

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

UNITED STATE
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 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 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)

Not A
(
Ide

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 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 small business filer. 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 Small business filer

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

The aggregate number of shares outstanding of Registrant's common stock, \$0.01 par value, on November 14, 2006 was _____.

AMERICAN SAFETY INSURANCE HOLDINGS, LTD.

FORM 10-Q

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risks

Item 4. Controls and Procedures

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Item 1A. Risk Factors

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

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits

PART I FINANCIAL INFORMATION
Item 1. Financial Statements

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

	December 31, <u>2005</u>	Sep
Assets		(U
Investments:		
Fixed maturity securities available for sale	\$ 364,856,826	\$ 47
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>1</u>
Total investments	415,496,577	52
Cash and cash equivalents	23,289,927	1
Accrued investment income	4,037,573	
Premiums receivable	17,315,778	2
Ceded unearned premium	28,870,656	3
Reinsurance recoverable	172,110,582	16
Deferred income taxes	11,933,791	1
Deferred policy acquisition costs	10,882,478	1
Property, plant and equipment	4,489,608	
Other assets	<u>6,572,007</u>	<u>—</u>
Total assets	\$ 694,998,977	\$ 79
	=====	=====

See accompanying notes to consolidated financial statements (unaudited).

December 31,

Sep

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

2005

Liabilities and Shareholders' Equity

Liabilities:

Unpaid losses and loss adjustment expenses	\$ 393,493,107	\$ 40
Unearned premiums	97,982,908	10
Ceded premiums payable	16,505,732	1
Accounts payable and accrued expenses	13,066,758	1
Deferred revenues	1,501,741	
Loan payable	37,810,099	3
Funds held	11,190,989	1
Minority Interest	<u>5,012,396</u>	

Total liabilities 576,563,730 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 September 30, 2006, 10,544,366 shares	67,537	
Additional paid-in capital	49,460,019	10
Retained earnings	70,457,352	8
Accumulated other comprehensive (loss) income, net	<u>(1,549,661)</u>	

Total shareholders' equity 118,435,247 18

Total liabilities and shareholders' equity \$ 694,998,977 \$79
=====

See accompanying notes to consolidated financial statements (unaudited).

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

	Three Months Ended		Nine
	September 30,		Se
	<u>2005</u>	<u>2006</u>	<u>2005</u>
Revenues:			
Direct premiums earned	\$ 54,933,171	\$ 55,588,691	\$ 168,456,7
Assumed premiums earned	(186,306)	135,000	(179,64
Ceded premiums earned	<u>(23,737,628)</u>	<u>(17,152,022)</u>	<u>(68,488,49</u>
Net premiums earned	31,009,237	38,571,669	99,788,6
Net investment income	3,653,075	6,001,675	10,236,9
Net realized gains (losses)	24,602	(8,692)	(19,86
Real estate income	-	-	3,000,0
Fee Income	321,528	450,365	796,9
Other income	<u>20,278</u>	<u>5,966</u>	<u>56,0</u>
Total revenues	35,028,720	45,020,983	113,858,8
	=====	=====	=====
Expenses:			
Losses and loss adjustment expenses	19,575,162	23,526,279	61,854,31
Acquisition expenses	6,790,113	7,038,445	20,909,50

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

Payroll and related expenses	2,344,439	4,360,605	8,492,92
Real estate expenses	(601,506)	54,979	2,086,95
Other expenses	2,318,189	3,422,802	7,516,06
Interest expense	265,364	83,999	795,00
Minority interest	<u>(93,408)</u>	<u>48,102</u>	<u>445,87</u>
Total expenses	<u>30,598,353</u>	<u>39,290,211</u>	<u>102,100,63</u>
Earnings before income taxes	4,430,367	5,730,772	11,758,19
Income taxes	<u>1,083,069</u>	<u>343,151</u>	<u>1,625,79</u>
Net earnings	\$ 3,347,298	\$ 5,387,621	\$ 10,132,39
Net earnings per share:			
Basic	\$ <u>0.50</u>	\$ <u>0.52</u>	\$ <u>1.5</u>
Diluted	\$ <u>0.47</u>	\$ <u>0.50</u>	\$ <u>1.4</u>
Weighted Average number of shares outstanding:			
Basic	6,702,609	10,438,692	6,737,12
	=====	=====	=====
Diluted	7,146,664	10,782,087	7,172,49
	=====	=====	=====

See accompanying notes to consolidated financial statements (unaudited).

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

	Nine Months <u>September</u> <u>2005</u>
Cash flow from operating activities:	
Net earnings	\$10,132,395
Adjustments to reconcile net earnings to net cash provided by operating activities:	
Realized losses (gains) on investments	19,863
Depreciation expense	760,274
Stock based compensation expense	-
Amortization of deferred acquisition costs, net	939,672
Amortization of premiums on investments	1,666,693
Deferred income taxes	(823,465)
Change in:	
Accrued investment income	(258,530)
Premiums receivable	484,246
Reinsurance recoverable	(20,373,785)
Ceded unearned premiums	(7,812,670)
Funds held	2,669,323
Unpaid losses and loss adjustment expenses	47,108,700
Unearned premiums	10,270,051
Ceded premiums payable	7,278,625
Deferred revenues	655,456
Accounts payable and accrued expenses	(2,043,568)
Other, net	<u>3,890,337</u>
Net cash provided by operating activities	54,563,617
Cash flow from investing activities:	
Purchases of fixed maturities	(112,119,012)
Purchases of common stock	(6,962,869)

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

Purchases of preferred stock	-
Proceeds from sale of fixed maturities	42,639,948
Proceeds from sale of equity investments	1,043,325
Decrease in short-term investments	12,068,162
Decrease of investment in real estate	2,005,440
Purchase of fixed assets, net	<u>(973,700)</u>
Net cash used in investing activities	(62,298,706)

See accompanying notes to consolidated financial statements (unaudited).

