HCC INSURANCE HOLDINGS INC/DE/
Form 10-K/A
December 27, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K/A
þ Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
o Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the fiscal year ended December 31, 2005
Commission file number 001-13790
HCC Insurance Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware	76-0336636
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
13403 Northwest Freeway, Houston, Texas	77040-6094
(Address of principal executive offices)	(Zip Code)

(713) 690-7300

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12 (b) of the Act:

Title of each class:	Name of each exchange on which registered:
COMMON STOCK, $1.00 PAR VALUE	New York Stock Exchange

Securities registered pursuant to Section 12 (g) of the Act: NONE

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act.
Yes þ No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
Yes o No þ

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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 þ	Accelerated filer o	Non-accelerated filer o

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

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The aggregate market value on June 30, 2005 (the last business day of the registrant s most recently completed second fiscal quarter) of the voting stock held by non-affiliates of the registrant was approximately $2.6 billion. For purposes of the determination of the above-stated amount, only directors and executive officers are presumed to be affiliates, but neither the registrant nor any such person concede that they are affiliates of the registrant.
The number of shares outstanding of the registrant s Common Stock, $1.00 par value, at February 28, 2006 was 111.1 million.
Documents incorporated by reference: Information called for in Part III of this Form 10-K is incorporated by reference to the registrant s definitive Proxy Statement filed within 120 days of the close of the registrant s fiscal year in connection with the registrant s annual meeting of shareholders.

HCC INSURANCE HOLDINGS, INC.
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As used in this report, unless otherwise required by the context, the terms we, us and our refer to HCC Insurance Holdings, Inc. and its consolidated subsidiaries and the term HCC refers only to HCC Insurance Holdings, Inc.

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EXPLANATORY NOTE RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

In light of published reports concerning the pricing of stock options and the timing of stock option grants at numerous other companies, in the second quarter of 2006 we undertook a voluntary internal review of our past practices related to grants of stock options. The voluntary review by our management concluded that the actual accounting measurement dates for certain past stock option grants differed from the originally stated grant dates, which were also utilized as the measurement dates for such awards. In August 2006, our Board of Directors formed a Special Committee of independent directors to commence an investigation of our past stock option granting practices for the period 1995 through 2005. The Special Committee was composed of the members of the Audit Committee of the Board of Directors. The Special Committee retained the law firm of Skadden, Arps, Slate, Meagher & Flom, LLP as its independent legal counsel and LECG as forensic accountants to aid in the investigation.

On November 17, 2006, we announced that the Special Committee had made certain determinations as a result of its review of our past stock option granting practices. The Special Committee found that we had used incorrect accounting measurement dates for stock option grants covering a significant number of employees and members of our Board of Directors during the period 1997 through 2005 and that certain option grants were retroactively priced. Additionally, at the direction of the Special Committee, we reviewed our stock option granting practices from 1992, the year of our initial public stock offering, through 1994 and in 2006 and found incorrect measurement dates due to retroactive pricing were used in 2006. In substantially all of these instances, the price on the actual measurement date was higher than the price on the stated grant date; thus recipients of the options could exercise at a strike price lower than the actual measurement date price. To determine the actual measurement dates, the Special Committee utilized the following sources of information:

- The dates on documentation such as e-mails, regulatory form filings, acquisition agreements and other correspondence;

- The date that the relevant stock option grant was entered into Equity Edge, our stock option tracking and accounting system;

- Requirements of Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*, and related interpretations; and

- Guidance from the Office of Chief Accountant of the Securities and Exchange Commission (SEC) contained in a letter dated September 19, 2006.

The Special Committee concluded that mis-priced option grants, the effect of which, together with certain other adjustments, resulted in a cumulative net decrease in shareholders equity at December 31, 2005 of $3.3 million, affected all levels of employees. The Special Committee found that Stephen L. Way, Chief Executive Officer, retroactively priced options, that he should have known he was granting options in a manner that conflicted with our stock option plans and public statements, and that this constituted a failure to align the stock option granting process with our stock option plans and public statements. Although finding his actions were inconsistent with the duties and obligations of a chief executive officer of a publicly-traded company, the Special Committee also found that Mr. Way s motivation appeared to be the attraction and retention of talent and to provide employees with the best option price. The Special Committee also concluded that Christopher L. Martin, Executive Vice President and General Counsel, was aware that options were being retroactively priced in a manner inconsistent with applicable plan terms and the procedures memoranda that he had prepared, that granting in-the-money options had accounting implications, and that he did not properly document our Compensation Committee s informal delegation of authority to Mr. Way. The Special Committee also found that there was no evidence that Mr. Way or Mr. Martin intended to falsify the consolidated financial statements.

Before the Board of Directors reviewed the results of the investigation, the Chairman of our Compensation Committee tendered his resignation from the Board of Directors on November 8, 2006. After reviewing the results of the investigation, the Board of Directors determined that it would be appropriate to accept the resignations of Mr. Way and Mr. Martin, which both tendered on November 17, 2006. Mr. Way will remain a director of HCC and serve as the non-executive Chairman of the Board of Directors and has entered into a consulting agreement with us to assist in the transition of leadership and to provide strategic guidance. We have entered into agreements with Mr. Way and Mr. Martin which, among other things, require them to disgorge an amount equal to the difference between

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the actual measurement date prices determined by HCC and the prices at which these individuals exercised mis-priced options since 1997.

For more information on these matters, including a detailed discussion of the financial effects of these matters, refer to Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations Restatement of Consolidated Financial Statements, Special Committee and Company Findings and to Note 2, Restatement of Consolidated Financial Statements, Special Committee and Company Findings, of the Notes to Consolidated Financial Statements.

As a result of the determinations of the Special Committee and because the resulting cumulative charge would be material to the second quarter and full year 2006 consolidated net earnings, we concluded on December 19, 2006 that we needed to amend this Annual Report on Form 10-K for the year ended December 31, 2005 as filed on March 16, 2006 (the Original Filing), to restate our consolidated financial statements for the years ended December 31, 2005, 2004 and 2003 and the related disclosures. However, the impact of the restatement in any of the restated periods is not material. We are making the restatement in accordance with generally accepted accounting principles to record the following:

- Non-cash compensation expense for the difference between the stock price on the stated grant date and the actual measurement date and for the fluctuations in stock price in certain instances where variable accounting should have been applied;

- Other adjustments that were not recorded in the originally filed financial statements due to their immateriality; and

- Related tax effects for all items.

We also concluded we did not maintain an effective control environment as our controls were not adequate to prevent or detect management override by certain former members of senior management related to our stock option granting practices and procedures. Accordingly, we have restated our report on internal control over financial reporting to reflect this material weakness.

This Form 10-K/A also includes the restatement of selected financial data as of and for the years ended December 31, 2005, 2004, 2003, 2002 and 2001, and the unaudited quarterly financial data for each of the quarters in the years ended December 31, 2005 and 2004. We have not amended any of our other previously filed annual reports on Form 10-K or quarterly reports on Form 10-Q for the periods affected by the restatement other than our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, which we are filing concurrently with this Form 10-K/A. For this reason, the consolidated financial statements and related financial information contained in such previously filed reports should no longer be relied upon.

We were unable to timely file our quarterly reports on Form 10-Q for the quarters ended June 30, 2006 and September 30, 2006, primarily due to not knowing the financial impact of the Special Committee s investigation. Our Form 10-Q s for these quarters are being filed concurrently with this Form 10-K/A. We have also restated the June 30, 2005 and September 30, 2005 financial statements included in our quarterly reports on Form 10-Q for the respective 2006 quarters.

