

AMERICAN SAFETY INSURANCE HOLDINGS LTD  
Form 10-Q  
November 14, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

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**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE  
QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

Commission File Number 1-14795

**AMERICAN SAFETY INSURANCE HOLDINGS, LTD.**

(Exact name of Registrant as specified in its charter)

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

44 Church Street

P.O. Box HM2064

Hamilton HM HX, Bermuda

(Address, zip code of principal executive offices)

(441) 296-8560

(Registrant's telephone number, including area code)

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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 for 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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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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, \$.01 par value, on November 4, 2005 was 6,740,932.

## AMERICAN SAFETY INSURANCE HOLDINGS, LTD.

FORM 10-Q

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## PART I FINANCIAL INFORMATION

### Item 1. Financial Statements

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

#### Consolidated Balance Sheets

	December 31, 2004	Sep (U
Assets		
Investments:		
Fixed maturity securities available for sale	\$ 286,057,489	\$ 34
Common stock	15,081,360	2
Investment in real estate	2,005,440	
Short-term investments	<u>25,898,131</u>	<u>1</u>
Total investments	329,042,420	38
Cash and cash equivalents	24,843,736	1
Restricted cash	144,500	
Accrued investment income	3,308,463	
Premiums receivable	21,093,810	2
Ceded unearned premium	25,454,691	3
Reinsurance recoverable	145,524,068	15

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Deferred income taxes	9,080,990	1
Deferred policy acquisition costs	11,559,188	1
Property, plant and equipment	3,900,473	
Other assets	<u>10,207,637</u>	
Total assets	\$ 584,159,976	\$ 64
	=====	==

See accompanying notes to consolidated financial statements (unaudited).

	December 31, <u>2004</u>	Sep
Liabilities and Shareholders' Equity		(U
Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 321,623,730	\$ 36
Unearned premiums	93,798,378	10
Reinsurance on paid losses and loss adjustment expenses	6,486,149	
Ceded premiums payable	11,852,028	1
Escrow deposits	144,500	
Accounts payable and accrued expenses	15,370,443	1
Loan payable	13,019,489	1
Funds held	8,334,794	1
Minority Interest	<u>4,750,782</u>	
Total liabilities	475,380,293	53
Shareholders' equity:		
Preferred stock, \$0.01 par value; authorized 5,000,000 shares; no shares issued and outstanding	-	
Common stock, \$0.01 par value; authorized 15,000,000 shares; issued and outstanding at December 31, 2004, 6,781,721 and September 30, 2005, 6,704,998 shares	67,817	
Additional paid-in capital	51,067,506	4
Retained earnings	55,800,942	6
Accumulated other comprehensive income (loss), net	<u>1,843,418</u>	
Total shareholders' equity	<u>108,779,683</u>	1
Total liabilities and shareholders' equity	\$ 584,159,976	\$6
	=====	==

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries

Consolidated Statements of Earnings

(unaudited)

	Three Months Ended <u>September 30,</u>	Nine Sep
	<u>2004</u>	<u>2004</u>
	<u>2005</u>	

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Revenues:

Direct premiums earned	\$ 58,181,446	\$ 55,684,179	\$ 165,247,47
Assumed premiums earned	400,237	(186,306)	3,441,14
Ceded premiums earned	<u>(24,000,183)</u>	<u>(24,260,302)</u>	<u>(67,898,65)</u>
Net premiums earned	34,581,500	31,237,571	100,789,96
Net investment income	2,529,210	3,653,075	6,849,46
Net realized gains (losses)	99,567	24,602	119,83
Real estate income	19,938,557	-	54,066,86
Other income	<u>46,982</u>	<u>20,278</u>	<u>191,60</u>
Total revenues	57,195,816	34,935,526	162,017,73

Expenses:

Losses and loss adjustment expenses	23,730,614	19,580,076	70,645,50
Acquisition expenses	6,954,856	6,692,005	20,078,98
Payroll and related expenses	2,433,557	2,344,439	7,762,70
Real estate expenses	16,605,783	(601,506)	45,092,80
Other expenses	2,687,602	2,577,721	5,681,04
Minority interest	275,182	(93,408)	611,83
Expense due to rescission	<u>59,825</u>	<u>5,832</u>	<u>(1,656,14)</u>
Total expenses	<u>52,747,419</u>	<u>30,505,159</u>	<u>148,216,73</u>

Earnings before income taxes	4,448,397	4,430,367	13,801,00
Income taxes	<u>1,190,605</u>	<u>1,083,069</u>	<u>2,796,62</u>
Net earnings	\$ 3,257,792	\$ 3,347,298	\$ 11,004,38

Net earnings per share:

Basic	<u>\$ 0.47</u>	<u>\$ 0.50</u>	<u>\$ 1.5</u>
Diluted	<u>\$ 0.45</u>	<u>\$ 0.47</u>	<u>\$ 1.4</u>

Average number of shares outstanding:

Basic	6,876,380	6,702,609	6,905,13
Diluted	7,275,259	7,146,664	7,394,73

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries

Consolidated Statements of Cash Flow

(unaudited)

Nine Months  
September

2004

Cash flow from operating activities:

Net earnings	\$11,004,380
Adjustments to reconcile net earnings to net cash provided by operating activities:	
Realized gains/(losses) on investments	(119,839)

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Depreciation expense	664,471
Deferral of acquisition costs, net	189,360
Amortization of premium	1,841,692
Change in:	
Accrued investment income	294,360
Premiums receivable	12,640,582
Reinsurance recoverable and ceded unearned premiums	(20,373,497)
Funds held	1,328,881
Deferred income taxes	2,362,775
Unpaid losses and loss adjustment expenses	69,469,381
Unearned premiums	474,537
Ceded premiums payable	(9,534,805)
Accounts payable and accrued expenses	(2,093,661)
Deferred revenue	1,646,819
Other, net	<u>(3,273,730)</u>
Net cash provided by operating activities	66,521,706
Cash flow from investing activities:	
Purchases of fixed maturities	(82,924,444)
Purchases of equity securities	(8,856,063)
Proceeds from sale of fixed maturities	25,943,752
Proceeds from sale of equity investments	386,820
(Increase) decrease in short-term investments	(15,850,395)
Settlement of notes receivable	1,435,000
Proceeds from sale of investment in real estate	30,691,445
Purchase of fixed assets, net	<u>(383,842)</u>
Net cash used in investing activities	(49,557,727)

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries

Consolidated Statements of Cash Flow (Continued)

(unaudited)

	Nine Months Ended <u>September 30</u>
	<u>2004</u>
Cash flow from financing activities:	
Proceeds from issuance of common stock	91,893
Stock repurchase payments	(2,484,974)
Repayment of loan payable	(17,361,652)
Repayment of escrow deposits	(7,738,823)
Withdrawals of restricted cash	<u>1,231,014</u>
Net cash used in financing activities	<u>(26,262,542)</u>
Net decrease in cash and cash equivalents	(9,298,563)
Cash and cash equivalents at beginning of period	<u>32,153,379</u>
Cash and cash equivalents at end of period	\$22,854,816
	=====
Supplemental disclosure of cash flow:	
Income taxes paid	\$ 3,525,270
	=====
Interest paid	\$ 910,928

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See accompanying notes to consolidated financial statements (unaudited).

