

AMERICAN SAFETY INSURANCE HOLDINGS LTD  
Form 10-Q  
November 07, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

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**FORM 10 Q**

Ö QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2008

“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  
(State or other jurisdiction  
of incorporation)

Not Applicable  
(I.R.S. Employer  
Identification No.)

The Boyle Building, 2<sup>nd</sup> Floor  
31 Queen Street  
Hamilton, HM 11Bermuda  
(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

Smaller reporting company

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 3, 2008 was 10,279,040.

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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

	September 30, <u>2008</u>	December 31, <u>2007</u>
	(Unaudited)	
<u>Assets</u>		
Investments:		
Fixed maturity securities available for sale,		
at fair value	\$ 528,640,154	\$ 529,569,518
Common stock, at fair value	24,239,770	25,393,664
Preferred stock, at fair value	3,323,300	5,793,165
Short-term investments, at fair value	<u>77,970,554</u>	<u>56,454,862</u>
Total investments	634,173,778	617,211,209
Cash and cash equivalents	10,752,693	12,859,681
Accrued investment income	6,298,913	5,771,983
Premiums receivable	29,320,519	22,851,520
Ceded unearned premiums	40,715,967	30,950,752
Reinsurance recoverable	190,185,627	190,299,574
Deferred income taxes	15,456,881	9,767,816
Deferred policy acquisition costs	18,592,999	16,831,357
Property, plant and equipment, net	10,746,391	9,216,015
Goodwill	9,695,572	2,316,629
Other assets	<u>25,577,952</u>	<u>15,932,723</u>
Total assets	<u>\$ 991,517,292</u>	<u>\$ 934,009,259</u>

Liabilities and Shareholders' Equity

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Liabilities:

Unpaid losses and loss adjustment expenses	\$550,787,544	\$ 504,779,132
Unearned premiums	129,845,518	111,459,142
Ceded premiums payable	31,838,197	15,368,967
Deferred revenues	1,050,075	1,074,238
Accounts payable and accrued expenses	9,134,940	10,004,721
Deferred rent	1,666,113	1,780,213
Funds held	15,871,967	18,509,621
Loans payable	38,899,508	38,645,936
Minority interest	<u>1,507,642</u>	<u>1,986,844</u>
Total liabilities	<u>780,601,504</u>	<u>703,608,814</u>

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	September 30, <u>2008</u>	December 31, <u>2007</u>
	(Unaudited)	
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 September 30, 2008, 10,274,368 and December 31, 2007, 10,703,457		
Additional paid-in capital	102,744	107,034
Retained earnings	100,254,398	106,238,456
Accumulated other comprehensive (loss) earnings, net	127,694,502	119,181,362
Total shareholders' equity	<u>(17,135,856)</u>	<u>4,873,593</u>
	<u>210,915,788</u>	<u>230,400,445</u>
Total liabilities and shareholders' equity	\$ 991,517,292	\$ 934,009,259
Book value per share	\$20.53	\$ 21.53
Diluted book value per share	\$19.94	\$ 20.81

See accompanying notes to consolidated financial statements (unaudited).



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American Safety Insurance Holdings, Ltd. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30, <u>2008</u>	<u>2007</u>	September 30, <u>2008</u>	<u>2007</u>
<b>Revenues:</b>				
Direct premiums earned	\$53,786,053	\$52,211,331	\$148,057,024	\$162,613,244
Assumed premiums earned	13,107,158	2,372,544	35,219,646	5,537,696
Ceded premiums earned	<u>(25,200,797)</u>	<u>(18,012,022)</u>	<u>(55,393,667)</u>	<u>(53,810,894)</u>
Net premiums earned	<u>41,692,414</u>	<u>36,571,853</u>	<u>127,883,003</u>	<u>114,340,046</u>
Net investment income	7,497,249	7,790,710	22,140,282	22,496,605
Net realized losses	(9,153,457)	(80,852)	(8,358,250)	(88,624)
Fee income	499,217	411,129	2,017,468	1,675,047
Other (loss) income	<u>(37,203)</u>	<u>17,873</u>	<u>(6,994)</u>	<u>50,049</u>
Total revenues	<u>40,498,220</u>	<u>44,710,713</u>	<u>143,675,509</u>	<u>138,473,123</u>
<b>Expenses:</b>				
Losses and loss adjustment expenses	25,058,586	21,012,676	77,468,416	68,586,303
Acquisition expenses	9,685,095	7,185,279	30,722,752	21,031,182
Payroll and related expenses	5,729,097	4,319,713	15,974,698	12,995,958
Other underwriting expenses	3,042,097	2,768,468	8,973,911	7,764,803
Interest expense	714,860	846,109	2,370,065	2,484,275
Corporate and other expenses	695,737	697,243	(612,417)	2,133,623
Minority interest	<u>(311,606)</u>	<u>26,178</u>	<u>(159,603)</u>	<u>150,266</u>
Total expenses	<u>44,613,866</u>	<u>36,855,666</u>	<u>134,737,822</u>	<u>115,146,410</u>
(Loss) earnings before income taxes	(4,115,646)	7,855,047	8,937,687	23,326,713
Income taxes	<u>178,952</u>	<u>808,906</u>	<u>421,822</u>	<u>1,916,696</u>
Net (loss) earnings	\$ (4,294,598)	\$ 7,046,141	\$ 8,515,865	\$ 21,410,017
<b>Net (loss) earnings per share:</b>				
Basic	<u>\$(0.42)</u>	<u>\$0.66</u>	<u>\$0.81</u>	<u>\$2.02</u>
Diluted	<u>\$(0.42)</u>	<u>\$0.64</u>	<u>\$0.79</u>	<u>\$1.95</u>



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Weighted average number of shares outstanding:

Basic	10,326,661	10,709,996	10,521,209	10,624,416
Diluted	10,326,661	11,044,340	10,782,741	10,938,607

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)

Nine Months Ended

September 30,  
2008

2007

Cash flow from operating activities:

Net earnings	\$ 8,515,865	\$21,410,017
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Realized losses on investments	8,358,250	88,624
Depreciation expense	3,001,560	2,080,462
Stock based compensation expense	883,514	394,779
Amortization of deferred acquisition costs, net	(1,761,642)	(2,992,356)
Amortization of premiums on investments	386,992	328,207
Deferred income taxes	(1,110,721)	(40,717)
Change in operating assets and liabilities:		
Accrued investment income	(526,930)	(1,081,960)
Premiums receivable	(6,468,999)	(9,604,000)
Reinsurance recoverable	113,945	11,854,793
Ceded unearned premiums	(9,765,215)	5,634,472
Funds held	(2,637,657)	854,273
Unpaid losses and loss adjustment expenses	46,008,414	37,189,602
Unearned premiums	18,386,376	(4,546,262)
Ceded premiums payable	16,469,230	(4,431,878)
Deferred revenues	(24,163)	(217,509)
Accounts payable and accrued expenses	(1,064,125)	(2,846,510)
Deferred rent	(114,100)	409,579
Other, net	<u>(8,468,034)</u>	<u>611,092</u>
Net cash provided by operating activities	<u>\$ 70,182,560</u>	<u>\$ 55,094,708</u>

Cash flow from investing activities:

Purchases of fixed maturities	\$(146,241,497)	\$(175,182,921)
Purchases of common stock	(2,811,572)	(7,736,877)
Proceeds from sale of fixed maturities	117,932,134	129,198,373
Proceeds from sale of equity securities	362,397	1,273,597
Consideration paid for acquired companies	(8,927,052)	-
(Increase) decrease in short-term investments	(21,515,692)	12,007,343
Purchase of fixed assets	<u>(4,228,613)</u>	<u>(3,773,100)</u>
Net cash used in investing activities	<u>\$ (65,429,895)</u>	<u>\$ (44,213,585)</u>

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	Nine Months Ended	
	September 30, <u>2008</u>	<u>2007</u>
Cash flow from financing activities:		
Repurchase of common stock	\$ (7,564,917)	\$ -
Proceeds from exercised stock options	<u>705,264</u>	<u>1,370,907</u>
Net cash (used in) provided by financing activities	<u>(6,859,653)</u>	1,370,907
Net (decrease) increase in cash and cash equivalents	(2,106,988)	12,252,030
Cash and cash equivalents at beginning of period	<u>12,859,681</u>	<u>11,293,296</u>
Cash and cash equivalents at end of period	\$ 10,752,693	\$23,545,326
Supplemental disclosure of cash flow information:		
Income taxes paid	\$ 115,339	\$ 5,000
Interest paid	\$ 1,562,768	\$ 2,358,831
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 Earnings

(Unaudited)

	Three Months Ended		Nine Months Ended	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Net (loss) earnings	\$ (4,294,598)	\$ 7,046,141	\$ 8,515,865	\$ 21,410,017
Other comprehensive (loss) earnings before income taxes:				
Unrealized (losses) gains on securities available-for-sale, net of minority interest of \$(222,068) and \$64,385 for the three months ended September 30, 2008 and 2007, respectively, and \$(266,875) and \$(30,123) for the nine months ended September 30, 2008 and 2007, respectively.	(24,082,589)	5,084,171	(34,934,186)	99,953
Unrealized gains (losses) on hedging transactions	10,776	(109,932)	(93,528)	(206,378)
Reclassification adjustment for realized losses included in net (loss) earnings	<u>9,153,457</u>	<u>75,819</u>	<u>8,358,250</u>	<u>83,972</u>
Total other comprehensive (loss) earnings before taxes	(14,918,356)	5,050,058	(26,669,464)	(22,453)
Income tax (benefit) expense related to items of other comprehensive income, net of minority interest of \$80,924 and \$(38,380) for the three months ended September 30, 2008 and 2007 respectively, and \$56,755 and \$(63,402) for the nine months ended September 30, 2008 and 2007, respectively.	<u>(2,833,489)</u>	<u>732,167</u>	<u>(4,660,015)</u>	<u>(312,680)</u>
Other comprehensive (loss) earnings net of income taxes	<u>(12,084,867)</u>	<u>4,317,891</u>	<u>(22,009,449)</u>	<u>290,227</u>
Total comprehensive (loss) earnings	\$ (16,379,465)	\$ 11,364,032	\$ (13,493,584)	\$ 21,700,244

See accompanying notes to consolidated financial statements (unaudited).