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The cumulative effect of the restatement for the period 1997 through 2005 was as follows (in thousands):

Increase (decrease) in net earnings and retained earnings:		
Non-cash compensation expense related to stock option grants (including $994 recorded as accrued expenses)	$ (26,608)	
Net adjustments for immaterial items previously unrecorded	1,316	
Reduction in earnings from continuing operations before income tax expense	(25,292)	
Related income tax benefit	6,667	
Reduction in net earnings from continuing operations and net earnings		$ (18,625)
Increase (decrease) to additional paid-in capital:		
Increase related to non-cash compensation expense	$ 25,614	
Reduction related to tax effects previously credited to additional paid-in capital	(11,012)	
Net increase in additional paid-in capital		14,602
Increase in other comprehensive income for immaterial items previously unrecorded		762
Net decrease in shareholders equity at December 31, 2005		$ (3,261)

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In order to further enhance investor understanding of the effects of the matters described above and to provide context for the composition of the cumulative adjustment to shareholders equity at December 31, 2002, we have provided the information below which shows the years to which the stock option compensation adjustments relate. Our consolidated financial statements and the related SEC reports for such periods have not been amended, except for the consolidated financial statements included in this Form 10-K/A. In addition to the stock option compensation adjustments, we also included the effect of other immaterial adjustments which were previously unrecorded and the related tax effects of all adjustments. The increase (decrease) in net earnings for each type of adjustment was as follows (in thousands):

	Net earnings as previously reported	Non-cash stock option compensation expense	Other	Tax effect	Total adjustments	Net earnings as restated
Years ended						
December 31, 1997	$ 50,083	$ (3,789)	$	$ 1,326	$ (2,463)	$ 47,620
1998	73,110	(3,664)		1,273	(2,391)	70,719
1999	26,572	(1,474)		(148)	(1,622)	24,950
2000	55,468	(4,586)	(1,124)	1,830	(3,880)	51,588
2001	30,197	(2,201)	1,881	88	(232)	29,965
2002	105,828	(2,043)	(27)	561	(1,509)	104,319
Cumulative effect at December 31, 2002	341,258	(17,757)	730	4,930	(12,097)	329,161
2003	143,561	(3,279)	1,270	475	(1,534)	142,027
2004	163,025	(2,571)	2,453	(208)	(326)	162,699
2005	195,860	(3,001)	(3,137)	1,470	(4,668)	191,192
Cumulative effect at December 31, 2005	$ 843,704	$ (26,608)	$ 1,316	$ 6,667	$ (18,625)	$ 825,079

All information in this Form 10-K/A is as of December 31, 2005 and does not reflect events occurring after the date of the Original Filing, other than the restatement and updating of certain disclosures affected by events subsequent to the date of the Original Filing. For the convenience of the reader, this Form 10-K/A sets forth the Original Filing in its entirety, as amended and modified to reflect the restatement. The following sections of this Form 10-K/A were amended to reflect the determinations of the Special Committee and the restatement:

Part I Item 1 Business;
Part I Item 1A Risk Factors;
Part I Item 3 Legal Proceedings;
Part II Item 6 Selected Financial Data;
Part II Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations;
Part II Item 8 Financial Statements and Supplementary Data;
Part II Item 9A Controls and Procedures;
Part III Item 13 Certain Relationships and Related Transactions; and
Part IV Item 15 Exhibits and Financial Statement Schedules.

This Form 10-K/A should be read in conjunction with our periodic filings made with the SEC, subsequent to the date of the Original Filing, including any amendments to those filings, as well as any Current Reports filed on Form 8-K subsequent to the date of the Original Filing. In addition, in accordance with applicable rules and regulations promulgated by the SEC, this Form 10-K/A includes updated certifications from our current Chief Executive Officer and Chief Financial Officer as Exhibits 31.1, 31.2, 32.1 and 32.2.

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FORWARD-LOOKING STATEMENTS

This report on Form 10-K/A contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created by those laws. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements include information about possible or assumed future results of our operations. All statements, other than statements of historical facts, included or incorporated by reference in this report that address activities, events or developments that we expect or anticipate may occur in the future, including such things as future capital expenditures, business strategy, competitive strengths, goals, growth of our business and operations, plans and references to future successes may be considered forward-looking statements. Also, when we use words such as anticipate, believe, estimate, expect, intend, plan, probably or similar expressions, we are making forward-looking statements.

Many risks and uncertainties may impact the matters addressed in these forward-looking statements, which could affect our future financial results and performance, including, among other things:

- *the effects of catastrophic losses;*
- *the cyclical nature of the insurance business;*
- *inherent uncertainties in the loss estimation process, which can adversely impact the adequacy of loss reserves;*
- *the effects of emerging claim and coverage issues;*
- *the effects of extensive governmental regulation of the insurance industry;*
- *potential credit risk with brokers;*
- *our increased retention of risk, which could expose us to greater potential losses;*
- *the adequacy of reinsurance protection;*
- *the ability or willingness of reinsurers to pay balances due us;*
- *the occurrence of terrorist activities;*
- *our ability to maintain our competitive position;*
- *changes in our assigned financial strength ratings;*
- *our ability to raise capital in the future;*
- *attraction and retention of qualified employees;*
- *fluctuations in the fixed income securities market, which may reduce the value of our investment assets;*
- *our ability to successfully expand our business through the acquisition of insurance-related companies;*
- *our ability to receive dividends from our insurance company subsidiaries in needed amounts;*
- *fluctuations in foreign exchange rates;*

failures of our information technology systems, which could adversely affect our business;

developments in the SEC s informal inquiry related to our past practices in connection with grants of stock options;

potential issues related to the effects of Sections 409A and 162(m) of the Internal Revenue Code and any expenses associated therewith;

changes to improve our internal controls related to the process of granting, documenting and accounting for stock option awards;

additional expenses and taxes associated with our stock option investigation and related matters;

potential litigation that could result from our stock option investigation;

the ability of our Executive Officers to define and implement a strategic business plan; and

our ability to cure all defaults or events of default under our outstanding loan agreements.

These events or factors could cause our results or performance to differ materially from those we express in our forward-looking statements. Although we believe that the assumptions underlying our forward-looking statements are reasonable, any of these assumptions, and, therefore, also the forward-looking statements based on these assumptions, could themselves prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements which are included in this report, our inclusion of this information is not a representation by us or any other person that our objectives and plans will be achieved.

Our forward-looking statements speak only at the date made and we will not update these forward-looking statements unless the securities laws require us to do so. In light of these risks, uncertainties and assumptions, any forward-looking events discussed in this report may not occur.

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PART I

ITEM 1. BUSINESS

Business Overview

HCC Insurance Holdings, Inc. is a Delaware corporation, which was formed in 1991. Its predecessor corporation was formed in 1974. Our principal executive offices are located at 13403 Northwest Freeway, Houston, Texas 77040, and our telephone number is (713) 690-7300. We maintain an Internet web-site at *www.hcc.com.* The reference to our Internet web-site address in this report does not constitute the incorporation by reference of the information contained at this site in this report. We will make available, free of charge through publication on our Internet web-site, a copy of our Annual Report on Form 10-K and quarterly reports on Form 10-Q and any current reports on Form 8-K or amendments to those reports, filed or furnished to the Securities and Exchange Commission as soon as reasonably practicable after we have filed or furnished such materials with the Securities and Exchange Commission.

