

AMERICAN SAFETY INSURANCE HOLDINGS LTD

Form 10-Q

August 09, 2007

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

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**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.

Commission File Number 1-14795

**AMERICAN SAFETY INSURANCE HOLDINGS, LTD.**

(Exact name of registrant as specified in its charter)

Bermuda Not Applicable (State or other jurisdiction (I.R.S. Employer of incorporation or Identification No.)  
organization)

The Boyle Building, 2<sup>nd</sup> Floor

31 Queen Street

Hamilton HM 11 Bermuda

(Address, zip code of principal executive offices)

(441) 296-8560

(Registrant's telephone number, including area code)

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Indicate by check mark whether registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one) Large accelerated filer  Accelerated filer  Non-accelerated filer  Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

The aggregate number of shares outstanding of Registrant's common stock, \$0.01 par value, on August 4, 2007 was 10,678,257.

## AMERICAN SAFETY INSURANCE HOLDINGS, LTD.

### FORM 10-Q

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## PART I - FINANCIAL INFORMATION

### Item 1. Financial Statements

#### American Safety Insurance Holdings, Ltd. and Subsidiaries

#### Consolidated Balance Sheets

	June 30, <u>2007</u> (Unaudited)	December 31, <u>2006</u>
Assets		
Investments:		
Fixed maturity securities available for sale	\$ 509,432,968	\$ 490,031,666
Common stock, at fair value	18,352,186	12,402,957
Preferred stock, at fair value	7,933,012	8,118,060
Short-term investments	<u>34,829,358</u>	<u>40,605,672</u>
Total investments	570,547,524	551,158,355

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Cash and cash equivalents	30,588,605	11,293,296
Accrued investment income	5,373,502	4,299,678
Premiums receivable	27,580,163	21,747,908
Ceded unearned premium	29,989,903	35,897,446
Reinsurance recoverable	175,095,180	185,010,493
Deferred income taxes	11,453,897	10,115,869
Deferred policy acquisition costs	15,965,304	12,402,764
Property, plant and equipment	8,390,632	5,644,629
Other assets	<u>11,495,023</u>	<u>9,560,230</u>
Total assets	\$ 886,479,733	\$847,130,668
	=====	=====

See accompanying notes to consolidated financial statements (unaudited).

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	June 30, <u>2007</u> (Unaudited)	De
Liabilities and Shareholders' Equity		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 466,787,601	\$ 439
Unearned premiums	114,904,983	115
Ceded premiums payable	26,341,582	25
Deferred Revenues	1,194,269	1
Accounts payable and accrued expenses	8,125,068	11
Deferred rent	1,733,458	
Loans payable	38,348,001	38
Funds held	17,713,938	16
Minority Interest	<u>3,204,778</u>	<u>3</u>
Total liabilities	<u>678,353,678</u>	<u>650</u>
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 30,000,000 shares; issued and outstanding at June 30, 2007, 10,678,257 and December 31, 2006, 10,554,200 shares	106,782	
Additional paid-in capital	106,152,623	10
Retained earnings	105,353,426	9
Accumulated other comprehensive income, net	<u>(3,486,776)</u>	
Total shareholders' equity	<u>208,126,055</u>	<u>19</u>
Total liabilities and shareholders' equity	\$ 886,479,733	\$ 84
	=====	==

See accompanying notes to consolidated financial statements (unaudited).

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

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	Three Months Ended June 30,		Six Months June 30,
	<u>2007</u>	<u>2006</u>	<u>2007</u>
<b>Revenues:</b>			
Direct premiums earned	\$ 55,279,604	\$ 53,240,065	\$ 110,401,913
Assumed premiums earned	1,652,652	-	3,165,152
Ceded premiums earned	<u>(17,522,310)</u>	<u>(17,975,179)</u>	<u>(35,798,872)</u>
Net premiums earned	39,409,946	35,264,886	77,768,193
Net investment income	7,481,950	4,726,070	14,705,895
Net realized gains (losses)	(26,730)	(3,169)	(7,772)
Fee income	748,293	374,439	1,263,918
Other income	<u>15,191</u>	<u>14,016</u>	<u>32,176</u>
Total revenues	<u>47,628,650</u>	<u>40,376,242</u>	<u>93,762,410</u>
<b>Expenses:</b>			
Losses and loss adjustment expenses	23,622,343	21,012,428	47,573,627
Acquisition expenses	7,727,666	6,367,883	13,845,903
Payroll and related expenses	4,521,848	3,991,686	8,676,245
Real estate expenses	271,540	102,461	294,134
Other expenses	2,733,533	2,876,627	6,138,581
Interest expense	821,759	837,623	1,638,166
Minority interest	<u>8,987</u>	<u>(39,174)</u>	<u>124,088</u>
Total expenses	<u>39,707,676</u>	<u>35,149,534</u>	<u>78,290,744</u>
Earnings before income taxes	7,920,974	5,226,708	15,471,666
Income taxes	<u>649,198</u>	<u>599,575</u>	<u>1,107,790</u>
Net earnings	\$ 7,271,776	\$ 4,627,133	\$ 14,363,876
Net earnings per share:			
Basic	\$ <u>0.69</u>	\$ <u>0.65</u>	\$ <u>1.36</u>
Diluted	\$ <u>0.66</u>	\$ <u>0.62</u>	\$ <u>1.31</u>
Weighted Average number of shares outstanding:			
Basic	10,605,708	7,106,393	10,580,917
Diluted	10,974,296	7,498,006	10,952,738

See accompanying notes to consolidated financial statements (unaudited).