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American Safety Insurance Holdings, Ltd. and Subsidiaries

Notes to Consolidated Financial Statements

September 30, 2008

(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-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, 2008 may not be indicative of the results that may be expected for the fiscal year ending December 31, 2008. 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 on Form 10-K of the Company for the fiscal year ended December 31, 2007.

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.

Certain balance sheet and statement of operations items have been reclassified for the periods ending September 30, 2007 and December 31, 2007. The presentation is consistent with the presentation for the three and nine months ended September 30, 2008 and did not result in any impact to net earnings or shareholders' equity.

**Note 2 - Nature of Operations**

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We are a Bermuda-based specialty insurance and reinsurance company that provides customized products and solutions to small and medium-sized businesses in industries that we believe are underserved by the standard market. For over twenty years we have developed specialized coverages and alternative risk transfer products not generally available to our customers in the standard 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 certain environmental, products liability, construction, healthcare and property risks, as well as developing programs for other specialty classes of risks and providing third party reinsurance. See Part II – Other Information, Item 1A for risks facing the Company.

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**Note 3 - Investments**

The amortized cost and estimated fair values of the Company's investments at September 30, 2008 and December 31, 2007 are as follows:

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
<u>September 30, 2008:</u>				
Securities available for sale:				
Fixed maturities:				
U.S. Treasury securities and obligations of U.S. Government corporations and agencies				
	\$ 63,145,452	\$ 1,932,632	\$ -	\$ 65,078,084
States of the U.S. and political subdivisions of the states	40,239,306	31,123	1,533,389	38,737,040
Corporate securities	242,536,885	683,477	19,230,680	223,989,682
Mortgage-backed securities	<u>201,503,899</u>	<u>1,178,244</u>	<u>1,846,795</u>	<u>200,835,348</u>
Total fixed maturities	\$547,425,542	\$ 3,825,476	\$22,610,864	\$528,640,154
Common Stock	\$ 25,689,794	\$ 1,987,594	\$ 3,437,618	\$ 24,239,770
Preferred Stock	\$ 4,989,240	\$ 36,950	\$ 1,702,890	\$ 3,323,300

December 31, 2007:

Securities available for sale:

Fixed maturities:

U.S. Treasury securities and obligations of  
U.S. Government corporations and agencies

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	\$ 84,566,516	\$ 1,581,197	\$ 12,959	\$ 86,134,754
States of the U.S. and political subdivisions of the states	7,548,971	49,633	118,463	7,480,141
Corporate securities	212,127,071	3,075,142	1,740,186	213,462,027
Mortgage-backed securities	<u>221,402,220</u>	<u>1,840,989</u>	<u>750,613</u>	<u>222,492,596</u>
Total fixed maturities	\$525,644,778	\$ 6,546,961	\$ 2,622,221	\$529,569,518
Common stock	\$ 23,188,713	\$ 3,313,413	\$ 1,108,462	\$ 25,393,664
Preferred stock	\$ 6,939,220	\$ -	\$ 1,146,055	\$ 5,793,165

During the nine months ended September 30, 2008, the Company recorded an other-than-temporary impairment charge of \$7.7 million related to debt and equity securities issued by Fannie Mae, Freddie Mac and Lehman Brothers.

**Note 4 - Segment Information**

We segregate our business into insurance operations and other, with the insurance operations segment being further classified into four segments: excess and surplus lines (E&S), alternative risk transfer (ART), assumed reinsurance (Assumed Re) and other. E&S is further classified into seven business lines: property, environmental, construction, products liability, excess, surety and healthcare. ART is further classified into two business lines: specialty programs and fully funded. Assumed Re consists of specialty property and casualty business assumed from unaffiliated specialty insurers and reinsurers, and began operations in the first quarter of 2007. Other includes lines of business that we no longer write (run off) as well as real estate and other ancillary product lines. Prior year amounts have been reclassified to conform to the current year presentation.

Within the E&S segment, our property coverage encompasses non-standard, surplus lines commercial property business and commercial multi-peril (CMP) policies. The casualty focus of our CMP products is premises liability. Our environmental insurance group provides general, professional and pollution liability to contractors, consultants and property owners. Construction provides commercial casualty insurance coverages, generally for residential and commercial contractors. Products liability 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. Our healthcare line provides customized liability insurance solutions for long-term care facilities.

In our ART segment, specialty programs facilitate the offering of insurance to homogeneous niche groups of risk through third party program managers. Our fully funded business provides a mechanism for insureds to post collateral so as to fully self-insure their risks and we are paid a fee for arranging this type of transaction.

In our Assumed Re segment, the Company provides both traditional and structured specialty property and casualty reinsurance for unaffiliated specialty insurers and reinsurers with a focus on small specialty insurers, risk retention groups and captives.

The Other segment consists of amounts associated with realized gains and losses on investments, the Company's investment in real estate which was essentially completed in 2005, and lines of business that we have placed in run-off, such as workers' compensation, excess liability insurance for municipalities and commercial lines.

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 three months ended September 30, 2008 and September 30, 2007 (in thousands of \$ US):

September 30, 2008		Insurance								Other	Total	
E & S		Assumed Re						ART				
		Products Liability						Specialty Programs	Fully Funded			
		Property	Environ	Construction	Excess	Surety	Healthcare					
Gross premiums written		\$ 1,415	\$11,345	\$ 8,183	\$ 1,385	\$1,544	\$ 3,121	\$ 13,828	\$ 30,088	\$ -	\$ -	\$ 74,470
Net premiums written		1,351	9,048	7,019	1,134	935	2,506	5,975	10,551	-	-	40,547
Net premiums earned		1,622	8,576	8,550	1,280	550	1,907	7,908	10,239	-	-	41,692
Fee income earned		-	-	-	-	-	-	-	-	352	147	499
Losses & loss adjustment expenses		1,027	4,898	5,138	764	329	655	5,514	6,183	-	-	25,059
Acquisition expenses		326	2,410	1,897	263	58	537	1,965	2,165	-	-	9,685
Gross underwriting profit		269	1,268	1,515	253	163	715	429	1,891	352	147	7,447
Income tax expense (benefit)												\$ 179
Net earnings (loss)						\$ 253					\$ (74)	\$ (4,295)

September 30, 2007		Insurance								Other	Total		
E & S		Assumed Re						ART					
		Products Liability						Specialty Programs	Fully Funded				
		Property	Environ	Construction	Excess	Surety	Healthcare						
Gross premiums written		\$ 1,050	\$ 11,391	\$ 14,481	\$ 899	\$ 1,756	\$ 1,645	\$ -	\$ 4,188	\$ 14,920	\$ -	\$ -	\$ 50,330
Net premiums written		862	6,195	9,382	730	192	1,633	-	4,188	8,938	-	-	32,120
Net premiums earned		223	9,558	14,339	626	188	1,697	-	2,373	7,568	-	-	36,572
Fee income earned		-	-	-	-	-	-	-	-	-	411	-	411
Losses & loss adjustment expenses		145	5,663	8,595	407	122	594	-	1,630	3,857	-	-	21,013
Acquisition expenses		36	2,503	3,137	48	(95)	455	-	734	367	-	-	7,185
Gross underwriting profit		42	1,392	2,607	171	161	648	-	9	3,344	411	-	8,785
Income tax expense (benefit)													\$ 809
						\$ 848					\$ (39)		\$ 809

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Net earnings (loss)

\$ 7,113

\$ (67) \$ 7,046

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The following table presents key financial data by segment for the nine months ended September 30, 2008 and September 30, 2007 (in thousands of \$ US):

September 30, 2008	Insurance								Other	Total		
	E & S			Products Liability			Assumed Re	ART	Specialty Programs	Fully Funded		
	Property	Environ	Construction	Excess	Surety	Healthcare						
Gross premiums written	\$ 5,705	\$37,677	\$ 28,253	\$ 4,498	\$5,874	\$8,180	\$ 8,224	\$42,456	\$ 60,586	\$ -	\$ -	\$201,453
Net premiums written	4,363	27,669	21,921	3,625	1,566	6,183	5,345	34,603	31,020	-	-	136,295
Net premiums earned	3,377	26,404	29,239	3,463	913	5,259	1,781	30,020	27,427	-	-	127,883
Fee income earned	-	-	-	-	-	-	-	-	-	1,242	775	2,017
Losses & loss adjustment expenses	2,138	16,520	17,572	2,068	546	1,815	926	20,405	15,476	-	2	77,468
Acquisition expenses	738	7,106	6,467	636	(302)	1,428	167	8,438	6,045	-	-	30,723
Gross underwriting profit	501	2,778	5,200	759	669	2,016	688	1,177	5,906	1,242	773	21,709
Income tax expense					\$ 422						\$ -	\$ 422
Net earnings					\$ 14,126						\$(5,610)	\$ 8,516
Assets					\$ 991,050						\$ 467	\$991,517
Equity					\$ 210,939						\$ (23)	\$210,916