As used in this report, unless otherwise required by the context, the terms we, us and our refer to HCC Insurance Holdings, Inc. and its consolidated subsidiaries and the term HCC refers only to HCC Insurance Holdings, Inc. All trade names or trademarks appearing in this report are the property of their respective holders.

We provide specialized property and casualty, surety, and group life, accident and health insurance coverages and related agency and reinsurance brokerage services to commercial customers and individuals. We concentrate our activities in selected, narrowly defined, specialty lines of business. We operate primarily in the United States, the United Kingdom, Spain, Bermuda and Ireland. Some of our operations have a broader international scope. We underwrite insurance both on a primary basis, where we insure a risk in exchange for a premium, and on a reinsurance basis, where we insure all or a portion of another insurance company s risk in exchange for all or a portion of the premium. We market our products both directly to customers and through a network of independent and affiliated brokers, producers and agents.

Since our founding, we have been consistently profitable, generally reporting annual increases in total revenue and shareholders equity. During the period 2001 through 2004, which is the latest period for which industry information is available, we had an average statutory combined ratio of 92.1% versus the less favorable 105.5% (source: A.M. Best Company, Inc.) recorded by the U.S. property and casualty insurance industry overall. During the period 2001 through 2005, our gross written premium increased from $1.0 billion to $2.0 billion, an increase of 102%, while net written premium increased 303% from $373.0 million to $1.5 billion. During this period, our revenue increased from $512.5 million to $1.6 billion, an increase of 221%. During the period December 31, 2001 through December 31, 2005, our shareholders equity increased 121% from $765 million to $1.7 billion and our assets increased 115% from $3.3 billion to $7.0 billion.

Our insurance companies are risk-bearing and focus their underwriting activities on providing insurance and/or reinsurance in the following lines of business:

- Diversified financial products
- Group life, accident and health
- Aviation
- London market account
- Other specialty lines

Our operating insurance companies are rated AA (Very Strong) (3rd of 22 ratings) by Standard & Poor s Corporation and AA- (Very Strong) by Fitch Ratings (4th of 24 ratings). Avemco Insurance Company, HCC Life Insurance Company, Houston Casualty Company and U.S. Specialty Insurance Company are rated A+ (Superior) (2nd of 16 ratings) by A.M. Best Company, Inc. American Contractors Indemnity Company, Perico Life Insurance Company and United States Surety Company are rated A (Excellent) (3rd of 16 ratings). A. M. Best placed our ratings under review with negative implications following our announcement on November 17, 2006 concerning the results of the independent investigation of our stock option granting practices and, at the same time, Standard & Poor s and Fitch

Ratings affirmed our ratings with a stable outlook. Standard & Poor s, Fitch Ratings and A.M. Best are nationally recognized independent rating agencies. These ratings are intended to provide an independent opinion of an insurer s ability to meet its obligations to policyholders and are not evaluations directed at investors.

Our underwriting agencies underwrite on behalf of our insurance companies and in certain situations for other non-affiliated insurance companies. They receive fees for these services and do not bear any of the insurance risk of the companies for which they underwrite. Our underwriting agencies generate revenues based on fee income and profit commissions and specialize in contingency (including contest indemnification, event cancellation and weather coverages); directors and officers liability; individual disability (for athletes and other high profile individuals); kidnap and ransom; employment practices liability; marine; professional indemnity; mortgage and residual value insurance; and other specialty lines of business. Our principal underwriting agencies are Covenant Underwriters, HCC Global Financial Products, HCC Indemnity Guaranty Agency, HCC Specialty Underwriters and Professional Indemnity Agency.

Our brokers provide reinsurance and insurance brokerage services for our insurance companies and our clients and receive fees for their services. A reinsurance broker structures and arranges reinsurance between insurers seeking to cede insurance risks and reinsurers willing to assume such risks. Reinsurance brokers do not bear any of the insurance risks of their client companies. They earn commission income, and to a lesser extent, fees for certain services, generally paid by the insurance and reinsurance companies with whom the business is placed. Insurance broker operations consist of consulting with retail and wholesale clients by providing information about insurance coverage and marketing, placing and negotiating particular insurance risks. Our brokers specialize in placing insurance and reinsurance for group life, accident and health, surety and property and casualty lines of business. Our brokers are Rattner Mackenzie, HCC Risk Management and Continental Underwriters.

Our Strategy

Our business philosophy is to maximize underwriting profits and produce non-risk-bearing fee and commission income while limiting risk in order to preserve shareholders equity and maximize earnings. We concentrate our insurance writings in selected, narrowly defined, specialty lines of business where we believe we can achieve an underwriting profit. We also rely on our experienced underwriting personnel and our access to and expertise in the reinsurance marketplace to achieve our strategic objectives. We market our insurance products both directly to customers and through affiliated and independent brokers, agents and producers.

The property and casualty insurance industry and individual lines of business within the industry are cyclical. There are times when a large number of companies offer insurance on certain lines of business, causing premiums to trend downward. During other times, insurance companies limit their writings in certain lines of business due to lack of capital or following periods of excessive losses. This results in an increase in premiums for those companies that continue to write insurance in those lines of business.

In our insurance company operations, we believe our operational flexibility, which permits us to shift the focus of our insurance underwriting activity among our various lines of business and also to shift the emphasis from our insurance risk-bearing business to our non-insurance, fee-based business, allows us to implement a strategy of emphasizing more profitable lines of business during periods of increased premium rates and de-emphasizing less profitable lines of business during periods of increased competition. In addition, we believe that our underwriting agencies and brokers complement our insurance underwriting activities. Our ability to utilize affiliated insurers, underwriting agencies and reinsurance brokers permits us to retain a greater portion of the gross revenue derived from written premium.

After a three-year period in which premium rates rose substantially, premium rates in several of our lines of business became more competitive during the past two years. The rate decreases were more gradual than the prior rate increases; thus, our underwriting activities remain profitable. During the past several years, we expanded our underwriting activities and increased our retentions in response to these market conditions. During 2005, we again increased our retentions on certain of our lines of business that were not generally exposed to catastrophe risk and where profit margins were usually more predictable. These higher retention levels increased our net written and earned premium and have resulted in additional underwriting profits and net earnings.

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Through reinsurance, our insurance companies transfer or cede all or part of the risk we have underwritten to a reinsurance company in exchange for all or part of the premium we receive in connection with the risk. We purchase reinsurance to limit the net loss to our insurance companies from both individual and catastrophic risks. The amount of reinsurance we purchase varies by, among other things, the particular risks inherent in the policies underwritten, the pricing of reinsurance and the competitive conditions within the relevant line of business.

When we determine to retain more underwriting risk in a particular line of business, we do so with the intention of retaining a greater portion of any underwriting profits without increasing our exposure to severe or catastrophe losses. In this regard, we may purchase less proportional or quota share reinsurance applicable to that line, thus accepting more of the risk but possibly replacing it with specific excess of loss reinsurance, where we transfer to reinsurers both premium and losses on a non-proportional basis for individual and catastrophic risks above a retention point. Additionally, we may obtain facultative reinsurance protection on individual risks. In some cases, we may choose not to purchase reinsurance in a line of business where we believe there has been a favorable loss history, our policy limits are relatively low or we determine there is a low likelihood of catastrophe exposure.

