company as it already consolidates its non-subsiary af

In July 2006, the FASB issued a Staff Position Number FIN 48 (FIN 48), Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement Number 109, Accounting for Income Taxes. This interpretation prescribes a method for the recognition and measurement of a tax position taken or expected to be taken on a return that is more likely than not to be realized. This interpretation is effective for fiscal years beginning after December 15, 2006. The pronouncement to determine impact if any it will have on its financial statements.

### Note 3 Nature of Operations

The following is a description of certain risks facing the Company:

Legal/Regulatory Risk is the risk that changes in the legal or regulatory environment create additional expenses not anticipated by the Company in pricing its products and beyond those reflected in its financial statements. That is, regulatory initiatives designed to reduce insurer profits or otherwise otherwise affect the way an insurer operates, new legal theories or insurance company insolvencies through guaranty funds, or changes in the way an insurer operates beyond those recorded in the financial statements. The Company attempts to mitigate this risk by operating in several states, thereby spreading this risk over a large geographic area.

The Potential Risk of United States Taxation of Bermuda Operations. Under current law, American Safety Insurance Holdings Ltd. is required to pay any taxes in Bermuda on either income or capital gains. American Safety has a Memorandum of Understanding with the Minister of Finance in Bermuda that will exempt American Safety from taxation until the year 2010. Whether a foreign corporation is engaged in a United States trade or business or not is determined by the level of activity in the United States that would subject it to United States taxation depends upon the level of activity in the United States. If the activities of a foreign company are "continuous, regular, and considerable," then the company is engaged in a United States trade or business. Management believes that American Safety is not engaged in a U.S. trade or business and in the future will continue to be operated in a manner that will not cause any of its subsidiaries to be a U.S. trade or business.

However, because the Internal Revenue Code of 1986, as amended, Treasury Regulations and other authorities do not identify activities that constitute being engaged in a United States trade or business, and the determination of whether a company is engaged in a United States trade or business is a fact-intensive determination, there can be no assurance that the Internal Revenue Service will not contend that the Company's subsidiaries are engaged in a United States trade or business. In general, if American Safety Insurance Holdings Ltd. is engaged in a United States trade or business, each could be subject to (i) United States Federal income tax on income connected with that trade or business and (ii) United States branch profits tax. Certain subsidiaries may also be, however, subject to United States federal and state income tax as they are domiciled and conduct business in the United States.

Credit Risk is the risk that issuers of securities owned by the insurer will default on their obligations to the reinsurers that have obligations to the insurer, will not pay or perform. The Company attempts to mitigate this risk by a conservative investment strategy, by obtaining sufficient collateral and by maintaining sufficient liquidity in its policies.

Interest Rate Risk is the risk that interest rates may change and cause a decrease in the value of the Company's investments.

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investments.

The Company's fixed maturity holdings are invested predominantly in high quality corp with relatively short durations. The fixed maturity portfolio is exposed to interest rate their fair values decline and as interest rates fall, their fair values rise. The changes maturity portfolio are presented as a component of shareholders' equity in accumulated other comp

We work to manage the impact of interest rate fluctuations on our fixed maturity port fixed maturity portfolio is managed with consideration given to the estimated payout timing of policies which limit the maximum duration and maturity of individual securities within the average duration and maturity of the entire portfolio.

### Note 4 - Investments

The amortized cost and estimated fair values of the Company's investments at Decce follows:

|   | <u>Amortized<br/>cost</u> | <u>Gross<br/>unrealized<br/>gains</u> | <u>Gross<br/>unrealized<br/>losses</u> |
|---|---------------------------|---------------------------------------|--|
| December 31, 2005:  |                           |                                       |  |
| Securities available for sale:  |                           |                                       |  |
| Fixed maturities:   |                           |                                       |  |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | \$ 86,740,033             | \$547,669                             | \$1,311,628                            |
| States of the U.S. and political subdivisions of the States                           | 64,740,408                | 386,303                               | 498,465                                |
| Corporate securities  | 84,763,525                | 618,765                               | 1,598,413                              |
| Mortgage-backed securities  | <u>132,992,335</u>        | <u>56,265</u>                         | <u>2,579,971</u>                       |
| Total fixed maturities:   | \$369,236,301             | \$1,609,002                           | \$5,988,477                            |
|   | =====                     | =====                                 | =====                                  |
| Common stock  | \$ 19,983,174             | \$2,721,304                           | \$ 998,374                             |
|   | =====                     | =====                                 | =====                                  |
| Preferred stock   | \$ 3,500,900              | \$ 106,100                            | \$ -                                   |
|   | =====                     | =====                                 | =====                                  |
| June 30, 2006:  |                           |                                       |  |
| Securities available for sale:  |                           |                                       |  |
| Fixed maturities:   |                           |                                       |  |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | \$ 90,149,772             | \$ 139,469                            | \$ 2,618,397                           |
| States of the U.S. and political subdivisions of the States                           | 73,658,363                | 27,633                                | 2,123,173                              |
| Corporate securities  | 94,243,484                | 175,899                               | 2,435,967                              |
| Mortgage-backed securities  | <u>176,634,417</u>        | <u>45,708</u>                         | <u>5,958,082</u>                       |
| Total fixed maturities:   | \$434,686,036             | \$ 388,709                            | \$13,135,619                           |
|   | =====                     | =====                                 | =====                                  |
| Common stock  | \$ 22,111,041             | \$3,136,762                           | \$ 1,313,558                           |
|   | =====                     | =====                                 | =====                                  |
| Preferred stock   | \$ 7,906,620              | \$ 8,920                              | \$ 215,260                             |
|   | =====                     | =====                                 | =====                                  |

**Note 5 - Segment Information**

The Company initially segregates its business into the following segments: Real Estate Operations and Other. The Insurance Operations segment is further classified into three additional lines: Environmental Specialty (Env.), Alternative Risk Transfer (ART), and Runoff. The E&S lines are then further classified into three sub-segments: Environmental Specialty (Env.), Construction (Const.), Excess and Surety. ART is then further classified into two sub-segments of business: Specialty Programs (Programs) and Fully-Funded (FF).

Real estate consists of the Harbour Village project in Ponce Inlet, Florida, which is substantially completed.

In our E&S line, Environmental Specialty writes insurance coverages for the environmental remediation industry. Other provides commercial casualty insurance coverages, generally in the area of construction and construction-related risks. Runoff provides umbrella liability coverage over other carriers' primary policies. Surety provides performance and completion bond coverages in the environmental remediation industry.

In our ART line, Specialty Programs facilitates the offering of insurance to homogeneous risks. Runoff provides a mechanism for insureds to post collateral and self-insure their risks. The Company's policy terms are generally standard for the type of transaction.

The Other segment consists of amounts associated with realized gains and losses on investments.

The Company measures all segments using net earnings, total assets and total equity. The Other segment is measured by net premiums earned, incurred losses and loss adjustment expenses not allocated to the Reportable Insurance Operations segments.

The following table presents key financial data by segment for the six months ended June 30, 2005 and June 30, 2006 (in thousands):

| June 30, 2005                     | Real Estate | Insurance |          |        |        |          |                    | Runoff |
|-----------------------------------|-------------|-----------|----------|--------|--------|----------|--------------------|--------|
|                                   |             | E&S       |          | ART    |        | FF       |                    |        |
|                                   |             | Env.      | Const.   | Excess | Surety |          | Specialty Programs |        |
| Gross premiums written            | \$-         | \$27,290  | \$47,046 | \$989  | \$935  | \$43,326 | \$810              |        |
| Net premiums written              | -           | 24,124    | 38,142   | 198    | 470    | 8,784    | 528                |        |
| Net premiums earned               | -           | 18,522    | 40,734   | 228    | 434    | 8,789    | 293                |        |
| Losses & loss adjustment expenses | -           | 10,187    | 24,720   | 137    | 452    | 5,369    | 10                 |        |
| Acquisition expenses              | -           | 4,637     | 9,369    | (69)   | 68     | 363      | (109)              |        |
| Underwriting profit (loss)        | \$ -        | \$ 3,698  | \$6,645  | \$160  | \$(86) | \$3,057  | \$392              |        |
| Income tax expense (benefit)      | \$118       |           |          |        | \$445  |          |                    |        |

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|              |         |           |
|--------------|---------|-----------|
| Net earnings | \$193   | \$6,654   |
| Assets       | \$3,924 | \$619,632 |
| Equity       | \$2,740 | \$111,334 |

| June 30, 2006                     | Real Estate | Insurance |          |            |           |                        |           |
|-----------------------------------|-------------|-----------|----------|------------|-----------|------------------------|-----------|
|                                   |             | Env.      | Const.   | E&S Excess | Surety    | ART Specialty Programs | Runoff FF |
| Gross premiums written            | \$-         | \$26,885  | \$47,578 | \$1,469    | 1,955     | \$36,640               | \$2,019   |
| Net premiums written              | -           | 19,808    | 44,048   | 382        | 1,083     | 9,705                  | 1,317     |
| Net premiums earned               | -           | 17,360    | 41,895   | 239        | 784       | 9,677                  | 940       |
| Losses & loss adjustment expenses | -           | 10,174    | 27,023   | 143        | 276       | 5,581                  | 145       |
| Acquisition expenses              | -           | 5,012     | 8,164    | (50)       | 152       | 143                    | (13)      |
| Underwriting profit               | \$ -        | \$ 2,174  | \$6,708  | \$146      | \$356     | \$3,683                | \$808     |
| Income tax expense (benefit)      | \$ (64)     |           |          |            | \$606     |                        |           |
| Net earnings                      | \$ (105)    |           |          |            | \$8,547   |                        |           |
| Assets                            | \$1,886     |           |          |            | \$771,949 |                        |           |
| Equity                            | \$651       |           |          |            | \$167,952 |                        |           |

Additionally, the Company conducts business in the following geographic segments: United States and Bermuda. Significant differences exist in the regulatory environment in each country. Those differences include laws regarding the types of investments, capital requirements, solvency monitoring, pricing, corporate taxation, etc. The following table provides key financial data about the geographic segments for the six months ended June 30, 2005 and June 30, 2006 (in thousands):

| June 30, 2005 | United States | Bermuda |
|---------------|---------------|---------|
| Income tax    | \$ 543        | \$ -    |
| Net earnings  | 2,381         | 4,404   |
| Assets        | 474,185       | 149,371 |
| Equity        | 58,902        | 55,071  |
| June 30, 2006 | United States | Bermuda |
| Income tax    | 616           | -       |
| Net earnings  | 2,751         | 5,977   |
| Assets        | 545,236       | 228,599 |
| Equity        | 58,373        | 110,127 |

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The following table presents key financial data by segment for the three months ended June 30, 2005 and June 30, 2006 (in thousands):

| June 30, 2005                     | Real Estate | Insurance |          |        |         |                    |         | Runoff |
|-----------------------------------|-------------|-----------|----------|--------|---------|--------------------|---------|--------|
|                                   |             | E&S       |          |        | ART     |                    |         |        |
|                                   |             | Env.      | Const.   | Excess | Surety  | Specialty Programs | FF      |        |
| Gross premiums written            | \$-         | \$13,696  | \$20,335 | \$647  | \$438   | \$20,583           | \$493   |        |
| Net premiums written              | -           | 13,157    | 16,026   | 129    | 220     | 5,514              | 395     |        |
| Net premiums earned               | -           | 9,777     | 19,742   | 116    | 215     | 4,480              | 204     |        |
| Losses & loss adjustment expenses | -           | 5,378     | 11,899   | 70     | 75      | 2,921              | 5       |        |
| Acquisition expenses              | -           | 2,244     | 4,790    | (36)   | 21      | 152                | (38)    |        |
| Underwriting profit (loss)        | \$ -        | \$ 2,155  | \$3,035  | \$82   | \$119   | \$1,407            | \$237   |        |
| Income tax expense (benefit)      | \$102       |           |          |        | \$223   |                    |         |        |
| Net earnings                      | \$165       |           |          |        | \$,049  |                    |         |        |
| June 30, 2006                     | Real Estate | Insurance |          |        |         |                    |         | Runoff |
|                                   |             | E&S       |          |        | ART     |                    |         |        |
|                                   |             | Env.      | Const.   | Excess | Surety  | Specialty Programs | FF      |        |
| Gross premiums written            | \$-         | \$14,244  | \$25,126 | \$858  | \$1,085 | \$20,295           | \$1,756 |        |
| Net premiums written              | -           | 11,737    | 23,863   | 214    | 643     | 5,922              | 1,129   |        |
| Net premiums earned               | -           | 9,040     | 20,981   | 117    | 431     | 4,935              | 572     |        |
| Losses & loss adjustment expenses | -           | 4,479     | 13,538   | 70     | 151     | 3,005              | 145     |        |
| Acquisition expenses              | -           | 2,371     | 3,990    | (18)   | 64      | (39)               | 64      |        |