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

		Nine Months Ended	
		<u>September 30,</u>	
		<u>2005</u>	
Cash flow from financing activities:			
Proceeds from issuance of common stock		791,646	
Stock repurchase payments		(2,945,714)	
Repayment of loan payable		(125,865)	
Repayment of escrow deposits		(144,500)	
Withdrawals of restricted cash		<u>144,500</u>	
Net cash provided by (used in) financing activities		<u>(2,279,933)</u>	
Net increase (decrease) in cash and cash equivalents		(10,015,022)	
Cash and cash equivalents at beginning of period		<u>24,843,736</u>	
Cash and cash equivalents at end of period		\$14,828,714	
		=====	
Supplemental disclosure of cash flow:			
Income taxes paid		\$ 287,617	\$
		=====	
Interest paid		\$ 739,913	\$
		=====	

See accompanying notes to consolidated financial statements (unaudited).

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

	Three Months Ended		
	<u>September 30,</u>		
	<u>2005</u>	<u>2006</u>	<u>200</u>
Net earnings	\$ 3,347,298	\$ 5,387,621	\$ 10,132
Other comprehensive income before income taxes:			
Unrealized gains (losses) on securities available for sale, net of minority interest of \$(255,095) and			

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

\$339,507 for the three months ended September 30, 2005 and 2006, respectively, and \$(179,225) and \$(67,028) for the nine months ended September 30, 2005 and 2006, respectively.	(3,984,150)	10,986,257	(3,575,000)
Unrealized gains (losses) on hedging transactions	160,778	(168,344)	273,000
Reclassification adjustment for realized (gains) and losses included in net earnings, net of minority interest of \$0 and \$(48,198) for the three months ended September 30, 2005 and 2006 respectively and \$0 and \$(48,198) for the nine months ended September 30, 2005 and 2006 respectively.	<u>(24,602)</u>	<u>(39,506)</u>	<u>19,000</u>
Total other comprehensive income (loss) before taxes	(3,847,974)	10,778,407	(3,281,000)
Income tax expense (benefit) related to items of other comprehensive income, net of minority interest of \$(86,911) and \$132,821 for the three months ended September 30, 2005 and 2006 respectively, and \$21,459 and \$(6,400) for the nine months ended September 30, 2005 and 2006, respectively.	<u>(844,560)</u>	<u>2,129,781</u>	<u>(641,000)</u>
Other comprehensive income (loss) net of income taxes	<u>(3,003,414)</u>	<u>8,648,626</u>	<u>(2,640,000)</u>
Total comprehensive income	\$ 343,884	\$14,036,247	\$ 7,492,000
	=====	=====	=====

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries
Notes to Consolidated Financial Statements
September 30, 2006
(unaudited)

Note 1 Basis of Presentation

The accompanying consolidated financial statements of American Safety Insurance Holdings, Ltd. (American Safety) and its subsidiaries and American Safety Risk Retention Group, Inc. (American Safety RRG), a non-subsiary risk retention group affiliate (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 make estimates, based on the best information available, in recording transactions resulting from business operations. The balance sheet amounts that involve a greater extent of accounting estimates and/or actuarial determinations subject to future changes are the Company s invested assets, deferred income taxes, and the liabilities for unpaid losses and loss adjustment expenses. As additional information becomes available (or actual amounts are determinable), the recorded estimates may be revised and reflected in operating results. While management believes that these estimates are adequate, such estimates may change in the future.

The results of operations for the nine months ended September 30, 2006 may not be indicative of the results that may be expected for the fiscal year ending December 31, 2006. These unaudited interim consolidated financial statements and notes should be read in conjunction with the financial statements and notes included in the Company s Form 10-K for the fiscal year ended December 31, 2005. Certain items in the prior periods financial statements have been reclassified to conform to the current year presentation.

The unaudited interim consolidated financial statements include the accounts of American Safety, each of its subsidiaries and American Safety RRG. All significant intercompany balances have been eliminated. In 2005 and in 2006, the Company changed its segment presentation. See Note 5 for additional information. Prior years have been reclassified to conform to current year presentation.

Note 2 Accounting Pronouncements

During the last two years, the Financial Accounting Standard Board (FASB) has issued a number of accounting pronouncements 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 as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. It also includes accounting considerations subsequent to the recognition of another-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. The guidance in FSP 115-1 amends FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, and was effective January 1, 2006. The adoption of this pronouncement did not have a material impact on the Company's financial statements.

In April 2006, the FASB issued a Staff Position Number FIN 46(R)-6, Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R) (FSP 46R-6). FSP 46R-6 responds to the need for guidance on the relevant risks and rewards that must be identified and evaluated in order to apply FIN 46(R) and is effective for fiscal periods beginning after June 15, 2006. This pronouncement will have no impact on the Company as it already consolidates its non-subsidiary affiliate American Safety RRG.

In July 2006, the FASB issued a Staff Position Number FIN 48 (FIN 48), Accounting for Uncertainty in Income Taxes. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB statement number 109, Accounting for Income Taxes. This interpretation prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently reviewing this pronouncement to determine what impact, if any, it will have on its financial statements.

In September 2006, the FASB issued statement number 157, Fair Value Measurements. Prior to this statement, there were different definitions of fair value in GAAP. Moreover, that guidance was dispersed among the many accounting pronouncements that require fair value measurements. This statement creates a single set of guidelines for measuring fair value. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. At the present time it is expected that this statement will not have a material impact on the Company's financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is encouraged. The Company does not believe SAB 108 will have a material impact on the Company's 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 in which an insurer operates will create additional expenses not anticipated by the Company in pricing its products and beyond those recorded in the financial statements. That is, regulatory initiatives designed to reduce insurer profits or otherwise affecting the industry in which the insurer operates, new court interpretation of policy terms and conditions, or insurance company insolvencies through guaranty fund assessments may create costs for the insurer beyond those recorded in the financial statements. The Company attempts to mitigate this risk by writing insurance business in several states, thereby spreading this risk over a large geographic area.