September 30, 2007	Insurance								Other	Total		
	E & S			Products Liability			Assumed Re	ART	Specialty Programs	Fully Funded		
	Property	Environ	Construction	Excess	Surety	Healthcare						
Gross premiums written	\$ 1,283	\$ 36,374	\$ 47,403	\$ 3,758	\$ 4,952	\$ 4,431	\$ -	\$ 15,699	\$ 49,705	\$ -	\$ -	\$ 163,605
Net premiums written	1,018	26,305	41,896	2,159	608	4,370	-	15,699	23,372	-	-	115,427
Net premiums earned	229	29,108	53,600	1,569	598	3,768	-	5,538	19,930	-	-	114,340
Fee income earned	-	-	-	-	-	-	-	-	-	1,675	-	1,675
Losses & loss adjustment expenses	149	16,972	33,570	1,020	389	1,318	-	3,822	11,346	-	-	68,586
Acquisition expenses	36	7,385	10,388	28	(282)	990	-	1,379	1,107	-	-	21,031
Gross underwriting profit	44	4,751	9,642	521	491	1,460	-	337	7,477	1,675	-	26,398
Income tax expense												
(benefit)					\$ 2,076						\$(159)	\$ 1,917
Net earnings (loss)					\$ 21,659						\$(249)	\$ 21,410

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Assets		\$ 898,628	\$ 315	\$898,943
Equity	\$ 219,935		\$ (49)	\$219,886

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Additionally, the Company conducts business in two geographic segments: the United States and Bermuda. Significant differences exist in the regulatory environment in each country. Those differences include laws regarding measurable information about the insurance operations by geographic segments. The following table provides key financial data about the geographic segments for the three months ended September 30, 2008 and September 30, 2007 (in thousands of \$ US):

<b>September 30, 2008</b>	<b>United States</b>	<b>Bermuda</b>	<b>Total</b>
Income tax	\$ 179	\$ -	\$ 179
Net (loss) earnings	\$ (4,492)	\$ 197	\$ (4,295)
<b>September 30, 2007</b>	<b>United States</b>	<b>Bermuda</b>	<b>Total</b>
Income tax	\$ 809	\$ -	\$ 809
Net earnings	\$ 1,560	\$ 5,486	\$ 7,046

The following table provides key financial data about the geographic segments as of and for the nine months ended September 30, 2008 and September 30, 2007 (in thousands of \$ US):

<b>September 30, 2008</b>	<b>United States</b>	<b>Bermuda</b>	<b>Total</b>
Income tax	\$ 422	\$ -	\$ 422
Net (loss) earnings	\$ (3,545)	\$ 12,061	\$ 8,516
Assets	\$ 566,325	\$425,192	\$ 991,517
Equity	\$ 69,115	\$141,801	\$ 210,916
<b>September 30, 2007</b>	<b>United States</b>	<b>Bermuda</b>	<b>Total</b>
Income tax	\$ 1,917	\$ -	\$ 1,917
Net earnings	\$ 3,683	\$ 17,727	\$ 21,410
Assets	\$ 524,105	\$374,838	\$ 898,943
Equity	\$ 72,256	\$147,630	\$ 219,886



**Note 5 - Income Taxes**

Total income tax expense for the periods ended September 30, 2008 and 2007 was allocated as follows:

	Three Months Ended		Nine Months Ended	
	September 30, <u>2008</u>	<u>2007</u>	September 30, <u>2008</u>	<u>2007</u>
Tax expense attributable to:				
Income from operations	\$ 178,952	\$ 808,906	\$ 421,822	\$1,916,696
Change in unrealized gain/(loss) on hedging transactions	3,663	(37,377)	(50,422)	(70,168)
Change in unrealized gain/(loss) on securities available for sale	<u>(2,918,076)</u>	<u>731,164</u>	<u>(4,666,348)</u>	<u>(305,914)</u>
Total	\$ (2,735,461)	\$1,502,693	\$(4,294,948)	\$1,540,614

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

	Three Months Ended		Nine Months Ended	
	September 30, <u>2008</u>	<u>2007</u>	September 30, <u>2008</u>	<u>2007</u>
Current	\$ 1,557,221	\$ 634,297	\$ 1,394,116	\$2,010,246
Deferred	(2,898,818)	96,662	(2,451,721)	(40,717)
Change in valuation allowance	<u>1,520,549</u>	<u>77,947</u>	<u>1,479,427</u>	<u>(52,833)</u>
Total	\$ 178,952	\$ 808,906	\$ 421,822	\$1,916,696

For the three and nine months ended September 30, 2008, the Company established a deferred tax asset of \$1.3 million related to realized losses on securities held. Additionally, the Company established a valuation allowance of \$1.3 million as it determined that it is not more likely than not that all of the deferred tax asset related to realized losses on securities held will be realized.

The state income tax expense (benefit) aggregated \$43,479 and \$(979) for the three months ended September 30, 2008 and 2007, respectively, and \$121,244 and \$(9,408) for the nine months ended September 30, 2008 and 2007, respectively, and is included in the current provision.



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Income tax expense from operations for the periods ended September 30, 2008 and 2007 differed from the amount computed by applying the United States Federal income tax rate of 34% to earnings before Federal income taxes as a result of the following:

	Three Months Ended		Nine Months Ended	
	September 30, <u>2008</u>	<u>2007</u>	September 30, <u>2008</u>	<u>2007</u>
Expected income tax (benefit) expense	\$(1,399,320)	\$ 2,670,712	\$ 3,038,814	\$ 7,931,082
Foreign earned income not subject to U.S. taxation	(67,144)	(1,865,357)	(4,100,529)	(6,027,236)
Change in valuation allowance	1,520,549	77,947	1,479,427	(52,833)
Tax-exempt interest	(81,049)	-	(179,839)	-
State taxes and other	<u>205,916</u>	<u>(74,396)</u>	<u>183,949</u>	<u>65,683</u>
Total	\$ 178,952	\$ 808,906	\$ 421,822	\$ 1,916,696

### Note 6 - Employee Stock Options

The Company's incentive stock 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, 2007. During the first nine months of 2008, the Company granted 136,302 options compared to 67,500 for the same period of 2007. No options were granted for the three months ended September 30, 2008 or 2007. Stock based compensation expense related to outstanding options was \$184,161 and \$126,006, for the three months ended September 30, 2008 and 2007, respectively, and \$570,877 and \$394,779, for the nine months ended September 30, 2008 and 2007, respectively, and is reflected in net earnings under payroll and related expenses.

In addition to stock options discussed above, the Company may grant restricted shares to employees under the incentive stock plan. During the first nine months of 2008, the Company granted 45,256 shares of restricted stock. The restricted shares vest on the grant date anniversary ratably over three years at 25%, 25% and 50%, respectively. Stock based compensation expense related to the restricted shares was \$97,486 and \$227,455 for the three and nine months ended September 30, 2008 respectively, and is reflected in net earnings under payroll and related expenses. There was no expense incurred during the 2007 period.

### Note 7 - Acquisition of LTC Companies

On February 11, 2008, the Company acquired 100% of the membership interests of LTC Risk Management, LLC and LTC Insurance Services, LLC ("LTC Group") for \$8,771,000. The LTC Group provides insurance and risk management solutions for the long-term care industry and will allow the Company to further diversify its business interests. The purchase excluded liabilities for any policies produced by the LTC Group prior

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to the effective date of the transaction. The results of the LTC Group's operations have been included with the Company's results since the acquisition date. The purchase price was allocated to the assets acquired and the liabilities assumed based on their fair value at the acquisition date. As a result, approximately \$1,602,000 was assigned to intangible assets which are being

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amortized over their estimated useful lives of ten years. The remaining purchase price of approximately \$7,181,000 was allocated to goodwill. Proforma financial statements are not presented as the acquisition does not meet materiality thresholds.

#### **Note 8 – Fair Value Measurements**

Effective January 1, 2008 on a prospective basis, we determined the fair values of certain financial instruments based on the fair value hierarchy established in Statement of Financial Accounting Standard 157, “Fair Value Measurements” (“SFAS 157”). SFAS 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1: quoted price (unadjusted) in active markets for identical assets

Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument

Level 3: inputs to the valuation methodology are unobservable for the asset or liability

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

Our Level 1 instruments are primarily U.S. Treasuries, money market funds and equity securities listed on stock exchanges. We use quoted prices for identical instruments to measure fair value.

Our Level 2 instruments include most of our fixed income securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities, and certain mortgage and asset-backed securities. We measure fair value of our Level 2 instruments using quoted prices of securities with similar characteristics.

Our Level 3 instruments include certain fixed maturity securities and an investment in an unrelated third party insurance entity. Fair value is based on internally developed criteria that use assumptions or other data that are not readily observable from objective sources.

As management is ultimately responsible for determining the fair value measurements for all securities, we validate prices received by comparing the fair value estimates to our knowledge of the current market and investigate any prices deemed not to be representative of fair value.