## American Safety Insurance Holdings, Ltd. and Subsidiaries

## Consolidated Statements of Comprehensive Income (Loss)

(unaudited)

	Three Months Ended		Ni
	September 30,		
	<u>2004</u>	<u>2005</u>	<u>200</u>
Net earnings	\$ 3,257,792	\$ 3,397,298	\$ 11,004
Other comprehensive income before income taxes:			
Unrealized gains (losses) on securities available for sale, net of minority interest of \$(227,614) and \$(255,095) for the three months ended September 30, 2004 and 2005, respectively, and \$(66,413) and \$(179,225) for the nine months ended September 30, 2004 and 2005, respectively.	4,590,502	(3,984,150)	214
Unrealized gains (losses) on hedging transactions	(241,743)	160,778	5
Reclassification adjustment for realized (gains) and losses included in net earnings, net of minority interest of \$(105,931) and \$0 for the three months ended September 30, 2004 and 2005 respectively and \$(76,383) and \$0 for the nine months ended September 30, 2004 and 2005, respectively.	<u>6,364</u>	<u>(24,602)</u>	<u>(43</u>
Total other comprehensive income (loss) before taxes	4,355,123	(3,847,974)	176
Income tax expense (benefit) related to items of other comprehensive income, net of minority interest of \$0 and \$(86,911) for the three months ended September 30, 2004 and 2005 respectively and \$0 and \$21,459 for the nine months ended September 30, 2004 and 2005, respectively.	<u>973,424</u>	<u>(844,560)</u>	<u>47</u>
Other comprehensive income (loss) net of income taxes	<u>3,381,699</u>	<u>(3,003,414)</u>	<u>128</u>
Total comprehensive income	\$ 6,639,491	\$343,884	\$ 11,132
	=====	=====	=====

See accompanying notes to consolidated financial statements (unaudited).

American Safety Insurance Holdings, Ltd. and Subsidiaries

September 30, 2005

(unaudited)

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

The accompanying unaudited interim consolidated financial statements of American Safety Insurance Holdings, Ltd. ( American Safety ) and its subsidiaries and American Safety Risk Retention Group, Inc. ( American Safety RRG ), a non-subsi-dary risk retention group affiliate (collectively the Company ) are prepared in accordance with accounting principles generally accepted in the United States of America and, in the opinion of management, reflect all normal, recurring adjustments considered necessary for a fair presentation of the interim period presented. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates, based on the best information available, in recording transactions resulting from business operations. The balance sheet amount that involves a greater extent of accounting estimates and actuarial determinations subject to future changes is the Company's liability 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 the liability for unpaid losses and loss adjustment expenses is adequate to cover the ultimate liability, such estimates may be more or less than the amounts actually paid when claims are settled.

The results of operations for the nine months ended September 30, 2005 may not be indicative of the results that may be expected for the fiscal year ending December 31, 2005. 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 of the Form 10-K of the Company for the fiscal year ended December 31, 2004.

The unaudited interim consolidated financial statements include the accounts of American Safety and each of its subsidiaries and American Safety RRG. All significant intercompany balances have been eliminated. Certain items from prior periods have been reclassified to conform with the 2005 presentation.

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### **Note 2 Accounting Pronouncements**

During the last two years, the Financial Accounting Standards Board (FASB) has issued a number of accounting pronouncements with various effective dates.

In December 2004, the FASB issued a revised version of SFAS 123, SFAS 123 (R), Share- Based Payments, which finalizes the accounting for stock options. The statement requires that compensation related to share based payment transaction be recognized in the financial statements. The cost will be measured based on the grant date fair value of the equity instrument issued. The Company plans to adopt SFAS 123 (R) in the first quarter of 2006 and does not expect the adoption to have a material effect on earnings.

In June 2005, the FASB issued Statement No.# 154 Accounting Changes and Error Corrections. The statement requires that any change in the method of depreciation, amortization or depletion for long-lived, non-financial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. This statement supersedes both APB Opinion No. 20 and FASB Statement No. 3, but contains elements of each. This statement will be effective for the Company for accounting changes and corrections of errors in fiscal years beginning after December 15, 2005, and does not expect the adoption to have a material effect on the earnings.

### **Note 3 Business Risks**

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

Legal/Regulatory Risk is the risk that changes in the legal or regulatory environment in which an insurer operates will create additional expenses not anticipated by the Company in pricing its products beyond those recorded in the financial statements. Regulatory initiatives designed to reduce insurer profits or otherwise affecting the industry in which the Company operates as well as new legal theories or insurance company insolvencies through guaranty fund assessments may create costs for the Company beyond those recorded in the financial statements. The Company attempts to mitigate this risk by writing insurance business in several states, thereby spreading this risk over a large geographic

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area. This risk also includes potential outcomes of the Company's litigation (See Part II, Item 1), which could be material.

**Potential Risk of United States Taxation of Bermuda Operations.** Under current Bermuda law, American Safety is not required to pay any taxes in Bermuda on either income or capital gains. American Safety has received an undertaking from the Minister of Finance in Bermuda that will exempt American Safety from taxation until the year 2016 in the event of any such taxes being imposed. The Company, exclusive of its United States subsidiaries, does not consider itself to be engaged in a trade or business in the United States and accordingly does not expect to be subject to direct United States income taxation. The Company's United States subsidiaries are subject to taxation in the United States.

Whether a foreign corporation is engaged in a United States trade or business or is carrying on an insurance business in the United States depends upon the level of activities conducted in the United States. If the activities of a foreign company are continuous, regular, and considerable, the foreign company will be deemed to be engaged in a United States trade or business. Due to the fact that American Safety will maintain and continue to maintain an office in Bermuda and American Safety and its Bermuda insurance subsidiary's business is reinsuring contracts via treaty reinsurance agreements, which are all signed outside of the United States, American Safety does not consider itself to be engaged in a trade or business in the United States and, accordingly, does not expect to be subject to United States income taxes.

However, because the Internal Revenue Code of 1986, as amended, Treasury Regulations and court decisions do not definitively identify activities that constitute being engaged in a United States trade or business, and because of the factual nature of the determination, there can be no assurance that the Internal Revenue Service will not contend that American Safety or its Bermuda insurance subsidiary are engaged in a United States trade or business. In general, if American Safety or its Bermuda insurance subsidiary are considered to be engaged in a United States trade or business, it would be subject to (i) United States Federal income tax on its taxable income that is effectively connected with a United States trade or business at graduated rates and (ii) the 30 percent branch profits tax on its effectively connected earnings and profits deemed repatriated from the United States.

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

**Interest Rate Risk** is the risk that interest rates may change and cause a decrease in the value of an insurer's investments. The Company attempts to mitigate this risk by attempting to match the maturities of its assets with the expected payouts of its liabilities.

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

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

### Note 4 Investments

The amortized cost and estimated fair values of the Company's investments at December 31, 2004 and September 30, 2005 are as follows:

	<u>Amortized cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>
December 31, 2004:			
Securities available for sale:			
Fixed maturities:			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$ 65,887,315	\$800,811	\$ 467,383
States of the U.S. and political subdivisions of the States	31,067,197	425,269	168,348
Corporate securities	90,742,305	1,618,821	650,822
Mortgage-backed securities	<u>97,243,632</u>	<u>306,453</u>	<u>747,761</u>



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Total fixed maturities	\$284,940,449	\$3,151,354	\$2,034,314
	=====	=====	=====
Common stock	\$ 14,001,929	\$1,455,131	\$ 375,700
	=====	=====	=====
September 30, 2005:			
Securities available for sale:			
Fixed maturities:			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$83,924,506	\$ 566,958	\$1,137,124
States of the U.S. and political subdivisions of the States	52,554,310	307,415	402,648
Corporate securities	90,112,601	801,762	1,298,214
Mortgage-backed securities	<u>126,042,670</u>	<u>76,249</u>	<u>1,845,154</u>
Total fixed maturities	\$352,634,087	\$1,752,384	\$4,683,140
	=====	=====	=====
Common stock	\$ 19,998,509	\$2,322,054	\$ 929,658
	=====	=====	=====

**Note 5 Segment Information**

The Company initially segregates its business into the following segments: Real Estate and Insurance Operations. The Insurance Operations segment is further classified into three reportable segments: Environmental, Excess and Surplus Lines (E&S) and Program Business.

Real estate consists of the Harbour Village project in Ponce Inlet, Florida, as discussed in Note 6. In our Insurance Operations segment, Environmental writes insurance coverages for the environmental remediation industry. E&S Lines provides commercial casualty insurance coverages, generally in the area of construction and products liability. Program Business facilitates the offering of insurance to homogeneous niche groups of risks.