The Potential Risk of United States Taxation of Bermuda Operations. Under current Bermuda law, American Safety is not required to pay any taxes in Bermuda on either income or capital gains. American Safety has received an undertaking from the Minister of Finance in Bermuda that will exempt American Safety from taxation until the year 2016 in the event of any such taxes being imposed. Whether a foreign corporation is engaged in a United States trade or business or is carrying on an insurance business in the United States that would subject it to United States taxation depends upon the level of activities conducted in the United States. If the activities of a foreign company are continuous, regular, and considerable, the foreign company will be deemed to be engaged in a United States trade or business. Management believes that American Safety and its Bermuda subsidiaries have been operated and in the future will continue to be operated in a manner that will not cause any of them to be treated as being engaged in a U.S. trade or business.

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

However, because the Internal Revenue Code of 1986, as amended, Treasury Regulations and court decisions do not definitively identify activities that constitute being engaged in a United States trade or business, and because of the factual nature of the determination, there can be no assurance that the Internal Revenue Service will not contend that American Safety and/or its Bermuda subsidiaries are engaged in a United States trade or business. In general, if American Safety or its Bermuda subsidiaries were engaged in a United States trade or business, each could be subject to (i) United States Federal income tax on income effectively connected with that trade or business and (ii) United States branch profits tax. Certain subsidiaries of American Safety are, however, subject to United States federal and state income tax as they are domiciled and conduct business in the United States.

Loss Reserve Risk. 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.

Credit Risk is the risk that issuers of securities owned by the insurer will default or other parties, including reinsurers that have obligations to the insurer, will not pay or perform. The Company attempts to mitigate this risk by adhering to a conservative investment strategy, by obtaining sufficient collateral and by maintaining sound reinsurance, credit and collection policies.

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

The Company's fixed maturity holdings are invested predominantly in high quality corporate, government and municipal bonds with relatively short durations. The fixed maturity portfolio is exposed to interest rate fluctuations; as interest rates rise, their fair values decline and as interest rates fall, their fair values rise. The changes in the fair market value of the fixed maturity portfolio are presented as a component of shareholders' equity in accumulated other comprehensive income, net of taxes.

We work to manage the impact of interest rate fluctuations on our fixed maturity portfolio. The effective duration of the fixed maturity portfolio is managed with consideration given to the estimated payout timing of our liabilities. We have investment policies which limit the maximum duration and maturity of individual securities within the portfolio and set target levels for average duration and maturity of the entire portfolio.

Note 4 Investments

The amortized cost and estimated fair values of the Company's investments at December 31, 2005 and September 30, 2006 are as follows:

	Amortized <u>cost</u>	Gross unrealized <u>gains</u>	Gross unrealized <u>losses</u>
December 31, 2005:			
Securities available for sale:			

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

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	132,992,335	56,265	2,579,971
Total fixed maturities:	\$ 369,236,301	\$1,609,002	\$5,988,477
	=====	=====	=====
Common stock	\$ 19,983,174	\$2,721,304	\$ 998,375
	=====	=====	=====
Preferred stock	\$ 3,500,900	\$ 106,100	\$ -
	=====	=====	=====

September 30, 2006:

Securities available for sale:

Fixed maturities:

U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$ 101,982,433	\$ 523,526	\$ 1,372,394
States of the U.S. and political subdivisions of the States	76,264,962	879,893	480,550
Corporate securities	107,019,358	871,002	1,346,540
Mortgage-backed securities	<u>195,477,008</u>	<u>756,502</u>	<u>2,897,774</u>
Total fixed maturities:	\$480,743,761	\$ 3,030,923	\$6,097,258
	=====	=====	=====
Common stock	\$ 22,093,540	\$ 4,047,679	\$ 971,140
	=====	=====	=====
Preferred stock	\$ 7,906,620	\$ 226,755	\$ 32,550
	=====	=====	=====

Note 5 Segment Information

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

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

In our E&S line, Environmental writes commercial casualty insurance coverages to protect against environmental risks, with a focus on the environmental remediation industry. Construction provides commercial casualty insurance coverages, generally in the area of residential and commercial. The non-construction general and products liabilities business offers both primary and excess products to small to middle market accounts. Excess provides umbrella liability coverage over other carriers' primary policies. Surety provides payment and performance bonds to the environmental remediation and construction industries.

In our ART line, Specialty Programs facilitates the offering of insurance to homogeneous niche groups of risks. Fully-funded provides a mechanism for insureds to post collateral and self-insure their risks. The Company is paid a fee for arranging this type of transaction.

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

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

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

The following table presents key financial data by segment for the nine months ended September 30, 2005 (in thousands):

September 30, 2005	Real Estate	E&S			Insurance		Specialty Programs
		Env.	Const.	Non-Const.	Excess	Surety	
Gross premiums written	\$ -	\$39,683	\$68,203	\$ -	\$1,457	\$1,768	\$67,696
Net premiums written	-	33,112	55,479	-	385	938	14,476
Fee income written	-	-	-	-	-	-	-
Net premiums earned	-	28,064	59,066	-	329	811	13,471
Fee income earned	-	-	-	-	-	-	-
Losses & loss adjustment expenses	-	14,433	36,948	-	197	684	8,178
Acquisition expenses	-	7,302	13,271	-	(91)	119	576
Underwriting profit (loss)	-	\$ 6,329	\$8,847	\$ -	\$223	\$ 8	\$4,717
Income tax expense (benefit)	\$ 578				\$ 1,063		
Net earnings (loss)	\$ 335				\$ 9,845		
Assets	\$3,746				\$644,260		
Equity	\$ 882				\$113,575		

September 30, 2006	Real Estate	E&S			Insurance		Specialty Programs
		Env.	Const.	Non-Const.	Excess	Surety	
Gross premiums written	\$ -	\$39,289	\$72,952	\$1,280	\$2,350	3,087	\$56,880
Net premiums written	-	29,676	68,543	597	505	2,131	15,606
Fee income written	-	-	-	-	-	-	-
Net premiums earned	-	27,306	65,023	179	378	1,503	14,138
Fee income earned	-	-	-	-	-	-	-
Losses & loss adjustment expenses	-	13,997	43,975	116	227	529	8,150
Acquisition expenses	-	7,712	12,299	(8)	(94)	308	244
Underwriting profit	\$ -	\$ 5,597	\$8,749	\$ 71	\$245	\$666	\$5,744
Income tax expense	\$ 184				\$ 724		
Net earnings (loss)	\$ (408)				\$ 14,223		
Assets	\$ 1,496				\$ 793,243		
Equity	\$ 347				\$ 189,469		