We also acquire or make strategic investments in companies that present an opportunity for future profits or for the enhancement of our business. We expect to continue to acquire complementary businesses. We believe that we can enhance acquired businesses through the synergies created by our underwriting capabilities and our other operations.

Our business plan is shaped by our underlying business philosophy, which is to maximize underwriting profit and net earnings while preserving and achieving long-term growth of shareholders equity. As a result, our primary objective is to increase net earnings rather than market share or gross written premium.

In our ongoing operations, we will continue to:

- emphasize the underwriting of lines of business where there is an anticipation of underwriting profits based on various factors including premium rates, the availability and cost of reinsurance and market conditions;

- limit our insurance companies aggregate net loss exposure from a catastrophic loss through the use of reinsurance for those lines of business exposed to such losses and diversification into lines of business not exposed to such losses; and

- consider the potential acquisition of specialty insurance operations and other strategic investments.

Industry Segment and Geographic Information

Financial information concerning our operations by industry segment and geographic data is included in the Consolidated Financial Statements and Notes thereto.

Recent Acquisitions

We have made a series of acquisitions that have furthered our overall business strategy. Our recent major transactions are described below:

On July 1, 2003, we acquired all of the outstanding shares of Covenant Underwriters Ltd. and Continental Underwriters Ltd., an underwriting agency and an insurance broker, respectively, specializing in commercial marine insurance. We initially paid $11.6 million and issued 471,806 shares of our common stock in connection with the acquisition. We paid an additional $1.6 million in 2005 related to a contractual earnout and may pay additional amounts if certain earnings targets are reached through December 31, 2006. We expect to pay $4.7 million in 2006 based on 2005 earnings.

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On January 31, 2004, we acquired all of the shares of Surety Associates Holding Co., Inc., the parent company of American Contractors Indemnity Company, a California-domiciled surety company. We paid $46.8 million for the acquisition. American Contractors Indemnity Company now operates with our other surety operations as part of our HCC Surety Group.

On October 1, 2004, we acquired all of the shares of InsPro Corporation, a California underwriting agency specializing in professional indemnity insurance and which does business as RA&MCO Insurance Services. We paid $7.0 million and issued 74,750 shares of our common stock in connection with the acquisition. RA&MCO operates as a division of Professional Indemnity Agency.

On February 25, 2005, we acquired United States Surety Company through a merger effected with its parent company, USSC Holdings, Inc. We issued 1.2 million shares of our common stock in connection with the acquisition. United States Surety Company is a Maryland-domiciled surety company and now operates as a part of our HCC Surety Group.

On July 14, 2005, we acquired the remaining 66% of De Montfort Group Limited that we did not own for $10.5 million and 274,000 shares of our common stock. We acquired our initial 34% interest in January 2005. The key operating subsidiary, De Montfort Insurance Company, provides surety and credit insurance. It has been renamed HCC International Insurance Company and a significant amount of our other United Kingdom operations will be combined with this company in 2006.

On December 1, 2005, we acquired Perico Ltd., a medical stop-loss insurance underwriting agency headquartered in St. Louis, Missouri. We paid $30.0 million and issued 158,599 shares of our common stock in connection with the acquisition.

On December 13, 2005, we acquired MIC Life Insurance Corporation, a Delaware-domiciled insurance company, for $20.0 million. MIC has been renamed Perico Life Insurance Company and operations will be located in St. Louis, Missouri.

We continue to evaluate acquisition opportunities and we may complete additional acquisitions during 2006. Any future acquisitions will be designed to expand and strengthen our existing lines of business or to provide access to additional specialty sectors, which we expect to contribute to our overall growth.

Recent Disposition

On December 31, 2003, we sold the business of our retail brokerage subsidiary, HCC Employee Benefits, Inc. We received $73.2 million in total consideration related to the sale.

Insurance Company Operations

Lines of Business

This table shows our insurance companies total premium written, otherwise known as gross written premium, by line of business and the percentage of each line to total gross written premium (dollars in thousands):

	2005		2004		2003	
Diversified financial products	$ 908,526	45%	$ 857,299	43%	$ 553,501	32%
Group life, accident and health	593,382	29	584,747	30	565,494	33
Aviation	210,530	10	204,963	10	214,718	12
London market account	144,425	7	178,950	9	223,149	13
Other specialty lines	176,139	9	133,964	7	73,475	4
Discontinued lines of business	5,284		15,230	1	109,557	6
Total gross written premium	$ 2,038,286	100%	$ 1,975,153	100%	$ 1,739,894	100%

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This table shows our insurance companies actual premium retained, otherwise known as net written premium, by line of business and the percentage of each line to total net written premium (dollars in thousands):

	2005		2004		2003	
Diversified financial products	$ 675,942	45%	$ 404,870	37%	$ 183,560	21%
Group life, accident and health	502,805	34	343,996	31	299,913	35
Aviation	130,743	9	144,687	13	99,447	12
London market account	78,809	5	107,509	10	155,987	18
Other specialty lines	109,106	7	83,980	7	36,837	4
Discontinued lines of business	3,819		20,477	2	89,758	10
Total net written premium	$ 1,501,224	100%	$ 1,105,519	100%	$ 865,502	100%

This table shows our insurance companies net written premium as a percentage of gross written premium, otherwise referred to as percentage retained, for our continuing lines of business:

	2005	2004	2003
Diversified financial products	74%	47%	33%
Group life, accident and health	85	59	53
Aviation	62	71	46
London market account	55	60	70
Other specialty lines	62	63	50
Continuing lines of business percentage retained	74%	55%	48%

Underwriting

We underwrite primary business produced through affiliated underwriting agencies, independent and affiliated brokers and producers and by direct marketing efforts. We also write facultative or individual account reinsurance as well as some treaty reinsurance business.

Diversified Financial Products

We underwrite a variety of financial insurance risks in our diversified financial products line of business. These risks include:

- directors and officers liability
- employment practices liability
- mortgage guaranty
- professional indemnity
- residual value insurance
- surety and credit
- other financial products

We began to underwrite this line of business through a predecessor company in 1977. Our insurance companies started participating in this business in 2001. We have substantially increased our level of business in this area through the acquisition of a number of agencies and insurance companies that operate in this line, both domestically and internationally. Each of the acquired entities has significant experience in their respective specialties within this line of business. We have also formed entities which offer products in this line of business developed around teams of experienced underwriters.

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In 2002 and 2003, following several years of insurance industry losses, significant rate increases were experienced throughout our diversified financial products line of business, particularly directors and officers liability, which we began underwriting opportunistically in 2002. We benefited greatly from these improved conditions despite the fact that we had not been involved in the past losses. Gross written premium in the diversified financial products line rose to $908.5 million in 2005 compared to $857.3 million in 2004 due to acquisitions, premium rate increases and other organic growth in all products in this line. Rates have softened in 2004 and 2005 for some of the products in this line, but our underwriting margins are still very profitable. There is also considerable investment income derived from this line of business due to the extended periods involved in claims resolution.

We had previously maintained reinsurance on our diversified financial products line of business, primarily on a proportional basis, but over the past two years have substantially increased our retentions. Although individual losses primarily in the directors and officers public company liability business may have potential severity, there is a relatively low risk of catastrophe exposure in this line of business and a reasonable expectation of underwriting profitability. Net premium written for the public company directors and officers liability was approximately $196.8 million in 2005. The remainder of the diversified financial products business is less volatile with relatively low limits.