The Company measures the Real Estate and Insurance Operations segments using net earnings, total assets and total equity. The reportable Insurance Operations segments are measured by net premiums earned, incurred losses and loss adjustment expenses and acquisition expenses. Assets are not allocated to the reportable Insurance Operations segments. The following table presents key financial data by segment for the nine months ended and as of September 30, 2004 and September 30, 2005 (in thousands):

	September 30, <u>2004</u>	Real <u>Estate</u>	<u>Insurance</u>			
			<u>Environmental</u>	<u>E&amp;S</u>	<u>Programs</u>	<u>Other</u>
Gross premiums written	-	32,879	71,110	61,765	1,910	
Net Premiums written	-	26,247	57,018	13,451	754	
Net premiums earned	-	23,333	58,133	12,699	6,625	
Losses and loss adjustment expenses	-	10,507	42,811	7,797	9,531	
Acquisition expenses	-	5,877	12,710	194	1,298	
Underwriting profit/(loss)	-	6,949	2,612	4,708	(4,204)	
Income tax/(benefit)	3,167		(975)			
Net earnings	5,807		1,410			
Assets	21,381		538,192			
Equity	13,037		91,317			
	September 30, <u>2005</u>	Real <u>Estate</u>	<u>Insurance</u>			

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		<u>Environmental</u>	<u>E&amp;S</u>	<u>Programs</u>	<u>Other</u>
Gross premiums written	-	39,683	69,660	70,062	1,589
Net Premiums written	-	33,112	55,864	15,930	(1,205)
Net premiums earned	-	28,064	59,395	14,075	(1,141)
Losses and loss adjustment expenses	-	14,433	37,145	8,193	2,098
Acquisition expenses	-	7,302	13,180	369	(149)
Underwriting profit/(loss)	-	6,329	9,070	5,513	(3,090)
Income tax/(benefit)	578		1,063		
Net earnings/(loss)	335		9,845		
Assets	3,746		646,061		
Equity	882		113,575		

Additionally, the Company conducts business in the following geographic segments: United States and Bermuda. Significant differences exist in the regulatory environment in each country. Those differences include laws regarding the types of investments, capital requirements, solvency monitoring, pricing, corporate taxation, etc. The following provides key measurable information about the geographic segments for the nine months ended and as of September 30, 2004 and September 30, 2005 (in thousands):

<u>September 30, 2004</u>	<u>United States</u>	<u>Bermuda</u>	<u>Total</u>
Income tax	2,797	-	2,797
Net earnings	4,524	6,480	11,004
Assets	428,329	131,498	559,827
Equity	55,685	48,566	104,251
<u>September 30, 2005</u>	<u>United States</u>	<u>Bermuda</u>	<u>Total</u>
Income tax	1,626	-	1,626
Net earnings	4,254	5,878	10,132
Assets	491,497	158,207	649,704
Equity	59,135	55,222	114,357

The following table presents key financial data by segment for the three months ended September 30, 2004 and September 30, 2005 (in thousands):

September 30, <u>2004</u>	Real <u>Estate</u>	<u>Insurance</u>			
		<u>Environmental</u>	<u>E&amp;S</u>	<u>Programs</u>	<u>Other</u>
Gross premiums written	-	10,589	23,731	19,772	484
Net Premiums written	-	8,569	18,546	5,867	27
Net premiums earned	-	8,697	19,733	4,968	1,183
Losses and loss adjustment expenses	-	4,056	15,446	2,946	1,283
Acquisition expenses	-	2,099	4,612	93	151
Underwriting profit/(loss)	-	2,542	(325)	1,929	(251)
Income tax/(benefit)	1,045			148	
Net earnings/(loss)	2,288			992	
September 30, <u>2005</u>	Real <u>Estate</u>	<u>Insurance</u>			
		<u>Environmental</u>	<u>E&amp;S</u>	<u>Programs</u>	<u>Other</u>
Gross premiums written	-	12,393	21,625	25,926	647
Net Premiums written	-	8,988	17,524	6,618	(1,640)
Net premiums earned	-	9,542	18,433	4,993	(1,730)
Losses and loss adjustment expenses	-	4,246	12,288	2,814	232

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Acquisition expenses	-	2,665	3,880	115	32
Underwriting profit/(loss)	-	2,631	2,265	2,064	(1,994)
Income tax/(benefit)	460		618		
Net earnings/(loss)	142		3,192		

The following provides key measurable information about the geographic segments for the three months ended September 30, 2004 and September 30, 2005 (in thousands):

<u>September 30, 2004</u>	<u>United States</u>	<u>Bermuda</u>	<u>Total</u>
Income tax	1,191	-	1,191
Net earnings	1,695	1,563	3,258
<u>September 30, 2005</u>	<u>United States</u>	<u>Bermuda</u>	<u>Total</u>
Income tax	1,083	-	1,083
Net earnings	1,873	1,474	3,347

**Note 6 Investment in Real Estate**

The Company's investment in the development of the Harbour Village Golf and Yacht Club ( Harbour Village ) project was comprised of 173 acres of property in Ponce Inlet, Florida that was acquired through foreclosure on April 13, 1999. At the date of foreclosure, the Company evaluated the carrying value of its investment in real estate by comparing the fair value of the foreclosed collateral to the book value of the underlying loan and accrued interest. As the book value of the loan plus accrued interest was less than the fair value of the collateral, no loss was recognized on foreclosure; the book value of the loan plus accrued interest became the basis of the real estate.

The Harbour Village project is substantially complete as all units are sold and closed. The Company does not expect to engage in any further real estate activities in the future. No additional revenue from Harbour Village is expected. There will be certain ongoing expenses for the project associated with legal, insurance and other related matters.

**Note 7 Income Taxes**

Total income tax expense for the periods ended September 30, 2004 and 2005 was allocated as follows:

	Three Months Ended September 30,		Nine Mon Septem
	<u>2004</u>	<u>2005</u>	<u>2004</u>
Tax expense attributable to:			
Income from continuing operations	\$ 1,190,605	\$ 1,083,069	\$ 2,796,621
Change in unrealized gains/(losses) on hedging transactions	(82,192)	54,665	1,782
Change in unrealized gains/(losses) on securities available for sale	<u>1,055,616</u>	<u>(986,136)</u>	<u>46,075</u>
Total	\$ <u>2,164,029</u>	\$ <u>151,598</u>	\$ <u>2,844,478</u>

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

	<u>Current</u>	<u>Deferred</u>
Three months ended:		
September 30, 2004	\$ (333,074)	\$ 1,523,679
September 30, 2005	\$ 1,452,076	\$ (369,007)

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Nine months ended:

September 30, 2004	\$	1,318,706	\$	1,477,915
September 30, 2005	\$	2,449,261	\$	(823,465)

The state income tax expense aggregated \$471,196 and \$412,758 for the nine months ended September 30, 2004 and 2005, respectively, and \$152,654 and \$354,282 for the three months ended September 30, 2004 and 2005, respectively, and is included in the current provision. Included in the current quarter state tax expense is a charge for \$318,191 related to a prior year tax adjustment.

Income tax expense for the periods ended September 30, 2004 and 2005 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 September 30,		Nine Months September
	2004	2005	2004
Expected income tax expense	\$ 1,512,455	\$ 1,506,325	\$ 4,692,340
Foreign earned income not subject to U.S. taxation	(531,218)	(501,428)	(2,203,121)
Valuation allowance	-	-	-
State taxes and other	<u>209,368</u>	<u>78,172</u>	<u>307,402</u>
	\$1,190,605	\$ 1,083,069	\$ 2,796,621
	=====	=====	=====

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

	December 31, 2004
Deferred tax assets:	
Loss reserve discounting	\$7,565,625
Unearned premium reserves	3,145,646
Difference between tax and GAAP basis of Harbour Village project	366,348
Difference between tax and GAAP method at Harbour Village project	146,738
Warranty reserve	282,556
NOL carry forward	88,443
Unrealized losses on securities	-
Other	<u>611,443</u>
Gross deferred tax assets	12,206,799
Valuation allowance	<u>(554,515)</u>
Gross deferred tax assets after valuation allowance	11,652,284
Deferred tax liabilities:	
Deferred acquisition costs	2,033,536
Unrealized gains on securities	288,062
Other	<u>249,696</u>
Gross deferred tax liabilities	<u>2,571,294</u>
Net deferred tax asset	\$9,080,990
	=====

The Company believes it is more likely than not that we will realize the full benefit of our deferred tax assets; therefore, a valuation allowance has not been established against these assets. However, given the historical loss position of American Safety RRG, it had established a 100% valuation allowance on its net deferred tax assets totaling \$554,515 at December 31, 2004. In the first quarter of 2005, American Safety RRG included as a reduction to income tax expense this valuation allowance as American Safety RRG's judgment about the realizability of the deferred tax assets changed due to American Safety RRG's profitability. This reduction in income tax expense was offset by an increase in minority interest expense and had no overall effect on the earnings or shareholders' equity of the Company.