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

Additionally, the Company conducts business in the two geographic segments: The 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 nine months ended September 30, 2005 and September 30, 2006 (in thousands):

September 30, 2005	<u>United States</u>	<u>Bermuda</u>	
Income tax	\$ 1,626	\$ -	\$
Net earnings	4,254	5,878	
Assets	489,799	158,207	
Equity	59,135	55,222	
September 30, 2006	<u>United States</u>	<u>Bermuda</u>	
Income tax	\$ 959	\$ -	\$
Net earnings	2,577	11,539	
Assets	526,431	268,308	
Equity	62,335	127,380	

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

September 30, 2005	Real Estate	Insurance					
		Env.	Const.	E&S Non-Const.	Excess	Surety	ART Specialty Programs
Gross premiums written	\$ -	\$12,393	\$21,157	\$ -	\$468	\$833	\$24,370
Net premiums written	-	8,988	17,337	-	187	468	5,692
Fee income written	-	-	-	-	-	-	-
Net premiums earned	-	9,542	18,332	-	101	377	4,765
Fee income earned	-	-	-	-	-	-	-
Losses & loss adjustment expenses	-	4,246	12,228	-	60	232	2,809
Acquisition expenses	-	2,665	3,902	-	(22)	51	212
Underwriting profit (loss)	-	\$ 2,631	\$2,202	-	\$63	\$94	\$1,744
Income tax expense	\$460				\$ 618		
Net earnings	\$142				\$ 3,192		
September 30, 2006	Real Estate	Insurance					
		Env.	Const.	E&S Non-Const.	Excess	Surety	ART Specialty Programs
Gross premiums written	\$ -	\$12,404	\$26,204	\$ 733	881	\$1,132	\$20,241
Net premiums written	-	9,869	25,325	50	123	1,048	5,900
Fee income written	-	-	-	-	-	-	-
Net premiums earned	-	9,947	23,151	155	139	720	4,460
Fee income earned	-	-	-	-	-	-	-
Losses & loss adjustment expenses	-	3,823	16,952	116	84	253	2,298
Acquisition expenses	-	2,700	4,135	(8)	(44)	156	99
Underwriting profit	\$ -	\$ 3,424	\$2,064	\$ 47	\$99	\$311	\$2,063
Income tax expense (benefit)	\$ 248				\$ 118		
Net earnings (loss)	\$ (303)				\$ 5,676		

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

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

<u>September 30, 2005</u>	<u>United States</u>	<u>Bermuda</u>	<u>Total</u>
Income tax	\$1,083	\$ -	\$1,083
Net earnings	\$1,873	\$ 1,474	\$3,347
<u>September 30, 2006</u>	<u>United States</u>	<u>Bermuda</u>	<u>Total</u>
Income tax	\$ 343	\$ -	\$ 343
Net earnings	\$(174)	\$5,562	\$5,388

Note 6 - Income Taxes

Total income tax expense for the periods ended September 30, 2005 and 2006 was allocated

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months</u> <u>September</u>
	<u>2005</u>	<u>2006</u>	<u>2005</u>
Tax expense attributable to:			
Income from continuing operations	\$ 1,083,069	\$ 343,151	\$ 1,625,796
Change in unrealized gains/(losses) on hedging transactions	54,665	(56,897)	93,114
Change in unrealized gains/(losses) on securities available for sale	<u>(986,136)</u>	<u>2,319,499</u>	<u>(713,327)</u>
Total	\$ 151,598 =====	\$ 2,605,753 =====	\$ 1,005,583 =====

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

	<u>Current</u>	<u>Deferred</u>	<u>Total</u>
Three months ended:			
September 30, 2005	\$ 1,452,076	\$ (369,007)	\$ 1,083,069
September 30, 2006	\$ 21,212	\$ 321,939	\$ 343,151
Nine months ended:			
September 30, 2005	\$ 2,449,261	\$ (823,465)	\$ 1,625,796
September 30, 2006	\$ 1,471,009	\$ (512,083)	\$ 958,926

The state income tax expense (benefit) aggregated \$412,758 and \$(9,000) for the nine months ended September 30, 2005 and 2006, respectively, and \$354,282 and \$(3,286) for the three months ended September 30, 2005 and 2006, respectively. State Income tax expense is included in the current provision for all periods.

Income tax expense for the periods ended September 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:

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months</u> <u>September</u>
	<u>2005</u>	<u>2006</u>	<u>2005</u>
Expected income tax expense	\$ 1,506,325	\$ 1,948,462	\$ 3,997,785
Foreign earned income not subject to	(501,428)	(1,891,168)	(1,998,619)

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

country-regionplaceU.S.	-	-	(554,515)
taxation	78,172	285,857	181,145
Valuation allowance			
State taxes and other			
	\$ 1,083,069	\$ 343,151	\$ 1,625,796

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, <u>2005</u>	September 30, <u>2006</u>
Deferred tax assets:		
Loss reserve discounting	\$ 9,288,244	\$ 9,757,154
Unearned premium reserves	3,118,965	2,741,728
Unrealized loss on securities	667,159	262,508
Other	<u>502,989</u>	<u>677,090</u>
Gross deferred tax assets	13,577,357	13,438,480
Deferred tax liabilities:		
Deferred acquisition costs	1,477,230	1,404,511
Unrealized gains on hedging transactions	<u>166,336</u>	<u>144,589</u>
Gross deferred tax liabilities	<u>1,643,566</u>	<u>1,549,100</u>
Net deferred tax asset	\$11,933,791	\$11,889,380
	=====	=====

Note 7- Stock Options

The Company's stock option plan grants 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 commencing in the first quarter of 2006. Compensation expense relating to stock options of \$453,710 is reflected in net earnings for the nine months ended September 30, 2006 and \$154,469 for the three months ended September 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 nine months ended September 30, 2005.