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|                                 |         |          |         |      |         |         |       |
|---------------------------------|---------|----------|---------|------|---------|---------|-------|
| Underwriting profit             | \$ -    | \$ 2,190 | \$3,453 | \$65 | \$216   | \$1,969 | \$363 |
| Income tax expense<br>(benefit) | \$ (39) |          |         |      | \$647   |         |       |
| Net earnings                    | \$ (63) |          |         |      | \$4,684 |         |       |

The following provides key measurable information about the geographic segments for the periods ended June 30, 2005 and 2006 (in thousands):

| June 30, 2005 | United States | Bermuda |
|---------------|---------------|---------|
| Income tax    | \$292         | \$-     |
| Net earnings  | 788           | 2,351   |
| June 30, 2006 | United States | Bermuda |
| Income tax    | 600           | -       |
| Net earnings  | 1,705         | 2,922   |

**Note 6 - Income Taxes** Total income tax expense for the periods ended June 30, 2005 and 2006 was allocated as follows:

|  | Three Months Ended  |                     | Six Months Ended  |
|--|---------------------|---------------------|-------------------|
|  | June 30, 2005       | June 30, 2006       | June 30, 2005     |
| Tax expense attributable to:   |                     |                     |                   |
| Income from continuing operations                                    | \$ 291,920          | \$ 599,575          | \$ 542,727        |
| Change in unrealized gains/(losses) on hedging transactions          | (57,018)            | 10,433              | 38,449            |
| Change in unrealized gains/(losses) on securities available for sale | <u>1,301,397</u>    | <u>(932,979)</u>    | <u>272,809</u>    |
| Total  | \$ <u>1,536,299</u> | \$ <u>(322,971)</u> | \$ <u>853,985</u> |

United States federal and state income tax expense (benefit) from continuing operations

|                     | Current      | Deferred     |
|---------------------|--------------|--------------|
| Three months ended: |              |              |
| June 30, 2005       | \$ 422,259   | \$ (130,339) |
| June 30, 2006       | \$ 1,572,959 | \$ (973,384) |
| Six months ended:   |              |              |
| June 30, 2005       | \$ 997,185   | \$ (454,458) |
| June 30, 2006       | \$ 1,449,797 | \$ (834,022) |

The state income tax expense (benefit) aggregated \$58,476 and \$(5,714) for the six months ended June 30, 2005 and 2006, respectively, and \$16,250 and \$(20,882) for the three months ended June 30, 2005 and 2006, respectively, and is included in the current provision. Income tax expense for the periods ended June 30, 2005 and 2006 differed from the amounts computed by applying the United States Federal income tax rate of 34% to earnings before Federal income taxes as a result of the following:

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|   | Three Months Ended<br>June 30, |                  | Six Months E<br>June 30, |
|---|--------------------------------|------------------|--------------------------|
|   | 2005                           | 2006             | 2005                     |
| Expected income tax expense                           | \$ 1,166,429                   | \$ 1,777,081     | \$ 2,491,460             |
| Foreign earned income not<br>subject to U.S. taxation | (798,899)                      | (993,431)        | (1,497,191)              |
| Valuation allowance                                   | -                              | -                | (554,515)                |
| State taxes and other                                 | <u>(75,610)</u>                | <u>(184,075)</u> | <u>102,973</u>           |
|   | \$ 291,920                     | \$ 599,575       | \$ 542,727               |
|   | =====                          | =====            | =====                    |

Deferred income taxes are based upon temporary differences between the financial statement and tax bases of assets and liabilities. The following deferred taxes are recorded:

|  | December 31,<br><u>2005</u> | June 30,<br><u>2006</u> |
|--|-----------------------------|-------------------------|
| Deferred tax assets:                     |                             |                         |
| Loss reserve discounting                 | \$ 9,288,244                | \$ 10,183,841           |
| Unearned premium reserves                | 3,118,965                   | 3,286,882               |
| Unrealized loss on securities            | 667,159                     | 2,582,007               |
| Other                                    | <u>502,989</u>              | <u>652,579</u>          |
| Gross deferred tax assets                | 13,577,357                  | 16,705,309              |
| Deferred tax liabilities:                |                             |                         |
| Deferred acquisition costs               | 1,477,230                   | 1,856,313               |
| Unrealized gains on hedging transactions | <u>166,336</u>              | <u>201,486</u>          |
| Gross deferred tax liabilities           | <u>1,643,566</u>            | <u>2,057,799</u>        |
| Net deferred tax asset                   | \$11,933,791                | \$14,647,510            |
|  | =====                       | =====                   |

### Note 7- Stock Options

The Company's stock option plan grants incentive stock options to employees. The majority of the options outstanding under the plan generally vest evenly over a three year period and have a term of 10 years. The Company uses the Black- Scholes option pricing model to value stock options.

The Company applied the recognition and measurement principles of SFAS No. 123R, Share Based Payment in the first quarter of 2006. Compensation expense of \$299,241 is reflected in net earnings for the six months ended June 30, 2006 and \$158,685 for the three months ended June 30, 2006.

The following table illustrates the effect on earnings and earnings per share, assuming we had applied the fair value recognition provisions of SFAS No. 123R Accounting for Share Based Payments for the three months and six months ended June 30, 2005.

|               | Three Months Ending<br>June 30,<br><u>2005</u> | Six Months Ending<br>June 30,<br><u>2005</u> |
|---------------|--|--|
|               | (In thousands, except per share amounts)       |  |
| Net earnings: |  |  |
| As reported   | \$ 3,139                                       | \$ 6,785                                     |

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|                         |          |         |
|-------------------------|----------|---------|
| Effect of stock options | 26       | (461)   |
| Pro forma net earnings  | \$ 3,165 | \$6,324 |
|                         | =====    | =====   |
| Net earnings per share: |          |         |
| Basic - as reported     | \$ 0.47  | \$ 1.00 |
| Basic - pro forma       | \$ 0.47  | \$ 0.94 |
| <br>                    |          |         |
| Diluted - as reported   | \$ 0.44  | \$ 0.94 |
| Diluted - pro forma     | \$ 0.44  | \$ 0.88 |

### Note 8 - Subsequent Events

In July 2006, the underwriters of the Company's recent public offering fully exercised their option to purchase an additional 480,000 shares of common stock at \$15.50 per share, providing an additional \$7.5 million.

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

We are a specialty insurance company that provides customized insurance products and services to various businesses in industries that we believe are underserved by the standard insurance market. We offer specialized insurance coverages and alternative risk transfer products not generally available in the standard insurance market because of the unique characteristics of the risks involved and the associated costs of underwriting these products for insureds with environmental risks and construction risks and other specialty classes of risks.

During 2005, we changed our segment reporting to coincide with our strategic direction. For periods prior to the year ended December 31, 2005, we segregated our business into real estate operations and other (which included realized gains and losses on investments and rescission expenses). We also had real estate operations, insurance operations and other, but the insurance operations segment was divided into additional segments: excess and surplus lines, alternative risk transfer and runoff. The excess and surplus lines were classified into four business lines: environmental, construction, excess and surety. The alternative risk transfer was further classified into two business lines: specialty programs and fully-funded. Prior year amounts are not comparable to the current year presentation. Our real estate operations consist solely of our development operations. See Note 5 to our consolidated financial statements for more information on our segment reporting.

The following information is presented on the basis of accounting principles generally accepted in the United States of America (GAAP) and should be read in conjunction with our consolidated financial statements and notes elsewhere in this report. All amounts and percentages are rounded.

The Company reported a 47% increase in net earnings for the three months ended June 30, 2006, or \$0.47 per diluted share, compared to \$3.1 million, or \$0.44 per diluted share, for the same period of 2005.

Financial highlights in the quarter included:

- o Gross premiums written increased 13% to \$63.4 million.
- o Net premiums written increased 23% to \$43.5 million.
- o Net premiums earned increased 5% to \$36.1 million.
- o Net investment income increased 40% to \$4.8 million.
- o The combined ratio improved to 95.2% from 98.9%.
- o Book value decreased to \$16.77 per outstanding share and \$16.14 per diluted share.

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Revenues for the quarter totaled \$40.9 million compared to \$38.6 million in 2005 due to an increase in net investment income. Net premiums earned increased \$1.5 million or 5% to \$36.1 million, primarily from construction and specialty program lines of business. The second quarter combined ratio improved to 95.2% from 98.9%.

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is comprised of a loss ratio of 59.3% and an expense ratio of 35.9%. Net investment income on invested assets increased 23% to \$429 million and the tax equivalent yield increased 68 basis points. The average equity for the quarter increased to 15.8% as compared to 11.7% for the same period of 2005.

For the six months ended June 30, 2006, net earnings improved 29% to \$8.7 million, or \$1.1 million, or \$.94 per diluted share for 2005. Total revenues of \$80.6 million increased 2% due to net investment income. Net premiums earned increased 3% to \$70.9 million due to increased revenue from specialty program business lines. The year to date combined ratio is 97.3% and is comprised of a loss ratio of 59.3% and an expense ratio of 36.2%. Net investment income increased 41% to \$9.3 million due to greater invested asset return on average equity for the six months ended June 30, 2006 improved to 13.4% from 12.5% for 2005.

With the completion of a common equity offering of 3.2 million shares during the quarter, and a follow-on offering of 480,000 shares in July, the Company successfully raised \$53.3 million of additional capital. The offering, including the over-allotment, increased the number of shares outstanding by 54% to 100 million. The book value per outstanding share decreased to \$16.77 from \$17.54 at December 31, 2005 due to the investments and the increase in common shares outstanding.