**Note 8 Goodwill and Intangibles**

Goodwill and indefinite-lived intangible assets are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have an indefinite life are to be amortized over their useful lives (but with no maximum life). The recorded indefinite-lived intangibles at December 31, 2004 and September 30, 2005 were \$1,467,000.

In accordance with the disclosure requirements of SFAS No. 142, Goodwill and Other Intangibles, there were no effects of goodwill on the net earnings for the nine months ended September 30, 2004 and 2005.

**Note 9 Stock Options**

The Company applied the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations in accounting for the plan. No compensation expense is reflected in net earnings as all options granted under the plan have an exercise price equal to the market value of the underlying common stock on the date of grant. The majority of the options in the plan vest over a three year period. The following table illustrates the effect on net earnings and earnings per share, assuming we had applied the fair value recognition provisions of SFAS No. 123 (R), Accounting for Stock-Based Compensation.

	Three Months Ending September 30,		Nine Months Ending September
	<u>2004</u>	<u>2005</u>	<u>2004</u>
	(In thousands, except per share amounts)		
Net earnings:			
As reported	\$ 3,258	\$ 3,347	\$ 11,004
Effect of stock options	<u>(3)</u>	<u>(3)</u>	<u>(199)</u>
Pro forma net earnings	\$ 3,255 =====	\$ 3,344 =====	\$10,805 =====
Net earnings per share:			
Basic - as reported	\$ 0.47	\$ 0.50	\$ 1.59
Basic - pro forma	\$ 0.47	\$ 0.50	\$ 1.56
Diluted - as reported	\$ 0.45	\$ 0.47	\$ 1.49
Diluted - pro forma	\$ 0.45	\$ 0.47	\$ 1.46

**Note 10 Loans Payable***Trust Preferred Offerings*

During 2003 American Safety Capital and American Safety Capital II, both non-consolidated, wholly-owned subsidiaries of the Company, issued \$8 million and \$5 million, respectively, of variable rate 30-year trust preferred securities. The proceeds are being used to support the growth of the Company's insurance business, to repay short term debt and for general corporate purposes. The securities require interest payments on a quarterly basis calculated at a floating rate of London InterBank Offering Rate (LIBOR) + 4.2% and LIBOR + 3.95% for American Safety Capital and American Safety Capital II, respectively. The securities can be redeemed by the Company commencing five years from the date of issue.

The underlying debt obligations between the Company and American Safety Capital and American Safety Capital II expose the Company to variability in interest payments due to changes in interest rates. Management entered into an interest rate swap for each trust preferred offering to manage that variability. Under each interest rate swap, the Company receives variable interest payments and makes fixed interest rate payments to the applicable capital trust entity, thereby creating fixed rate long-term debt. The overall effective fixed rate expense as a result of this hedge is 7.1% and 7.6% for American Safety Capital and American Safety Capital Trust II, respectively, over the first five years of the obligation.

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Changes in fair value of the interest rate swaps designated as hedging instruments of the variability of cash flow associated with a floating rate, long-term debt obligation is reported in accumulated other comprehensive income. The gross unrealized gains (losses) on the interest rate swaps at December 31, 2004 and September 30, 2005 were \$192,589 and \$329,499 for American Safety Capital and \$(14,724) and \$122,233 for American Safety Capital Trust II, respectively. The interest rate swaps are 100% effective.

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

The information in the following discussion should be read in conjunction with the Company's consolidated financial statements and notes thereto included elsewhere in this Report. All amounts and percentages are rounded.

American Safety Insurance Holdings, Ltd (the Company) is a specialty insurance holding company which, through its subsidiaries, develops, underwrites, manages and markets property and casualty insurance and reinsurance to targeted niche markets for environmental remediation, contracting and other specialty risks. The Company was formed in 1986 as a group captive insurance company in Bermuda to provide stable, long term insurance protection for the asbestos abatement and environmental remediation industries in the United States, and now provides a broad range of specialty insurance coverages and services in all 50 states through approximately 230 independent insurance brokers and agencies.

The Company's earnings from insurance operations increased to \$3.2 million in the third quarter of 2005 compared to \$992,000 for the same quarter in 2004. Net earnings for the third quarter were \$3.3 million, or \$0.47 per diluted share as compared to earnings of \$3.3 million, or \$0.45 per diluted share for the third quarter of 2004. Insurance earnings for the nine months ended September 30, 2005 increased to \$9.8 million from \$1.4 million for the nine months ended September 30, 2004. Net earnings for the nine months ended September 30, 2005 were \$10.1 million, or \$1.41 per diluted share, as compared to \$11.0 million, or \$1.49 per diluted share, for the nine months ended September 30, 2004.

The following table sets forth the Company's net earnings (in thousands):

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Insurance Operations	\$992	\$3,192	\$1,410	\$9,800
Real Estate Operations	2,288	142	5,807	5,807
Other, including realized gains and (losses)	22	13	3,787	3,787
	=====	=====	=====	=====
Net Earnings	\$3,258	\$3,347	\$11,004	\$10,100
	=====	=====	=====	=====

The increase in insurance earnings for the quarter and the nine months ended September 30, 2005 was due to improved underwriting results combined with increased investment income. The underwriting results for the quarter and the nine months ended September 30, 2005 were driven by an improved loss ratio, which for the quarter decreased to 63% from 69% and for the nine months decreased to 62% from 70% for the same period of 2004. The underwriting results for the quarter and nine months ended September 30, 2005 included a charge of \$552,000 resulting from the commutation of a reinsurance treaty with a former reinsurer and a reinstatement reinsurance premium accrual of \$2.3 million on certain reinsurance contracts associated with the Company's discontinued lines. The combined ratio decreased for the quarter to 98% from 101% and for the nine months decreased to 97% from 104% for the same period in 2004. The decrease in real estate earnings for the quarter and for the nine months ended September 30, 2005 was due to the substantial completion of the Company's real estate operations at Harbour Village. Other significant items for the nine months of 2004 include non-recurring earnings of \$3.8 million, predominantly due to the recovery on an impaired note receivable.

Total revenues for the third quarter of 2005 decreased 39% to \$35 million compared to the same quarter of 2004 as a result of the expected decrease in real estate income. Net premiums earned for the third quarter of 2005 decreased 10% to \$31 million compared to the same quarter of 2004 due to the accrual of reinstatement reinsurance premiums previously mentioned. Net investment income for the quarter increased 44% to \$3.7 million from \$2.5 million in the third quarter of 2004 due to increased invested assets and an increase in the annualized yield to 3.9% from 3.6%.

Total revenues for the nine months ended September 30, 2005 decreased 30% to \$114 million compared to the same period in 2004 as a result of the expected decrease in real estate income. Net premiums earned for the nine months ended September 30, 2005 remained unchanged

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at \$100 million. Net investment income for the nine months ended September 30, 2005 increased 50% to \$10.2 million from \$6.8 million for the same period in 2004 due to increased invested assets and an increase in the annualized yield to 3.8% from 3.5%. Total invested assets increased 18% to \$385 million from \$327 million at December 31, 2004.

The Company's book value per share increased 6.4% to \$17.06 at September 30, 2005 from \$16.04 at December 31, 2004, due to the contribution of net earnings during the nine months ended September 30, 2005, offset in part by the change in unrealized loss on the Company's investment portfolio during the year due to increases in interest rates.