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

Six Months  
June 30,

2007

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Net earnings	\$	14,363,876	\$
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Realized losses (gains) on investments		7,772	
Depreciation expense		1,438,847	
Stock based compensation expense		268,773	
Amortization of deferred acquisition costs, net		(3,562,540)	
Amortization of premiums on investments		250,767	
Deferred income taxes		(137,379)	
Change in:			
Accrued investment income		(1,073,824)	
Premiums receivable		(5,832,255)	
Reinsurance recoverable		9,915,313	
Ceded unearned premiums		5,907,543	
Funds held		1,385,329	
Unpaid losses and loss adjustment expenses		27,114,105	
Unearned premiums		(292,821)	
Ceded premiums payable		878,674	
Deferred revenues		1,564	
Deferred rent		324,116	
Accounts payable and accrued expenses		(3,453,881)	
Other, net		<u>(1,845,759)</u>	
Net cash provided by operating activities	\$	45,658,220	

Cash flow from investing activities:

Purchases of fixed maturities	(118,038,130)
Purchases of common stock	(5,169,648)
Purchases of preferred stock	-
Proceeds from sale of fixed maturities	92,543,259
Proceeds from sale of common stock	169,891
Decrease (increase) in short-term investments	5,776,314
Purchase of fixed assets	<u>(2,775,510)</u>
Net cash used in investing activities	\$ (27,493,824)

See accompanying notes to consolidated financial statements (unaudited).

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Continued from page 4

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

	Six Months Ended <u>June 30,</u>	
	<u>2007</u>	<u>2006</u>
Cash flow from financing activities:		
Proceeds from issuance of common stock	<u>1,130,913</u>	<u>47,088,000</u>
Net cash used in financing activities	<u>1,130,913</u>	<u>47,088,000</u>

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Net increase (decrease) in cash and cash equivalents	19,295,309	4,149,7
Cash and cash equivalents at beginning of period	<u>11,293,296</u>	<u>23,289,9</u>
Cash and cash equivalents at end of period	\$ 30,588,605	\$ 27,439,6
Supplemental disclosure of cash flow:		
Income taxes paid	\$ -	\$ 1,541,
Interest paid	\$ 1,565,006	\$ 1,733,
Non-cash activity (1)		
Fixed asset additions	\$ 1,409,340	\$
Deferred rent	\$ 1,409,340	\$

(1) Represents tenant build out allowance and future reduction in rent over the term of the lease.

See accompanying notes to consolidated financial statements (unaudited).

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American Safety Insurance Holdings, Ltd. and Subsidiaries

Consolidated Statements of Comprehensive Income  
(unaudited)

	Three Months Ended		S
	<u>June 30,</u>		
	<u>2007</u>	<u>2006</u>	<u>200</u>
Net earnings	\$ 7,271,776	\$ 4,627,133	\$ 14,36
Other comprehensive income before income taxes:			
Unrealized losses on securities available for sale, net of minority interest of \$(110,455) and \$(167,259) for the three months ended June 30, 2007 and 2006, respectively, and \$(94,508) and \$(406,535) for the six months ended June 30, 2007 and 2006, respectively.	(6,374,553)	(4,071,054)	(4,984
Unrealized (losses) gains on hedging transactions	(22,533)	31,686	(96
Reclassification adjustment for realized losses (gains) and included in net earnings	<u>27,111</u>	<u>3,169</u>	<u>8</u>
Total other comprehensive loss before taxes	(6,369,975)	(4,036,199)	(5,072
Income tax benefit related to items of other comprehensive income, net of minority interest of \$(32,505) and \$(57,869) for the three months ended June 30, 2007 and 2006 respectively, and \$(25,022) and \$(139,221) for the six months ended June 30, 2007 and 2006, respectively.	<u>(1,235,218)</u>	<u>(864,677)</u>	<u>(1,044</u>

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Other comprehensive loss net of income taxes	(5,134,757)	(3,171,522)	(4,027,000)
Total comprehensive income	\$2,137,019	\$ 1,455,611	\$ 10,336,000
	=====	=====	=====

See accompanying notes to consolidated financial statements (unaudited).

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**American Safety Insurance Holdings, Ltd. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**June 30, 2007**  
**(unaudited)**

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

The accompanying consolidated financial statements of American Safety Insurance Holdings, Ltd. ( American Safety Insurance ) and its subsidiaries and American Safety Risk Retention Group, Inc. ( American Safety RRG ), a non-subsidiary 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 six months ended June 30, 2007 may not be indicative of the results that may be expected for the fiscal year ending December 31, 2007. These unaudited interim consolidated financial statements and notes should be read in conjunction with the financial statements and notes included in the audited consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

The unaudited interim consolidated financial statements include the accounts of American Safety Insurance, each of its subsidiaries and American Safety RRG. All significant intercompany balances have been eliminated.

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### **Note 2 Accounting Pronouncements**

In February 2007, the FASB issued Statement of Financial Accounting Standards Number 159, The Fair Value Option for Financial Assets and Liabilities. This statement allows companies to elect to carry the vast majority of financial assets and liabilities at fair value, with changes in fair value recorded into earnings. This statement is effective for fiscal years beginning after November 15, 2007. The Company has chosen not to early adopt this pronouncement.

### **Note 3 Nature of Operations**

We are a specialty insurance and reinsurance company that provides customized insurance and reinsurance products and solutions to small and medium-sized business in industries that we believe are underserved by the standard market. For over twenty years 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 risks, construction risks and other specialty risks and providing reinsurance. See Part II Other Information, Item

IA for risks facing the Company.