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Assets measured at fair value on a recurring basis are summarized below:

As of September 30, 2008  
Fair Value Measurements Using  
(\$ in 000's)

<u>Sept. 30, 2008</u>	Quoted Prices in Active Markets for Identical Assets <u>(Level 1)</u>	Significant Other Observable Inputs <u>(Level 2)</u>	Significant Unobservable Inputs <u>(Level 3)</u>	<u>Total</u>
Fixed maturities	\$ 36,091,150	\$490,155,759	\$ 2,393,245	\$528,640,154
Equities securities	23,305,436	-	4,257,634	27,563,070
Short term investments	<u>77,970,554</u>	<u>-</u>	<u>-</u>	<u>77,970,554</u>
Total	\$137,367,140	\$490,155,759	\$ 6,650,879	\$634,173,778

Level 3 Financial Instruments	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	Fixed	
	Maturities	Equities
Balance at July 1, 2008	\$ 2,360,044	\$ 4,257,634
Total gains (losses) (realized/unrealized)		
Included in earnings	-	-
Included in other comprehensive income	33,201	-
Net purchases	-	-
Net transfers in (out of) Level 3	<u>-</u>	<u>-</u>
Balance at September 30, 2008	\$ 2,393,245	\$ 4,257,634
Change in net unrealized gains (losses) relating		
to assets still held at reporting date	\$ 33,201	\$ -

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Level 3 Financial Instruments	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	Fixed Maturities	Equities
Balance at January 1, 2008	\$ -	\$ 2,610,588
Total gains (losses) (realized/unrealized)		
Included in earnings	-	-
Included in other comprehensive income	22,981	-
Net purchases	1,990,220	1,647,046
Net transfers in (out of) Level 3	<u>380,044</u>	<u>-</u>
Balance at September 30, 2008	\$ 2,393,245	\$ 4,257,634
Change in net unrealized gains (losses) relating		
to assets still held at reporting date	\$ 22,981	\$ -

On a quarterly basis, we evaluate whether the fair values of the Company's individual securities are other-than-temporarily impaired when the fair value is below amortized cost. To make this assessment we consider several factors including (i) our intent and ability to hold the security, (ii) the potential for the security to recover in value, (iii) an analysis of the financial condition of the issuer, (iv) an analysis of the collateral structure and credit support of the security, if applicable, (v) the time during which there has been a decline below cost, and (vi) the extent of the decline below cost. If we conclude a security is other-than-temporarily impaired, we write down the amortized cost of the security to fair value, with a charge to net realized investment losses in the Consolidated Statements of Operations.

During the nine months ended September 30, 2008, the Company recorded an other-than-temporary impairment charge of \$7.7 million related to debt and equity securities issued by Fannie Mae, Freddie Mac and Lehman Brothers.

#### Note 9 - 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 December 2007, the FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements – an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the

fair value of the non-controlling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements

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regarding the interests of the parent and its non-controlling interests. SFAS 160 is effective for the Company beginning January 1, 2009. The Company is currently evaluating the impact of the adoption of SFAS 160.

In December 2007, the FASB issued SFAS 141(R), "Business Combinations" ("SFAS 141(R)"). SFAS 141(R) expands on the guidance of SFAS 141, extending its applicability to all transactions and other events in which an entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed and interests transferred as a result of business combinations. SFAS 141(R) expands on required disclosures to improve the statement users' abilities to evaluate the nature and financial effects of business combinations. SFAS 141(R) establishes principles and requirements for determining how an enterprise recognizes and measures the fair value of certain assets and liabilities acquired in a business combination, including non-controlling interest, contingent consideration and certain acquired contingencies. SFAS 141(R) also requires acquisition-related transaction expenses and restructuring cost be expensed as incurred rather than capitalized as a component of the business combination. SFAS 141(R) is effective for any acquisitions made on or after January 1, 2009. The pronouncement will only have an affect to the extent the Company completes business acquisitions after the effective date.

In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, "Effective Date of FASB Statement No. 157" ("FSP No. 157-2"), which delays the effective date of SFAS 157 for non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008. The Company is currently evaluating the impact of the adoption of FSP No. 157-2. As allowed under FSP No. 157-2, as of January 1, 2008, we have elected not to fully adopt SFAS 157 and are deferring adoption for certain non-financial assets and liabilities until January 1, 2009.

In March 2008, the FASB issued SFAS No. 161, "Disclosures About Derivative Instruments and Hedging Activities — an amendment of FASB Statement No. 133" ("SFAS 161"). SFAS No. 161 enhances the disclosure requirements of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", regarding an entity's derivative instruments and hedging activities. SFAS No. 161 is effective for the Company's fiscal year beginning January 1, 2009. The Company is currently evaluating the impact of the adoption of SFAS 161.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles" ("SFAS 162"). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of non-governmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS 162 is effective sixty days following the SEC's approval of the Public Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in conformity with Generally Accepted Accounting Principles. The Company does not believe that the adoption of SFAS 162 will have a material impact on its financial statements.

In October 2008, the FASB issued FASB Staff Position No. FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" ("FSP No. 157-3"), which clarifies the application of FASB Statement No. 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP No. 157-3 became effective October 10, 2008 including prior periods for which financial statements have not been issued. The Company has implemented FSP No. 157-3 as of September 30, 2008.



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

We are a Bermuda-based specialty insurance and reinsurance company that provides customized products and solutions to small and medium-sized businesses in industries that we believe are underserved by the standard market. For over twenty years, we have developed specialized coverages and alternative risk transfer products not generally available to our customers in the standard 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 certain environmental, products liability, construction, healthcare and property risks, as well as developing programs for other specialty classes of risks and providing third party reinsurance. .

We segregate our business into insurance operations and other, with the insurance operations segment being further classified into four segments: excess and surplus lines (E&S), alternative risk transfer (ART), assumed reinsurance (Assumed Re) and other. E&S is further classified into seven business lines: property, environmental, construction, products liability, excess, surety and healthcare. ART is further classified into two business lines: specialty programs and fully funded. Assumed Re consists of specialty property and casualty business assumed from unaffiliated specialty insurers and reinsurers, and began operations in the first quarter of 2007. Other includes lines of business that we no longer write (run off) as well as real estate and other ancillary product lines. Prior year amounts have been reclassified to conform to the current year presentation.

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 table below summarizes the Company's net premiums written and net premiums earned by business line, consolidated revenues and percentage change year over year:

Three Months Ended	Nine Months Ended	Three Months Ended	Nine Months Ended
September 30,	September 30,		



2008

2007

2008

2007

2008/2007

2008/2007



<b>Net premiums written:</b>	(in thousands)	(in thousands)
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Environmental	\$ 9,048	\$ 6,195	\$ 27,669	\$ 26,305	46.1 %	5.2%
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Construction	7,019	9,382	21,921	41,896	(25.2)%	(47.7)%
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Excess	935	192	1,566	608	387.0 %	157.6%
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Healthcare	2,028	-	5,345	-	- %	-%
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Products Liability	1,134	730	3,625	2,159	55.3 %	67.9%
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Property	1,351	862	4,363	1,018	56.7 %	328.6%
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Surety

2.506

1.633

6.183

4.370

53.5 %

41.5%

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Total Excess & Surplus Lines	24,021	18,994	70,672	76,356	26.5 %	(7.4)%
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Segment





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Specialty Programs	<u>10,551</u>	<u>8,938</u>	<u>31,020</u>	<u>23,372</u>	18.0 %	32.7%
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Assumed Reinsurance Segment	<u>5.975</u>	<u>4.188</u>	<u>34.603</u>	<u>15.699</u>	42.7 %	120.4%
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<b>Total net premiums written</b>	\$ 40,547	\$ 32,120	\$ 136,295	\$ 115,427	26.2 %	18.1%
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**Net premiums earned:**

Excess and Surplus Lines Segment

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Environmental	\$ 8,575	\$ 9,558	\$ 26,404	\$ 29,108	(10.3)%	(9.3)%	
Construction	8,550	14,339	29,240	53,600	(40.4)%		(45.4)%

Excess	551	188	913	598	193.1 %	52.7%
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Healthcare	1,061	-	1,781	-	- %	- %
Products Liability	1,280	626	3,463	1,569	104.5 %	120.7%
Property	1,622	223	3,377	229	627.4 %	1,374.7%
Surety	<u>1,907</u>	<u>1,697</u>	<u>5,259</u>	<u>3,768</u>	12.4 %	39.6%
Total Excess & Surplus Lines						
Segment	23,546	26,631	70,437	88,872	(11.6)%	(20.7)%
Alternative Risk Transfer Segment						
Specialty Programs	<u>10,238</u>	<u>7,568</u>	<u>27,426</u>	<u>19,930</u>	35.2 %	37.6%
Assumed Reinsurance Segment	<u>7,908</u>	<u>2,373</u>	<u>30,020</u>	<u>5,538</u>	233.2 %	442.1%
<b>Total net premiums earned</b>	<u>\$ 41,692</u>	<u>\$ 36,572</u>	<u>\$127,883</u>	<u>\$ 114,340</u>	14.0 %	11.8%



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Net investment income	7,497	7,791	22,140	22,497	(3.8)%	(1.6)%
Net realized (losses) / gains	(9,153)	(81)	(8,358)	(89)	(11,200.0)%	(9,291.0)%
Fee income	499	411	2,017	1,675	21.4 %	20.4%
Other (loss) income	<u>(37)</u>	<u>18</u>	<u>(7)</u>	<u>50</u>	(305.6)%	(114.0)%
<b>Total revenues</b>	\$ 40,498	\$ 44,711	\$143,675	\$138,473	(9.4)%	3.8%

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The following table sets forth the components of our GAAP combined ratio for the periods indicated:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
Loss & loss adjustment expense ratio	60.1%	57.5%	60.6%	60.0%

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Expense ratio	<u>43.1%</u>	<u>37.8%</u>	<u>41.9%</u>	<u>35.1%</u>
Combined ratio	103.2%	95.3%	102.5%	95.1%

### Three Months Ended September 30, 2008

compared to Three Months Ended September 30, 2007

#### Net (Loss) Earnings

For the three months ended September 30, 2008, the Company had a net loss of \$4.3 million, or \$(0.42) per diluted share, compared to net earnings of \$7.0 million, or \$0.64 per diluted share, for the same period of 2007. The 2008 net loss is a result of net realized losses on our investments of \$9.2 million, which includes the \$7.7 million other than temporary impairment of investments issued by Freddie Mac, Fannie Mae and Lehman Brothers and realized losses of \$1.4 million from the sale of other fixed maturity securities due to credit concerns about certain financial services companies. Without the net realized losses, the Company's net earnings would have been \$4.9 million. See explanations below for the various components of net (loss) earnings.