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

	Three Months Ended September 30,		Nine Months Ended September 30,		Three En Sept 30,
	2004	2005	2004	2005	2
	(Dollars in thousands)				
Net premiums written:					
Environmental	\$ 8,569	\$ 8,988	\$ 26,247	\$ 33,112	
Excess and surplus	18,546	17,524	57,018	55,864	(
Programs	5,867	6,618	13,451	15,930	1
Other	<u>27</u>	<u>(1,640)</u>	<u>754</u>	<u>(1,205)</u>	<u>(6,17</u>
Total net premiums written	\$ 33,009	\$ 31,490	\$ 97,470	\$ 103,701	(
	=====	=====	=====	=====	=
Net premiums earned:					
Environmental	\$ 8,697	\$ 9,542	\$ 23,333	\$ 28,064	
Excess and surplus	19,733	18,433	58,133	59,395	(
Programs	4,968	4,993	12,699	14,075	
Other	<u>1,183</u>	<u>(1,730)</u>	<u>6,625</u>	<u>(1,141)</u>	<u>(24</u>
Total net premiums earned	34,581	31,238	100,790	100,393	(
Net investment income	2,529	3,653	6,849	10,237	4
Net realized gains (losses)	100	25	120	(20)	(7
Real estate income	19,939	-	54,067	3,000	(10
Other income	<u>47</u>	<u>20</u>	<u>192</u>	<u>56</u>	<u>(5</u>
Total Revenues	\$ 57,196	\$ 34,936	\$162,018	\$ 113,666	(3
	=====	=====	=====	=====	=

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

	Three months ended September 30,		Nine months ended September 30,	
	2004	2005	2004	2005
Insurance operations:				
Loss and loss adjustment expense ratio	68.6 %	62.7%	70.1%	61.6%
Expense ratio	<u>32.7</u>	<u>35.2</u>	<u>34.1</u>	<u>35.5</u>
Combined ratio.....	101.3%	97.9%	104.2%	97.1%
	=====	=====	=====	=====

Quarter Ended September 30, 2005 Compared to Quarter Ended September 30, 2004

*Net Premiums Earned*

**Environmental.** Net earned premiums increased to \$9.5 million in the third quarter of 2005 compared to \$8.7 million for the same quarter of 2004. Net written premiums increased to \$8.9 million in the third quarter of 2005 compared to \$8.6 million for the same quarter of 2004. Most of the growth in this segment for the quarter was due to increased production in the Company's Prostar online rating and quoting system, as well as increased premiums generated from audits on expired policies. The Company has experienced a decline in the state of New York environmental contractor and consultant premiums as a result of the new underwriting criteria implemented in New York. The Company believes the initiatives it had undertaken in the state of New York will improve the ultimate profitability of the segment. The Company continues to experience a slight decline in premium rates for this segment over 2004 due to increased competition and the overall changing in pricing conditions in the marketplace. The Company plans to focus its efforts on expanding Prostar's capabilities and increasing the market share of the smaller environmental accounts.

**Excess and Surplus.** Net earned premiums decreased to \$18.4 million in the third quarter of 2005 compared to \$19.7 million for the same quarter of 2004. Net written premiums decreased to \$17.5 million in the third quarter of 2005 compared to \$18.5 million for the same quarter of 2004. Construction risks make up a majority of the book of business written by the this segment. The Company has started to experience a slight decline in premium rates on its renewal book of commercial construction business due to less business being shifted out of the standard market and a general softening of pricing in the market place. Premium rates on the residential construction business have remained more stable. The changing market conditions have resulted in a decline in the Company's renewal retention rates and new business volume. The Company remains committed to its disciplined underwriting approach and the Company has also not broadened its policy terms and conditions. The Company intends for residential construction risks to be the focus of the new business efforts as it believes this area continues to offer modest growth opportunities.

**Programs.** Net earned premiums remained steady at \$4.9 million in the third quarter of 2005 and 2004. Net written premiums increased to \$6.6 million in the third quarter of 2005 compared to \$5.9 million for the same quarter of 2004. The increase for the third quarter was primarily due to written premiums contributed from three new programs added in late 2004 and the first half of 2005, as well as growth in fully funded policies. No new programs were added during the third quarter of 2005. The Company has focused its efforts on increasing its retention levels on programs allowing the Company the opportunity to increase its earnings potential from underwriting profits. Fee income earned in the third quarter of 2005 from fully funded policies was \$386,000 as compared to \$27,000 for the third quarter of 2004. The Company believes this segment has continued growth opportunities for this product in the healthcare, residential construction and product manufacturing industries. The Company's focus in the program business unit is on insurance programs that allow the Company to participate in underwriting profits, while also earning fee income as the policy-issuing carrier.

**Other.** Net earned premiums decreased to negative \$1.7 million in the third quarter of 2005 compared to \$1.2 million for the same period of 2004. New written premiums decreased to negative \$1.6 million in the third quarter of 2005 compared to \$27,000 for the same period of 2004. In the third quarter of 2005 net written and net earned premiums decreased due to an accrual of \$2.0 million for reinstatement reinsurance premiums on discontinued lines. The Company's assumed liability program and workers' compensation business were put in run-off in 2004.

*Net Investment Income*

Net investment income increased to \$3.7 million in the quarter ended September 30, 2005 from \$2.5 million in the quarter ended September 30, 2004 due to higher levels of invested assets generated by positive cash flows from operations and an increased investment yield. Average invested assets were \$371 million in the quarter ended September 30, 2005 compared to \$284 million in the quarter ended September 30, 2004. The pre-tax investment yield increased to 3.9% from 3.6% in the quarters ended September 30, 2005 and September 30, 2004, respectively, and the after-tax investment yield increased to 3.2% from 2.9%, respectively. The increase in investment yield is consistent with the overall market rate increases.

*Net Realized Gains and Losses*

Net realized gains decreased to \$25,000 in the third quarter of 2005 compared to \$100,000 for the same period of 2004. Sales of investments are generally the result of changing investment strategies to maximize investment income.

*Real Estate Income*



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The final two condominium units at Harbour Village were closed in the second quarter of 2005, thus the Company has no real estate income in the third quarter of 2005. The Company does not expect to engage in any further real estate activities in the future. The earnings and funds generated from Harbour Village have been redeployed into the Company's insurance operations. See Note 6 to the Consolidated Financials Statements herein for additional information regarding Harbour Village.

### *Losses and Loss Adjustment Expenses*

In the quarter ended September 30, 2005, the Company's loss ratio improved 5.9 points to 62.7% as compared to 68.6% for the same period of 2004. This improvement was attributable to lower loss reserve development. During the quarter ended September 30, 2005, the Company experienced adverse loss development of \$74,000 compared to \$3.3 million in the same quarter of 2004. The \$3.3 million adverse loss development consisted of \$3.0 million on the excess and surplus lines and \$0.3 million on discontinued lines.

### *Acquisition Expenses*

Acquisition expenses are amounts that are paid to agents and brokers for the production of premium for the Company offset in part by the ceding commissions we retain from our reinsurers. For our program business, fees are typically earned through ceding commissions and have the effect of lowering our acquisition expenses. Acquisition expenses also include amounts paid for premium taxes to the states where the Company does business on an admitted basis. Acquisition expenses were \$6.7 million in the quarter ended September 30, 2005 compared to \$6.9 million in the quarter ended September 30, 2004. Acquisition expenses as a function of net earned premiums were 21.4% in the quarter ended September 30, 2005 and 20.1% in the quarter ended September 30, 2004.

### *Real Estate Expenses*

Real estate expenses were a benefit of \$601,000 for the third quarter of 2005 compared to \$16.9 million of expense for the same period of 2004. The final two condominium units were closed in the second quarter of 2005 at Harbour Village. During the third quarter of 2005, the Company received \$980,000 for settlement on roof litigation at Harbour Village. This receipt was applied as a reduction to real estate expenses as it had been expensed previously. The Company does not expect to engage in any further real estate activities in the future. The majority of earnings and funds generated from Harbour Village have been redeployed into the Company's insurance operations.