	Three Months Ending September 30, <u>2005</u>	Nine Months Ending September 30, <u>2005</u>
	(In thousands, except per share amounts)	
Net earnings:		
As reported	\$ 3,347	\$ 10,132
Effect of stock options	<u>(3)</u>	<u>(463)</u>
Pro forma net earnings	\$ 3,344	\$9,669
	=====	=====
Net earnings per share:		
Basic - as reported	\$ 0.50	\$ 1.50
Basic - pro forma	\$ 0.50	\$ 1.44
Diluted - as reported	\$ 0.47	\$ 1.41
Diluted - pro forma	\$ 0.47	\$ 1.35

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 solutions to small and medium-sized businesses in industries that we believe are underserved by the standard insurance market. Since 1986, we have developed specialized insurance coverages and alternative risk transfer products not generally available to our customers in the standard insurance market because of the unique characteristics of the risks involved and the associated needs of the insureds. We specialize in underwriting these products for insureds with environmental and construction risks as well as other specialty classes of risks.

During 2005, we changed our segment reporting to coincide with our strategic direction. In our segment reporting for periods prior to the year ended December 31, 2005, we segregated our business into real estate operations, insurance operations and other (which included realized gains and losses on investments and rescission expenses). We continue to segregate our business into real estate operations, insurance operations and other, but the insurance operations segment is further classified into three additional segments: excess and surplus lines, alternative risk transfer and runoff. The excess and surplus lines segment is further classified into five business lines: environmental, construction, non-construction, excess and surety. The alternative risk transfer segment is further classified into two business lines: specialty programs and fully-funded. Prior year amounts have been reclassified to conform to the current year presentation. Our real estate operations consist solely of our development of the placePlaceTypeHarbour PlaceTypeVillage property which is substantially complete. 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 unaudited consolidated financial statements and the related notes included elsewhere in this report. All amounts and percentages are rounded.

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

	Three Months Ended September 30,		Three Months Ended September 30, 2005 to 2006	Nine Months Ended September 30,	
	2005	2006		2005	2006
Net premiums written:					
Excess and Surplus Lines					
Environmental	\$ 8,988	\$ 9,869	9.8%	\$ 33,112	\$ 29,869
Construction	17,337	25,325	46.1	55,479	68,325
Non-construction	-	50	100.0	-	50
Excess	187	123	(34.2)	385	123
Surety	<u>468</u>	<u>1,048</u>	<u>123.9</u>	<u>938</u>	<u>2,096</u>
Total	26,980	36,415	34.9	89,914	101,363
Alternative Risk Transfer					
Specialty Programs	<u>5,692</u>	<u>5,900</u>	<u>3.7</u>	<u>14,476</u>	<u>15,400</u>
Total	5,692	5,900	3.7	14,476	15,400
Runoff	<u>(2,108)</u>	<u>-</u>	<u>(100.0)</u>	<u>(2,143)</u>	<u>-</u>
Total net premiums written	\$ 30,564	\$ 42,315	38.4%	\$ 102,247	\$ 117,763
Fully funded fee income written	\$ 1,087	\$ 143	(86.8)%	\$ 1,754	\$ 1,400
Net premiums earned:					
Excess and Surplus Lines					
Environmental	\$ 9,542	\$ 9,947	4.2%	\$ 28,064	\$ 28,064
Construction	18,332	23,151	26.3	59,066	66,312
Non-construction	-	155	100.0	-	155
Excess	101	139	37.6	329	139
Surety	<u>377</u>	<u>720</u>	<u>90.9</u>	<u>811</u>	<u>1,519</u>
Total	28,352	34,112	20.3	88,270	96,165
Alternative Risk Transfer					
Specialty Programs	<u>4,765</u>	<u>4,460</u>	<u>(6.4)</u>	<u>13,471</u>	<u>13,471</u>
Total	4,765	4,460	(6.4)	13,471	13,471

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

Runoff	<u>(2,108)</u>	<u>—</u>	<u>(100.0)</u>	<u>(1,952)</u>	
Total net premiums earned	\$ 31,009	\$ 38,572	24.4%	\$99,789	\$ 10
Fully funded fee income earned	322	450	39.8	796	
Net investment income	3,653	6,002	64.3	10,237	1
Net realized gains (losses)	25	(9)	(136.0)	(20)	
Real estate income	—	—	—	3,000	
Other income	<u>20</u>	<u>6</u>	<u>(70.0)</u>	<u>57</u>	
Total Revenues	\$ 35,029	\$ 45,021	28.5%	\$ 113,859	\$ 12
	=====	=====		=====	=====

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

	Three months ended <u>September 30,</u>		Nine months ended <u>September 30,</u>	
	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>
Insurance operations:				
Loss and loss adjustment expense ratio	63.1%	61.0%	62.0%	61.5%
Expense ratio	<u>35.5</u>	<u>36.7</u>	<u>35.7</u>	<u>36.8</u>
Combined ratio.....	98.6%	97.7%	97.7%	98.3%
	=====	=====	=====	=====

Three Months ended September 30, 2006 Compared to Three Months ended September 30, 2005

Net Premiums Earned

Excess and Surplus Lines

Environmental. Net premiums earned increased 4.2% to \$9.9 million in the third quarter of 2006 compared to \$9.5 million for the same quarter of 2005. The Company experienced a 20% increase in gross premiums written in the Prostar Online premiums during the current quarter, however this increase was offset by decreases primarily in the middle market unit. The Company recently updated its policy forms in both the middle market and Prostar sector to be more in line with market offerings. This should improve the Company's retention levels and new business opportunities. The Company does not expect that its claims experience will be materially impacted by the changes in the policy form. With respect to pricing in this line, the Company has experienced rate decreases ranging from five to ten percent on renewals depending on the product.

Construction. Net premiums earned increased 26.3% to \$23.2 million in the third quarter of 2006 compared to \$18.3 million for the same quarter of 2005. Net premiums earned increased due to higher retention levels and greater gross premiums written in non-western states (states other than Arizona, California, Colorado, Nevada, and Washington) as a result of the Company's geographic diversification efforts. While the Company experienced rate declines on its renewal book of approximately ten percent during the quarter, the Company has maintained restrictive policy terms and conditions. The Company continues to exercise underwriting discipline as evidenced by the low renewal retention rate of approximately 60% based on number of accounts.