#### Net Premiums Earned

##### *Excess and Surplus Lines*

*Environmental.* Net premiums earned decreased 10.3% to \$8.6 million for the three months ended September 30, 2008, compared to \$9.6 million for the same period of 2007. The decline was primarily attributable to lower audit premiums, together with an increase in our environmental impairment liability writings during the quarter, which tend to have longer than twelve month policy durations.

*Construction.* Net premiums earned decreased 40.4% to \$8.6 million for the three months ended September 30, 2008, compared to \$14.3 million for the same period of 2007. The principal reason for the decline was a 25.2% decline in gross written premium driven by lower renewal retention rates in as the Company continues to exercise underwriting discipline in a more competitive market. In addition, the effects of a slow housing market translated into lower average premiums per account and a reduction in audit premiums.

*Excess.* Net premiums earned increased 193.1% to \$0.6 million for the three months ended September 30, 2008, compared to \$0.2 million for the same period of 2007. The Company's excess product offering is focused primarily in the construction and products liability areas.

*Healthcare.* During 2008, the Company continued its diversification strategy through the acquisition of 100% of the membership interests of LTC Risk Management, LLC and LTC Insurance Services, LLC ("LTC Group"). The LTC Group, now known as ASI Healthcare, provides insurance and risk



management solutions for the long-term care industry. Net premiums earned for the three months ended September 30, 2008 were approximately \$1.1 million and represent net premiums earned on business written subsequent to the acquisition effective date.

*Products Liability.* The Company's products liability line began production in the second half of 2006. Net premiums earned increased 104.5% to \$1.3 million for the three months ended September 30, 2008 compared to \$0.6 million for the same period of 2007. This line has experienced growth in 2008 as compared to the same period in 2007 as the Company continues to build this book of business. The products are offered to small and middle market accounts including smaller manufacturers, distributors, non-habitational real estate and certain owner, landlord and tenant risks. The Company does not intend to write certain high severity classes of risks such as invasive medical products, pharmaceuticals and nutraceuticals.

*Property.* The Company's property and commercial multi-peril line began production in June 2007. Net premiums earned increased 627.4% to \$1.6 million for the three months ended September 30, 2008 as compared to \$0.2 million in net premiums earned for the three months ended September 30, 2007. Net premiums earned increased due to the growth in gross premiums written as the Company continues to build this book of business.

*Surety.* Net premiums earned increased 12.4% to \$1.9 million for the three months ended September 30, 2008, compared to \$1.7 million for the same period of 2007. The increase in surety premiums is 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. During 2007, the Company expanded its offerings to include non-environmental contractor bonds by entering into an agreement with a small specialty carrier to provide contract surety to small non-environmental contractors that do not fit the standard surety market.

#### ***Alternative Risk Transfer***

*Specialty Programs.* Net premiums earned increased 35.2% to \$10.2 million for the three months ended September 30, 2008 compared to \$7.6 million for the same period in 2007. Net premiums earned increased due to increases in premiums written as well as higher retention levels in our specialty programs, thereby allowing the Company the opportunity to increase its earnings potential from underwriting profits. The impact of \$14.1 million in premiums from a specialty program written during the third quarter 2008 has no net effect on net earned premium, as the premium is ceded 100% to an unrelated insurance company. The increased retention levels in 2008 compared to the same period in 2007 were primarily due to the impact of the July 1, 2007 casualty reinsurance treaty, which changed the reinsurance structure for this line of business from quota share to excess of loss.

#### ***Assumed Reinsurance***

The Company began writing third party assumed reinsurance during the first quarter of 2007. Net earned premiums increased 233.2% to \$7.9 million for the three months ended September 30, 2008 from \$2.4 million for the same period of 2007 due to increased assumed reinsurance premiums written as the Company builds this line of business. The Company's primary focus is traditional and structured reinsurance for small specialty insurers, risk retention groups and captives.

**Fee Income Earned**

Fee income earned increased 21.4% to \$0.5 million for the three months ended September 30, 2008 as compared to \$0.4 million for the same period of 2007. The increase is primarily attributable to consulting fees earned through Ordinance Holdings, Limited (Ordinance), a subsidiary which was acquired during the third quarter of 2007, as well as brokerage fees earned through the ASI Healthcare acquisition.

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Partially offsetting the increase, the Company has seen some adverse impact on fees received from its fully funded products due to the overall market softening as traditional insurance pricing begins to provide a cost effective alternative to self-insurance.

### **Net Investment Income**

Net investment income decreased 3.8% to \$7.5 million for the three months ended September 30, 2008 compared to \$7.8 million for the same period of 2007. This decrease was the result of lower investment yields due to the investment of funds at lower market interest rates, partially offset by an increase in average invested assets. Average invested assets increased to \$615.8 million at September 30, 2008 from \$580.9 million at September 30, 2007 due primarily to cash flows from operations. The average pre-tax and after-tax investment yields were 4.9% and 4.2% compared to 5.4% and 4.5% for the three months ended September 30, 2008 and 2007, respectively.

### **Net Realized Losses**

Net realized losses increased to \$9.2 million for the three months ended September 30, 2008 compared to a \$0.1 million for the same period of 2007. The 2008 net realized losses includes a charge of \$7.7 million for other than temporary impairment of debt and equity securities issued by Lehman Brothers, Freddie Mac and Fannie Mae and realized losses of \$1.4 million from the sale of other fixed maturity securities due to credit concerns about certain financial services companies. The Company, from time to time, may sell securities in response to market conditions, interest rate fluctuations or credit concerns in accordance with its investment guidelines and/or to fund the cash needs of the Company as well as individual operating subsidiaries.

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

Losses and loss adjustment expenses totaled \$25.1 million, or 60.1% of net premiums earned, for the three months ended September 30, 2008 compared to \$21.0 million, or 57.5%, for the same period of 2007. The increase is primarily attributable to a 14.0% increase in net premiums earned and \$0.7 million of additional current accident year reserves from two specialty programs. There was no prior year adverse reserve development in the 2008 or 2007 quarters.

### **Acquisition Expenses**

Policy acquisition expenses are the cost of acquiring policies including commissions, premium taxes paid to states in which we are admitted to conduct business and excise taxes, offset by ceding commissions we receive from our reinsurers. Policy acquisition expenses increased to \$9.7 million for the three months ended September 30, 2008 as compared to \$7.2 million for the same period of 2007, and policy acquisition expenses as a percentage of net premiums earned, increased to 23.3% for the three months ended September 30, 2008 compared to 19.6% for the same period of 2007. The increase is due in part to the increase in the proportion of premiums generated by our assumed reinsurance segment which is currently comprised primarily of quota share reinsurance treaties that carry higher acquisition expenses, resulting in an increase in acquisition expenses of \$1.2 million. The specialty program acquisition expense increased to \$2.2 million, or 21.1% of net premiums earned for the three months ended September 30, 2008, from \$0.4 million, or 4.8% of net premiums earned for the three months ended September 30, 2007, primarily due to the impact of the July 1, 2007 treaty which changed the reinsurance structure from quota share, where a ceding commission is

received, to excess of loss, where no ceding commissions are received.

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

Payroll and other underwriting expenses increased 23.7% to \$8.8 million for the three months ended September 30, 2008, compared to \$7.1 million for the same 2007 period. The increase is due to normal salary increases, increased headcount primarily from the addition of new product lines added in conjunction with the Company's product diversification strategy, as well as increased depreciation and professional fee expenses.

### **Corporate and Other Expenses**

Corporate and other expenses were \$0.7 million for the three months ended September 30, 2008 and 2007.

### **Minority Interest Expense**

Minority interest expense is associated with the Company's non-subsiary affiliate, American Safety Risk Retention Group, Inc. ("RRG"). Minority interest expense was negative \$0.3 million for the three months ended September 30, 2008 compared to minority interest expense of \$26,000 for the same period of 2007. RRG incurred net realized losses on its investment portfolio of \$0.3 million.

### **Income Taxes**

Income tax expense for the three months ended September 30, 2008 was \$0.2 million, compared to \$0.8 million for the same period of 2007. The lower tax rate in the third quarter of 2008 was due primarily to lower earnings in our U.S. operations as a result of lower net earned premiums in the U.S., together with the net realized losses on the Company's investment portfolio and higher acquisition and other underwriting expenses. During the quarter ended September 30, 2008, the Company established a deferred tax asset of \$1.3 million related to realized losses on securities held. Additionally, the Company established a valuation allowance of \$1.3 million as it determined that it is not more likely than not that all of the deferred tax asset related to realized losses on securities held will be realized.

### **Nine Months Ended September 30, 2008 compared to**

### **Nine Months Ended September 30, 2007**

### **Net Earnings**



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Net earnings decreased 60.2% to \$8.5 million, or \$0.79 per diluted share, for the nine months ended September 30, 2008, compared to \$21.4 million, or \$1.95 per diluted share, for the same period of 2007. The 2008 net earnings are negatively impacted by net realized losses on our investments of \$8.4 million, which includes the \$7.7 million other-than-temporary impairment of investments issue by Freddie Mac, Fannie Mae and Lehman Brothers and net realized losses of \$.7 million from the sale of other investment securities.

### **Net Premiums Earned**

#### *Excess and Surplus Line*

*Environmental.* Net premiums earned decreased 9.3% to \$26.4 million for the nine months ended September 30, 2008, as compared to \$29.1 million for the same period of 2007. The Company continues to experience rate declines averaging in the 5% to 15% range for 2008, as compared to 2007.

*Construction.* Net premiums earned decreased 45.4% to \$29.2 million for the nine months ended September 30, 2008 as compared to \$53.6 million for the same period in 2007. The Company has seen a significant decline in its western states book of business, partially offset by geographic diversification efforts. The principal reason for the decrease was a 40.4% decline in gross premiums written, driven by 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. Contributing further to the decrease in net premiums earned is the July 1, 2007 casualty reinsurance treaty, resulting in lower premium retention rates for 2008 compared to 2007.