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**Note 4 Investments**

The amortized cost and estimated fair values of the Company's investments at June 30, 2007 and December 31, 2006 were as follows:

	Amortized <u>cost</u>	Gross unrealized <u>gains</u>	Gross unrealized <u>losses</u>
June 30, 2007:			
Securities available for sale:			
Fixed maturities:			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$ 115,146,652	\$ 167,493	\$ 1,694,592
States of the U.S. and political subdivisions of the States	7,566,890	12,548	346,491
Corporate securities	162,991,812	510,653	2,309,501
Mortgage-backed securities	<u>232,061,823</u>	<u>159,894</u>	<u>4,834,213</u>
Total fixed maturities:	517,767,177	850,588	9,184,797
	=====	=====	=====
Common stock	\$ 15,258,395	\$ 3,386,587	\$ 292,796
	=====	=====	=====
Preferred stock	\$ 7,906,620	\$ 75,140	\$ 48,748
	=====	=====	=====
Total	\$ 540,932,192	\$ 4,312,315	\$ 9,526,341
	=====	=====	=====
December 31, 2006:			
Securities available for sale:			
Fixed maturities:			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$ 123,390,583	\$ 368,236	\$ 1,378,807
States of the U.S. and political subdivisions of the States	7,584,447	42,338	238,041
Corporate securities	131,469,859	814,574	812,477
Mortgage-backed securities	<u>230,080,072</u>	<u>731,214</u>	<u>2,020,332</u>
Total fixed maturities:	\$ 492,524,961	\$ 1,956,362	\$ 4,449,657
	=====	=====	=====
Common stock	\$ 10,258,638	\$ 2,491,431	\$ 347,112
	=====	=====	=====
Preferred stock	\$ 7,906,620	\$ 221,830	\$ 10,390
	=====	=====	=====
Total	\$ 510,690,219	\$ 4,669,623	\$ 4,807,159
	=====	=====	=====

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**Note 5 Segment Information**



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We segregate our business into insurance operations and other, with the insurance operations segment being further classified into four additional segments: excess and surplus lines (E&S), alternative risk transfer (ART), assumed reinsurance (Assumed Re) and runoff. E&S is further classified into six business lines: property, environmental, construction, non-construction, excess and surety. ART is further classified into two business lines: specialty programs and fully funded. Run-off includes lines of business that we no longer write. Prior year amounts have been reclassified to conform to the current year presentation.

Within the E&S sub segment, our environmental insurance coverages protect against environmental exposures for contractors in the environmental remediation industry and property owners. Construction provides commercial casualty insurance coverages, generally for residential and commercial contractors. Non-construction offers general liability and product liability coverages for smaller manufacturers and distributors, non-habitational real estate and certain real property owner, landlord and tenant risks. Excess provides excess and umbrella liability coverages over our own and other carriers' primary casualty policies, with a focus on construction risks. Surety provides payment and performance bonds primarily to the environmental remediation and construction industries.

In our Assumed Re segment, the Company assumes specialty property and casualty business from unaffiliated insurers and reinsurers.

In our ART segment, Specialty Programs facilitates the offering of insurance to homogeneous niche groups of risks. Fully funded provides a mechanism for insureds to post collateral so as to fully self-insure their risks. In addition we offer a partially funded product complementing our fully funded product and allowing our customers to partially self-insure their risks. We are paid a fee for arranging this type of transaction and, in the case of partially funded business, we may assume some underwriting risks.

Our Run-off segment includes lines of business that we have placed in run-off, such as workers' compensation, excess liability insurance for municipalities and commercial lines.

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

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The following table presents key financial data by segment for the three months ended June 30, 2007 and June 30, 2006 (in thousands of \$ US):

June 30, 2007	Insurance						Assumed Re	ART	Run
	Prop	Env.	Const.	E&S Non-Const.	Excess	Surety			
Gross premiums written	233	11,844	16,929	2,048	1,227	1,476	8,742	15,352	-
Net premiums written	156	9,363	16,811	1,024	156	1,467	8,742	6,747	-
Net premiums earned	7	10,024	18,895	482	184	1,156	1,653	7,009	-
Fee income earned	-	-	-	-	-	-	-	-	748
Losses & loss adjustment expenses	4	5,671	11,985	314	119	404	1,184	3,941	-
Acquisition expenses	-	2,548	3,449	310	(100)	304	345	872	-
Underwriting profit (loss)	3	1,805	3,461	(142)	165	448	124	2,196	748
Income tax expense (benefit)	-	-	-	-	-	760	-	-	-

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June 30, 2006									
Insurance									
		E&S			Assumed Re		ART		
	Prop	Env.	Const.	Non-Const.	Excess	Surety	Assumed Re	Specialty Programs	FF
Net earnings (loss)	-								7,459
Gross premiums written	-	14,243	24,297	547	858	1,085	-	20,576	-
Net premiums written	-	11,736	23,033	547	214	643	-	5,463	-
Net premiums earned	-	9,040	20,957	24	117	431	-	4,696	-
Fee income earned	-	-	-	-	-	-	-	-	375
Losses & loss adjustment expenses	-	4,479	13,522	16	70	151	-	2,774	-
Acquisition expenses	-	2,371	3,985	5	(18)	64	-	(39)	-
Underwriting profit (loss)	-	2,190	3,450	3	65	216	-	1,961	375
Income tax expense (benefit)	-					647			
Net earnings (loss)	-					4,684			

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The following table presents key financial data by segment for the six months ended June 30, 2007 and June 30, 2006 (in thousands of \$ US):

June 30, 2007									
Insurance									
		E&S			Assumed Re		ART		
	Prop.	Env.	Const.	Non-Const.	Excess	Surety	Assumed Re	Specialty Programs	FF
Gross premiums written	233	24,982	32,922	2,859	3,196	2,786	11,511	34,785	
Net premiums written	156	20,111	32,513	1,429	417	2,737	11,511	14,435	

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Net premiums earned	7	19,549	39,261	943	411	2,071	3,165	12,361	
Fee income earned									1,
Losses & loss adjustment expenses	4	11,309	24,975	613	267	724	2,192	7,490	
Acquisition expenses	-	4,882	7,251	(20)	(187)	535	645	740	
Underwriting profit (loss)	3	3,358	7,035	350	331	812	328	4,131	1,
Income tax expense (benefit)	-					1,228			
Net earnings (loss)	-					14,546			
Assets	-					886,416			
Equity	-					208,093			