Non-Construction. The Company's non-construction general liability product, which began production in 2006 had favorable growth producing net premiums earned of \$155,000 for the quarter ended September 30, 2006. The Company is experiencing strong submission and production activity in this line.

The non-construction general and products liability business offers 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.

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

Excess. Net premiums earned increased to \$139,000 in the third quarter of 2006 compared to \$101,000 for the same quarter of 2005. The Company is experiencing strong submission activity and production continues to increase. The Company's excess product offering is focused primarily in the construction and products liability area.

Surety. Net premiums earned increased to \$720,000 in the third quarter of 2006 compared to \$377,000 for the same period of 2005. The increase in surety premiums primarily is due to the Company's focus in the environmental contractor surety market due primarily to the lack of capacity serving this segment of the market. The Company also recently expanded its offerings to include non-environmental contractor bonds.

Alternative Risk Transfer

Specialty Programs. Net premiums earned decreased 6.4% to \$4.5 million in the third quarter of 2006 compared to \$4.8 million for the same quarter of 2005. The decrease was primarily attributable to premiums generated in 2005 by a program that was not renewed in the fourth quarter of 2005 and a reduction in writings in the Company's construction general liability wrap-up program. Premiums in the construction wrap-up program are tied to specific projects. Premiums are lower due to delays in the start dates of projects. During the current quarter the company added three new programs. With the addition of these new programs, the Company has thirteen active programs at September 30, 2006. The Company continues to increase retention levels on selected programs allowing it the opportunity to increase its earnings potential from underwriting profits.

Runoff. Net premiums earned were zero for the third quarter of 2006 compared to negative \$2.1 million for the same period of 2005. In 2005 net earned premiums decreased due to an accrual of \$2.3 million for reinstatement reinsurance premiums on discontinued lines. 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.

Fully Funded. Fee income for the third quarter of 2006 increased 39.8% to \$450,000 from \$322,000 for the same period of 2005. The Company recently added a fully funded product for property catastrophe exposures due to the unavailability of affordable insurance in the market place. The Company has seen some adverse impact from the overall market softening on its production efforts in this line as traditional insurance pricing declines provide a cost effective alternative to self-insurance.

Net Investment Income

Net investment income increased 64.3% to \$6.0 million in the quarter ended September 30, 2006 from \$3.7 million in the quarter ended September 30, 2005 due to higher levels of invested assets and an increased investment yield. Average invested assets increased to \$502.1 million in the quarter ended September 30, 2006 from \$371.4 million in the same quarter of 2005, due to positive cash flow from operations and additional capital raised from the issuance of Trust Preferred securities in the fourth quarter of 2005 and the equity offering in the second quarter of 2006. The average tax equivalent yield increased 68 basis points to 5.0%

Net Realized Gains and Losses

Net realized gains and losses decreased to a loss of \$9,000 in the third quarter of 2006 compared to a net gain of \$25,000 for the same period of 2005. The Company from time to time may sell securities in response to market conditions or interest rate fluctuations in accordance with its investment guidelines or to fund the cash needs of individual operating subsidiaries.

Real Estate Income

The Company did not have any real estate income in the third quarter of 2006 or 2005, respectively. The final condominium units at PlaceTypeplaceHarbour PlaceTypeVillage 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 PlaceTypeplaceHarbour PlaceTypeVillage beach club and the management of remaining warranty claims on previously sold condominium units.

Losses and Loss Adjustment Expenses

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

In the quarter ended September 30, 2006, the Company's loss ratio decreased 2.1 points to 61.0% as compared to 63.1% for the same period of 2005. The Company experienced net adverse loss development of \$835,000 in the third quarter of 2006. This development included reserve redundancies of \$1.1 million in the environmental line and \$165,000 in the program business line and \$2.1 million of adverse loss development from certain discontinued commercial business in placeStateNew York in the construction line. Prior year net adverse loss development was \$74,000 for the third quarter of 2005. The third quarter of 2005 loss ratio was adversely impacted by premium reinstatements of \$2.3 million.

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 and premium taxes paid to states where business is written on an admitted basis. For our program business, fees are earned through ceding commissions and have the effect of lowering our acquisition expenses. Acquisition expenses were \$7.0 million in the quarter ended September 30, 2006 compared to \$6.8 million in the quarter ended September 30, 2005. Acquisition expenses as a function of net earned premiums were 18.2% in the quarter ended September 30, 2006 and 21.9% in the quarter ended September 30, 2005, primarily due to increased retention levels which produce higher earned premiums with minimal additional expenses.

Real Estate Expenses

Real estate expenses were \$55,000 for the third quarter of 2006 compared to a benefit of \$601,000 for the same period of 2005. During the third quarter of 2005 the Company received \$980,000 for settlement on roof litigation at PlaceTypeplaceHarbour PlaceTypeVillage. This receipt was applied as a reduction to real estate expenses as it had been previously expensed.

Payroll and Other Expenses

Payroll and other expenses increased to \$8.6 million in the third quarter of 2006 compared to \$4.9 million for the same period of 2005. Payroll expenses increased by \$2 million as the 2005 quarter included a \$700,000 reduction in accrued bonus expenses. The remainder of the salary expense increase was due to increased head count to support the Company's strategy to deploy the new capital, the inclusion of the FASB Statement 123R option expense of \$154,000 and normal salary increases. Other expenses increased by \$1.7 million for the third quarter of 2006 compared to the same quarter of 2005. This increase was due to increased interest costs of \$574,000 resulting from the issuance of trust preferred securities in November 2005, increased legal and regulatory costs of \$388,000, and \$316,000 in additional depreciation expense due to investments in our systems.