The following table sets forth the Company's consolidated revenues:

|                            | Three Months<br>Ended June 30, |                   | Six Months<br>Ended June 30, |                   | Three<br>Ende |
|----------------------------|--------------------------------|-------------------|------------------------------|-------------------|---------------|
|                            | 2005                           | 2006              | 2005                         | 2006              | 2005          |
| -----                      |                                |                   |                              |                   |               |
| (Dollars in thousands)     |                                |                   |                              |                   |               |
| Net premiums written:      |                                |                   |                              |                   |               |
| Excess and Surplus Lines   |                                |                   |                              |                   |               |
| Environmental              | \$ 13,157                      | \$ 11,737         | \$ 24,124                    | \$ 19,808         |               |
| Construction               | 16,026                         | 23,863            | 38,142                       | 44,048            |               |
| Excess                     | 129                            | 214               | 198                          | 382               |               |
| Surety                     | <u>220</u>                     | <u>643</u>        | <u>470</u>                   | <u>1,083</u>      |               |
| Total                      | 29,532                         | 36,457            | 62,934                       | 65,321            |               |
| Alternative Risk Transfer  |                                |                   |                              |                   |               |
| Specialty Programs         | 5,514                          | 5,922             | 8,784                        | 9,705             |               |
| Fully-Funded               | 395                            | 1,129             | 528                          | 1,317             |               |
| Total                      | 5,909                          | 7,051             | 9,312                        | 11,022            |               |
| Runoff                     |                                |                   |                              |                   |               |
| Total net premiums written | <u>          </u>              | <u>          </u> | <u>(35)</u>                  | <u>          </u> |               |
|                            | \$ 35,441                      | \$ 43,508         | \$ 72,211                    | \$ 76,343         |               |
|                            | =====                          | =====             | =====                        | =====             |               |
| Net premiums earned:       |                                |                   |                              |                   |               |
| Excess and Surplus Lines   |                                |                   |                              |                   |               |
| Environmental              | \$ 9,777                       | \$ 9,040          | \$ 18,522                    | \$ 17,360         |               |
| Construction               | 19,742                         | 20,981            | 40,734                       | 41,895            |               |
| Excess                     | 116                            | 117               | 228                          | 239               |               |
| Surety                     | <u>215</u>                     | <u>431</u>        | <u>434</u>                   | <u>784</u>        |               |
| Total                      | 29,850                         | 30,569            | 59,918                       | 60,278            |               |
|                            |                                |                   |                              |                   | 10            |

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|                             |            |            |            |            |            |
|-----------------------------|------------|------------|------------|------------|------------|
| Alternative Risk Transfer   |            |            |            |            |            |
| Specialty Programs          | 4,480      | 4,935      | 8,789      | 9,677      | 1          |
| Fully-Funded                | <u>204</u> | <u>572</u> | <u>293</u> | <u>940</u> | <u>18</u>  |
| Total                       | 4,684      | 5,507      | 9,082      | 10,617     | 1          |
| Runoff                      | <u>-</u>   | <u>-</u>   | <u>155</u> | <u>-</u>   | <u>-</u>   |
|                             |            |            |            |            |            |
| Total net premiums earned   | \$34,534   | \$36,076   | \$69,155   | \$70,895   |            |
| Net investment income       | 3,427      | 4,795      | 6,584      | 9,270      | 3          |
| Net realized gains (losses) | (96)       | (3)        | (44)       | 360        | 9          |
| Real estate income          | 691        | -          | 3,000      | -          | (10)       |
| Other income                | <u>34</u>  | <u>23</u>  | <u>36</u>  | <u>87</u>  | <u>(3)</u> |
| Total Revenues              | \$ 38,590  | \$ 40,891  | \$78,731   | \$ 80,612  |            |
|                             | =====      | =====      | =====      | =====      |            |

The following table sets forth the components of the Company's insurance operations GAAP combined ratio for the periods indicated:

|  | Three months ended<br>June 30, |             | Six months ended<br>June 30, |             |
|--|--------------------------------|-------------|------------------------------|-------------|
|  | 2005                           | 2006        | 2005                         | 2006        |
| Insurance operations:                  |                                |             |                              |             |
| Loss and loss adjustment expense ratio | 62.3%                          | 59.3%       | 61.2%                        | 61.1%       |
| Expense ratio                          | <u>36.6</u>                    | <u>35.9</u> | <u>35.5</u>                  | <u>36.2</u> |
| Combined ratio.....                    | 98.9%                          | 95.2%       | 96.7%                        | 97.3%       |
|  | =====                          | =====       | =====                        | =====       |

**Three Months ended June 30, 2006 Compared to Three Months ended June 30, 2005**

**Net Premiums Earned**

Excess and Surplus Lines>

Environmental. Net premiums earned decreased 7.5% to \$9.0 million in the second quarter of 2006 compared to the same quarter of 2005. Net premiums earned and written decreased primarily due to the Company's decision to exit the New York market. Net premiums written decreased 10.8% to \$11.7 million in the second quarter of 2006 compared to \$13.2 million for the same quarter of 2005. Gross written premiums increased 4% to \$14.0 million in the second quarter of 2006 compared to \$13.7 million for the same quarter of 2005. The increase in premiums was driven primarily by a 7% increase in Prostar online premiums, and a 5% increase in the environmental impairment liability premiums. These increases were offset in part by a 4% decrease in the middle market business.

Construction. Net premiums earned increased 5.9% to \$20.9 million in the second quarter of 2006 compared to \$19.7 million for the same quarter of 2005. Net premiums written increased 48.9% to \$23.9 million in the second quarter of 2006 compared to \$16.0 million for the same quarter of 2005. Gross premiums written increased 24% to \$25.9 million in the second quarter of 2006 compared to \$20.9 million for the same quarter of 2005. Gross premiums written, net premiums earned and net premiums written all increased primarily due to an increase in premium writings in non-western states as a result of the Company's geographic diversification efforts. The Company's geographic expansion beyond the western U.S. increased gross premiums written to \$2.5 million from \$760,000. Overall, the Company has continued to maintain restrictive policy terms and conditions in its construction line.

Excess. Net premiums earned increased to \$117,000 in the second quarter of 2006 compared to \$116,000 for the same quarter of 2005. Net premiums written increased to \$214,000 in the second quarter of 2006 compared to \$129,000 for the same quarter of 2005. Gross premiums written increased to \$860,000 in the second quarter of 2006 compared to \$650,000 for the same quarter of 2005. The increase in premiums was a result of the Company adding a senior underwriting manager and an underwriting team that will be responsible for growing the Company's excess product, developing its non-construction general liability business and assisting in the geographic diversification efforts in the construction line.

With the addition of new staff, the Company has expanded its excess liability product to write over other carriers's primary policies and to offer umbrella liability coverage. The Company also increased the available policy limits up to \$5.0 million. The Company's excess product offering will be focused primarily in the construction and products liability area.

The non-construction general liability business will offer both primary and excess products to small to middle market accounts. Certain high severity classes of risks such as invasive, medical products, pharmaceuticals, and neutraceuticals will be avoided. Effective July 1, a new quota share reinsurance arrangement for the excess and non-construction business was completed with a maximum retention of \$1.0 million.

Surety. Net premiums earned increased to \$431,000 in the second quarter of 2006 compared to \$215,000 for the same period of 2005. Net premiums written increased to \$643,000 in the second quarter of 2006 compared to \$220,000 for the same period of 2005. Gross written premiums increased to \$1.1 million in the second quarter of 2006 compared to \$436,000 for the same period of 2005. The increase in surety premiums is primarily due to the Company's focus on growing its environmental contractor surety business, a currently underserved market segment. In line with the Company's strategy to increase its retention levels, effective June 1, 2006, the Company did not renew the quota share reinsurance treaty in its surety line.

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#### Alternative Risk Transfer

Specialty Programs. Net premiums earned increased 10.2% to \$4.9 million in the second quarter of 2006 compared to \$4.5 million for the same quarter of 2005. Net premiums earned increased due to increased retentions. Net premiums written decreased 7.4% to \$5.5 million in the second quarter of 2006 compared to \$5.9 million for the same quarter of 2005. Gross written premiums decreased 1.4% to \$20.3 million in the second quarter of 2006 compared to \$20.6 million for the same quarter of 2005. The decrease was primarily attributable to premiums generated by a program that was not renewed in the fourth quarter of 2005. The Company added one new program during the second quarter, a claims made miscellaneous errors & omissions liability program. This program is expected to add approximately \$1.5 million of gross written premiums during 2006 and \$5.0 million in 2007. The Company assumes a 20% quota share retention in the first \$2.0 million layer of coverage on this program.

Fully Funded. Net premiums earned increased 180.5% to \$572,000 in the second quarter of 2006 compared to \$204,000 for the same quarter of 2005. Net premiums written increased 185.9% to \$1.1 million in the second quarter of 2006 compared to \$394,000 in the same quarter of 2005. Fee income earned in the quarter from the fully funded lines increased more than 17% to \$374,000 in the second quarter of 2006 compared to \$320,000 in the same quarter of 2005.

#### Runoff

Both net earned and net premiums written decreased to zero for the quarter ended June 30, 2006 and 2005 respectively. The Company put its assumed liability program and workers' compensation business into runoff in 2004 because they did not meet the Company's profit or production expectations.

### **Net Investment Income**

Net investment income increased 39.9% to \$4.8 million in the quarter ended June 30, 2006 from \$3.4 million in the quarter ended June 30, 2005 due to higher levels of invested assets and an increased investment yield. Average invested assets increased to \$429.3 million in the quarter ended June 30, 2006 from \$348.9 million in the same quarter of 2005. The tax equivalent yield increased 68 basis points to 4.9%

### **Net Realized Gains and Losses**

Net realized losses decreased to \$3,000 in the second quarter of 2006 compared to \$96,000 for the same period of 2005. Sales of investments are generally the result of changing investment strategies to maximize investment income

### **. Real Estate Income**

The Company did not have any real estate income in the second quarter of 2006 compared to \$691,000 in the second quarter of 2005. The reduction in real estate income was due to the substantial completion of the Harbour Village project. The final condominium units at Harbour Village were sold and closed in the second quarter of 2005.

The Company does not engage in any real estate activities, except for the completion of the remainder of the Harbour Village project, which includes the construction of a beach club and the management of remaining warranty claims on previously sold condominium units. The Company does not expect to engage in any real estate activities in the future. The earnings and funds generated from Harbour Village have been invested into the Company's insurance operations.

### **Losses and Loss Adjustment Expenses**

In the quarter ended June 30, 2006, the Company's loss ratio decreased 3.0 points to 59.3% as compared to 62.3% for the same period of 2005. This decrease was attributable to the absence of any adverse loss reserve development in the second quarter of 2006. For the second quarter of 2005 adverse loss development was \$1.1 million on discontinued lines.

### **Acquisition Expenses**

Acquisition expenses are amounts that are paid to agents and brokers for the production of premiums for the Company offset in part by the ceding commissions we retain from our reinsurers. For our program business, fees are typically earned through ceding commissions and have the effect of lowering our acquisition expenses. Acquisition expenses also include amounts paid for premium taxes to the states where the Company does business on an admitted basis. Acquisition expenses were \$6.4 million in the quarter ended June 30, 2006 compared to \$6.9 million in the quarter ended June 30, 2005. Acquisition expenses as a function of net earned premiums were 17.8% in the quarter ended June 30, 2006 and 19.9% in the quarter ended June 30, 2005. The decrease was primarily due to increased

retention levels.

### **Real Estate Expenses**

Real estate expenses decreased to \$102,000 for the second quarter of 2006 compared to \$424,000 for the same period of 2005. The decrease in real estate expenses was primarily due to substantial completion of the Harbour Village project.

### **Payroll and Other Expenses**

Payroll and other expenses increased to \$7.8 million in the second quarter of 2006 compared to \$6.4 million for the same period of 2005. Payroll expenses increased by \$810,000 for the second quarter of 2006 compared to the second quarter of 2005, resulting from an increased head count and costs associated with the expensing of the cost of stock options resulting from adoption FAS 123R on January 1, 2006. FASB statement 123R governing the expensing of stock options that was implemented in the first quarter of 2006. Expensing of options totaled \$158,000 for the second quarter of 2006. Other expenses increased by \$500,000 for the second quarter of 2006 compared to the same quarter of 2005. This increase was primarily due to increased interest costs of \$574,000 resulting from the issuance of trust preferred securities in November 2005.

### **Income taxes**

Income taxes for the quarter ended June 30, 2006 totaled \$600,000 for an effective tax rate of 11.5% compared to \$292,000 for an effective tax rate of 8.5% for the same period of 2005. This increase in tax expense is a result of higher earnings for U.S. operations in 2006 compared to 2005.

## **Six Months ended June 30, 2006 Compared to Six Months ended June 30, 2005**

### **Net Premiums Earned**

#### **Excess and Surplus Lines**

Environmental. Net premiums earned decreased 6.3% to \$17.4 million in the first six months of 2006 as compared to \$18.5 million for the same period in 2005. Net premiums written decreased 17.9% to \$19.8 million compared to \$24.1 million for the same time period of 2005. Gross premiums written decreased 1.5% to \$26.9 million for the first six months of 2006 compared to \$27.3 million for the same period of 2005. The decline in premium writings was due primarily to three factors: (i) \$1.8 million of reinstatement reinsurance premiums resulting from the settlement of a prior year claim (ii) a decline in the Company's middle-market business due to increased competition and the overall changing pricing conditions in the market place; and (iii) an expected decline in the Company's book of environmental contractor and consultant premiums in the State of New York as a result of changes in the underwriting process, which the Company believes will improve the ultimate profitability of the environmental business line. These decreases were offset, in part, by strong growth in business submitted through the Company's ProStar online rating and quoting system ( ProStar ) and business from the Company's environmental impairment liability products. The Company intends to focus its efforts on expanding ProStar's capabilities and increasing its market share of insuring environmental risks of small and medium-sized businesses.