*Excess.* Net premiums earned increased 52.7% to \$0.9 million for the nine months ended September 30, 2008 compared to \$0.6 million for the same period of 2007. 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.

*Healthcare.* The Company continued its diversification strategy through the acquisition of 100% of the membership interests of LTC Risk Management, LLC and LTC Insurance Services, LLC ("LTC Group"). The LTC Group, now known as ASI Healthcare, provides insurance and risk management solutions for the long-term care industry. Net premiums earned for the nine months ended September 30, 2008 were approximately \$1.8 million and represent net premiums earned on business written subsequent to the acquisition effective date.

*Products Liability.* The Company's products liability line began production in the second half of 2006. Net premiums earned increased 120.7% to \$3.5 million for the nine months ended September 30, 2008 compared to \$1.6 million for the same period of 2007. This line has experienced growth in 2008 as compared to the same period in 2007 as the Company continued to build this book of business. The products are offered to small and middle markets accounts including smaller manufacturers, distributors, non-habitational real estate and certain owner, landlord and tenant risks. The Company does not intend to write certain high severity classes of risks such as invasive medical products, pharmaceuticals and nutraceuticals.

*Property.* The Company's property and commercial multi-peril line began production in June 2007. Net premiums earned increased 1,374.7% to \$3.4 million for the nine months ended September 30, 2008 as compared to \$0.2 million in net premiums earned for the nine months ended September 30, 2007. Net premiums earned increased due to the growth in gross premiums written as the Company continues to build this book of business.

*Surety.* Net premiums earned increased 39.6% to \$5.3 million for the nine months ended September 30, 2008 as compared to \$3.8 million for the same period of 2007. The increase in surety premiums is attributable to the growth in written premiums 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 in the general market. During 2007, the Company expanded its offerings to include non-environmental contractor bonds by entering into an agreement with a small specialty carrier to provide contract surety to small non-environmental contractors that do not fit the standard surety market.

#### ***Alternative Risk Transfer***

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*Specialty Programs.* Net premiums earned increased 37.6% to \$27.4 million for the nine months ended September 30, 2008 as compared to \$20.0 million for the same period of 2007. Net premiums earned increased due to increases in premiums written as well as higher retention levels in our specialty programs, thereby allowing the Company the opportunity to increase its earnings potential from underwriting profits. The impact of \$14.1 million in premiums from a specialty program written during the third quarter 2008 has no net effect on net earned premium, as the premium is ceded 100% to an unrelated insurance company. The increased retention levels in 2008 compared to the same period in 2007 were primarily due to the impact of the July 1, 2007 casualty reinsurance treaty, which changed the reinsurance structure for this line of business from quota share to excess of loss.

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***Assumed Reinsurance***

Net premiums earned increased 442.1% to \$30.0 million for the nine months ended September 30, 2008 from to \$5.5 million for the same period of 2007 due to increased reinsurance premiums written as the Company builds this line of business. Beginning in 2007, the Company, through its Bermuda based reinsurance operation, began to assume specialty property and casualty business from unaffiliated insurers and reinsurers. The Company's primary focus is traditional and structured reinsurance for small specialty insurers, risk retention groups and captives, combined with structured reinsurance capabilities, produced increased writings in 2008 compared to the same period in 2007, when the Company first entered the market.

**Fee Income Earned**

Fee income earned increased 20.4% to \$2.0 million for the nine months ended September 30, 2008 as compared to \$1.7 million for the same period of 2007. The increase is primarily attributable to consulting fees earned through our Ordinance subsidiary, which was acquired during the third quarter of 2007, as well as brokerage fees earned resulting from the ASI Healthcare acquisition. Partially offsetting the increase, the Company has seen some adverse impact on fees received from its fully funded products due to the overall market softening as declining traditional insurance pricing begins to provide a cost effective alternative to self-insurance.

**Net Investment Income**

Net investment income decreased 1.6% to \$22.1 million for the nine months ended September 30, 2008 as compared to \$22.5 million for the same period of 2007. The decrease is the result of lower investment yields due to lower market interest rates, partially offset by an increase in average invested assets. Average invested assets increased to \$625.7 million at September 30, 2008 from \$571.2 million at September 30, 2007, reflecting positive cash flow from operations. The average pre-tax and after-tax investment yields were 4.7% and 4.0%, respectively for the nine months ended September 30, 2008, compared to 5.3% and 4.4%, respectively, for the nine months ended September 30, 2007.

**Net Realized Losses**

Net realized losses from the sale and other than temporary impairment of investments totaled \$8.4 million for the nine months ended September 30, 2008, compared to net realized losses of \$0.1 million for the same period of 2007. The 2008 net realized losses include a charge of \$7.7 million for other-than-temporary impairment of debt and equity securities issued by Lehman Brothers, Freddie Mac and Fannie Mae and realized losses of \$0.7 million from the sale of other securities. The Company, from time to time, may sell securities to fund its cash needs or the cash needs of individual operating subsidiaries or in response to market conditions, interest rate fluctuations or credit concerns in accordance with its investment guidelines.

**Losses and Loss Adjustment Expenses**

Losses and loss adjustment expenses totaled \$77.5 million, or 60.6% of net premiums earned, for the nine months ended September 30, 2008, compared to \$68.6 million, or 60.0%, for the same 2007 period. The dollar increase is attributable to an 11.8% increase in net earned premiums,

changes in the mix of

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business, \$0.7 million of additional current accident year reserves from two specialty programs as well as prior year reserve development in the second quarter in our environmental product line of \$1.5 million due in large part to New York business. The Company continues to reduce its exposure to New York business as evidenced by a \$2.0 million, or 47.3%, reduction in gross premiums written for the nine months ended September 30, 2008. During 2007, there was \$0.4 million reserve development related to the commutation of a reinsurance treaty. Partially offsetting these increases was the impact of the July 1, 2007 excess of loss reinsurance treaty on our core business lines.

#### **Acquisition Expenses**

Policy acquisition expenses are the cost of acquiring policies including commissions, premium taxes paid to states in which we are admitted to conduct business and excise taxes, offset by ceding commissions we receive from our reinsurers. Policy acquisition expenses increased to \$30.7 million for the nine months ended September 30, 2008 as compared to \$21.0 million for the same period of 2007, and, as a percentage of net premiums earned, increased to 24.0% for the nine months ended September 30, 2008 compared to 18.4% for the same period of 2007. The increase is due to the change in the mix of business and increased acquisition expense in the specialty program line. The proportion of premiums generated by our assumed reinsurance segment, which is currently comprised primarily of quota share reinsurance treaties that carry higher acquisition expenses, resulted in an increase in acquisition expenses of \$7.1 million. The increase related to the specialty program line was due to a change in our reinsurance structure for specialty programs from quota share, where we received a ceding commission to excess of loss, where no commission is received. Specialty programs acquisition expenses increased by \$4.9 million. Partially offsetting this increase was a decrease in acquisition expense for our construction line of business of \$3.9 million due to a 45% reduction in net premiums earned.

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

Payroll and other underwriting expenses increased 20.2% to \$24.9 million for the nine months ended September 30, 2008, compared to \$20.8 million for the same 2007 period. The increase is due to normal salary increases and increased headcount primarily from the addition of newer product lines added in conjunction with the Company's product diversification strategy, higher depreciation and amortization expenses of \$0.9 million and higher software maintenance expenses of \$0.5 million.

#### **Corporate and Other Expenses**

Corporate and other expenses decreased to negative \$0.6 million for the nine months ended September 30, 2008, compared to \$2.1 million for the same 2007 period. This decrease was due to the \$2.8 million reversal of an accrued warranty liability established in 2004 in connection with our former real estate project in Florida, which was essentially completed in 2005.

#### **Minority Interest Expense**

Minority interest expense is associated with the Company's non-subsiidiary affiliate, American Safety Risk Retention Group, Inc. ("RRG"). The minority interest expense was negative \$0.2 million for the nine months ended September 30, 2008, compared to minority interest expense of \$0.2 million for the same period of 2007. RRG incurred net realized losses on its investment portfolio of \$0.3 million.

**Income Taxes**

Income tax expense for the first nine months of 2008 was \$0.4 million or 4.7% of pre-tax income, compared to \$1.9 million or 8.2% of pre-tax income for the same period of 2007. The lower tax rate is due to lower earnings in the Company's U.S. subsidiaries as a result of net realized losses on the

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investment portfolio, higher acquisition expenses and higher losses and loss adjustment expenses. During the nine months ended September 30, 2008, the Company established a deferred tax asset of \$1.3 million related to realized losses on securities held. Additionally, the Company established a valuation allowance of \$1.3 million as it determined that it is not more likely than not that all of the deferred tax asset related to realized losses on securities held will be realized.

### **Fair Value Valuation**

Effective January 1, 2008 on a prospective basis, we determined the fair values of certain financial instruments based on the fair value hierarchy established in Statement of Financial Accounting Standard 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value.

Level 1: quoted price (unadjusted) in active markets for identical assets

Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument

Level 3: inputs to the valuation methodology are unobservable for the asset or liability

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

Our Level 1 instruments are primarily U.S. Treasuries, money market funds and equity securities listed on stock exchanges. We use quoted prices for identical instruments to measure fair value.

Our Level 2 instruments include most of our fixed income securities, which consist of U.S. government agency securities, municipal bonds, certain corporate debt securities, and certain mortgage and asset-backed securities. We measure fair value of our Level 2 instruments using quoted prices of securities with similar characteristics.

Our Level 3 instruments include certain fixed maturity securities and an investment in an unrelated third party insurance entity. Fair value is based on internally developed criteria that use assumptions or other data that are not readily observable from objective sources.