### *Income taxes*

The effective tax rate decreased to 17% for the quarter ended September 30, 2005 from 27% for the same period of 2004, as a result of lower taxable income on the Company's US operations. The effective tax rate was increased during the quarter by \$232,000 tax adjustment expense related to the Company's real estate project made in connection with the Company's annual tax return filing. Absent this adjustment, the effective tax rate would have been 19% for the quarter ended September 30, 2005

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## **Nine Months Ended September 30, 2005 Compared to Nine Months Ended September 30, 2004**

### Net Premiums Earned

**Environmental.** Net earned premiums increased to \$28.1 million in the nine months ended September 30, 2005 as compared to \$23.3 million in the same period of 2004. Net written premiums increased to \$33.1 million compared to \$26.2 million for the same time period. Most of the growth in this segment for the first nine months of 2005 was due to increased production in the Company's Prostar online rating and quoting system, as well as increased premiums generated from audits on expired policies. The Company has experienced a decline in the state of New York environmental contractor and consultant premiums as a result of the new underwriting criteria implemented in the state of New York. The Company believes the initiatives it has undertaken in New York will improve the ultimate profitability of the segment. The Company continues to experience a slight decline in premium rates over 2004 due to increased competition and the overall changing in pricing conditions in the marketplace. The Company intends to focus its efforts on expanding Prostar's capabilities and increasing the market share of the smaller environmental accounts.

**Excess and Surplus.** Net earned premiums increased to \$59.4 million in the first nine months of 2005 as compared to \$58.1 million in 2004. Net written premiums decreased to \$55.7 million compared to \$57.1 million for the same time period. Construction risks make up a majority of the

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book of business written by the E&S segment. The Company has started to experience a slight decline in premium rates on its renewal book of commercial construction business due to less business being shifted out of the standard market and a general softening of pricing in the market place. Premium rates on the residential construction business have remained more stable. The changing market conditions have resulted in a decline in the Company's renewal retention rates and new business volume. The Company remains committed to its disciplined underwriting approach and the Company has also not broadened its policy terms and conditions. The Company intends for residential construction risks to be the focus of the new business efforts as it believes this area continues to offer modest growth opportunities.

**Programs.** Net earned premiums increased to \$14.1 million for the nine months ended September 30, 2005 as compared to \$12.7 million in the same period of 2004. Net written premiums increased to \$15.9 million compared to \$13.5 million for the same time period. The increase for the first nine months of 2005 was primarily due to written premiums contributed from three new programs added in late 2004 and the first half of 2005, as well as growth in fully funded policies. The Company has focused its efforts on increasing its retention levels on programs allowing the Company the opportunity to increase its earnings potential from underwriting profits. Fee income earned for the nine months ended September 30, 2005 from fully funded policies was \$797,000 as compared to \$83,000 for the same period of 2004. The Company sees continued growth opportunities for this product in the healthcare, residential construction and product manufacturing industries. The Company's focus in the program business unit is on insurance programs that allow the Company to participate in underwriting profits, while also earning fee income as the policy-issuing carrier.

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**Other.** Net earned premiums decreased to negative \$1.1 million for the first nine months of 2005 as compared to \$6.6 million in 2004. Net written premiums decreased to negative \$1.2 million compared to \$0.7 million for the same period of 2004. For the first nine months of 2005 net written and net earned premiums decreased due to an accrual of \$2.0 million for reinsurance premiums on discontinued lines in the third quarter. The Company's assumed liability program and workers' compensation business were put in run-off in 2004.

### *Net Investment Income*

Net investment income increased to \$10.2 million in the nine months ended September 30, 2005 from \$6.8 million in the nine months ended September 30, 2004 due to higher levels of invested assets generated by positive cash flows from operations and an increased investment yield. Average invested assets were \$356 million during the nine months ended September 30, 2005 compared to \$262 million for the same period of 2004. The average pre-tax and after tax yields were 3.8% and 3.5% compared to 3.1% and 2.8% for the nine months ended September 30, 2005 and 2004 respectively. The increase in yield is consistent with the overall market rate increases.

### *Net Realized Gains and Losses*

Net realized gains and losses changed from a net gain of \$120,000 in the nine months ended September 30, 2004 to a net loss of \$20,000 for the nine months ended September 30, 2005. Sales of investments are generally the result of changing investment strategies to maximize investment income.

### *Real Estate Income*

Real estate income decreased to \$3 million for the nine months ended September 30, 2005 compared to \$54 million for the same period of 2004. In the second quarter of 2005, the final two condominium units were closed at Harbour Village. The Company does not expect to engage in any further real estate activities in the future. The earnings and funds generated from Harbour Village have been redeployed into the Company's insurance operations. See Note 6 to the Consolidated Financials Statements herein for additional information regarding Harbour Village.

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### *Losses and Loss Adjustment Expenses*

For the nine months ended September 30, 2005, the Company's loss ratio improved 8.5 points from 70.1% to 61.6% as compared to the same period of 2004. This improvement was attributable to lower loss reserve development. For the nine months ended September 30, 2005, adverse loss development decreased to \$1.1 million from \$12.3 million for the same period of 2004. For the nine months ended September 30, 2004 the \$12.3 million adverse loss development consisted of \$7.7 million on the excess and surplus lines and \$4.6 million on discontinued lines. For the nine months ended September 30, 2005 the \$1.1 million adverse loss development was on discontinued lines.

### *Acquisition Expenses*

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Policy acquisition expenses increased to \$21 million for the nine months ended September 30, 2005 from \$20 million for the nine months ended September 30, 2004. Acquisition expenses as a function of net earned premiums were 20.6% for the nine months ended September 30, 2005 compared to 19.9% for the nine months ended September 30, 2004.

### *Real Estate Expenses*

Real estate expenses associated with Harbour Village decreased to \$2.1 million in the nine months ended September 30, 2005 from \$45.1 million for the nine months ended September 30, 2004. In the second quarter of 2005, the final two condominium units were closed. During the third quarter of 2005, the Company received \$980,000 for settlement on roof litigation at Harbour Village. This receipt was applied as a reduction to real estate expenses as it had been expensed previously. The Company does not expect to engage in any further real estate activities in the future. The earnings and funds generated from Harbour Village have been redeployed into the Company's insurance operations. See Part II Item 1 for additional information.

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### *Payroll and Other Expenses*

Payroll and other expenses increased to \$16.8 million in the nine months of 2005 compared to \$13.4 million. In the nine months ended September 30, 2004, the Company collected \$2.6 million as final settlement of a notes receivable. This receipt was applied as a reduction to other expenses in the prior nine months. Absent this receipt payroll and other expenses increased to \$16.8 million for nine months ended September 30, 2005 from \$16 million for the same period of 2004. This increase was attributable to expenses associated with the implementation of Sarbanes-Oxley and regulatory audits which were \$967,000 for the nine months ended September 30, 2005 compared to \$55,000 for the same period of 2004.

### *Expenses due to Rescission*

During the second quarter of 2004, the Company received \$1.8 million in settlement of professional liability claims against parties who were involved in the Principal Management rescission litigation, as discussed in Part II, Item 1, Principal Management Rescission Litigation.

### *Minority Interest Expense*

Minority interest expense is associated with our non-subsiary affiliate, American Safety RRG. In the past, given the historical loss position of American Safety RRG, a valuation allowance on its net deferred tax assets had been established. In the first quarter of 2005, American Safety RRG included in income the reduction of this valuation allowance (totaling \$554,515) as management's judgment about the realizability of its deferred tax assets changed due to American Safety RRG's profitability. As a result, minority interest for nine months ended September 30, 2005 was \$445,000 as compared to \$612,000 for the same period of 2004.

### *Income taxes*

The effective tax rate was 11% for the nine months ended September 30, 2005 as compared to 20% for the same period of 2004. The decrease is due to lower taxable income on the Company's US operations. The effective tax rate was increased during the third quarter of 2005 by \$232,000 tax adjustment expense related to the Company's real estate project made in connection with the Company's annual tax filing. Absent this adjustment, the effective tax rate would have been 12% for the nine months ended September 30, 2005

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## **Liquidity and Capital Resources**

The Company meets its cash requirements and finances its growth principally through cash flows generated from operations. Since 2000 the Company has operated in a hardening market with increased insurance premium rates for general liability coverages and increased fees for program business opportunities. During 2004, the Company began to experience a leveling of premium rates due to entrance of new insurance competitors into the specialty insurance market and overall market conditions. The Company's primary sources of short-term cash flow are premium writings and investment income. Short-term cash requirements relate to claims payments, reinsurance premiums, commissions, salaries, employee benefits, real estate development expenses, and other operating expenses. Due to the uncertainty regarding the timing and amount of settlements of unpaid claims, the Company's future liquidity requirements may vary; therefore, the Company has structured its

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investment portfolio maturities to allow for variations in those factors. The Company believes its current cash flows are sufficient for the short-term needs of its business and its invested assets are sufficient for the long-term needs of its insurance business.