Income taxes

Income taxes for the quarter ended September 30, 2006 totaled \$343,000 for an effective tax rate of 6.0% compared to \$1.1 million for an effective tax rate of 24.4% for the same period of 2005. The tax expense decreased for the quarter ended September 30, 2006 due to lower country-regionplaceU.S. taxable income driven by the reserve development during the quarter.

Nine Months ended September 30, 2006 Compared to Nine Months ended September 30, 2005

Net Premiums Earned

Excess and Surplus Lines

Environmental. Net premiums earned decreased 2.7% to \$27.3 million in the first nine months of 2006 as compared to \$28.1 million for the same period in 2005. The decline in premiums earned 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 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.

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

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. The Company recently updated its policy forms in both the middle market and Prostar sector to be more in line with current market offerings. This should improve the Company's retention levels and new business opportunities. The Company does not expect that its claims experience will be materially impacted by the changes in the policy form. With respect to pricing in this line, the Company during the nine months experienced rate decreases ranging from five to ten percent on renewals depending on the product.

Construction. Net premiums earned increased 10.4% to \$65.2 million in the first nine months of 2006 as compared to \$59.1 million for the same time period in 2005. Net premiums earned increased due to higher retention levels and greater gross premiums written due to an increase in premium writings in non-western states (states other than Arizona, California, Colorado, Nevada, and Washington) as a result of the Company's geographic diversification. While the Company during the nine months experienced rate declines on its renewal book of approximately ten percent, the Company has maintained restrictive policy terms and conditions. The Company continues to exercise underwriting discipline as evidenced by the Company's low renewal retention rate.

Non-Construction. The Company's non-construction general liability product, which began production in 2006, produced net premium earned of \$179,000 for the first nine months. The Company is experiencing strong submission and production activity in this line. 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.

Excess. Net premiums earned increased 14.9% to \$378,000 in the first nine months of 2006 as compared to \$329,000 for the same time period in 2005. The Company is experiencing strong submission activity and production continues to increase. The Company's excess product offering is focused primarily in the construction and products liability area. With the addition of new staff, the Company has expanded its excess liability product to write over other carriers' primary policies and to offer umbrella liability coverage. The Company also increased the available policy limits up to \$5.0 million.

Surety. Net premiums earned increased 85.3% to \$1.5 million in the first nine months of 2006 as compared to \$811,000 for the same time period in 2005. The increase in surety premiums is due to the Company continuing to focus its growth efforts in the environmental contractor surety due to the lack of capacity serving this segment of the market. The Company also recently expanded its offerings to include non-environmental contractor bonds. 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 4.9% to \$14.1 million for the first nine months of 2006 as compared to \$13.5 million for the same time period in 2005. Net premiums earned increased primarily due to increased retention levels on selected programs allowing the Company the opportunity to increase earnings potential from underwriting profits. During the nine months ended September 30, 2006, the company added five new programs. With the addition of these new programs, the Company has thirteen active programs at September 30, 2006. The ratio of net written premiums to gross premiums written increased to 27% for the first nine months of 2006 compared to 21% for the same period of 2005. The Company continues to increase retention levels on selected programs allowing it the opportunity to increase its earnings potential from underwriting profits.

Runoff. Net premiums earned was zero for the nine months ended September 30, 2006 compared to negative \$2.1 million for the same period of 2005. In 2005 net earned premiums decreased due to an accrual of \$2.0 million for reinstatement reinsurance premiums on discontinued lines. The Company's assumed liability and workers' compensation business was put in run-off in 2004.

Fully Funded. Fee income for the first nine months of 2006 increased 65.5% to \$1.3 million from \$796,000 for the same period of 2005. The Company recently added a fully funded product for property catastrophe exposures due to the unavailability of affordable insurance in the market place. The Company has seen some adverse impact from the overall market softening on its production efforts in this line as traditional insurance pricing declines provide a cost effective alternative to self-insurance.

Net Investment Income

Net investment income increased 49.2% to \$15.3 million for the nine months ended September 30, 2006 from \$10.2 million in the nine months ended September 30, 2005 due to higher levels of invested assets and increased investment yield. Average invested assets increased to \$461.9 million from \$355.9 million. The average invested assets increased due to positive cash flow from operations and additional capital raised from the issuance of Trust Preferred securities in the fourth quarter of 2005 and the equity offering in the second quarter of 2006. The tax equivalent yield increased 62 basis points to 4.8%.

Net Realized Gains and Losses

Net realized gains and losses changed from a net loss of \$20,000 for the nine months ended September 30, 2005 to a net gain of \$351,000 for the nine months ended September 30, 2006. The Company from time to time may sell securities in response to market conditions or interest rate fluctuations in accordance with its investment guidelines or to fund the cash needs of individual operating subsidiaries.

Real Estate Income

The Company did not have any real estate income in the first nine months of 2006 compared to \$3.0 million in the first nine months of 2005. The final condominium units at placePlaceTypeHarbour PlaceTypeVillage were sold and closed in the second quarter of 2005.

Losses and Loss Adjustment Expenses

For the nine months ended September 30, 2006, the Company's loss ratio was 61.5% compared to 62.0% for the same period of 2005. For the nine months ended September 30, 2006 the Company experienced adverse loss development of \$1.5 million compared to \$1.1 million for the nine months ended September 30, 2005. The 2006 adverse loss development included \$2.4 million of adverse loss development on certain discontinued commercial construction business in placeStateNew York construction line, partially offset by reserve redundancies of \$434,000 on the environmental line, \$300,000 on discontinued lines and \$165,000 in the program business line. The reserve strengthening for the nine months ended September 30, 2005 was \$1.1 million on the Company's runoff lines of business.

Acquisition Expenses

Policy acquisition expenses decreased to \$20.5 million for the nine months ended September 30, 2006 from \$20.9 million for the nine months ended September 30, 2005. Acquisition expenses as a function of net premiums earned were 18.9% for the nine months ended September 30, 2006 compared to 20.9% for the nine months ended September 30, 2005. The decrease was primarily due to increased premium retention levels.

Real Estate Expenses

Real estate expenses decreased to \$224,000 for the first nine months of 2006 compared to \$2.1 million for the same period of 2005. The decrease in real estate expenses was primarily due to the substantial completion of the PlaceTypeplaceHarbour PlaceTypeVillage project.