Group Life, Accident and Health

We write medical stop-loss business through HCC Life Insurance Company and since its December 2005 acquisition, Perico Life Insurance Company. Our medical stop-loss insurance provides coverages to companies, associations and public entities that elect to self-insure their employees medical coverage for losses within specified levels, allowing them to manage the risk of excessive health insurance exposure by limiting aggregate and specific losses to a predetermined amount. We first began writing this business through a predecessor company in 1980. Our insurance companies started participating in this business in 1997. This line of business has grown both organically and through acquisitions. We are considered a market leader in medical stop-loss insurance. We also underwrite a small program of group life insurance offered to our insureds as a complement to our medical stop-loss products.

Premium rates rose substantially beginning in 2000 and although competition has increased in recent years, underwriting results have remained profitable. Medical stop-loss business has relatively low limits, a low level of catastrophe exposure and a generally predictable result. Therefore, we have increased our retentions annually since 2001 and currently buy no reinsurance for this line of business.

We began writing alternative workers compensation and occupational accident insurance in 1996 and this business is currently written through U.S. Specialty Insurance Company. The business in this line has relatively low limits, a relatively low level of catastrophe exposure and a generally predictable result.

Aviation

We are a market leader in the general aviation insurance industry insuring aviation risks, both domestically and internationally. Types of aviation business include:

- antique and vintage military aircraft
- cargo operators
- commuter airlines
- corporate aircraft
- fixed base operations
- military and law enforcement aircraft
- private aircraft owners
- rotor wing aircraft

We offer coverages that include hulls, engines, avionics and other systems, liabilities, cargo and other ancillary coverages. We generally do not insure major airlines, major manufacturers or satellites. Insurance claims related to general aviation business tend to be seasonal, with the majority of the claims being incurred during the spring and summer months.

We have been underwriting aviation risks through Houston Casualty Company since 1981 and since 1959 in Avemco Insurance Company and U.S. Specialty Insurance Company, which were acquired in 1997. We are one of the largest writers of personal aircraft insurance in the United States. Our aviation gross premium has remained relatively stable since 1998, although we have increased our retentions as this business is predominantly written with small limits and has generally predictable results.

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London Market Account

Our London market account business consists of accident and health, marine, energy and property business, and has been primarily underwritten by Houston Casualty Company s London branch office. In the future, we intend to utilize HCC International Insurance Company to underwrite the non-U.S. based risks which comprise this line of business. This line represents some of our accident and health business and most of our catastrophe exposure. We have underwritten these risks for more than 15 years, increasing or decreasing our premium volume depending on market conditions, which can be very volatile in this line. The following table presents the details of net premium written within the London market account line of business (in thousands):

	2005	2004	2003
Marine	$ 23,799	$ 19,537	$ 14,552
Energy	15,621	26,258	40,065
Property	18,379	19,613	24,857
Accident and health	21,010	42,101	76,513
Total London market account net written premium	$ 78,809	$ 107,509	$ 155,987

We underwrite marine risks for ocean-going vessels including hull, protection and indemnity, liabilities and cargo. We have underwritten marine risks since 1984 in varying amounts depending on market conditions.

In our energy business, we underwrite physical damage and business interruption. We have been underwriting both onshore and offshore energy risks since 1988. This business includes:

- drilling rigs
- gas production and gathering platforms
- natural gas facilities
- petrochemical plants
- pipelines
- refineries

Rates were relatively low for an extended period of time reaching levels where underwriting profitability was difficult to achieve. As a result, we have underwritten energy risks on a very selective basis, striving for quality rather than quantity. Underwriting profitability was adversely impacted by the 2004 and 2005 hurricane activity, but this has resulted in rates increasing substantially and policy conditions becoming more stringent. However, we continue to reinsure much of our catastrophe exposure, buying substantial amounts of reinsurance both on a proportional and excess basis.

We underwrite property business specializing in risks of large, often multinational, corporations, covering a variety of commercial properties including:

- factories
- hotels
- industrial plants
- office buildings

retail locations

utilities

We have written property business since 1986, including business interruption, physical damage and catastrophe risks, including flood and earthquake. Rates increased significantly following September 11, 2001, but had trended downward by 2005 despite the hurricane activity of 2004. The massive losses from hurricanes in 2005 have resulted in substantial rate increases, but due to over capacity, policy conditions have remained unchanged, unlike energy risks. Accordingly, we are substantially reducing our involvement in policies with exposures in the Florida and U.S. Gulf Coast regions. We continue to buy substantial catastrophe reinsurance which, unlike many industry participants, has shown to be adequate during 2004 and 2005 when large amounts of industry capital were lost. While seriously affecting our earnings in the third quarter of each year, we still were able to produce record annual earnings.

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We began writing London market accident and health risks in 1996, including trip accident, medical and disability. Due to past experience and other market factors, we significantly decreased premiums starting in 2004, although our business is now much more stable.

Our London market account is reinsured both proportionally and on an excess of loss basis. Catastrophe exposure is closely monitored and reinsurance is purchased accordingly to limit our net exposure to a level that any loss is not expected to impact our capital. Previous net catastrophe losses from Hurricane Andrew in 1992, the Northridge Earthquake in 1994, the terrorist attacks on September 11, 2001 and the hurricanes of 2004 and 2005 did not exceed net earnings in the affected quarter.

Other Specialty Lines

In addition to the above, we underwrite various other specialty lines of business for which individual premiums by line of business are not at this time significant to our overall results of operations.

Principal Insurance Companies

Houston Casualty Company

Houston Casualty Company is our largest insurance company subsidiary. It is domiciled in Texas and insures risks worldwide. Houston Casualty Company receives business through independent agents and brokers, our underwriting agencies and reinsurance brokers, and other insurance and reinsurance companies. Houston Casualty Company writes diversified financial products, aviation, London market account and other specialty lines of business. It is also an issuing carrier for our affiliated underwriting agencies. Houston Casualty Company s 2005 gross written premium, including Houston Casualty Company-London, was $833.6 million.

Houston Casualty Company-London

Houston Casualty Company operates a branch office in London, England, in order to more closely align its underwriting operations with the London market, a historical focal point for some of the business that it underwrites. Houston Casualty Company-London underwrites diversified financial products and London market account business, some of which is produced by our affiliated underwriting agencies. Beginning in 2006, we intend to focus the underwriting activities of Houston Casualty Company-London s office on risks based in the United States. We intend to use HCC International Insurance Company as a platform for much of the European and other international risks previously underwritten by Houston Casualty Company-London.

U.S. Specialty Insurance Company

U.S. Specialty Insurance Company is a Texas-domiciled property and casualty insurance company. It primarily writes diversified financial products, aviation, accident and health business. U.S. Specialty Insurance Company acts as an issuing carrier for certain business underwritten by our underwriting agencies. U.S. Specialty Insurance Company s gross written premium in 2005 was $449.6 million.

HCC Life Insurance Company

HCC Life Insurance Company is an Indiana-domiciled life insurance company. It operates as a group life, accident and health insurer. In early 2005, we consolidated the operations of our underwriting agency, HCC Benefits Corporation, into HCC Life Insurance Company. HCC Life Insurance Company s gross written premium in 2005 was $482.6 million.

Avemco Insurance Company

Avemco Insurance Company is a Maryland-domiciled property and casualty insurer and operates as a direct market underwriter of general aviation business. It has also been an issuing carrier for accident and health business and some other lines of business underwritten by our underwriting agencies and an unaffiliated underwriting agency. Avemco Insurance Company s gross written premium in 2005 was $149.7 million.