Construction. Net premiums earned increased 2.9% to \$41.9 million in the first six months of 2006 as compared to \$40.7 million for the same time period in 2005. Net premiums written increased 15.5% to \$44.0 million

compared to \$38.1 million for the same time period of 2005. Gross premiums written increased 1.1% to \$47.6 million for the first six months of 2006 compared to \$47.0 million for the same period of 2005. The increase in net premiums written and net premiums earned was primarily due to increased retentions and geographic diversification.

Excess. Net premiums earned increased 4.8% to \$239,000 in the first six months of 2006 as compared to \$228,000 for the same time period in 2005. Net premiums written increased 92.3% to \$382,000 in the first six months of 2006 compared to \$198,000 for the same time period of 2005. Gross premiums written increased 48.5% to \$1.5 million for the first six months of 2006 compared to \$989,000 for the same time period of 2005. The increase in premiums was due to the Company adding a senior underwriting manager and an underwriting team that will be responsible for growing the Company's excess product, developing its non-construction general liability business and assisting in the geographic diversification efforts in the construction line.

Surety. Net premiums earned s increased 80.6% to \$784,000 in the first six months of 2006 as compared to \$434,000 for the same time period in 2005. Net premiums written increased 130.4% to \$1.1 million compared to \$470,000 for the same time period of 2005. Gross premiums written increased 109% to \$2.0 million for the first six months of 2006 compared to \$935,000 for the same period of 2005. The increase in premiums is attributable to the Company focusing its growth efforts in environmental contractor surety. In line with the Company's strategy to increase its retention levels, effective June 1, 2006, the Company did not renew the quota share reinsurance treaty in its surety line.

#### Alternative Risk Transfer

Specialty Programs. Net premiums earned increased 10.1% to \$9.7 million for the first six months of 2006 as compared to \$8.8 million for the same time period in 2005. Net premiums written increased 10.5% to \$9.7 million compared to \$8.8 million for the same time period of 2005. This increase is primarily due to increased retention levels on selected programs allowing the Company the opportunity to increase earnings potential from underwriting profits. Gross premiums written decreased 15.4% to \$36.6 million for the first six months of 2006 compared to \$43.3 million. The decrease in gross premiums written is attributable to premiums generated by a program that was not renewed in the fourth quarter of 2005.

Fully Funded. Net premiums earned increased 220.8% to \$940,000 for the first six months of 2006 as compared to \$293,000 for the same time period in 2005. Net premiums written increased 149.4% to \$1.3 million compared to \$528,000 for the same time period of 2005. Fee income earned for the first six months of 2006 increased 110.9% to \$867,000 compared to \$411,000 for the same period of 2005.

Runoff. Both net premiums earned and net premiums written decreased to zero for the six months ended June 30, 2006 compared to \$155,000 and negative \$35,000 for the same period of 2005, respectively

#### . Net Investment Income

Net investment income increased 40.8% to \$9.3 million in the six months ended June 30, 2006 from \$6.6 million in the six months ended June 30, 2005 due to higher levels of invested assets and increased investment yield. Average invested assets increased to \$425.1 million from \$342.5 million. The tax equivalent yield increased 68 basis points to 4.9%.

### **Net Realized Gains and Losses**

Net realized gains and losses changed from a net loss of \$44,000 in the six months ended June 30, 2005 to a net gain of \$360,000 for the six months ended June 30, 2006. Sales of investments are generally the result of changing investment strategies to maximize investment income. In the first quarter of 2006, the Company rebalanced its common stock investment portfolio, in accordance with its investment policies, which resulted in \$215,000 of net realized gains. The remainder of net realized gains were from sales of fixed income securities.

### **Real Estate Income**

The Company did not have any real estate income in the first six months of 2006 compared to \$3.0 million in the first six months of 2005. The reduction in real estate income was due to the substantial completion of the Harbour Village project. The final condominium units at Harbour Village were sold and closed in the second quarter of 2005.

### **Losses and Loss Adjustment Expenses**

For the six months ended June 30, 2006, the Company's loss ratio was 61.1% compared to 61.2% for the same period of 2005. For the six months ended June 30, 2006 the Company experienced an adverse loss development of \$688,000 compared to \$1.1 million for the six months ended June 30, 2005. The 2006 reserve strengthening primarily was related to the settlement of a prior year New York claim which required \$1.0 million of reserve strengthening offset in part by favorable development in the Company's environmental business line. The reserve strengthening for the six months ended June 30, 2005 was on the Company's runoff lines of business.

### **Acquisition Expenses**

Policy acquisition expenses decreased to \$13.4 million for the six months ended June 30, 2006 from \$14.0 million for the six months ended June 30, 2005. Acquisition expenses as a function of net earned premiums were 18.9% for the six months ended June 30, 2006 compared to 20.3% for the six months ended June 30, 2005. The decrease was primarily due to increased retention levels.

### **Real Estate Expenses**

Real estate expenses decreased to \$170,000 for the first six months of 2006 compared to \$2.7 million for the same period of 2005. The decrease in real estate expenses was primarily due to the substantial completion of the Harbour Village project.

### **Payroll and Other Expenses**

Payroll and other expenses increased to \$14.9 million for the first six months of 2006 compared to \$11.9 million for the same period of 2005. Payroll expenses increased by \$1.4 million for the first six months of 2006 compared to 2005, resulting from an increased head count and costs associated with FASB statement 123R the expensing of stock options which was implemented in the first quarter of 2006. Expensing of options totaled \$299,000 for the first six months of 2006. Other expenses increased by \$1.6 million for the first six months of 2006 compared to 2005. This increase was due to increased interest costs of \$1.2 million resulting from the issuance of trust preferred securities in November 2005.

### **Minority Interest Expense**

Minority interest expense is associated with our non-subsiary affiliate, American Safety RRG. In the past, given the historical loss position of American Safety RRG, a valuation allowance on its net deferred tax assets had been established. For the first six months of 2005, American Safety RRG included in income the reduction of its \$554,000 valuation allowance as judgment about the realizability of American Safety RRG's deferred tax assets change due to its profitability. As a result, the Company's minority interest expense for the six months ended June 30, 2005 was \$539,000. In first six months of 2006, American Safety RRG included in expense \$764,000 related to the settlement of a prior year claim. Net of taxes, the claim affected American Safety RRG's net earnings by \$505,000. As a result, minority interest expense for the six months ended June 30, 2006 was a benefit of \$512,000.

### **Income taxes**

Income taxes for the six months ended June 30, 2006 totaled \$616,000 for an effective tax rate of 6.6% compared to \$543,000 for an effective tax rate of 7.5% for the same period of 2005. The primary reason for the lower tax rate for the six months ended June 30, 2006 was due to the settlement of a prior year New York claim in the first quarter of 2006, which resulted in a \$2.8 million pretax charge. The majority of this settlement was incurred by the Company's U.S. subsidiaries.

### **Equity**

The Company's total equity at June 30, 2006 was \$168.5 million compared to \$118.4 million as at December 31, 2005. During the second quarter of 2006 the Company raised an additional \$46.0 million net of expenses through a public stock offering. The Company issued \$3.2 million shares as a result of this transaction. In July 2006, the Company's underwriters fully exercised their over-allotment option, purchasing 480,000 additional shares of common shares at \$15.50 per share. This resulted in the Company receiving an additional \$7.0 million net of expenses.

### **Liquidity and Capital Resources**

We meet our cash requirements and finance our growth principally through cash flows generated from operations and the issuance of securities. Our primary sources of short-term cash flow are premium writings and investment income. Short-term cash requirements relate to claims payments, reinsurance premiums, commissions, salaries, employee benefits and other operating expenses.

In June 2006 we issued 3,200,000 shares of our common stock in an underwriting public offering at a price of \$15.50 per share. Net of underwriting discounts and expenses we received \$46.0 million. We intend to use the net proceeds from the sale of the Common Shares in this offering to implement our business and growth strategy by (i) increasing the capital and surplus base of our insurance subsidiaries in order to expand in the markets where we currently operate and to retain additional premium on the policies we currently underwrite and (ii) use the balance of the net proceeds for general corporate purposes, including potential acquisitions. The precise amounts and timing of expenditures of the net proceeds will depend on our funding requirements and the availability of other capital resources. Previously in November 2005, we issued \$25.0 million in trust preferred securities.

Due to the uncertainty regarding the timing and amount of settlements of unpaid claims, our future liquidity requirements may vary; therefore, we have structured our investment portfolio maturities to help mitigate the

variations in those factors. We believe our current cash flows are sufficient for the short-term needs of our business and its invested assets are sufficient for the intermediate term needs of our insurance business.

Net cash provided from operations was \$30.8 million for the six months ended June 30, 2006 and \$30.9 million for the same period of 2005.

Our ability to pay future dividends to shareholders will depend, to a significant degree, on the ability of our subsidiaries to generate earnings from which to pay dividends. The jurisdictions in which we and our insurance and reinsurance subsidiaries are domiciled place limitations on the amount of dividends or other distributions payable by insurance companies in order to protect the solvency of insurers. Given our expected growth and the capital requirements associated with that growth, we do not anticipate paying dividends on our common shares in the near future.

We substantially completed the Harbour Village project in 2005. The estimated completion cost for the remainder of the Harbour Village project is approximately \$600,000 and represents amounts needed to construct a beach club and manage remaining warranty claims on closed condominium units. An accrual of this amount has been established. Management believes that cash on hand will meet the remaining liquidity needs of Harbour Village.

#### **Off Balance Sheet Arrangements**

See "Off-Balance Sheet Arrangements" in Item 7 of the Company's Form 10-K for the year ended December 31, 2005.

#### **Contractual Obligations**

See "Contractual Obligations" in Item 7 of the Company's Form 10-K for the year ended December 31, 2005.

#### **Income Taxes**

We are incorporated under the laws of Bermuda and, under current Bermuda law, are not obligated to pay any taxes in Bermuda based upon income or capital gains. We have received an undertaking from the Minister of Finance in Bermuda pursuant to the provisions of The Exempted Undertakings Tax Protection Act 1966, which exempts us and our shareholders, other than shareholders ordinarily resident in Bermuda, from any Bermuda taxes computed on profits, income or any capital asset, gain or appreciation, or any tax in the nature of estate, duty or inheritance until March 28, 2016. We, exclusive of our United States subsidiaries, do not consider ourselves to be engaged in a trade or business in the United States and accordingly, do not expect to be subject to direct United States income taxation. Our U.S. subsidiaries are subject to taxation in the United States.

#### **Combined Ratio**

The combined ratio of an insurance company measures only the underwriting results of insurance operations and not the profitability of the overall company. Our reported combined ratio for our insurance operations may not provide an accurate indication of our overall profitability. For instance, depending on our mix of business, the combined ratio may fluctuate from time to time and may not reflect the overall profitability of our insurance operations. Our combined ratio excludes certain holding company expenses as well as real estate and rescission

expenses.

### **Forward-Looking Statements**

Certain statements in this report are forward-looking statements within the meaning of U.S. securities laws. You can generally identify these statements by the use of forward-looking terminology, such as may, will, expect, estimate, anticipate, believe, target, plan, project or continue or the negatives or other variations or similar terminology. Forward-looking statements relate to, among other things:

- o general economic conditions and other factors, including prevailing interest rate level may affect our ability to sell our insurance products and services, the market value of and profitability of our policies;
- o the availability and terms of future strategic acquisitions;
- o our expenditures for the contributions of new programs;
- o our future liquidity requirements

Actual results may differ materially from the results suggested by the forward-looking statements for a number of reasons including those described in Part II-Item 1A Risk Factors . We have made these statements based on our plans and analyses of our Company, our business and the insurance industry as a whole. Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of the assumptions could over time prove to be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this report will themselves prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of this information should not be regarded as a representation by us or any other person that our objectives will be achieved. We expressly disclaim any obligation to update any forward-looking statement unless required by law.