As management is ultimately responsible for determining the fair value measurements for all securities, we validate prices received by comparing the fair value estimates to our knowledge of the current market and investigate any prices deemed not to be representative of fair value.





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Assets measured at fair value on a recurring basis are summarized below:

As of September 30, 2008  
Fair Value Measurements Using  
(\$ in 000's)

<u>Sept. 30, 2008</u>	Quoted Prices in Active Markets for Identical Assets <u>(Level 1)</u>	Significant Other Observable Inputs <u>(Level 2)</u>	Significant Unobservable Inputs <u>(Level 3)</u>	<u>Total</u>
Fixed maturities	\$ 36,091,150	\$490,155,759	\$ 2,393,245	\$528,640,154
Equities securities	23,305,436	-	4,257,634	27,563,070
Short term investments	<u>77,970,554</u>	<u>-</u>	<u>-</u>	<u>77,970,554</u>
Total	\$137,367,140	\$490,155,759	\$ 6,650,879	\$634,173,778

Level 3 Financial Instruments	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	Fixed	Equities
	Maturities	Equities
Balance at July 1, 2008	\$ 2,360,044	\$ 4,257,634
Total gains (losses) (realized/unrealized)		
Included in earnings	-	-
Included in other comprehensive income	33,201	-
Net purchases	-	-
Net transfers in (out of) Level 3	<u>-</u>	<u>-</u>
Balance at September 30, 2008	\$ 2,393,245	\$ 4,257,634
Change in net unrealized gains (losses) relating		
to assets still held at reporting date	\$ 33,201	\$ -

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Level 3 Financial Instruments	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	Fixed	
	Maturities	Equities
Balance at January 1, 2008	\$ -	\$ 2,610,588
Total gains (losses) (realized/unrealized)		
Included in earnings	-	-
Included in other comprehensive income	22,981	-
Net purchases	1,990,220	1,647,046
Net transfers in (out of) Level 3	<u>380,044</u>	<u>-</u>
Balance at September 30, 2008	\$ 2,393,245	\$ 4,257,634
Change in net unrealized gains (losses) relating		
to assets still held at reporting date	\$ 22,981	\$ -

On a quarterly basis, we evaluate whether the fair values of the Company's individual securities are other-than-temporarily impaired when the fair value is below amortized cost. To make this assessment we consider several factors including (i) our intent and ability to hold the security, (ii) the potential for the security to recover in value, (iii) an analysis of the financial condition of the issuer, (iv) an analysis of the collateral structure and credit support of the security, if applicable, (v) the time during which there has been a decline below cost, and (vi) the extent of the decline below cost. If we conclude a security is other-than-temporarily impaired, we write down the amortized cost of the security to fair value, with a charge to net realized investment losses in the Consolidated Statements of Operations.

During the nine months ended September 30, 2008, the Company recorded an other-than-temporary impairment charge of \$7.7 million related to debt and equity securities issued by Fannie Mae, Freddie Mac and Lehman Brothers.

### Liquidity and Capital Resources

The Company meets its cash requirements and finances its growth principally through cash flows generated from operations. Due to the soft market, the Company has experienced a decline of premium rates due to the entrance of new insurance competitors, overall market conditions and changes in the mix of our business (i.e. timing of cash receipts in assumed reinsurance business). The Company's primary sources of short-term cash flow are premium writings and investment income. Short-term cash requirements relate to claims payments, ceded 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 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.

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Net cash provided by operations was \$70.2 million for the nine months ended September 30, 2008 compared to net cash provided by operations of \$55.1 million for the same period of 2007. The cash flow from operations increased in 2008 compared to 2007 primarily due to the increased cash flow from unpaid losses and loss adjustment expenses of \$8.8 million and unearned premiums, net of ceded

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unearned premiums, of \$7.5 million, both due to higher earned premiums. In addition, an increase in cash flow from ceded premiums payables due primarily to the settlement of premiums related to the July 1, 2007 casualty reinsurance treaty which resulted in returned premiums as well as payments on other reinsurance treaties were not made until the fourth quarter. Partially offsetting these increases in operating cash flow was a decrease in cash provided by reinsurance recoverables of \$11.7 million resulting from an increase in ceded reserves due to higher reinsurance activity. An additional decrease was due to higher assumed reinsurance receivables of \$8.0 million due to the increased assumed reinsurance activity together with the timing of receipts under those treaties.

Net cash used in investing activities was \$65.4 million for the nine months ended September 30, 2008 compared to net cash used in investing activities of \$44.2 million for the same period of 2007. The increase in net cash used in investing activities was primarily due to a net purchase of investments of \$52.3 million for 2008 compared to a net purchase of investments during the 2007 period of \$40.4 million. In addition, during 2008, consideration paid for acquired subsidiaries totaled \$8.9 million, including direct transaction costs.

Net cash used in financing activities was \$6.9 million for the nine months ended September 30, 2008. The use of cash was due to the repurchase of 472,700 shares of the Company's common stock for \$7.3 million, or a weighted average price of \$15.41, partially offset by funds received from stock option exercises of \$0.7 million. During the corresponding 2007 period, there were stock option exercises of \$1.4 million.

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 places limitations on the amount of dividends or other distributions payable by insurance companies in order to protect the solvency of insurers. Given our growth and the capital requirements associated with that growth, we do not anticipate paying dividends on the common shares in the near future.

### **Income Taxes**

We are incorporated under the laws of Bermuda and, under current Bermuda law, are not obligated to pay 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 United States subsidiaries, we are not 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 loss adjustment 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 an insurer has an underwriting profit, and a combined ratio above 100% indicates that an insurer has an underwriting loss. The combined ratio increased to 103.2% for the three months ended September 30, 2008 from 95.3% for the same period of 2007. The increase was primarily attributable to an increase in the loss ratio of 2.6 percentage points due primarily to changes



in the mix of business and \$.7 million of additional current accident year reserves related to two specialty programs. The expense ratio increased by 5.3 percentage points due to higher acquisition expenses primarily as a result of the changes in the mix of business and the impact of the change in quota share to excess of loss reinsurance on its specialty program line. The combined ratio increased to 102.5% for the nine months ended September 30, 2008 from 95.1% for the same period of 2007. The loss ratio increased by .6 percentage points due primarily to changes in the mix of business, \$.7 million of additional current accident year reserves related to two specialty programs, prior year reserve development in our environmental product line recorded in the second quarter of \$1.5 million due in large part to New York Business partially offset by the impact of the July 1, 2007 excess of loss reinsurance treaty on our core business lines. The expense ratio increased 6.8 percentage points primarily as a result of the change in the mix of business, the impact of the change in quota share to excess of loss reinsurance associated with the July 1, 2007 excess of loss reinsurance treaty as well as salary and other underwriting increases.

The expense ratio portion of our reported combined ratio excludes interest expense, minority interest, fee income and corporate and other expenses. These excluded amounts totaled approximately \$1,598,000 and \$1,981,000 for the three months ended September 30, 2008 and 2007, respectively and \$3,616,000 and \$6,443,000 for the nine months ended September 30, 2008 and 2007, respectively.

### *Forward-Looking Statements*

This report contains forward-looking statements. These forward-looking statements reflect the Company's current views with respect to future events and financial performance, including insurance market conditions, premium growth, acquisitions, cash flow, investments, losses, expenses, ratios, reserves, new products and the impact of new accounting standards. Forward-looking statements involve risks and uncertainties which may cause actual results to differ materially, including competitive conditions in the insurance industry, levels of new and renewal insurance business, developments in loss trends, adequacy and changes in loss reserves and actuarial assumptions, timing or collectability of reinsurance recoverables, market acceptance of new coverages and enhancements, changes in reinsurance costs and availability, potential adverse decisions in court and arbitration proceedings, the integration and other challenges attendant to acquisitions, and changes in levels of general business activity and economic conditions.

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.



### **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, 2007 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 have materially affected, or are 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 affect on our financial condition or operating results, except for the matter discussed below.

*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 summary 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.

On May 18, 2007, the District Court of Appeals 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 was denied by the Court on July 6, 2007. The Plaintiffs' filed a motion for leave to amend their complaint with the trial court. On September 14, 2007, the trial court issued an order vacating its judgment against the Company, dismissing the Plaintiffs' claims with prejudice and denying Plaintiffs' motion for leave to amend. On October 9, 2007, the Plaintiffs' appealed the denial of their motion for leave to amend. On February 7, 2008, the Plaintiffs filed their initial brief in support of their appeal and on April 22, 2008, filed a motion requesting oral argument in front of the Appeals Court. Oral argument was held on October 7, 2008. In a per curium decision on October 20, 2008, the Florida Fifth District Court of Appeals affirmed the trial court's denial of plaintiffs' motion to amend.

### **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, 2007 which is on file with the SEC.

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

In October 2008, A.M. Best, the most widely recognized insurance company rating agency, affirmed its rating of "A" (Excellent) on a group basis of American Safety Insurance, including our two U.S. insurance subsidiaries, our Bermuda reinsurance subsidiary and our U.S. non-subsiary risk retention group affiliate. A.M. Best also affirmed the rating outlook of stable. An "A" (Excellent) rating is the third highest of fifteen ratings assigned by A.M. Best to companies that have, in the opinion of A.M. Best, an excellent ability to meet their ongoing obligations to policyholders.

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.

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Best. 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.

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 subsidiaries, A.M. Best may downgrade us.

***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 nine months ended September 30, 2008, approximately 32.7% of our gross written premiums were written in these two industries as compared to 51.2% the nine months ended September 30, 2007. Even with the decrease, 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 in certain business lines, 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 types of 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 offer 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. Our in-house actuarial staff reviews the reserves of our major lines on a quarterly basis and a full actuarial analysis of our reserves is performed on an annual basis by an independent third party actuarial firm, which may include reserve studies, rate studies and regulatory opinions.