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American Contractors Indemnity Company

American Contractors Indemnity Company is a California-domiciled surety company. It writes court, specialty contract, license and permit bonds. American Contractors Indemnity Company has been in operation since 1990 and operates as a part of our HCC Surety Group. American Contractors Indemnity Company s 2005 gross written premium was $76.3 million.

HCC Europe

Houston Casualty Company Europe, Seguros y Reaseguros, S.A. is a Spanish insurer. It underwrites diversified financial products business. HCC Europe s surety operations make up a part of our HCC Surety Group. HCC Europe is also an issuing carrier for business underwritten by our underwriting agencies and has been in operation since 1978. HCC Europe s gross written premium in 2005 was $130.6 million.

HCC Reinsurance Company

HCC Reinsurance Company Limited is a Bermuda-domiciled reinsurance company which writes assumed reinsurance from our insurance companies and from unaffiliated insurance companies and a limited amount of primary insurance. HCC Reinsurance Company is an issuing carrier for diversified financial products business underwritten by our underwriting agency, HCC Indemnity Guaranty. HCC Reinsurance Company s gross written premium in 2005 was $70.0 million.

HCC Specialty Insurance Company

HCC Specialty Insurance Company is an Oklahoma-domiciled property and casualty insurance company in operation since 2002. It writes diversified financial products and other specialty lines of business produced by our underwriting agencies. HCC Specialty Insurance Company s gross written premium in 2005 was $17.6 million.

United States Surety Company

United States Surety Company was acquired in February 2005 and is a Maryland-domiciled surety company that has been in operation since 1996. The results of operations of United States Surety Company were included in our 2005 financial results as of March 1, 2005. It writes contract bonds and operates as a part of our HCC Surety Group. United States Surety Company s 2005 gross written premium since its acquisition was $14.5 million.

Perico Life Insurance Company

Perico Life Insurance Company was a previously dormant company acquired in December 2005 and is a Delaware-domiciled life insurance company. Perico Life Insurance Company now operates as a group life, accident and health insurer. In 2006, we intend to consolidate the operations of our recently acquired underwriting agency, Perico Ltd., into Perico Life Insurance Company.

HCC International Insurance Company

HCC International Insurance Company PLC, formerly known as De Montfort Insurance Company, was acquired in 2005 and writes diversified financial products business, primarily in the surety and credit insurance areas. HCC International Insurance Company has been in operation since 1982 and is domiciled in the United Kingdom. The results of operations of HCC International Insurance Company were consolidated with our 2005 financial results as of July 1, 2005, and its 2005 gross written premium since its acquisition was $17.7 million. We intend to significantly expand the underwriting activities of HCC International Insurance Company beyond surety and credit insurance and to use it as an integral part of a European platform for our international insurance operations.

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Underwriting Agency Operations

Our underwriting agencies act on behalf of affiliated and non-affiliated insurance companies and provide insurance underwriting management and claims administration services. Our underwriting agencies do not assume any insurance or reinsurance risk themselves and generate revenues based entirely on fee income and profit commissions. These subsidiaries are in a position to direct and control business they produce. Our insurance companies serve as policy issuing companies for the majority of the business written by our underwriting agencies. If an unaffiliated insurance company serves as the policy issuing company, our insurance companies may reinsure the business written by our underwriting agencies. Total revenue generated by our underwriting agencies in 2005 amounted to $157.0 million.

Professional Indemnity Agency

Professional Indemnity Agency, Inc., based in Mount Kisco, New York and with branch offices in San Francisco and Concord, California, acts as an underwriting manager for diversified financial products specializing in directors and officers liability and professional indemnity, kidnap and ransom, employment practice liability and other specialty lines of business on behalf of affiliated and unaffiliated insurance companies. It has been in operation since 1977.

HCC Specialty Underwriters

HCC Specialty Underwriters Inc., formerly known as ASU International, Inc., with its home office in Wakefield, Massachusetts and with branch offices in London, England, Los Angeles, California and New York, New York, acts as an underwriting manager for group life, accident and health and other specialty lines of business on behalf of affiliated and unaffiliated insurance companies. It has been in operation since 1982.

HCC Global Financial Products

HCC Global Financial Products, LLC acts as an underwriting manager for diversified financial products, specializing in directors and officers liability business on behalf of affiliated insurance companies. It has been in operation since 1999, underwriting domestic business from Farmington, Connecticut and international business from Barcelona, Spain and London, England.

HCC Diversified Financial Products

HCC Diversified Financial Products Limited is an underwriting agency based in London, England and underwrites diversified financial products, specializing in professional indemnity business principally in the United Kingdom on behalf of affiliated insurance companies. It has been in operation since 1997. In 2006, we intend to consolidate the operations of HCC Diversified Financial Products into HCC International Insurance Company.

Covenant Underwriters

Covenant Underwriters, Ltd. is an underwriting agency based in Covington, Louisiana with an office in New York, New York specializing in commercial marine insurance underwritten on behalf of affiliated and unaffiliated insurance companies. It has been in operation through predecessor entities since 1993.

HCC Indemnity Guaranty Agency

HCC Indemnity Guaranty Agency, Inc. underwrites mortgage guaranty, structured products and residual value insurance and reinsurance on behalf of affiliated insurance companies. It has been in operation since 2004.

Illium Insurance Group

In December 2005, we completed the acquisition of Illium Insurance Group, Ltd., the parent of a managing agent for a syndicate at Lloyd s of London, which specializes in United Kingdom third party liability, employers liability and commercial motor risks. We previously had a minority ownership in Illium and provided underwriting capacity, along with other parties, to its Lloyd s syndicate. We expect to use Illium and its managed syndicate as a platform for expanding our operations within the Lloyd s market and to continue with the additional non-affiliated capacity for the syndicate.

Reinsurance and Insurance Broker Operations

Our reinsurance and insurance brokers provide a variety of services, including marketing, placing, consulting on and servicing insurance risks for their clients, which include medium to large corporations, unaffiliated and affiliated insurance and reinsurance companies, and other risk taking entities. The brokers earn commission income and, to a lesser extent, fees for certain services, generally paid by the underwriters with whom the business is placed. Some of these risks may be initially underwritten by our insurance companies and they may retain a portion of the risk. Total revenue generated by our brokers in 2005 amounted to $31.9 million.

Rattner Mackenzie

Rattner Mackenzie Limited is a reinsurance broker based in London, England with additional operations in Hamilton, Bermuda and Mt. Kisco, New York. Rattner Mackenzie specializes in group life, accident and health reinsurance and some specialty property and casualty lines of business. It operates as a Lloyd s broker for insurance and reinsurance business placed on behalf of unaffiliated and affiliated insurance companies, reinsurance companies and underwriting agencies and has been in operation since 1989.

Continental Underwriters

Continental Underwriters Ltd. is an insurance broker based in Covington, Louisiana specializing in commercial marine insurance and has been in operation since 1970.

HCC Risk Management

HCC Risk Management Corporation, based in Houston, Texas, is a reinsurance broker specializing in placing reinsurance on behalf of affiliated and unaffiliated insurance companies and has been in operation since 1991.

Other Operations

Other operating income consists of 1) equity in the earnings of mainly insurance-related companies in which we invest, 2) dividends and interest from certain other insurance-related strategic investments and gains or losses from the disposition of these investments, 3) income related to two mortgage impairment insurance contracts which, while written as insurance policies, receive accounting treatment as derivative financial instruments, 4) the profit or loss from an inventory of generally insurance-related trading securities and 5) other miscellaneous income. Other operating income was $39.8 million in 2005, but can vary considerably from period to period depending on the amount of investment or disposition activity.