**See Part II-Item 1A- Risk Factors .**

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

For a in-depth discussion of the Company's market risks, see Management's Discussion and Analysis of Quantitative and Qualitative Disclosures about Market Risk in Item 7A of the Company's Form 10-K for the year ended December 31, 2005 and Note 4 to the Consolidated Financial Statements herein.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this Report, concluded that, as of such date, the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company (including consolidated subsidiaries) would be made known to them.

#### **Changes in Internal Control**

There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation described above that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

We, through our subsidiaries, are routinely a party to pending or threatened litigation or arbitration disputes in the normal course of or related to our business. Based upon information presently available, in view of legal and other defenses available to our subsidiaries, management does not believe that any pending or threatened litigation or arbitration disputes will have any material adverse effect on our financial condition or operating results, except for the matters discussed below or in *Legal Proceedings* in Item 3 of our Form 10-K for the fiscal year ended December 31, 2005 and as discussed herein.

**Warranty Reinsurance Litigation.** We are a defendant in several cases, liquidation actions and reinsurance claims, collectively identified as the *National Warranty* issue. American Safety Reinsurance, Ltd. ( *American Safety Re* ) was an excess-of-loss reinsurer through a reinsurance treaty with National Warranty Risk Retention Group ( *National Warranty* ) that provided insurance coverage to automobile dealerships and other providers that were obligors on automobile warranty contracts they sold to consumers. National Warranty filed for liquidation in the Cayman Islands (the location of its legal creation). This liquidation had a cascading effect, including the subsequent filing of bankruptcy by various obligors of vehicle service contracts insured by National Warranty. As a result, there are potentially over one million vehicle service contracts that are not being honored by the obligors.

The liquidators of National Warranty have made claims of \$25.4 million pursuant to two reinsurance contracts issued by American Safety Re to National Warranty in 2002 and 2003. In addition, consumers of vehicle service contracts have sued American Safety Re, and the trial court certified that case as a class action, although we are appealing that determination. Lastly, claims have been made by sellers/obligors of the vehicle service contracts who were insured by National Warranty. There are five sellers/obligors cases against us and other professional services providers, including other reinsurers, relating to National Warranty, with claims in excess of \$2.6 million. All of these claims are based on fraud and/or theories of contractual violations. We continue to believe that American Safety Re has valid defenses to the claims including, among others, that it had commuted its obligations under reinsurance treaties, its liability is limited to the amount of coverage provided under the policies, which varies based on premium and loss ratios, and that most of the claimants cannot make claims directly against it. We have an accrual in place that we believe will be sufficient to satisfy any potential liability relating to the outcome of these matters.

*Griggs et al. v. American Safety Reinsurance, Ltd. et al.*, Case No. 2003-31509, Circuit Court, Seventh Judicial District, Volusia County, Florida. Seven plaintiffs filed suit against us and three of our subsidiaries seeking to recover a \$2.1 million loan made by the plaintiffs in 1986 to Ponce Marina, Inc., the former owner of the Harbour Village property. The plaintiffs claimed that we were responsible for the repayment of the loan, with interest. The plaintiffs propounded four theories of liability and the court granted judgment for us on three of the theories. However, the court entered judgment on August 10, 2005 against us for approximately \$3.4 million, which includes interest, on the remaining theory. The court held that we, as a condition of our loan, required Ponce Marina, Inc. to demand that the plaintiffs enter into an agreement with Ponce Marina, Inc., to the detriment of their loans and to our benefit, and thus, we had entered into a quasi-contract with the plaintiffs to repay their loan with interest.

We filed an appeal in December 2005. Based on the merits of the case and likelihood of ultimate payment, we have not established an accrual for the decision.

*Sizemore v. American Safety Insurance Services, Inc. et al.*, Case No 2005-31704, Circuit Court, Seventh

Judicial District, Volusia County, Florida. American Safety Insurance Services, Inc., its parents and a number of its affiliates are defendants in a suit brought by an individual who contends that defendants are liable to him for a debt owed to him by Ponce Marina, Inc. in the amount of \$400,000 plus interest and costs. The plaintiff also intends to seek class certification on behalf of himself and 21 other unnamed plaintiffs for the case on these claims in excess of \$1.7 million plus interest and costs. On January 27, 2006, the trial court dismissed the case. The plaintiff was permitted to file an amended complaint on or before March 6, 2006. The plaintiff filed an amended complaint on March 7, 2006, alleging various theories of recovery, some of which were also alleged in the Griggs case. On May 4, 2006, the trial court dismissed the case and gave the plaintiff 20 days to file an amended complaint. The plaintiff filed a third amended complaint and our third Motion to Dismiss will be heard on August 22, 2006. We continue to vigorously defend this case, as we believe that the case is without merit. Based on the merits of the case and the likelihood of ultimate payment, we have not established an accrual for the decision.

## **Item 1A. Risk Factors**

### **Risk Factors Relating to American Safety Insurance**

#### **A downgrade in our A.M. Best rating or increased capital requirements could impair our ability to sell insurance policies.**

Some policyholders are required to obtain insurance coverage from insurance companies that have an A- (Excellent) rating or higher from A.M. Best, the most widely recognized insurance company rating agency. Additionally, many producers are prohibited by their internal guidelines from representing insurance companies that are rated below A- (Excellent) by A.M. Best. In November 2005, A.M. Best reaffirmed its rating of A (Excellent), with a negative outlook on a group basis of American Safety Insurance, including our two U.S. insurance subsidiaries, our Bermuda reinsurance subsidiary and our U.S. non-sub subsidiary risk retention group affiliate. An A (Excellent) rating is assigned to companies that have, in the opinion of A.M. Best, an excellent ability to meet their ongoing obligations to policyholders. A.M. Best assigned a negative outlook to the rating in September 2004 in response to our reserve strengthening in the second quarter of 2004 because of a concern by A.M. Best with the underwriting results from our core business lines and the potential for further reserve strengthening in the future. A.M. Best reaffirmed this rating and outlook in November 2005. If A.M. Best requires us to increase our capital in order to maintain our rating and we are unable to raise the required amount of capital to be contributed to our insurance subsidiaries, A.M. Best may downgrade us.

A.M. Best assigns ratings that represent an independent opinion of an insurer's ability to meet its obligations to policyholders that is of concern primarily to policyholders, insurance brokers and agents and its rating and outlook should not be considered an investment recommendation. Because A.M. Best continually monitors companies with regard to their ratings, our ratings could change at any time, and any downgrade of our current rating could impair our ability to sell insurance policies and, ultimately, our financial condition and operating results.

#### **The exclusions and limitations in our policies may not be enforceable.**

We draft the terms and conditions of our excess and surplus lines policies to manage our exposure to expanding theories of legal liability in business lines such as asbestos abatement, construction defect, environmental and professional liability. Many of the policies we issue include exclusions or other conditions that define and limit coverage. In addition, many of our policies limit the period during which a policyholder may bring a claim under the policy, which period in many cases is shorter than the statutory period under which these claims can be brought against our policyholders. While these exclusions and limitations help us assess and control our loss exposure, it is possible that a court or regulatory authority could nullify or void an exclusion or limitation, or legislation could be enacted modifying or barring the use of these exclusions and limitations, particularly with respect to evolving business lines such as construction defect. This could result in higher than anticipated losses and loss adjustment expenses by extending coverage beyond our underwriting intent or increasing the number or size of claims, which could have a

material adverse effect on our operating results. In some instances, these changes may not become apparent until some time after we have issued the insurance policies that are affected by the changes. As a result, the full extent of liability under our insurance contracts may not be known for many years after a policy is issued.

**The risks we underwrite are concentrated in relatively few industries.**

We focus much of our underwriting on specialty risks in the construction and environmental remediation industries. For the year ended December 31, 2005, approximately 61.6% of our gross premiums written were in these two industries. Accordingly, our operating results could be more exposed than our more diversified competitors to unfavorable changes in business, economic or regulatory conditions, changes in federal, state or local environmental standards and establishment of legal precedents affecting these industries. Similarly, a significant incident impacting one of these industries that has the effect of increasing claims generally (or their settlement value) could negatively impact our financial condition and operating results.

**We may respond to market trends by expanding or contracting our underwriting activities, which may cause our financial results to be volatile.**

Although we perform substantial due diligence and risk analysis before entering into a new business line or insuring a new type of risk, and carefully assess the impact of exiting a business line, changing business lines inherently has more risk than remaining in the same business lines over a period of time. Because we actively seek to expand or contract our capacity in the markets we serve in response to factors such as loss experience and premium production, our operating results may experience material fluctuations.

**Our industry is highly competitive and we may lack the financial resources to compete effectively.**

We believe that competition in the specialty insurance markets that we target is fragmented and not dominated by one or more competitors. We face competition from several companies, such as insurance companies, reinsurance companies, underwriting agencies, program managers and captive insurance companies. Many of our competitors are significantly larger and possess greater financial, marketing and management resources than we do. We compete on the basis of many factors, including coverage availability, claims management, payment terms, premium rates, policy terms, types of insurance offered, overall financial strength, financial strength ratings and reputation. If any of our competitors offers premium rates, policy terms or types of insurance that are more competitive than ours, we could lose business. If we are unable to compete effectively in the markets in which we operate or to establish a competitive position in new markets, our financial condition and operating results would be adversely impacted

**. Our actual incurred losses may be greater than reserves for our losses and loss adjustment expenses.**

Insurance companies are required to maintain reserves to cover their estimated liability for losses and loss adjustment expenses with respect to both reported and incurred but not reported ( IBNR ) claims. Reserves are estimates at a given time involving actuarial and statistical projections of what we expect to be the cost of the ultimate resolution and administration of claims. These estimates are based on facts and circumstances then known, predictions of future events, estimates of future trends, projected claims frequency and severity, potential judicial expansion of liability precedents, legislative activity and other factors, such as inflation. A full actuarial analysis of our reserves is performed on an annual basis, which may include reserve studies, rate studies and regulatory opinions.

Notwithstanding these efforts, the establishment of appropriate reserves for losses and loss adjustment expenses reserves is an inherently uncertain process, particularly in the environmental remediation industry, construction industry and some of the other industries for which we write policies where extensive historical data may not exist or where the risks insured are long-tail in nature, in that claims that have occurred may not be reported to us for long periods of time. For instance, there is little empirical data for residential construction defect claims and hence, traditional actuarial analysis may be inapplicable or less reliable, which may cause our reserve estimates for this

business line to be more volatile. Due to these uncertainties, our ultimate losses could materially exceed our reserves for losses and loss adjustment expenses, especially in business lines where we intend to increase our risk retention. For example, during the last two years, we increased our loss reserves as a result of litigation matters specifically related to our construction lines policies and policies written on runoff lines, which lowered our net earnings and shareholders' equity during these periods.

To the extent that reserves for losses or loss adjustment expenses are estimated in the future to be inadequate, we would have to increase our reserves and incur charges to earnings in the periods in which the reserves are increased. In addition, increases in reserves may also cause additional reinsurance premiums to be payable to our reinsurers in the form of reinstatement premiums. These increases in reserves and reinstatement premiums would adversely impact our financial condition and operating results. To the extent any individual case reserves prove to be inadequate, our financial condition and operating results would be adversely affected. For more information on our losses and loss adjustment expenses, see Management's Discussion and Analysis of Financial Condition and Results of Operations.