Payroll and Other Expenses

Payroll and other expenses increased to \$23.5 million for the first nine months of 2006 compared to \$16.8 million for the same period of 2005. Payroll expenses increased by \$3.4 million for the first nine months of 2006 compared to 2005, which included a \$700,000 reduction in accrued bonus expense. The remainder of the increase is due to an increase in head count of 33 people to support the Company's strategy to deploy the new capital, the inclusion of the FASB Statement 123R option expense of \$454,000 and normal salary increases. Other expenses increased by \$3.3 million for the first nine months of 2006 compared to 2005. This increase was due to increased interest expense of \$1.8 million resulting from the issuance of trust preferred securities in November 2005, \$600,000 increase in legal and regulatory costs, and a \$663,000 increase in depreciation expense due to investments in our systems.

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 nine 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 changed due to its profitability. As a result, the Company's minority interest expense for the nine months ended September 30, 2005 was \$445,000. In first nine 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 nine months ended September 30, 2006 was a benefit of \$464,000.

Income taxes

Income taxes for the nine months ended September 30, 2006 totaled \$959,000 for an effective tax rate of 6.4% compared to \$1.6 million for an effective tax rate of 13.8% for the same period of 2005. The Company had a lower effective tax rate for the nine months ended September 30, 2006 due to lower taxable income in the Company's U.S. insurance and real estate operations as a result of reserve development.

Equity

The Company's total equity at September 30, 2006 was \$189.7 million compared to \$118.4 million as at December 31, 2005. During June and July of 2006 the Company raised an additional \$53.0 million net of expenses through a public stock offering. In addition, equity increased due to increased earnings during the year and a decrease in the unrealized loss on investments.

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.

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 \$45.5 million for the nine months ended September 30, 2006 and \$54.6 million for the same period of 2005. This decrease is primarily a result of an anticipated increase in loss payments made by the Company in 2006 due to the maturing of certain product lines. For the nine months ended September 30, 2006 the Company had paid out \$17.0 million in losses compared to \$9.5 million at September 30, 2005.

In June and July of 2006 we issued 3,680,000 shares of our common stock in an underwritten public offering at a price of \$15.50 per share. Net of underwriting discounts and expenses we received \$53.0 million. The net proceeds from the sale of the Common Shares in this offering will be used 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. Previously in November 2005, we issued \$25.0 million in trust preferred securities.

The Company currently does not pay dividends on its common shares. 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 PlaceTypeplaceHarbour PlaceTypeVillage project in 2005. The estimated completion cost for the remainder of the PlaceTypeplaceHarbour PlaceTypeVillage project is approximately \$1.6 million and represents amounts needed to complete construction of 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 PlaceTypeplaceHarbour PlaceTypeVillage.

Reserves

On a quarterly basis, the Company's internal actuary performs a review of lines of business with significant net exposure. The evaluation entails the examination of our current actuarial assumptions compared to actual claim activity. If there is a material deviation from actual emerged losses and the actuarially determined expected losses, further research is completed to determine the cause. Discussions with the claims staff and the underwriting staff about these deviations, in some cases, reveal trends that warrant modifications of the current assumptions about loss

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

development patterns and or expected loss ratios. Based on these latest loss reserve projections, management establishes revised estimates of loss reserves as appropriate.

As part of our year-end audit, the Company has an external actuarial firm review the analysis prepared by our internal actuary and issue an actuarial opinion on the insurance operating companies' reserve adequacy.

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. Exclusive of our country-region United States subsidiaries, we 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 interest expense.

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, continue or the negatives or other variations or similar terminology. Forward-looking statements relate to, among other things:

- future claims experience;
- our plans for excess product offerings;
- premium estimates for new programs;
- our plans for the funds we recently raised
- Harbour Village completion and warranty costs
- Our adequacy of our reserves;
- 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.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

For an 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 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.

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

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 PlaceTypeplaceHarbour PlaceTypeVillage 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, which has been set for oral argument on December 5, 2006. 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 was heard on August 22, 2006, and on September 18, 2006, the plaintiff's case was dismissed with prejudice. On October 17, 2006, the plaintiff filed an appeal of the dismissal. 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 September 2006, A.M. Best reaffirmed its rating of A (Excellent), with a stable outlook on a group basis of American Safety Insurance, including our two country-region U.S. insurance subsidiaries, our Bermuda reinsurance subsidiary and our U.S. non-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 reaffirmed this rating and outlook in September 2006. 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 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 Item 1 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.

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

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:

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

- (1) credit risk, which is the risk that our invested assets will decrease in value due to unfavorable financial prospects or a downgrade in the credit rating of an entity in which we have invested;
- (2) interest rate risk, which is the risk that our invested assets may decrease due to changes in interest rates;
- (3) equity price risk, which is the risk that we will incur economic loss due to a decline in equity prices;
- (4) 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, 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, 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, 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 carrying on business through a permanent establishment in the U.S.). If any of American Safety, 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 country-regionplaceU.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 country-regionplaceU.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 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 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 placecountry-regionU.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 is considered to be a Passive Foreign Investment Company (a PFIC) for country-regionplaceU.S. federal income tax purposes.

If American Safety 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 placeplaceU.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 placeplaceU.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 placeplaceU.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 placeBermuda 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-subsidiary 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 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.

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

The risk factors presented above are 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 than we do, 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

Not applicable.

Item 5. Other Information

None

Item 6. Exhibits

The following exhibits are filed as part of this report:

<u>Exhibit No.</u>	<u>Description</u>
11	Computation of Earnings Per Share
31.1	Certification Pursuant to ss.302 of the Sarbanes-Oxley Act of 2002
31.2	Certification Pursuant to ss.302 of the Sarbanes-Oxley Act of 2002
32.1	Certification Pursuant to ss.906 of the Sarbanes-Oxley Act of 2002
32.2	Certification Pursuant to ss.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 November 2002.

American Safety Insurance Holding

By: /s/ Stephen R. Crim

Stephen R. Crim
President and Chief Executive

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