June 30, 2006

Insurance

				E&S		Assumed Re	ART		
	Prop.	Env.	Const.	Non-Const.	Excess	Surety	Assumed Re	Specialty Programs	FF
Gross premiums written	-	26,884	46,749	547	1,469	1,955	-	36,922	
Net premiums written	-	19,808	43,218	547	382	1,083	-	9,988	
Net premiums earned	-	17,360	41,871	24	239	783	-	9,678	
Fee income earned	-	-	-	-	-	-	-	-	8
Losses & loss adjustment expenses	-	10,174	27,007	16	143	276	-	5,851	
Acquisition expenses	-	5,012	8,159	5	(50)	152	-	144	
Underwriting profit (loss)	-	2,174	6,705	3	146	355	-	3,683	8
Income tax expense (benefit)	-					606			
Net earnings (loss)	-					8,547			
Assets	-					768,498			
Equity	-					167,952			

Our Bermuda corporations conduct business in Bermuda and our U.S. corporations conduct business in the U.S. 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 provides key measurable information about the geographic segments for the three months ended June 30, 2007 and June 30, 2006 (in thousands of \$ US):

<b>June 30, 2007</b>	<b>United States</b>	<b>Bermuda</b>
Income tax	649	-
Net earnings	1,259	6,013
<b>June 30, 2006</b>	<b>United States</b>	<b>Bermuda</b>
Income tax	600	-
Net earnings	1,705	2,922

The following table provides key financial data about the geographic segments for the six months ended June 30, 2007 and June 30, 2006 (in thousands of \$ US):

<b>June 30, 2007</b>	<b>United States</b>	<b>Bermuda</b>	<b>Total</b>
Income tax	1,108	0	1,108
Net earnings	2,123	12,241	14,364
Assets	527,060	359,420	886,480
Equity	69,120	139,006	208,126
<b>June 30, 2006</b>	<b>United States</b>	<b>Bermuda</b>	<b>Total</b>
Income tax	616	-	616
Net earnings	2,751	5,977	8,728
Assets	545,236	225,148	770,384
Equity	58,373	110,127	168,500

## Note 6 Income Taxes

Total income tax expense for the periods ended June 30, 2007 and 2006 was allocated as follows:

	Three Months Ended		Six Months
	<u>2007</u>	<u>June 30,</u> <u>2006</u>	<u>2007</u>
Tax expense attributable to:			
Income from continuing operations	\$ 649,198	\$ 599,575	\$ 1,107,790
Change in unrealized gains/(losses) on hedging transactions	(7,661)	10,433	(32,791)
Change in unrealized gains/(losses) on securities available for sale	<u>(1,260,062)</u>	<u>(932,979)</u>	<u>(1,037,078)</u>
Total	\$ (618,525)	\$ (322,971)	\$ 37,921
	=====	=====	=====

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	<u>Current</u>	<u>Deferred</u>	Change Valuation Allowance
Three months ended:			
June 30, 2007	\$ 948,856	\$ (221,533)	\$ (7)
June 30, 2006	\$ 1,572,959	\$ (973,384)	\$
Six months ended:			
June 30, 2007	\$ 1,375,949	\$ (137,379)	\$ (13)
June 30, 2006	\$ 1,449,797	\$ (834,022)	\$

The state income tax benefit aggregated \$16,783 and \$20,882 for the three months ended June 30, 2007 and 2006, respectively, and \$8,429 and \$5,714 for the six months ended June 30, 2007 and 2006, respectively. The state income tax provision.

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Income tax expense for the periods ended June 30, 2007 and 2006 differed from the amount that would have been recorded if the United States Federal income tax rate of 34% to earnings before Federal income taxes as a result of the

	Three Months Ended		Six Months Ended	
	<u>June 30,</u>		<u>June 30,</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Expected income tax expense	\$ 2,693,135	\$ 1,777,081	\$ 5,260,370	\$
Foreign earned income not subject to U.S. taxation	(2,044,379)	(993,431)	(4,161,879)	
Change in Valuation allowance	(78,125)	-	(130,780)	
Tax-exempt interest	-	(166,607)	-	
State taxes and other	<u>78,567</u>	<u>(17,468)</u>	<u>140,079</u>	
	\$ 649,198	\$ 599,575	\$ 1,107,790	\$
	=====	=====	=====	

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The Company adopted the provisions of FIN 48 on January 1, 2007. In completing its FIN 48 analysis, the Company determined that it did not have any liability for unrecognized tax benefits. The Company does not believe it would be subject to any penalties in any open tax years and, therefore, has not booked any such amounts. The Company would classify interest (if applicable) as interest expense and penalties (if applicable) in other expenses in the Company's financial statements.

### Note 7 Employee Stock Options

The Company's stock option plan grants incentive stock options to employees. The majority of the options outstanding under the plan 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's methodology for valuing options has not changed from December 31, 2006. During the first six months of 2007, the Company granted 67,500 options compared to 54,000 for the same period of 2006. No options were granted for the three months ended June 30, 2007 and 2006 respectively.

The Company started applying the recognition and measurement principles of SFAS No. 123R, Share Based Payment, in the first quarter of 2006. For the three months ended June 30, 2007 and 2006, stock based compensation expense was \$142,677 and \$158,685, respectively. Stock based compensation expense was \$268,773 and \$299,241 for the first six months of 2007 and 2006, respectively, and is reflected in net earnings under payroll and related expenses.

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

We are a specialty insurance and reinsurance company that provides customized insurance and reinsurance products and solutions to small and medium-sized businesses in industries that we believe are underserved by the standard insurance market. For over twenty years, 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 risks and construction risks as well as in developing programs for other specialty classes of risks and providing reinsurance.

We segregate our business into insurance operations and other, with the insurance operations segment further classified into four additional segments: excess and surplus lines, alternative risk transfer, runoff and a new segment, assumed reinsurance. The excess and surplus lines segment is then further classified into six business lines: property, environmental, construction, surety, non-construction and excess. The alternative risk transfer segment is further classified into two business lines: specialty programs and fully funded and partially funded. Assumed reinsurance, which began operations in the first quarter of 2007, consists of specialty property and casualty business assumed from unaffiliated insurers and reinsurers. Our run-off segment includes lines of business that we have placed in run-off, such as workers' compensation, excess liability insurance for municipalities and commercial lines. Our other segment consists of amounts associated with realized gains and losses on investments.