Notwithstanding these efforts, the establishment of appropriate reserves for losses and loss adjustment expenses 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. 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 or intend to increase our risk retention.

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. These increases in reserves and reinsurance premiums would adversely impact our financial condition and operating results. 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 on 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, or assuming more risks exposing the Company to greater volatility in its earnings.

*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. The total amount of reinsurance recoverables at September 30, 2008 was \$190.2 million, or 90.2% of shareholders' equity. Of this amount, \$71.1 million, or approximately 37.4% of the total recoverable amount, is collateralized by cash, irrevocable letters of credit or other acceptable forms of collateral posted by the reinsurer.

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 collateral or fulfill their obligations to us.

We are unable to ensure the credit worthiness of our reinsurers. For example, in 2005 and 2006, as a result of significant adverse loss reserve development, A.M. Best and Standard and Poor's, a division of The McGraw Hill Companies, Inc. ("S&P"), downgraded the financial strength ratings of the insurance and reinsurance operating subsidiaries of Alea Group Holdings (Bermuda) Ltd., including among others, Alea North American Insurance Company and Alea London Limited ("Alea"), one of our reinsurers. Subsequently, Alea requested that A.M. Best withdraw all ratings of Alea. A.M. Best currently has assigned a NR-4 (Company Request) to Alea. As of September 30, 2008, our unsecured estimated net exposure to Alea was approximately \$9.8 million, primarily in our specialty programs. This estimate is based upon our estimates of losses and will not reflect our exposure if our actual losses differ from those estimates.



*We rely on independent insurance agents, managing general agents and brokers to market our products.*

We market most of our insurance products through approximately 250 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. Furthermore, as of September 30, 2008, approximately 14% of our gross premiums written for our excess and surplus lines segment were produced through two producers (who focus on our construction business line). The loss of one or more of these producers could have a material adverse effect on our operating results.

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

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

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

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

- achieve critical mass in premium writing in order to meet profitability objective;
- identify insurable risks not adequately served by the standard insurance market;
- maintain adequate levels of capital or obtain access to affordable sources 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;
- complete acquisitions of small specialty insurers, general agents or lines of business;
- maintain our financial strength ratings; and
- estimate ultimate losses and loss adjustment expenses in specialty lines with little or no historical data.

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.

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*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; potential liabilities associated with the business prior to acquisition; 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 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 or yield on our investment portfolios may have a material impact on our operating results.*

We derive a significant portion of our net earnings from our invested assets. As a result, our operating results depend in part on the performance of our various investment portfolios. As of September 30, 2008, the aggregate fair value of our investment portfolios was \$634.2 million and net investment income derived from these assets was \$22.1 million, or 247.7% of our pre-tax earnings. Our investment portfolios are subject to various risks, including:

- 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;
- interest rate risk, which is the risk that our invested assets may decrease due to changes in interest rates;
- equity price risk, which is the risk that we will incur economic loss due to a decline in equity prices;
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duration risk, which is the risk that our invested assets may not adequately match the duration of our insurance liabilities; and

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- mortgage-backed securities, which may have exposure to sub-prime mortgages although all securities are issued by FNMA, FHLMC or GNMA.

Financial market conditions may cause a further adverse impact on our investment portfolios that require the Company to record other-than-temporary impairment charges in addition to the amounts recorded during the nine months ended September 30, 2008.

Our investment portfolios are 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 portfolios are managed by a professional investment management firm in accordance with detailed investment guidelines established by the relevant Company's Board of Directors that stress diversification of risks, conservation of principal and liquidity. If our investment portfolios are not appropriately matched with the respective insurance and reinsurance liabilities of our insurance companies, 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 continual 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.

***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

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material adverse effect on our business and operating results, particularly where we have not established an accrual or a sufficient accrual for damages, settlements or expenses. For information on the material litigation in which we are involved, see "Item 3 — Legal Proceedings".

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## **Risk Factors Related to Taxation**

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

American Safety Insurance Holdings, Ltd., its reinsurance subsidiary, American Safety Re and its segregated account captive, American Safety Assurance, are organized in Bermuda. American Safety Insurance Holdings, Ltd., 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 Holdings, Ltd., 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 Holdings, Ltd., 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 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” 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 Code. It is possible that the IRS could challenge the effectiveness of these provisions and that a court could sustain that challenge, in which case, one’s 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”).***

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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

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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 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 2008 or subsequent years, and neither expects its direct or indirect insureds (including related persons) to directly or indirectly hold 20% or more of its voting power or value, but we cannot be certain that this will be the case because some of the factors which determine the extent of RPII may be beyond our control. If these thresholds are met or exceeded, and if you are an affected U.S. person, your investment could be materially adversely affected. The RPII provisions, however, have never been interpreted by the courts or the U.S. Treasury Department (the "Treasury Department") in final regulations, and regulations interpreting the RPII provisions of the Code exist only in proposed form. It is not certain whether these regulations will be adopted in their proposed form or what changes or clarifications might ultimately be made thereto or whether any of those changes, as well as any interpretation or application of RPII by the IRS, the courts or otherwise, might have retroactive effect. The Treasury Department has authority to impose, among other things, additional reporting requirements with respect to RPII. Accordingly, the meaning of the RPII provisions and the application thereof to us is uncertain.

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

Section 1248 of the Internal Revenue Code of 1986, as amended (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, other than Fredrick C. Treadway or Treadway Associates, L.P., of American Safety Insurance should be treated as owning (directly, indirectly through foreign entities or constructively) 10% or more of the total voting power of American Safety Insurance. As a result, American Safety Insurance should not be a CFC and Section 1248 of the Code, as applicable under the general CFC rules, should not apply to dispositions of our shares. It is possible, however, that the IRS could challenge these provisions in our organizational documents and that a court could sustain that challenge. To the extent American Safety Insurance is a CFC, a 10% U.S. Shareholder may in certain circumstances be required to report a disposition of Common Shares by attaching IRS Form 5471 to the U.S. federal income tax or information return that it would normally file for the taxable year in which the disposition occurs.

For purposes of Section 1248 of the Code and the requirement to file Form 5471, special rules apply with respect to a U.S. person's disposition of shares of a foreign insurance company that has RPII during the five-year period ending on the date of the disposition. In general, if a U.S. person disposes of shares in a foreign insurance corporation in which U.S. persons own 25% or more of the shares (even if the amount of gross RPII is less than 20% of the corporation's gross insurance income and the ownership of its shares by direct or indirect insureds and related persons is less than the 20% threshold), any gain from the disposition may be treated as a dividend to the extent of that person's share 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 these special rules and proposed Treasury Department regulations, the IRS may assert that Section 1248 of the Code and the requirement to file Form 5471 apply to dispositions of Common Shares because American Safety Insurance is engaged in the insurance business indirectly through subsidiaries.

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

Bermuda currently imposes no income taxes 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 the tax will not be applicable to American Safety Insurance, American Safety Re or American Safety Assurance until March 28, 2016. No assurance can be given that American Safety Insurance, American Safety Re or American Safety Assurance will not be subject to any Bermuda tax after that date.

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

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

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

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

The property and casualty insurance industry has historically been a cyclical industry consisting of both "soft market" periods and "hard market" periods. During soft market periods, insurers tend to be more aggressive in writing policies and competitive in the pricing of those 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.

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

In recent years, 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

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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-sub 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 non-financial 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 is 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 relies on dividends from its insurance subsidiaries to be able to pay dividends and fulfill its other financial obligations. The payment of dividends by these subsidiaries and other intercompany transactions are subject to regulatory restrictions and will depend on the surplus and earnings of these subsidiaries. As a result, insurance holding companies may not be able to receive dividends from their subsidiaries at times and in amounts sufficient to pay dividends and fulfill their other financial obligations. Additionally, as a Bermuda holding company, American Safety Insurance 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 affect upon potential claims against us and our insureds. 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

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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.

**Changes in U.S. federal income tax law could materially adversely affect us.** Legislation has been introduced in the U.S. Congress intended to eliminate some perceived tax advantages of companies (including insurance companies) that have legal domiciles outside the United States but have certain U.S. connections. It is possible that similar legislation could be introduced and enacted by the current Congress or future Congresses that could have an adverse impact on us.

The risk factors presented above are all of the ones that we consider to be material as of the date of this quarterly report on Form 10-Q. However, they are not the only risks facing the company. Additional risks not presently known to us, or which we consider immaterial based on our current knowledge or understanding, 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 may make. 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 may be required by law.

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

### ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid Per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
10/1 – 10/31/2007	-	-	-	500,000
11/1 – 11/30/2007	-	-	-	500,000
12/1 – 12/31/2007	27,300	\$18.75	27,300	472,700
1/1 – 1/31/2008	-	-	27,300	472,700
2/1 – 2/29/2008	-	-	27,300	472,700
3/1 – 3/31/2008	116,500	\$16.95	143,800	356,200
4/1 – 4/30/2008	10,900	\$17.67	154,700	345,300
5/1 – 5/31/2008	93,850	\$16.05	248,550	251,450
6/1 – 6/30/2008	10,000	\$15.90	258,550	241,450
7/1 – 7/31/2008	141,765	\$13.50	400,315	99,685
8/1 – 8/31/2008	99,685	\$15.44	500,000	-
9/1 – 9/30/2008	-	-	500,000	-
Total	500,000	\$15.59		

The Company announced a stock repurchase program for up to 500,000 shares of the Company's outstanding common stock on December 3, 2007. The repurchase of the 500,000 shares was completed on August 12, 2008.



**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

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**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 § 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification Pursuant to § 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification Pursuant to § 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification Pursuant to § 906 of the Sarbanes-Oxley Act of 2002



SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 7th day of November, 2008.

American Safety Insurance Holdings, Ltd.

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

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