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Operating Ratios

Premium to Surplus Ratio

This table shows the ratio of statutory gross written premium and net written premium to statutory policyholders surplus for our property and casualty insurance companies (dollars in thousands):

	2005	2004	2003	2002	2001
Gross written premium	$ 2,049,116	$ 1,992,361	$ 1,746,413	$ 1,163,397	$ 1,014,833
Net written premium	1,495,931	1,121,343	867,795	545,475	371,409
Policyholders surplus	1,110,268	844,851	591,889	523,807	401,393
Gross written premium ratio	184.6%	235.8%	295.1%	222.1%	252.8%
Gross written premium industry average (1)	*	201.6%	219.3%	244.4%	210.8%
Net written premium ratio	134.7%	132.7%	146.6%	104.1%	92.5%
Net written premium industry average (1)	*	108.5%	117.4%	130.3%	112.0%

(1) Source: A.M. Best Company, Inc.

* Not available

While there is no statutory requirement regarding a permissible premium to policyholders surplus ratio, guidelines established by the National Association of Insurance Commissioners provide that a property and casualty insurer s annual statutory gross written premium should not exceed 900% and net written premium should not exceed 300% of its policyholders surplus. However, industry standards and rating agency criteria place these ratios at 300% and 200%, respectively. Our property and casualty insurance companies have maintained ratios lower than such guidelines.

Combined Ratio GAAP

The underwriting experience of a property and casualty insurance company is indicated by its combined ratio. The GAAP combined ratio is a combination of the loss ratio (the ratio of incurred losses and loss adjustment expenses to net earned premium) and the expense ratio (the ratio of policy acquisition costs and other underwriting expenses, net of ceding commissions, to net earned premium). We calculate the GAAP combined ratio using financial data derived from our consolidated financial statements reported under accounting principles generally accepted in the United States of America (generally accepted accounting principles). Our insurance companies GAAP loss ratios, expense ratios and combined ratios are shown in the following table:

	2005 (As restated)	2004 (As restated)	2003 (As restated)	2002 (As restated)	2001 (As restated)
Loss ratio	67.1%	63.8%	66.1%	60.8%	78.0%
Expense ratio	26.1	26.7	24.6	25.5	25.4
Combined ratio GAAP	93.2%	90.5%	90.7%	86.3%	103.4%

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Combined Ratio Statutory

The statutory combined ratio is a combination of the loss ratio (the ratio of incurred losses and loss adjustment expenses to net earned premium) and the expense ratio (the ratio of policy acquisition costs and other underwriting expenses, net of ceding commissions, to net written premium). We calculate the statutory combined ratio using financial data derived from the combined financial statements of our insurance company subsidiaries reported in accordance with statutory accounting principles. Our insurance companies statutory loss ratios, expense ratios and combined ratios are shown in the following table:

	2005	2004	2003	2002	2001
Loss ratio	67.1%	64.3%	66.8%	62.0%	78.0%
Expense ratio	25.5	26.7	23.0	23.9	23.8
Combined ratio Statutory	92.6%	91.0%	89.8%	85.9%	101.8%
Industry average	*	98.3%	100.1%	107.5%	115.9%

* Not available

The statutory ratio data is not intended to be a substitute for results of operations in accordance with generally accepted accounting principles. We believe including this information is useful to allow a comparison of our operating results with those of other companies in the insurance industry. The source of the industry average is A.M. Best Company, Inc. A.M. Best Company, Inc. reports insurer performance based on statutory financial data to provide more standardized comparisons among individual companies and to provide overall industry performance; this data is not an evaluation directed at investors.

Reserves

Our net loss and loss adjustment expense reserves are composed of reserves for reported losses and reserves for incurred but not reported losses, less a reduction for reinsurance recoverables related to those reserves. Reserves are recorded by product line and are undiscounted, except for reserves related to acquisitions.

The process of estimating our loss and loss adjustment expense reserves involves a considerable degree of judgment by management and is inherently uncertain. The recorded reserves represent management s best estimate of unpaid loss and loss adjustment expense by line of business. Because we provide insurance coverage in specialized lines of business that often lack statistical stability, management considers many factors and not just actuarial point estimates in determining ultimate expected losses and the level of net reserves required and recorded.

To record reserves on our lines of business, we utilize expected loss ratios, which management selects based on the following: 1) information used to price the applicable policies, 2) historical loss information where available, 3) any public industry data for that line or similar lines of business and 4) an assessment of current market conditions. Management also considers the point estimates and ranges calculated by our actuaries, together with input from our experienced underwriting and claims personnel. Because of the nature and complexities of the specialized types of business we insure, management may give greater weight to the expectations of our underwriting and claims personnel, who often perform a claim by claim review, rather than to the actuarial estimates. However, we utilize the actuarial point and range estimates to monitor the adequacy and reasonableness of our recorded reserves.

Each quarter-end, management compares recorded reserves to the most recent actuarial point estimate and range for each line of business. If the recorded reserves vary significantly from the actuarial point estimate, management determines the reasons for the variances and may adjust the reserves up or down to an amount that, in management s judgment, is adequate based on all of the facts and circumstances considered, including the actuarial point estimates. Generally, we maintain total consolidated net reserves above the total actuarial point estimate but within the actuarial range.

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Our actuaries utilize standard actuarial techniques in making their actuarial point estimates. These techniques require a high degree of judgment and changing conditions can cause fluctuations in the reserve estimates. We believe that our review process is effective, such that any required changes are recognized in the period of change as soon as the need for the change is evident. Reinsurance recoverables offset our gross reserves based upon the contractual terms of our reinsurance agreements.

With the exception of 2004, our net reserves historically have shown positive development except for the effects of losses from commutations, which we have completed in the past and may negotiate in the future. Commutations can produce negative prior year development since, under generally accepted accounting principles, any excess of undiscounted reserves assumed over assets received must be recorded as a loss at the time the commutation is completed. Economically, the loss generally represents the discount for the time value of money that will be earned over the payout of the reserves; thus, the loss may be recouped as investment income is earned on the assets received. Based on our reserving techniques and our past results, we believe that our net reserves are adequate.

The reserving process is intended to reflect the impact of inflation and other factors affecting loss payments by taking into account changes in historical payment patterns and perceived trends. There is no precise method for the subsequent evaluation of the adequacy of the consideration given to inflation, or to any other specific factor, or to the way one factor may impact another.

We underwrite primary and reinsurance risks that are denominated in a number of foreign currencies and, therefore, maintain loss reserves with respect to these policies in the respective currencies. These reserves are subject to exchange rate fluctuations, which may have an effect on our net earnings.

The loss development triangles below show changes in our reserves in subsequent years from the prior loss estimates, based on experience at the end of each succeeding year, on the basis of generally accepted accounting principles. The estimate is increased or decreased as more information becomes known about the frequency and severity of losses for individual years. A redundancy means the original estimate was higher than the current estimate; a deficiency means that the current estimate is higher than the original estimate.

The first line of each loss development triangle presents, for the years indicated, our gross or net reserve liability including the reserve for incurred but not reported losses. The first section of each table shows, by year, the cumulative amounts of loss and loss adjustment expense paid at the end of each succeeding year. The second section sets forth the re-estimates in later years of incurred losses, including payments, for the years indicated. The cumulative redundancy (deficiency) represents, at the date indicated, the difference between the latest re-estimated liability and the reserves as originally estimated.