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.

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

	Three Months		Six Months		Three Months Ended June 2007
	Ended June 30,		Ended June 30,		
	2007	2006	2007	2006	2007
(Dollars in thousands)					
<b>Net premiums written:</b>					
Excess and Surplus Lines					
Environmental	\$ 9,363	\$ 11,736	\$ 20,111	\$ 19,808	(2)
Construction	16,811	23,033	32,513	43,218	(2)
Non-construction	1,024	547	1,429	547	8
Property	156	-	156	-	10
Excess	156	214	417	382	(2)
Surety	<u>1,467</u>	<u>643</u>	<u>2,737</u>	<u>1,083</u>	<u>12</u>
Total	28,977	36,173	57,363	65,038	(2)
Alternative Risk Transfer					
Specialty Programs	<u>6,747</u>	<u>5463</u>	<u>14,435</u>	<u>9,988</u>	<u>2</u>
Assumed Reinsurance	<u>8,742</u>	<u>-</u>	<u>11,511</u>	<u>-</u>	<u>1</u>
<b>Total net premiums written</b>	\$ 44,466	\$ 41,636	\$ 83,309	\$ 75,026	==
<b>Net premiums earned:</b>					
Excess and Surplus Lines					
Environmental	\$ 10,024	\$ 9,040	\$ 19,549	\$ 17,360	1
Construction	18,895	20,957	39,261	41,871	(1)
Non-construction	482	24	943	24	1,90
Property	7	-	7	-	10
Excess	184	117	411	239	5
Surety	<u>1,156</u>	<u>431</u>	<u>2,071</u>	<u>783</u>	<u>16</u>
Total	\$ 30,748	\$ 30,569	62,242	60,277	

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Alternative Risk Transfer					
Specialty Programs	<u>7,009</u>	<u>4,696</u>	<u>12,361</u>	<u>9,678</u>	<u>4</u>
Assumed Reinsurance	<u>1,653</u>	<u>-</u>	<u>3,165</u>	<u>-</u>	<u>10</u>
<b>Total net premiums earned</b>	\$ 39,410	\$ 35,265	\$ 77,768	\$ 69,955	1
Net investment income	7,482	4,726	14,706	9,270	5
Net realized gains (losses)	(27)	(3)	(8)	360	(80)
Fee income	748	374	1,264	867	10
Other income	<u>15</u>	<u>14</u>	<u>32</u>	<u>30</u>	<u>1</u>
<b>Total Revenues</b>	\$ 47,628	\$ 40,376	\$ 93,762	\$ 80,482	\$ 1
	=====	=====	=====	=====	=====

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

	Three months ended <u>June 30,</u>		Six months ended <u>June 30,</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Insurance operations:				
Loss and loss adjustment expense ratio	59.9%	59.6%	61.2%	61.7%
Expense ratio	<u>34.5</u>	<u>35.7</u>	<u>33.8</u>	<u>35.6</u>
Combined ratio.....	94.4%	95.3%	95.0%	97.3%
	====	====	====	====

**Three Months Ended June 30, 2007 compared to  
Three Months Ended June 30, 2006**

**Net Premiums Earned**

*Excess and Surplus Lines*

*Environmental.* Net premiums earned increased 11% to \$10.0 million for the three months ended June 30, 2007, compared to \$9.0 million for the same period 2006. The Company has experienced rate declines in the environmental line in 2007.

*Construction.* Net premiums earned decreased 10% to \$18.9 million for the three months ended June 30, 2007, compared to \$20.9 million for the same period in 2006. During the quarter, the Company saw a significant decline in its western states book of business due primarily to increased competition, partially offset by geographic diversification outside of western states. The effects of a slowing housing market translated into lower average premiums per account and a reduction in audit premiums also contributed to the decline. In addition construction premiums were further impacted by rate declines.

*Non-Construction.* Net premiums earned increased to \$482,000 for the three months ended June 30, 2007, compared to \$24,000 for the same period in 2006. This product began production in the second half of 2006. This line offers both primary and excess products to smaller manufacturers, distributors, non-habitational real estate and certain real property owner, landlord and tenant risks.

*Property.* The Company's property general liability line, which began production in June 2007, produced \$7,000 in net premiums earned for the three months ended June 30, 2007.

*Excess.* Net premiums earned increased 57% to \$184,000 for the three months ended June 30, 2007 as compared to \$117,000 for the same period of 2006. The Company's excess product offering is focused primarily in the construction and products liability areas. The addition of a new underwriting team in Middletown, New Jersey has allowed the Company to expand its excess liability products to write over other carriers primary policies and to offer umbrella liability coverage.

*Surety.* Net premiums earned increased 168% to \$1.2 million for the three months ended June 30, 2007 as compared to \$0.4 million for the same period of 2006. Effective June 1, 2006 the Company did not renew the quota share reinsurance agreement resulting in an increase in net premiums earned. The increase in surety premiums is also due to the Company's continuing to focus its growth efforts in the environmental contractor surety market because of the lack of capacity serving this segment of the market.

*Alternative Risk Transfer.*

*Specialty programs.* Net premiums earned increased 49% to \$7 million for the three months ended June 30, 2007 as compared to \$4.7 million for the same period in 2006. Net premiums earned increased primarily due to increased retention levels, thereby allowing the Company the opportunity to increase its earnings potential from underwriting profits.

*Fee Income Earned.* Fee income earned on fully funded policies increased 100% to \$748,000 for the three months ended June 30, 2007 as compared to \$374,000 for the same period of 2006. The Company has seen some adverse impact from the overall market softening in its production efforts in this line as declines in traditional insurance pricing provides a cost effective alternative to self-insurance.

The Company introduced a partially funded product during the fourth quarter of 2006 to complement its fully funded product. This product is used for entities that want to self-insure a portion of their risk and combines a level of indemnity risk with a self-insured component. This is a new product and there were no fees generated in the current quarter of 2007.