Net cash provided from operations was \$55 million for the nine months ended September 30, 2005, and \$67 million for the nine months ended September 30, 2004. This decrease was primarily caused by increased loss payments, which increased to \$35 million from \$18 million in the same period of 2004.

The estimated completion cost for the remainder of Harbour Village is approximately \$2 million and represents amounts needed to construct a beach club. Management believes that cash on hand will meet the remaining liquidity needs of Harbour Village.

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

### Income Taxes

The Company is incorporated under the laws of Bermuda and, under current Bermuda law, is not obligated to pay any taxes in Bermuda based upon income or capital gains. The Company has received an undertaking from the Minister of Finance in Bermuda pursuant to the provisions of The Exempted Undertakings Tax Protection Act 1966, which exempts the Company and its 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. The Company, exclusive of its United States subsidiaries, does not consider itself to be engaged in a trade or business in the United States and accordingly does not expect to be subject to direct United States income taxation. The Company's United States subsidiaries are subject to taxation in the United States.

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### Impact of Inflation

Property and casualty insurance premiums are established before the amount of losses and loss adjustment expenses are known and therefore before the extent by which inflation may affect such expenses is known. Consequently, the Company attempts, in establishing its premiums, to anticipate the potential impact of inflation. However, for competitive and regulatory reasons, the Company may be limited in raising its premiums consistent with anticipated inflation, in which event the Company, rather than its insureds, would absorb inflation costs. Inflation also affects the rate of investment return on the Company's investment portfolio with a corresponding effect on the Company's investment income.

### Combined Ratio

The combined ratio of an insurance company measures only the underwriting results of insurance operations and not the profitability of the overall business. Our reported combined ratio for our insurance operations may not provide an accurate indication of our overall profitability. For instance, depending on our mix of business the combined ratio may not fluctuate consistently with the overall Company profitability.

### Reserves

Certain of our insurance policies and reinsurance assumed, including general and pollution liability policies covering environmental remediation, excess and surplus, and workers' compensation risks, may be subject to claims brought years after an incident has occurred or the policy period has ended. We are required to maintain reserves to cover the unpaid portion of our ultimate liability for losses and loss adjustment expenses with respect to (i) reported claims and (ii) incurred but not reported claims. A full actuarial analysis is performed to provide this estimate of all unpaid loss and loss adjustment expense obligations of the Company under the terms of its contracts and agreements. In evaluating whether the reserves make a reasonable provision for unpaid loss and loss adjustment expense, it is necessary to project future loss and loss adjustment expense payments. It is certain that the actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections. If the net loss reserves were to increase by 5% this would reduce pre-tax income by \$11 million. If the net loss reserves were to decrease by 5% this would increase pre-tax income by \$11 million.

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With respect to reported claims, case reserves are established on a case-by-case basis. The reserve amounts on each reported claim are determined by taking into account the circumstances surrounding each claim and policy provisions relating to the type of loss. Loss reserves are reviewed on a regular basis, and as new information becomes available, appropriate adjustments are made to reserves.

In establishing product line incurred but not reported (IBNR) reserves, several methods are employed in determining ultimate losses: the expected loss ratio method; the Bornhuetter-Ferguson method based on expected loss ratios, paid losses and reported losses; and the loss development method based on paid and reported losses. The expected loss ratio method uses industry expected losses adjusted for our experience while the loss development method relies on industry payment and reporting patterns to develop our actual losses. The Bornhuetter-Ferguson method is a combination of the other two methods, using expected loss ratios to produce expected losses, then applying loss payment and reporting patterns to the expected losses to produce the expected IBNR. We review the ultimate projections from all three methods and, based on the merits of each method, determine our estimated ultimate losses.

However, the establishment of appropriate loss reserves is an inherently uncertain process, and there can be no assurance that such ultimate payments will not materially exceed our reserves.

### 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 and new products and the Harbour Village real estate development project. 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 collectibility 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. For additional factors, which could influence the Company's operating and financial performance, see the Company's filings with the Securities and Exchange Commission.

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

The Company's market risk has not changed materially since December 31, 2004.

### 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 have been no changes in the Company's internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the third quarter of 2005 that have materially affected or are reasonably likely to affect the Company's internal control over financial reporting.

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## PART II OTHER INFORMATION

### Item 1. Legal Proceedings

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The Company, through its subsidiaries, is routinely a party to pending or threatened litigation or arbitration disputes in the normal course of or related to its business. Based upon information presently available, in view of legal and other defenses available to the Company's subsidiaries, management does not believe that any pending or threatened litigation or arbitration disputes will have any material adverse effect on the Company's financial condition or operating results, except for the following matter.

*Acquisition Rescission Litigation.* In April 2000, the Company filed a lawsuit in the U.S. District Court for the Northern District of Georgia for damages and, alternatively, to rescind the stock purchase of a Michigan insurance agency and two related insurance companies specializing in insurance program business based upon the sellers' breach of the representations and warranties made in the definitive agreements concerning the business affairs and financial condition of the acquired companies. The Company also sought to retain funds and company stock escrowed as part of the transaction. Over the past five years the court ruled on several motions and issues. The result of the pretrial motions were orders dismissing the Company's claims and holding that Company should release \$685,000 of the remaining amounts in an escrow account to the defendants. The court declined to rule on the disposition of escrowed shares of stock. The Company has appealed all of the adverse orders and ruling. The trial court entered a final judgment against the Company for \$685,000. The Company plans to appeal this decision. In addition, the trial court finalized its declination to rule on the disposition of the escrowed shares of stock. As a result, a new suit has been filed against the Company for the stock. The Company plans to file an answer to this suit. In 2004, the Company accrued \$1.4 million of additional expense as a result of previous adverse rulings and currently maintains this amount.

*Assumed Reinsurance Litigation.* The Company is a defendant in several cases, liquidation actions and reinsurance claims identified as the National Warranty issue. American Safety Reinsurance, Ltd. was an excess of loss reinsurer of the National Warranty Risk Retention Group (National Warranty) who, in turn, provided insurance coverage to automobile dealerships and other providers who became obligors pursuant to extended automobile warranty contracts they sold to consumer purchasers. National Warranty filed for liquidation in the Cayman Islands (the location of its legal creation). This liquidation had a cascading effect, including the subsequent filing of bankruptcy by various obligors of vehicle service contracts insured by National Warranty. As a result, there are potentially over a million vehicle service contracts that are not being honored by the obligors.

In these lawsuits, the consumer purchasers and automobile dealers have alleged various theories of liability against the Company. Generally, the Company has filed various motions arguing lack of personal jurisdiction and privity of contract, in the various actions and awaits the decisions of the courts. The Joint Official Liquidators (JOL) and the lead counsel for the Rocker class action, which is the leading case, have been meeting to devise a strategy to create a potential global settlement with the Company. However, their potential settlement numbers are not considered reasonable at this time. The JOLs have made a claim against the reinsurance treaty, however, additional information is needed to verify if any claim, in fact, exists. The Company believes it has several valid defenses and intends to vigorously contest these lawsuits.

*Donald Griggs et al. v. American Safety Reinsurance Ltd. Et al., Case No 2003-31509, Circuit Court, Seventh District, Volusia County, Florida.* Seven plaintiffs filed suit against the Company and three of its subsidiaries seeking to recover a \$2,100,000 loan made by the plaintiffs in 1986 to Ponce Marina, Inc., the former owner of the Harbour Village property. The plaintiffs claimed that the Company was responsible for the repayment of the Loan, with interest. The plaintiffs propounded four theories of liability and the Court granted judgment for the Company on three of the theories. However, the Court entered judgment on August 10, 2005 against the Company for \$3,426,703.50, which includes interest, on the remaining theory. The court held that the Company, as a condition of its loan, required the former owner to demand that the Seven take certain actions as to their loan, to their detriment and to the benefit of the Company, and thus, the Company had entered into a quasi-contract with the Seven to repay their loan with interest.