**If we are unable to obtain reinsurance on favorable terms, our ability to write new policies would be adversely affected.**

Reinsurance is a contractual arrangement under which one insurer (the ceding company) transfers to another insurer (the reinsurer) a portion of the liabilities that the ceding company has assumed under an insurance policy it has issued. Our business continues to involve ceding portions of the risks that we underwrite to reinsurers. The availability and cost of reinsurance are subject to prevailing market conditions that are beyond our control and are factors that could materially impact our financial condition and operating results. There is no certainty that reinsurance will continue to be available in the form or in the amount that we require or, if available, at an affordable cost. The availability of reinsurance is dependent not only on reinsurers' reactions to the specific risks that we underwrite, but also events that impact the overall reinsurance industry, such as the recent hurricanes in 2005. If we are unable to maintain or replace our reinsurance, our total loss exposure would increase and, if we were unwilling or unable to assume that increase in exposure, we would be required to mitigate the increase in exposure by writing fewer policies or writing policies with lower limits or different coverage.

**We may be unable to recover amounts due from our reinsurers.**

While reinsurance contractually obligates the reinsurer to reimburse us for a portion of our losses, it does not relieve us of our primary financial liability to our insureds. If our reinsurers are either unwilling or unable to pay some or all of the claims made by us on a timely basis, we bear the financial exposure. As a result, we are subject to credit risk with respect to our reinsurers.

We purchase reinsurance from reinsurers we believe to be financially sound. We have written reinsurance security procedures that establish financial requirements for reinsurance companies that must be met prior to reinsuring any of the business we write. Among these requirements is a stipulation that reinsurance companies must have an A.M. Best rating of at least A- (Excellent) and a financial size category of Class VIII or greater at the time of writing any reinsurance unless sufficient collateral has been provided at the time we enter into our reinsurance agreement. A financial size category of Class VIII is assigned by A.M. Best to companies with adjusted policyholder surplus of \$100 million to \$250 million, which, on a statutory basis of accounting, is the amount remaining after all liabilities, including loss reserves, are subtracted from all admitted assets. We have also established an internal reinsurance security committee, consisting of members of senior management, which meets quarterly to discuss and approve reinsurance security. To protect against our reinsurers' inability to satisfy their contractual obligations to us, our reinsurance contracts stipulate a collateral requirement for reinsurance companies that do not meet the financial strength and size requirements described above. These collateral requirements can be met through the issuance of unconditional letters of credit, the establishment and funding of escrow accounts for our benefit or cash advances paid into a segregated account. In the event collateral is not sufficient, there is no certainty that these reinsurers will be able

to provide additional capital.

**We are subject to risks related to litigation.**

From time to time, we are subject to lawsuits and other claims arising out of our insurance and real estate operations. We have responded to the lawsuits we face and, although the outcome of these lawsuits cannot be predicted, we believe that there are meritorious defenses and intend to vigorously contest these claims. Adverse judgments in one or more of these lawsuits could require us to change aspects of our operations in addition to paying significant damage amounts. In addition, the expenses related to these lawsuits may be significant. Lawsuits can have a material adverse effect on our business and operating results, particularly where we have not established an accrual, or a sufficient accrual, for damages or expenses. For information on the material litigation in which we are involved, see Part II Other Information ? Legal Proceedings.

**We rely on independent insurance agents and brokers to market our products.** We market most of our insurance products through approximately 230 independent insurance agents and brokers, which we refer to as producers. These producers are not obligated to promote our products and may sell competitors products. Our profitability depends, in part, on the marketing efforts of these producers and on our ability to offer insurance products and services while maintaining financial strength ratings that meet the requirements of our producers and their customers. The failure or inability of producers to market our insurance products successfully would have a material adverse effect on our business and operating results.

**We are subject to credit risk in connection with producers that market our products.**

In accordance with industry practice, when the insured pays premiums for our policies to producers for payment over to us, these premiums are considered to have been paid and, in most cases, the insured is no longer liable to us for those amounts, whether or not we actually have received the premiums. Consequently, we assume a degree of credit risk associated with the producers with whom we choose to do business. To date, we have not experienced any material losses related to these credit risks.

Our growth strategy is dependent on several factors, the failure to achieve any one of which may impair our ability to expand our operations or may prevent us from operating profitably.

Our growth strategy includes expanding in our existing markets, entering new geographic markets, creating relationships with new producers and developing new insurance products. In order to generate this growth, we are subject to various risks, including risks associated with our ability to:

- o identify insurable risks not adequately served by the standard insurance market;
- o maintain adequate levels of capital;
- o obtain reinsurance on favorable terms;
- o obtain necessary regulatory approvals when writing on an admitted basis;
- o attract and retain qualified personnel to manage our expanded operations; and
- o maintain our financial strength ratings.

Our inability to achieve any of the above objectives could affect our growth strategy and may cause our business and operating results to suffer.

If we lose key personnel or are unable to recruit qualified personnel, our ability to implement our business strategies could be delayed or hindered.

Our future success will depend, in part, upon the efforts of our executive officers and other key personnel. Our ability to recruit and retain key personnel will depend upon a number of factors, such as our results of operations, business prospects and the level of competition then prevailing in the market for qualified personnel. The loss of any of these officers or other key personnel or our inability to recruit key personnel could prevent us from fully implementing our business strategies and could materially adversely affect our business, financial condition and operating results.

**We routinely evaluate opportunities to expand our business through acquisitions of other companies or business lines. There are many risks associated with acquisitions that we may be unable to control.**

We evaluate potential acquisition opportunities as a means to grow our business. There are a number of risks attendant to any acquisition. These risks include, among others, the difficulty in integrating the operations and personnel of an acquired company; potential disruption of our ongoing business; inability to successfully integrate acquired systems and insurance programs into our operations; maintenance of uniform standards, controls and procedures; possible impairment of relationships with employees and insureds of an acquired business as a result of changes in management; and that the acquired business may not produce the level of expected profitability. As a result, the impact of any acquisition on our future performance may not be consistent with original expectations, and may impair our business, financial condition and operating results.

**We may require additional capital in the future, which may not be available or may only be available on unfavorable terms.**

Our future capital requirements depend on many factors, including our ability to write profitable new business, retain existing customers and establish premium rates and reserves at levels sufficient to cover losses and related expenses. Many factors will affect our capital needs and their amount and timing, including our growth and profitability, our claims experience and the availability of reinsurance, as well as possible acquisition opportunities, market disruptions and other unforeseeable developments. If we have to raise additional capital, equity or debt financing may not be available at all or may be available only on terms that are unfavorable to us. In the case of equity financings, dilution to our shareholders could result. In any case, those securities may have rights, preferences and privileges that are senior to those of the Common Shares offered hereby. In the case of debt financings, we may be subject to covenants that restrict our ability to freely operate our business. If we cannot obtain adequate capital on favorable terms or at all, we may not have sufficient funds to implement our operating plans and our business, financial condition and operating results could be adversely affected.

**Changes in the value of our investment portfolio may have a material impact on our operating results.**

We derive a significant portion of our net income from our invested assets. As a result, our operating results depend in part on the performance of our investment portfolio. Our investment portfolio is subject to various risks, including:

- o credit risk, which is the risk that our invested assets will decrease in value due to unfavorable prospects or a downgrade in the credit rating of an entity in which we have invested;
- o interest rate risk, which is the risk that our invested assets may decrease due to changes in

- o equity price risk, which is the risk that we will incur economic loss due to a decline in equity prices.
- o duration risk, which is the risk that our invested assets may not adequately match the duration of our liabilities.

**Our investment portfolio is comprised mostly of fixed-income securities. We do not hedge our investments against interest rate risk and, accordingly, changes in interest rates may result in fluctuations in the value of these investments.**

Our investment portfolio is managed by a professional investment management firm in accordance with detailed investment guidelines established by our Board of Directors that stress diversification of risks, conservation of principal and liquidity. If our investment portfolio is not appropriately matched with our insurance and reinsurance liabilities, we may be forced to liquidate investments prior to their maturity at a significant loss in order to cover these liabilities. This might occur, for instance, in the event of a large or unexpected claim or series of claims. Large investment losses could significantly decrease our asset base, thereby affecting our ability to underwrite new business.

**We rely upon the successful and uninterrupted functioning of our information technology, information processing and telecommunication systems.**

Our business is highly dependent upon the successful and uninterrupted functioning of our information technology, information processing and telecommunications systems. We rely on these systems to support our marketing operations, process new and renewal business, provide customer service, make claims payments and facilitate premium collections and policy cancellations. These systems also enable us to perform actuarial and other modeling functions necessary for underwriting and rate development. We have a highly trained staff that is committed to the development and maintenance of these systems. However, the failure of these systems could interrupt our operations or materially impact our ability to evaluate and write new business. Because our information technology, information processing and telecommunications systems interface with and depend on third party systems, we could experience service denials if demand for this service exceeds capacity or if the third party systems fail or experience interruptions. If sustained or repeated, a system failure or service denial could result in a deterioration of our ability to write and process new and renewal business and provide customer service or compromise our ability to pay claims in a timely manner. There can be no guarantee that these systems can effectively support our continued growth. Additionally, some of our systems are not fully redundant, and our disaster recovery planning does not account for all eventualities, which could adversely affect our business.

### **Risk Factors Related to Taxation**

**Our Bermuda operations may be subject to U.S. tax.**

American Safety Insurance, its reinsurance subsidiary, American Safety Reinsurance ( "American Safety Re" ), and its segregated account captive, American Safety Assurance Ltd. ( "American Safety Assurance" ), are organized in Bermuda. American Safety Insurance, American Safety Re and American Safety Assurance are operated in a manner such that none should be subject to U.S. tax (other than U.S. excise tax on insurance and reinsurance premium income attributable to insuring or reinsuring U.S. risks and U.S. withholding tax on some types of U.S. source investment income) because none of these companies should be treated as engaged in a trade or business within the U.S. (and, in the case of American Safety Re and American Safety Assurance, to be doing business through a permanent establishment within the U.S.). However, because there is considerable uncertainty as to the activities that constitute being engaged in a trade or business within the U.S. (and what constitutes a permanent establishment under the income tax treaty between the U.S. and Bermuda (the "Bermuda Treaty" ) as well as the entitlement of American Safety Re and American Safety Assurance to treaty benefits), there can be no assurances that the U.S. Internal Revenue Service (the "IRS" ) will not contend successfully that American Safety Insurance, American Safety Re and/or American Safety Assurance is engaged in a trade or business in the U.S. (or that American Safety Re or American Safety Assurance is not engaged in a trade or business in the U.S.).

Assurance is carrying on business through a permanent establishment in the U.S.). If any of American Safety Insurance, American Safety Re or American Safety Assurance were considered to be engaged in a trade or business in the U.S., it could be subject to U.S. corporate income taxes and additional branch profits taxes on the portion of its earnings effectively connected to such U.S. business, in which case its operating results could be materially adversely affected.

**If you acquire 10% or more of the Common Shares, you may be subject to taxation under the controlled foreign corporation ( CFC ) rules.**

Under certain circumstances, a U.S. 10% shareholder (as defined in Certain Tax Considerations Certain U.S. Federal Income Tax Considerations Tax Treatment of Shareholders Classification as a Controlled Foreign Corporation ) of a foreign corporation that is a CFC for an uninterrupted period of 30 days or more during a taxable year must include in gross income for U.S. federal income tax purposes that U.S. 10% shareholder's Subpart F Income, even if the Subpart F Income is not distributed to that U.S. 10% shareholder. Subpart F Income of a foreign insurance corporation typically includes foreign personal holding company income (such as interest, dividends and other types of passive income), as well as insurance and reinsurance income (including underwriting and investment income) attributable to the insurance of risks situated outside the CFC's country of incorporation.

We believe that because of the dispersion of our Common Share ownership, provisions in our organizational documents that limit voting power and other factors, no U.S. person who acquires Common Shares directly or indirectly through one or more foreign entities should be required to include our Subpart F Income in income under the CFC rules of the Internal Revenue Code of 1986, as amended (the Code ). It is possible, however, that the IRS could challenge the effectiveness of these provisions and that a court could sustain that challenge, in which case your investment could be materially adversely affected.