*Assumed Reinsurance.* The Company, through its Bermuda based reinsurance operation, assumes specialty property and casualty business from unaffiliated insurers and reinsurers. For the three months ended June 30, 2007 the Company generated \$1.7 million in net premiums earned in this line of business. The Company has entered into small participations on several treaties, covering directors and officers' liability, property catastrophe and excess auto liability.

#### **Net Investment Income**

Net investment income increased 58% to \$7.5 million for the three months ended June 30, 2007 as compared to \$4.7 million for the same period of 2006. This increase was due to an increase in invested assets and higher investment yields. Average invested assets increased to \$569.9 million at June 30, 2007 from \$429.3 million at June 30, 2006 due to a secondary offering in June 2006, which raised \$53 million, and positive cash flows from operations. The average pre-tax and after-tax investment yields were 5.3% and 4.4% compared to 4.5% and 3.7% for the three months ended June 30, 2007 and 2006 respectively.

#### **Net Realized Gains (Losses)**

Net realized losses from the sale of investments increased to \$27,000 for the three months ended June 30, 2007, compared to \$3,000 for the same period of 2006. The Company, from time to time, may sell securities to fund the cash needs of individual operating subsidiaries or in response to market conditions or interest rate fluctuations in accordance with its investment guidelines.

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

The Company's loss and loss adjustment expense ratio remained relatively flat at 59.9% for the three months ended June 30, 2007, as compared to 59.6% for the same period of 2006. In 2007, the Company increased its expected loss ratio on certain lines of business to reflect softening conditions.

#### **Acquisition Expenses**

Policy acquisition expenses are amounts that are paid to producers of premiums. These expenses are offset in part by the ceding commissions we receive from our reinsurers. For our program business, fees typically are earned through ceding commissions and have the effect of lowering our



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acquisition expenses. Policy acquisition expenses increased to \$7.7 million for the three months ended June 30, 2007 as compared to \$6.4 million for the same period of 2006, and, as a percentage of net premiums earned, increased to 19.6% for the three months ended June 30, 2007, compared to 18.1% for the same period of 2006. The increase in the ratio is due to increased retentions and the change in the mix of business in the Company's premium writings.

### Payroll and Other Expenses

Payroll and other expenses increased 6% to \$7.3 million for the three months ended June 30, 2007, as compared to \$6.9 million for the same period of 2006. The increase is due to normal annual salary increases and an increase in head count, which is primarily related to the addition of a claims handling office in California and an underwriting office in New Jersey. In addition, the Company had an increase in rent expense and depreciation which was partially offset by a lower provision for doubtful accounts.

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### Income Taxes

Income tax expense for the three months ended June 30, 2007 was 8.2% of pre-tax income as compared to 11.5% for the same period of 2006. The lower tax rate is primarily due to a larger percentage of the Company's profits being earned in Bermuda than was the case for the 2006 quarter.

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## Six Months Ended June 30, 2007 compared to Six Months Ended June 30, 2006

### Net Premiums Earned

#### *Excess and Surplus Lines.*

*Environmental.* Net premiums earned increased 13% to \$19.5 million for the six months ended June 30, 2007, as compared to \$17.4 million for the same period of 2006. The accrual of \$1.8 million of reinstatement premiums resulting from the settlement of a prior year claim negatively impacted net premiums earned in 2006. Without this 2006 accrual, net premiums earned were essentially flat period to period as the Company has experienced rate declines in its environmental line in 2007.

*Construction.* Net premiums earned decreased 6% to \$39.3 million for the six months ended June 30, 2007 as compared to \$41.9 million for the same period in 2006. The Company has seen a significant decline in its western states book of business, partially offset by geographic diversification efforts. The principal reason driving the decline was lower renewal retention rates in the western states as the Company continues to exercise underwriting discipline in a more competitive market. The effects of a slowing housing market translated into lower average premiums per account and a reduction in audit premiums also contributed to the decline. This line was further impacted by rate declines.

*Non-Construction.* Net premiums earned increased to \$943,000 for the six months ended June 30, 2007 as compared to \$24,000 for the same period of 2006. This product began operation in the second half of 2006. This line offers both primary and excess products to smaller manufacturers, distributors, non-habitational real estate and certain owner, landlord and tenant risks.

*Property.* The Company's property general liability line, which began production in June 2007, produced \$7,000 in net premiums earned for the six months ended June 30, 2007.

*Excess.* Net premiums earned increased 72% to \$411,000 for the six months ended June 30, 2007 as compared to \$239,000 for the same period of 2006. The Company's excess product offering is focused primarily in the construction and product liability areas. The addition of the underwriting team in New Jersey in 2006 has allowed the Company to expand its excess liability products to write over other carriers' primary policies and to offer umbrella liability coverage.

**Surety.** Net premiums earned increased 165% to \$2.1 million for the six months ended June 30, 2007 as compared to \$0.8 million for the same period of 2006. Effective June 1, 2006 the Company did not renew the quota share reinsurance treaty in its surety line, resulting in an increase in net retentions and, as a result, an increase in net premiums earned. The increase in surety premiums is also due to the Company continuing to focus its growth efforts in the environmental contractor surety market because of the lack of capacity serving this segment of the market.

*Alternative Risk Transfer.*

**Specialty Programs.** Net premiums earned increased 28% to \$12.4 million for the six months ended June 30, 2007 as compared to \$9.7 million for the same period of 2006. Net premiums earned increased due primarily to increased retention levels, thereby allowing the Company the opportunity to increase its earnings potential from underwriting profits.

**Fee Income Earned.** Fee income earned on fully funded policies increased 46% to \$1.3 million for the six months ended June 30, 2007 as compared to \$0.9 million for the same period of 2006. The Company has seen some adverse impact from the overall market softening on its production efforts in this line as the decline in traditional insurance pricing provides a cost effective alternative to self-insurance.