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The Company has reviewed the decision of the Court with outside legal counsel and plans to vigorously pursue an appeal. Based on the merits of the case and the likelihood of ultimate payment, the Company has not established an accrual for the decision.

*Baber v. Borowiec v. American Safety Casualty Insurance Company,* This case arises out of a claim brought by the Baber family against two lawyers (Borowiecs) for legal malpractice. The Borowiecs are insured by American Safety Casualty Insurance Company (ASCIC) under a Lawyers Professional Liability Program underwritten and managed through ASCIC's program manager Professional Coverage Managers, Inc. During the adjustment of this claim, ASCIC issued a reservation of rights letter, denied the claim based on a coverage issue, rejected a policy limits demand and intervened into the underlying suit.

The Babers and Boroweics eventually entered into a Morris Agreement wherein the Babers agreed not to pursue any judgment against the Boroweics. Rather, the Boroweics assigned their bad faith rights against ASCIC to the Babers. The court found this to be reasonable and also found that the Babers, as a result of the accident, had incurred \$11 million in damages. The Babers have sued ASCIC for bad faith. There is no final judgment, as of this date, against the Boroweics or ASCIC.

The Court granted the Baber's motion for summary judgment and found, as a matter of law, that coverage exists for this claim. ASCIC will appeal this ruling at the appropriate time. The bad faith portion of this case is set for trial on January 6, 2006. The Company intends to vigorously defend these claims

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The reinsurance for this program is a 90/10 Quota Share treaty with a \$2 million ECO/XPL limit. In addition, the Company has a Clash Cover treaty with a \$5 million limit.

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

Not applicable.

### Item 3. Defaults Upon Senior Securities

Not applicable. Item 4. Submission of Matters to a Vote of Security Holders None.

### Item 5. Other Information

On November 2, 2005, the Company announced the appointment of William C. Tepe as Chief Financial Officer. Mr. Tepe will assume his position with the Company effective November 14, 2005, and will replace Steven B. Mathis as Chief Financial Officer. Mr. Mathis will be assigned the key role of Vice President, Planning and Treasury.

### Item 6. Exhibits

The following exhibits are filed as part of this report:

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

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#### SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Report caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, November 2005.

American Safety Insurance Holding

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

By: /s/ Steven B. Mathis  
 Steven B. Mathis  
 Chief Financial Officer  
 (Principal Financial Officer)

Exhibit 11

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

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>
	September 30, <u>2004</u>	September 30, <u>2005</u>	September 30, <u>2004</u>
Basic:			
Earnings available to common shareholders.....	\$ 3,257,792 =====	\$ 3,347,298 =====	\$ 11,004,380 =====
Weighted average common shares outstanding.....	6,876,380	6,702,609	6,905,133
Basic earnings per common shares ...	\$ 0.47 =====	\$ 0.50 =====	\$ 1.59 =====
Diluted:			
Earnings available to common shareholders.....	\$ 3,257,792 =====	\$ 3,347,298 =====	\$ 11,004,380 =====
Weighted average common shares outstanding.....	6,876,380	6,702,609	6,905,133
Weighted average common shares equivalents associated with options....	398,879	444,055	489,597
Total weighted average common shares.....	7,275,259 =====	7,149,664 =====	7,394,730 =====
Diluted earnings per common shares.....	\$ 0.45 =====	\$ 0.47 =====	\$ 1.49 =====

Exhibit 31.1

**Certification Pursuant to ss.302 of the Sarbanes-Oxley Act of 2002**

I, Stephen R. Crim certify that:



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1. I have reviewed this quarterly report on Form 10-Q of American Safety Insurance
2. Based on my knowledge, this report does not contain any untrue statement of omit to state a material fact necessary to make the statements made, circumstances under which such statements were made, not misleading with res covered by this report;
3. Based on my knowledge, the financial statements, and other financial inform this report, fairly present in all material respects the financial cond operations and cash flows of the registrant as of, and for, the periods report;
4. The registrant's other certifying officer(s) and I are responsible for maintaining disclosure controls and procedures (as defined in Exchange Act RU 15d-15(e)) for the registrant and have:
  - (a) designed such disclosure controls and procedures, or caused such di and procedures to be designed under our supervision, to ensu information relating to the registrant, including its consolidated made known to us by others within those entities, particularly du which this report is being prepared;
  - (b) designed such internal control over financial reporting, or cau control over financial reporting to be designed under our superv reasonable assurance regarding the reliability of financial r preparation of financial statements for external purposes in accorda accepted accounting principles;
  - (c) evaluated the effectiveness of the registrant's disclosure controls presented in this report our conclusions about the effectiveness controls and procedures, as of the end of the period covered by th such evaluation; and
  - (d) disclosed in this report any change in the registrant's inter financial reporting that occurred during the registrant's most rec that has materially affected, or is reasonably likely to materi registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based evaluation of internal control over financial reporting, to the registrant's audit committee of the registrant's board of directors (or persons performi functions):
  - (a) All significant deficiencies and material weaknesses in the desi internal control over financial reporting which are reasonably l affect the registrant's ability to record, process, summarize and information; and
  - (b) Any fraud, whether or not material, that involves management or ot have a significant role in the registrant's internal controls over fin

Date: November 11, 2005

/s/ Stephen R. Crim  
Stephen R. Crim  
Chief Executive Officer  
American Safety Insurance

**Certification Pursuant to ss.302 of the Sarbanes-Oxley Act of 2002**

I, Steven B. Mathis, certify that:

1. I have reviewed this quarterly report on Form 10-Q of American Safety Insurance
2. Based on my knowledge, this report does not contain any untrue statement of omit to state a material fact necessary to make the statements made, circumstances under which such statements were made, not misleading with respect to the operations and cash flows of the registrant as of, and for, the periods covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this Report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods covered by this report;
4. The registrant's other certifying officer(s) and I are responsible for maintaining disclosure controls and procedures (as defined in Exchange Act Rule 15d-15(e)) for the registrant and have:
  - (a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that information relating to the registrant, including its consolidated financial statements, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) evaluated the effectiveness of the registrant's disclosure controls and procedures presented in this report and our conclusions about the effectiveness of the registrant's disclosure controls and procedures, as of the end of the period covered by this report and during such evaluation; and
  - (d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our evaluation of internal control over financial reporting, to the registrant's audit committee of the registrant's board of directors (or persons performing similar functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: November 11, 2005

/s/ Steven B. Mathis  
Steven B. Mathis  
Chief Financial Officer  
American Safety Insurance

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Exhibit 32.1

**Certification Pursuant to § 906 of the**

**Sarbanes-Oxley Act of 2002**

The undersigned, as the Chief Executive Officer of American Safety Insurance Group, Ltd., certifies that, to the best of his knowledge and belief, the Quarterly Report on Form 10-Q for the period ended September 30, 2005, which accompanies this certification fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of American Safety Insurance Group, Ltd. at the dates and for the periods indicated. The foregoing certification is made pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350) and shall not be relied upon for any other purpose.

Date: November 11, 2005

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

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

The information in this Exhibit 32.1 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, except as shall be expressly set forth by specific reference in such filing.

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Exhibit 32.2

**Certification Pursuant to § 906 of the**

**Sarbanes-Oxley Act of 2002**

The undersigned, as the Chief Executive Officer of American Safety Insurance Group, Ltd., certifies that, to the best of his knowledge and belief, the Quarterly Report on Form 10-Q for the period ended September 30, 2005, which accompanies this certification fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of American Safety Insurance Group, Ltd. at the dates and for the periods indicated. The foregoing certification is made pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350) and shall not be relied upon for any other purpose.

Date: November 11, 2005

/s/ Steven B. Mathis  
Steven B. Mathis

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

The information in this Exhibit 32.2 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, except as shall be expressly set forth by specific reference in such filing.

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