**U.S. persons who hold Common Shares may be subject to U.S. federal income taxation at ordinary income rates on their proportionate share of our related party insurance income ( RPII ).**

If the RPII of American Safety Re or American Safety Assurance were to equal or exceed 20% of its gross insurance income in any taxable year and direct or indirect insureds (and persons related to those insureds) own directly or indirectly through entities 20% or more of the voting power or value of American Safety Re or American Safety Assurance, then a U.S. person who owns any Common Shares (directly or indirectly through foreign entities) on the last day of the taxable year would be required to include in its income for U.S. federal income tax purposes that person's pro rata share of that company's RPII for the entire taxable year, determined as if that RPII were distributed proportionately only to U.S. persons at that date regardless of whether that income is distributed. In addition, any RPII that is includible in the income of a U.S. tax-exempt organization may be treated as unrelated business taxable income. Neither American Safety Re nor American Safety Assurance expects gross RPII to equal or exceed 20% of its gross income for 2005 or subsequent years, and neither expects its direct or indirect insureds (including related persons) to directly or indirectly hold 20% or more of its voting power or value, but we cannot be certain that this will be the case because some of the factors which determine the extent of RPII may be beyond our control. If these thresholds are met or exceeded, and if you are an affected U.S. person, your investment could be materially adversely affected. The RPII provisions, however, have never been interpreted by the courts or the U.S. Treasury Department (the Treasury Department ) in final regulations, and regulations interpreting the RPII provisions of the Code exist only in proposed form. It is not certain whether these regulations will be adopted in their proposed form or what changes or clarifications might ultimately be made thereto or whether any of those changes, as well as any interpretation or application of RPII by the IRS, the courts or otherwise, might have retroactive effect. The Treasury Department has authority to impose, among other things, additional reporting requirements with respect to RPII. Accordingly, the meaning of the RPII provisions and the application thereof to us is uncertain.

**U.S. persons who dispose of Common Shares may be subject to U.S. federal income taxation at the rates applicable to dividends on a portion of their gain, if any.**

Section 1248 of the Code provides that if a U.S. person sells or exchanges stock of a foreign corporation and that person owned, directly, indirectly through certain foreign entities or constructively, 10% or more of the voting power of the corporation at any time during the five-year period ending on the date of disposition when the corporation was a CFC, any gain from the sale or exchange of the shares will be treated as a dividend to the extent of that person's share of the CFC's earnings and profits (determined under U.S. federal income tax principles) during the period that person held the shares and while the corporation was a CFC (with certain adjustments). We believe that because of the dispersion of our Common Share ownership, provisions in our organizational documents that limit voting power and other factors, no U.S. shareholder of American Safety Insurance, other than Frederick C. Treadway or Treadway Associates, L.P., or their successors, heirs or assigns, should be treated as owning (directly, indirectly through foreign entities or constructively) 10% or more of the total voting power of American Safety Insurance. As a result, American Safety Insurance should not be a CFC and Section 1248 of the Code, as applicable under the general CFC rules, should not apply to dispositions of our shares. It is possible, however, that the IRS could challenge these provisions in our organizational documents and that a court could sustain that challenge. To the extent American Safety Insurance is a CFC, a 10% U.S. Shareholder may in certain circumstances be required to report a disposition of Common Shares by attaching IRS Form 5471 to the U.S. federal income tax or information return that it would normally file for the taxable year in which the disposition occurs.

For purposes of Section 1248 of the Code and the requirement to file Form 5471, special rules apply with respect to a U.S. person's disposition of shares of a foreign insurance company that has RPII during the five-year period ending on the date of the disposition. In general, if a U.S. person disposes of shares in a foreign insurance corporation in which U.S. persons own 25% or more of the shares (even if the amount of gross RPII is less than 20% of the corporation's gross insurance income and the ownership of its shares by direct or indirect insureds and related persons is less than the 20% threshold), any gain from the disposition will generally be treated as a dividend to the extent of that person's shares of the corporation's undistributed earnings and profits that were accumulated during the period that person owned the shares (whether or not those earnings and profits are attributable to RPII). As a result of the special rules and proposed Treasury Department regulations, the IRS may assert that Section 1248 of the Code and the requirements to file Form 5471 apply to dispositions of Common Shares because American Safety Insurance is engaged in the insurance business indirectly through subsidiaries.

**U.S. persons who hold Common Shares will be subject to adverse tax consequences if American Safety Insurance is considered to be a Passive Foreign Investment Company (a PFIC ) for U.S. federal income tax purposes.**

If American Safety Insurance is considered a PFIC for U.S. federal income tax purposes, a U.S. person who owns Common Shares will be subject to adverse tax consequences, including subjecting the investor to a greater tax liability than might otherwise apply and subjecting the investor to tax on amounts in advance of when tax would otherwise be imposed, in which case your investment could be materially adversely affected. In addition, if American Safety Insurance were considered a PFIC, upon the death of any U.S. individual owning Common Shares, that individual's heirs or estate would not be entitled to a step-up in the basis of the shares which might otherwise be available under U.S. federal income tax laws. American Safety Insurance does not believe that it is, and does not expect to become, a PFIC for U.S. federal income tax purposes. No assurance can be given, however, that American Safety Insurance will not be deemed a PFIC by the IRS. If American Safety Insurance were considered a PFIC, it could have material adverse tax consequences for an investor that is subject to U.S. federal income taxation. There are currently no regulations regarding the application of the PFIC provisions to an insurance company. New regulations or pronouncements interpreting or clarifying these rules may be forthcoming. We cannot predict what impact, if any, that guidance would have on an investor that is subject to U.S. federal income taxation.

**American Safety Insurance, American Safety Re and American Safety Assurance may become subject to Bermuda taxes in the future.**

Bermuda currently imposes no income tax on corporations. American Safety Insurance, American Safety Re and American Safety Assurance have received an assurance from the Bermuda Minister of Finance, under The Exempted Undertakings Tax Protection Act 1966 of Bermuda, as amended (the "Tax Protection Act"), that if any legislation is enacted in Bermuda that would impose tax computed on profits or income, or computed on any capital asset, gain or appreciation, or any tax in the nature of estate duty or inheritance tax, then the imposition of that tax will not be applicable to American Safety Insurance, American Safety Re or American Safety Assurance until March 28, 2016. No assurance can be given that American Safety Insurance, American Safety Re or American Safety Assurance will not be subject to any Bermuda tax after that date.

**The impact of Bermuda's letter of commitment to the Organization for Economic Cooperation and Development to eliminate harmful tax practices is uncertain and could adversely affect American Safety Insurance's, American Safety Re's and American Safety Assurance's tax status in Bermuda.**

The Organization for Economic Cooperation and Development (the "OECD") has published reports and launched a global dialogue among member and non-member countries on measures to limit harmful tax competition. These measures are largely directed at counteracting the effects of tax havens and preferential tax regimes in countries around the world. In the OECD's report dated April 18, 2002 and updated as of June 2004, Bermuda was not listed as an uncooperative tax haven jurisdiction because it had previously committed to eliminate harmful tax practices and to embrace international tax standards for transparency, exchange of information and the elimination of any aspects of the regimes for financial and other services that attract business with no substantial domestic activity. We are not able to predict what changes will arise from the commitment or whether these changes will subject us to additional taxes.

**Risk Factors Relating to the Property and Casualty Insurance Industry**

**Policy pricing in our industry is cyclical, and our financial results are impacted by that cyclicity.**

The property and casualty insurance industry has historically been a cyclical industry consisting of both soft market periods and hard market periods. During soft market periods, insurers tend to be more aggressive in writing policies and competitive in the pricing of those policies. Hard market periods are characterized by shortages of underwriting capacity and high premium rates. Beginning in 2000, we believe our industry experienced a hardening market, reflected by increasing rates and more restrictive coverage terms. These trends appeared to have started slowing in 2004. We believe the industry is now experiencing a softening market, where pricing generally has become more competitive and policy terms and conditions have become less restrictive. Therefore, we may not be able to achieve our growth and profitability goals. Because this cyclicity is due in large part to the economy, the particular needs of insureds and the actions of our competitors, we cannot predict the timing or duration of changes in the insurance market cycle.

**Our industry is subject to significant and increasing regulatory scrutiny.**

Recently, the insurance industry has been subject to a significant and increasing level of scrutiny by various regulatory bodies, including state attorneys general and insurance departments, concerning certain practices within the insurance industry. These practices include the receipt of contingent commissions by insurance brokers and agents from insurance companies and the extent to which this compensation has been disclosed, bid rigging and related matters. As a result of these and related matters, there have been a number of recent revisions to existing, or proposals to modify or enact new, laws and regulations regarding the relationship between insurance companies and producers. Any changes or further requirements that are adopted by federal, state or local governments could adversely affect our business and operating results.

**We operate in a heavily regulated industry, and existing and future regulations may constrain how we conduct our business and could impose liabilities and other obligations upon us.**

**Insurance Regulation.** Our primary insurance and reinsurance subsidiaries, as well as our non-subsubsidiary risk retention group affiliate, are subject to regulation under applicable insurance statutes of the jurisdictions in which they are domiciled or licensed and write insurance. This regulation may limit our ability to, or speed with which we can, effectively respond to market opportunities and may require us to incur significant annual regulatory compliance expenditures. Insurance regulation is intended to provide safeguards for policyholders rather than to protect shareholders of our insurance companies. Insurance regulation relates to authorized business lines, capital and surplus requirements, types and amounts of investments, underwriting limitations, trade practices, policy forms, claims practices, mandated participation in shared markets, loss reserve adequacy, insurer solvency, transactions with related parties, changes in control, payment of dividends and a variety of other financial and nonfinancial components of an insurance company's business. For instance, our insurance subsidiaries are subject to risk-based capital, or RBC, restrictions. RBC is a method of measuring the amount of capital appropriate for an insurance company to support its overall business in light of its size and risk profile. The ratio of a company's actual policyholder surplus to its minimum capital requirements will determine whether any state regulatory action is required. State regulatory authorities use the RBC formula to identify insurance companies which may be undercapitalized and may require further regulatory attention. Each of our domestic insurance subsidiaries satisfies its minimum capital requirements and none of them has been identified by any regulatory authority as being undercapitalized or requiring further regulatory attention. A number of legislative initiatives currently are under consideration by Congress. Any changes in insurance laws and regulations could materially adversely affect our operating results. We are unable to predict what additional laws and regulations, if any, affecting our business may be promulgated in the future or how they might be interpreted.

**Dividend Regulation.** Like other insurance holding companies, American Safety Insurance Holdings, Ltd. relies on dividends from its insurance subsidiaries to be able to pay dividends and fulfill its other financial obligations. The payment of dividends by these subsidiaries and other intercompany transactions are subject to regulatory restrictions and will depend on the surplus and earnings of these subsidiaries. As a result, insurance holding companies may not be able to receive dividends from their subsidiaries at times and in amounts sufficient to pay dividends and fulfill their other financial obligations. Additionally, as a Bermuda holding company, American Safety Insurance Holdings, Ltd. is subject to Bermuda regulatory constraints that will affect its ability to pay dividends on the Common Shares and to make other payments. Under the Companies Act, 1981 of Bermuda (the Companies Act), insurance holding companies may declare or pay a dividend out of distributable reserves only if it has reasonable grounds to believe that it is, and would after the payment be, able to pay liabilities as they become due and if the realizable value of its assets would thereby not be less than the aggregate of its liabilities and issued share capital and share premium accounts. We do not anticipate paying cash dividends on the Common Shares in the near future.

**Environmental Regulation.** Environmental remediation activities and other environmental risks are heavily regulated by both federal and state governments. Environmental regulation is continually evolving, and changes in the regulatory patterns at federal and state levels may have a significant effect upon potential claims against our insureds and us. These changes also may affect the demand for the types of insurance offered by and through us and the availability or cost to us of reinsurance. We are unable to predict what additional laws and regulations, if any, affecting environmental remediation activities and other environmental risks may be promulgated in the future, how they might be applied, and what their impact might be.