The Company introduced a partially funded product in 2006 to complement the fully funded product. This product is used for entities that want to self-insure a portion of their risk and combines a level of underwriting risk with a self-insured component. This is a new product and no fees have been earned in 2007.

**Assumed Reinsurance.** The Company, through its Bermuda based reinsurance operation, assumes specialty property and casualty business from unaffiliated insurers and reinsurers. For the first six months of 2007, the Company has entered into small participations on several treaties, including treaties covering directors and officers liability, property catastrophe and excess auto liability. This line of business generated \$3.2 million in net premiums earned for the six months ended June 30, 2007.

### **Net Investment Income**

Net investment income increased 59% to \$14.7 million for the six months ended June 30, 2007 as compared to \$9.3 million for the same period of 2006, due to an increase in the Company's invested assets and higher investment yields. Average invested assets increased to \$560.9 million at June 30, 2007 from \$440.3 million at June 30, 2006, reflecting \$53 million of proceeds from the Company's secondary equity offering in June 2006 and positive cash flow from operations. The average pre-tax and after-tax investment yields were 5.2% and 4.4% compared to 4.2% and 3.5% for the six months ended June 30, 2007 and 2006 respectively.

### **Net Realized Gains (Losses)**

Net realized gains from the sale of investments decreased to a net loss of \$8,000 for the six months ended June 30, 2007, compared to net gains of \$360,000 for the same period of 2006. The Company, from time to time, may sell securities to fund the cash needs of individual operating subsidiaries or in response to market conditions or interest rate fluctuations in accordance with its investment guidelines.

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

The Company's loss and loss adjustment expense ratio remained relatively flat at 61.2% for the six months ended June 30, 2007 compared to 61.7% for the same period of 2006. In 2006, the accrual of \$1.8 million of reinstatement premiums resulting from the settlement of a prior year claim negatively impacted net premium earned, which in turn negatively impacted the loss ratio. In addition in 2006, the Company experienced adverse loss development of \$688,000. This development was primarily related to a prior year New York claim. In 2007, due to the softening market, the Company increased its expected loss ratio.

### **Acquisition Expenses**

Policy acquisition expenses are amounts that are paid to producers of premiums. These expenses are affected in part by the ceding commissions we receive from our reinsurers. For our program business, fees typically are earned through ceding commissions and have the affect of lowering acquisition expenses. Policy acquisition expenses remained flat at \$13.8 million for the six months ended June 30, 2007, compared to \$13.4 million for the same period of 2006, and, as a percentage of net premiums earned, decreased to 17.8% for the six months ended June 30, 2007 compared to 19.2% for the same period in 2006. The decrease in the acquisition expense ratio is due to increased retentions, the change in mix of business in the Company's premium writings and lowered net premiums earned in 2006 as the Company accrued \$1.8 million in reinstatement premiums.

#### **Minority Interest Expense**

Minority interest expense is associated with the Company's non-subsidiary affiliate, American Safety RRG. The minority interest expense was \$124,000 for the six months ended June 30, 2007, compared to (\$511,000) for the same period of 2006. The driver of the change was that, in 2006, American Safety RRG included in expenses \$764,000 related to the settlement of a prior year claim.

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#### **Payroll and Other Expenses**

Payroll and other expenses increased 12.7% to \$14.8 million for the six months ended June 30, 2007, compared to \$13.1 million for the same period of 2006. The change is due to an increase in head count, which is primarily related to the addition of a claims handling office in California and an underwriting office in New Jersey, normal annual salary increases and increases in rent expense, depreciation expense and costs associated with the relocation of our U.S. subsidiaries.

#### **Income Taxes**

Income tax expense for the first six months of 2007 was \$1.1 million or 7.2% of pre-tax income, compared to \$615,000 or 6.6% of pre-tax income for the same period of 2006. In 2006, the tax rate was lower due to the settlement of a prior year claim, resulting in a \$2.8 million pre-tax charge incurred by the Company's U.S. subsidiaries.

#### **Liquidity and Capital Resources**

The Company meets its cash requirements and finances its growth principally through cash flows generated from operations. The Company is currently operating in a softening market and as a result, has been experiencing a decline in premium rates due to the entrance of new insurance competitors and overall market conditions. The Company's 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, the Company's future liquidity requirements may vary; therefore, the Company has structured its investment portfolio maturities to help mitigate the variations in those factors. The Company believes its current cash flows are sufficient for the short-term needs of its business and its invested assets are sufficient for the long-term needs of its insurance business.

Net cash provided from operations was \$45.7 million for the six months ended June 30, 2007 and \$32.3 million for the same period of 2006. This increase primarily was attributable to higher net investment income and lower loss payments, which decreased to \$6.4 million for the six months ended June 30, 2007 from \$22.2 million for the same period of 2006.

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.

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## Income Taxes

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

## Combined Ratio

Our underwriting results are best indicated by our GAAP combined ratio, which is the sum of (a) the ratio of incurred losses and settlement expenses to net premiums earned (loss ratio) and (b) the ratio of policy acquisition costs and other operating expenses to net premiums earned (expense ratio). A combined ratio below 100% indicates that a company has an underwriting profit, and a combined ratio above 100% indicates an insurer has an underwriting loss. Our reported expense ratio excludes certain holding company expenses such as interest expense as well as real estate and fee income.

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

- o conditions in the insurance markets served by the Company as well as general economic conditions and other factors, including prevailing interest rate levels and stock market performance, which may affect our ability to sell our insurance products and services, the market value of our investments and the lapse rate and profitability of our policies;
- o the availability and terms of future strategic acquisitions;

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- o changes in the federal income tax laws and regulations which may affect the relative tax advantages of some of our products;
  - o legal or regulatory changes or actions, including those relating to the underwriting of insurance products, regulation of the sale, underwriting and pricing of insurance products and services;
  - o our ability to maintain or improve our current rating by A.M. Best Company ("A.M. Best");
  - o expectations regarding the adequacy of our reserves for losses and loss adjustment expenses;
  - o our ability to leverage our relationships with producers;
  - o our areas of projected growth, growth opportunities and growth strategy;
  - o our ability to expand our information technology capabilities;
  - o the diversification of our insurance risk portfolio; and
  - o our future liquidity requirements.

Actual results may differ materially from the results suggested by the forward-looking statements for a number of reasons. 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.

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

For a in-depth discussion of the Company's market risks, see Management's Discussion and Analysis of Quantitative and Qualitative Disclosures about Market Risk in Item 7A of the Company's Form 10-K for the year ended December 31, 2006 and Part II Other Information, Item 1A-Risk Factors 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.

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## **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.

*City Automotive and Oak Services.* The plaintiffs in these two cases were dealers and marketers of extended vehicle service contracts insured by National Warranty Risk Retention Group. As previously disclosed, we entered into an arbitration agreement with the plaintiffs in exchange for a dismissal of all ASI parties from the pending litigation. The arbitration agreement provided for a floor and a ceiling on the amount that the arbitrators might ultimately award. As a result of mediation conducted on May 18, 2007, we settled all claims of City Automotive and Oak Services. The settlement amount was within the range of limits set by the arbitration agreement and was fully reserved.

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

Marina, Inc., to the detriment of their loans and to our benefit, and thus, we had entered into a quasi-contract with the plaintiffs to repay their loan with interest.

We filed an appeal in December 2005, and oral argument on our appeal was heard on December 5, 2006. On May 18, 2007, the District Court of Appeal of the State of Florida, Fifth District, reversed the judgment against the Company. The plaintiffs filed a motion for rehearing with the Appeals Court, which motion was denied by the Court on July 6, 2007.

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

Our business is subject to a number of risks and uncertainties. These risks and uncertainties are described in detail in our Form 10-K for the year ended December 31, 2006, that is on file with the SEC. Some of these risks are highlighted below.

##### **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. Additionally, many producers are prohibited by their internal guidelines from representing insurance companies that are rated below A- (Excellent) by A.M. Best. 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 and/or with limited geographic dispersion.**

We focus much of our underwriting on specialty risks in the construction and environmental remediation industries and our construction business has been concentrated in the western states. For the year ended June 30, 2007, approximately 51.1% of our gross premiums written were in these two industries and we have experienced a significant decline in our western states construction business. We plan to increase our retention of risk in these areas. 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 or geographic locations. Similarly, a significant incident impacting one of these industries or the western states that has the effect of increasing claims generally (or their settlement value) could negatively impact our financial condition and operating results.

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##### **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 in a soft 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.

**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 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.

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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 have increased 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.

We are subject to risks related to litigation.

From time to time, we are subject to lawsuits and other claims arising out of our business 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.

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.

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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.

**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. As of, and for the six months ended June 30, 2007, the fair value of our investment portfolio was \$570.5 million and our income derived from these assets was \$14.7 million, or 95.1% of our pre-tax earnings. Our investment portfolio is subject to various risks, including:

- o credit risk, which is the risk that our invested assets will decrease in value due to unfavorable changes in the financial prospects or a downgrade in the credit rating of an entity in which we have invested;
- o interest rate risk, which is the risk that our invested assets may decrease in value due to changes in interest rates;
- o equity price risk, which is the risk that we will incur economic loss due to a decline in equity prices; and
- o duration risk, which is the risk that our invested assets may not adequately match the duration of our insurance 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.

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

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

**U.S. persons who hold our 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 of our common shares (directly or indirectly through foreign entities) on the last day of the taxable year would be required to include in its income for U.S. federal income tax purposes that person's pro rata share of that company's RPII for the entire taxable year, determined as if that RPII were distributed proportionately only to U.S. persons at that date regardless of whether that income is distributed. In addition, any RPII that is includible in the income of a U.S. tax-exempt organization may be treated as unrelated business taxable income. Neither American Safety Re nor American Safety Assurance expects gross RPII to equal or exceed 20% of its gross income for 2006 or subsequent years, and neither expects its direct or indirect insureds



(including related persons) to directly or indirectly hold 20% or more of its voting power or value, but we cannot be certain that this will be the case because some of the factors which determine the extent of RPII may be beyond our control. If these thresholds are met or exceeded, and if you are an affected U.S. person, your investment could be materially adversely affected. The RPII provisions, however, have never been interpreted by the courts or the U.S. Treasury Department (the Treasury Department) in final regulations, and regulations interpreting the RPII provisions of the Code exist only in proposed form. It is not certain whether these regulations will be adopted in their proposed form or what changes or clarifications might ultimately be made thereto or whether any of those changes, as well as any interpretation or application of RPII by the IRS, the courts or otherwise, might have retroactive effect. The Treasury Department has authority to impose, among other things, additional reporting requirements with respect to RPII. Accordingly, the meaning of the RPII provisions and the application thereof to us is uncertain.

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

If American Safety Insurance is considered a PFIC for U.S. federal income tax purposes, a U.S. person who owns our 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 our common shares, that individual's heirs or estate would not be entitled to a step-up in the basis of the shares which might otherwise be available under U.S. federal income tax laws. American Safety Insurance does not believe that it is, and does not expect to become, a PFIC for U.S. federal income tax purposes. No assurance can be given, however, that American Safety Insurance will not be deemed a PFIC by the IRS. If American Safety Insurance were considered a PFIC, it could have material adverse tax consequences for an investor that is subject to U.S. federal income taxation. There are currently no regulations regarding the application of the PFIC provisions to an insurance company. New regulations or pronouncements interpreting or clarifying these rules may be forthcoming. We cannot predict what impact, if any, that guidance would have on an investor that is subject to U.S. federal income taxation.

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

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

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**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**

None

**Item 5. Other Information**

None.

**Item 6. Exhibits**

The following exhibits are filed as part of this report:

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

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**SIGNATURES**

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 9th day of August 2007.

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)