### **Risk Factors Relating to the Common Shares**

#### **Our stock price may be subject to significant fluctuations.**

The stock price for the Common Shares may fluctuate in response to a number of factors, including:

- o quarterly variations in our operating results;
- o changes in expectations about our future operating results;
- o changes in financial estimates and recommendations by securities analysts concerning us

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- o operating and stock price performance of other companies that investors may deem comparable;
- o news reports relating to our business and trends in our markets;
- o changes in the laws and regulations affecting our business;
- o acquisitions and financings by us or others in the insurance industry; and
- o sales, or the possibility of future sales, of substantial amounts of Common Shares by our directors or principal shareholders, or the perception that these sales will or could occur.

Common Shares held by our executive officers and directors, as well as any Common Shares held by the selling shareholders not subject to this offering are subject to lock-up agreements for a period of 90 days after the date of the underwriting agreement. See Underwriting.

### **The trading market for the Common Shares is thin, which could result in illiquidity of an investment in the Common Shares.**

The Common Shares trade on the New York Stock Exchange. The average daily trading volume of the 52 weeks ended August 11, 2006 was approximately 23,000 shares. While the Common Shares to be sold in this offering will increase the number of shares available for trading, a more active trading market may not develop and, if it does develop, it may not be sustained, which could result in illiquidity of an investment in the Common Shares.

### **Limitations on share ownership and voting rights might prevent a third party from acquiring us.**

Our Bye-Laws provide that no shareholder may vote more than 9.5% of the outstanding Common Shares, regardless of the percentage of the Common Shares a shareholder owns. This restriction does not apply to Frederick C. Treadway (one of our founders) or Treadway Associates, L.P., a limited partnership owned by Mr. Treadway and his children, including their respective heirs, successors and assigns. Additionally, this provision may only be amended with the consent of Mr. Treadway or Treadway Associates, L.P.

Our Bye-Laws contain other provisions that may be viewed as preventing a third party from acquiring us. Specifically, our Bye-Laws prohibit an interested shareholder of American Safety Insurance from either directly or indirectly being a party to or taking any action in connection with any business combination with American Safety Insurance for a period of five years following the date that person first became an interested shareholder, unless (a) the business combination was approved by a prior resolution of the continuing directors of our Board of Directors or (b) the business combination was approved by a prior resolution of at least 66(2)/3% of the outstanding voting shares of American Safety Insurance other than those voting shares beneficially held by an interested shareholder. Under these provisions, Mr. Treadway and Treadway Associates L.P., and their respective heirs, successors and assigns, are not interested shareholders. Our Bye-Laws require the affirmative vote of at least 66(2)/3% of the outstanding voting shares to amend, repeal or adopt any provision inconsistent with the foregoing provision. In addition, our Bye-Laws provide for a classified or staggered Board of Directors.

These provisions could have the effect of discouraging a prospective acquirer from making a tender offer or otherwise attempting to acquire us. To the extent that these provisions discourage takeover attempts, they could deprive shareholders of opportunities to realize takeover premiums for their shares or could depress the market price of the Common Shares. Further, any acquisition of us would require the prior approval of the Bermuda Monetary Authority. In addition, under Delaware and Oklahoma law, as a result of our ownership of American Safety Casualty Insurance Company and American Safety Indemnity Company, respectively, no person may obtain 10% or more of our voting shares without the prior approval of the insurance departments of those states. For more information on the limitations on our share ownership and the ability to exercise voting power on our shares, see Description of the Common Shares.

The risk factors presented above are all of the ones we consider material as of the date of this filing. However, they are not the only risks facing our company. Additional risks not presently known to us, or which we consider immaterial, may also adversely affect us. There may be risks that a particular investor views differently from us, and our analysis may be incorrect. If any of the risks that we face actually occurs, our business, financial condition and operating results could be materially adversely affected and could differ materially from any possible results suggested by any forward-looking statements that we have made or might make. In that case, the trading price of the Common Shares could decline, and you could lose part or all of your investment. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable

**Item 3. Defaults Upon Senior Securities**

Not applicable.

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

The Company held its annual meeting of shareholders on June 19, 2006. Cody W. Birdwell, Frank D. Lackner, and Thomas W. Mueller were reappointed as directors of the Company. Steven L. Groot was elected a director of the Company. BDO Seidman, LLP was ratified as the Company’s independent registered accounting firm.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

The following exhibits are filed as part of this report:

| Exhibit No. | Description   |
|-------------|---|
| 3.1         | Memorandum of Association of American (incorporated by reference to Exhibit 3.1 to Statement on Form S-1 of American Safety Insurance No.333-42749) as filed with the SEC on January 27, 1998 |
| 3.2         | Bye-Laws of American Safety Insurance Holdings, Ltd. to Exhibit 3.2 to Amendment No. 1 to the American Safety Insurance Holdings, Ltd. with the SEC on January 27, 1998)                      |
| 11          | Computation of Earnings Per Share   |
| 31.1        | Certification Pursuant to § 302 of the Sarbanes-Oxley Act of 2002   |
| 31.2        | Certification Pursuant to § 302 of the Sarbanes-Oxley Act of 2002   |
| 32.1        | Certification Pursuant to § 906 of the Sarbanes-Oxley Act of 2002   |
| 32.2        | Certification Pursuant to § 906 of the Sarbanes-Oxley Act of 2002   |

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 14th day of August 2006.

American Safety Insurance Holding

By: /s/ Stephen R. Crim  
 Stephen R. Crim  
 President and Chief Executive Officer

By: /s/ William C. Tepe  
 William C. Tepe  
 Chief Financial Officer  
 (Principal Financial Officer)

Exhibit 11

American Safety Insurance Holdings, Ltd. and subsidiaries  
 Computation of Earnings Per Share

|  | Three Months Ended    |                       | Six Months            |
|--|-----------------------|-----------------------|-----------------------|
|  | June 30,<br>2005      | June 30,<br>2006      | June 30,<br>2005      |
| <b>Basic:</b>                                      |                       |                       |                       |
| Earnings available to common<br>shareholders.....  | \$ 3,138,754<br>===== | \$ 4,627,134<br>===== | \$ 6,785,097<br>===== |
| Weighted average common shares<br>outstanding..... | 6,718,269<br>=====    | 7,106,393<br>=====    | 6,754,670<br>=====    |
| Basic earnings per common shares ...               | \$ 0.47<br>=====      | \$ 0.65<br>=====      | \$ 1.00<br>=====      |
| <b>Diluted:</b>                                    |                       |                       |                       |
| Earnings available to common<br>shareholders.....  | \$ 3,138,754<br>===== | \$ 4,627,134<br>===== | \$ 6,785,097<br>===== |
| Weighted average common shares<br>outstanding..... | 6,718,269             | 7,106,393             | 6,754,670             |

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|  |           |           |           |
|--|-----------|-----------|-----------|
| Weighted average common shares equivalents associated with options.... | 400,382   | 391,613   | 442,421   |
| Total weighted average common shares.....                              | 7,118,651 | 7,498,006 | 7,197,091 |
|  | =====     | =====     | =====     |
| Diluted earnings per common shares.....                                | \$ 0.44   | \$ 0.62   | \$ 0.94   |
|  | =====     | =====     | =====     |

Certification Pursuant to § 302 of the Sarbanes-Oxley Act of 20

Stephen R. Crim, certify that:

- 1) I have reviewed this report on Form 10-Q of American Safety Insurance Holdings, Ltd.;
- 2) Based on my knowledge, this report does not contain any untrue statement of a material necessary to make the statements made, in light of the circumstances under w misleading with respect to the period covered by this report;
- 3) Based on my knowledge, the financial statements, and other financial information incl all material respects the financial condition, results of operations and cash f the periods presented in this report;
- 4) The registrant 's other certifying officer(s) and I are responsible for establishing an procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the regis
  - (a) Designed such disclosure controls and procedures, or caused such disc designed under our supervision, to ensure that material information rel consolidated subsidiaries, is made known to us by others within those ent in which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls conclusions about the effectiveness of the disclosure controls and p covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control registrant's most recent fiscal quarter (the registrant's fourth fiscal q that has materially affected, or is reasonably likely to materially affe over financial reporting; and
- 5) The registrant's other certifying officer(s) and I have disclosed, based on our most over financial reporting, to the registrant's auditors and the audit committee o (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of inter which are reasonably likely to adversely affect the registrant's ability to report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have registrant's internal controls over financial reporting.

Date: August 14, 2006

/s/Stephen R. Crim  
Stephen R. Crim  
President and Chief Execut

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Certification Pursuant to § 302 of the Sarbanes-Oxley Act of 2002

I, William C. Tepe, certify that:

- 1) I have reviewed this report on Form 10-Q of American Safety Insurance Holdings, Ltd.;
- 2) Based on my knowledge, this report does not contain any untrue statement of a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, misleading with respect to the period covered by this report;
- 3) Based on my knowledge, the financial statements, and other financial information included in this report present fairly in all material respects the financial condition, results of operations and cash flows for the periods presented in this report;
- 4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining internal control procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and I have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information required to be disclosed by the registrant in its consolidated subsidiaries, is made known to us by others within those entities, in a timely manner, which this report is being prepared;
  - (b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and reported our conclusions about the effectiveness of the disclosure controls and procedures covered by this report based on such evaluation; and
  - (c) Disclosed in this report any change in the registrant's internal control over financial reporting during the registrant's most recent fiscal quarter (the registrant's fourth quarter for the report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5) The registrant's other certifying officer(s) and I have disclosed, based on our knowledge, the internal control over financial reporting, to the registrant's auditors and the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of the internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees having access to the registrant's internal controls over financial reporting.

Date: August 14, 2006

/s/William C. Tepe  
William C. Tepe  
Chief Financial Officer

Exhibit 32.1

Certification Pursuant to § 906 of the  
Sarbanes-Oxley Act of 2002

The undersigned, as the Chief Executive Officer of American Safety Insurance Group, Ltd.

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knowledge and belief, the Quarterly Report on Form 10-Q for the period ended June 30, 2006, fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 periodic report fairly presents, in all material respects, the financial condition and results of American Safety Insurance Group, Ltd. at the dates and for the periods indicated. The foregoing certificate is given under the Sarbanes-Oxley Act of 2003 (18 U.S.C. §1350) and shall not be relied upon for any other purpose.

Date: August 14, 2006

/s/ Stephen R. Crim  
Stephen R. Crim  
Chief Executive Officer

A signed original of this written statement required by § 906, or other document authenticating the signature that appears in typed form within the electronic version of this written statement provided to American Safety Insurance Holdings, Ltd. and will be retained by American Safety Insurance Group, Ltd. to the Securities and Exchange Commission or its staff upon request.

The information in this Exhibit 32.1 shall not be deemed filed for purposes of Section 13(a) of 1934, as amended, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, unless expressly set forth by specific reference in such filing.

Certification Pursuant to § 906 of the  
Sarbanes-Oxley Act of 2002

The undersigned, as the Chief Financial Officer of American Safety Insurance Group, Ltd., in his knowledge and belief, the Quarterly Report on Form 10-Q for the period ended June 30, 2006, fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 periodic report fairly presents, in all material respects, the financial condition and results of American Safety Insurance Group, Ltd. at the dates and for the periods indicated. The foregoing certificate is given under the Sarbanes-Oxley Act of 2003 (18 U.S.C. §1350) and shall not be relied upon for any other purpose.

Date: August 14, 2006

/s/ William C. Tepe  
William C. Tepe  
Chief Financial Officer

A signed original of this written statement required by § 906, or other document authenticating the signature that appears in typed form within the electronic version of this written statement provided to American Safety Insurance Holdings, Ltd. and will be retained by American Safety Insurance Group, Ltd. to the Securities and Exchange Commission or its staff upon request.

The information in this Exhibit 32.1 shall not be deemed "filed" for purposes of Section 13(a) of 1934, as amended, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, unless expressly set forth by specific reference in such filing.