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This loss development triangle shows development in loss reserves on a gross basis (in thousands):

	2005	2004	2003 (As restated)	2002 (As restated)	2001 (As restated)	2000	1999	1998	1997	1996	
	$ 2,813,720	$ 2,089,199	$ 1,525,313	$ 1,158,915	$ 1,132,258	$ 944,117	$ 871,104	$ 460,511	$ 275,008	$ 229,049	$
nts											
on											
on											
ies				5,587		(66,571)	(32,437)	(136)			
	2,813,720	2,089,199	1,525,313	1,164,502	1,132,258	877,546	838,667	460,375	275,008	229,049	
ve											
		511,766	396,077	441,775	390,232	400,279	424,379	229,746	160,324	119,453	
rs											
			587,349	571,907	612,129	537,354	561,246	367,512	209,724	179,117	
ars											
				682,534	726,805	667,326	611,239	419,209	241,523	193,872	
rs											
					803,152	720,656	686,730	435,625	259,067	212,097	
s											
						758,126	721,011	453,691	262,838	223,701	
							725,639	462,565	267,038	225,595	
ars											
								462,126	270,362	227,177	
ars											
									268,939	228,621	
rs											
										230,745	
s											
ated t:											
ear	2,813,720	2,089,199	1,525,313	1,164,502	1,132,258	877,546	838,667	460,375	275,008	229,049	
		2,118,471	1,641,426	1,287,003	1,109,098	922,080	836,775	550,409	308,501	252,236	
rs											
			1,666,931	1,393,143	1,241,261	925,922	868,438	545,955	316,250	249,013	
ars											
				1,464,448	1,384,608	1,099,657	854,987	547,179	304,281	250,817	

rs				1,455,046	1,102,636	900,604	537,968	305,022	247,245	
rs					1,135,143	887,272	522,183	295,975	249,853	
						894,307	521,399	296,816	243,015	
ars							513,918	292,544	242,655	
rs								291,164	241,904	
rs									244,687	
s										
tive ncy cy)	$ (29,272)	$ (141,618)	$ (299,946)	$ (322,788)	$ (257,597)	$ (55,640)	$ (53,543)	$ (16,156)	$ (15,638)	$

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The gross deficiencies reflected in the above table for years after 1998 resulted from the following:

During 2005 and 2004, we recorded $49.8 million and $127.7 million, respectively, in gross losses related to the 2001 and 2000 accident years on certain assumed accident and health reinsurance contracts reported in discontinued lines of business, due to our processing of additional information received and our continuing evaluation of reserves on this business.

During 2005, we reduced our gross reserves on the 2004 hurricanes by $13.4 million to reflect current estimates of our remaining liabilities, which partially offset the 2005 adverse development discussed above.

During 2003, we recorded $132.9 million in gross losses related to 1999 and 2000 accident years on certain assumed accident and health reinsurance contracts reported in discontinued lines of business, due to our processing of additional information received and our continuing evaluation of reserves on this business.

The 2000 and 1999 years in the table were also negatively affected by late reporting loss information received during 2001 for certain discontinued business.

The gross development in 2004 resulted in a $30.5 million negative effect on our net losses. The remainder of the gross development discussed above did not have a material effect on our net losses because the majority of the gross losses were reinsured.

The gross reserves in the discontinued line of business, particularly with respect to accident and health reinsurance, have shown substantial negative development in the last few years. This assumed accident and health reinsurance is primarily excess coverage for large losses related to workers compensation policies. Losses tend to develop and affect excess covers considerably after the original loss was incurred. Additionally, certain primary insurance companies that we reinsured have experienced financial difficulty and some of them are in liquidation, with guaranty funds now responsible for administering the business. Losses related to this business are historically late reporting. While we attempt to anticipate these conditions in setting our gross reserves, we have only been partially successful to date and there could be additional negative development in these reserves in the future. The gross losses that have developed negatively have been substantially reinsured and therefore have little effect on our net earnings.

The gross deficiencies reflected in the table for the years prior to 1999 resulted from two principal conditions:

We had development of large claims on individual policies which were either reported late or for which reserves were increased as subsequent information became available. As these policies were substantially reinsured, there was no material effect on our net earnings.

During 1999, in connection with the insolvency of one of the insurance companies that we reinsured and the commutation of all liabilities with another, we re-evaluated all loss reserves and incurred but not reported loss reserves related to business placed with these reinsurers to determine the ultimate losses we might conservatively expect. These reserves were then used as the basis for the determination of the provision for reinsurance recorded in 1999.

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The following table provides a reconciliation of the gross liability for loss and loss adjustment expense payable on the basis of generally accepted accounting principles (in thousands):

	2005	2004 (As restated)	2003 (As restated)
Reserves for loss and loss adjustment expense payable at beginning of year	$ 2,089,199	$ 1,525,313	$ 1,158,915
Reserve additions from acquisition of subsidiaries	19,236	15,537	5,587
Incurred loss and loss adjustment expense:			
Provision for loss and loss adjustment expense for claims occurring in current year	1,567,501	1,173,042	922,838
Increase in estimated loss and loss adjustment expense for claims occurring in prior years *	29,272	116,113	122,501
Incurred loss and loss adjustment expense	1,596,773	1,289,155	1,045,339
Loss and loss adjustment expense payments for claims occurring during:			
Current year	379,722	344,729	242,753
Prior years	511,766	396,077	441,775
Loss and loss adjustment expense payments	891,488	740,806	684,528
Reserves for loss and loss adjustment expense payable at end of year	$ 2,813,720	$ 2,089,199	$ 1,525,313

* Changes in loss and loss adjustment expense reserves for losses occurring in prior years reflect the gross effect of the resolution of losses for other than the reserve value and the subsequent adjustments of loss reserves.

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This loss development triangle shows development in loss reserves on a net basis (in thousands):

	2005 (As restated)	2004	2003	2002 (As restated)	2001	2000	1999	1998	1997	1996	19
ves, net											
rance ve ments	$ 1,533,433	$ 1,059,283	$ 705,200	$ 458,702	$ 313,097	$ 249,872	$ 273,606	$ 118,912	$ 119,634	$ 117,283	$ 99
sition											
sition											
liaries on eserves 99 write				5,587		(6,048)	(3,343)	(410)			
rance erables								63,851	15,008	2,636	1
ted es, net											
rance lative net of rance,	1,533,433	1,059,283	705,200	464,289	313,097	243,824	270,263	182,353	134,642	119,919	100
ear		172,224	141,677	136,561	126,019	102,244	145,993	56,052	48,775	47,874	41
years			135,623	173,566	131,244	139,659	174,534	103,580	64,213	66,030	56
years				136,106	163,808	118,894	185,744	113,762	80,227	72,863	64
years					93,405	138,773	180,714	121,293	81,845	81,620	67
ears						158,935	197,416	120,452	84,986	81,968	72
ears							200,833	127,254	87,626	82,681	73
years								131,631	89,194	84,108	73
years									88,061	84,847	74
years										84,770	75

ears											74
timated ty, net rance, f year	1,533,433	1,059,283	705,200	464,289	313,097	243,824	270,263	182,353	134,642	119,919	100
ear		1,084,677	735,678	487,403	306,318	233,111	260,678	186,967	120,049	116,145	95
years			770,497	500,897	338,194	222,330	254,373	175,339	116,745	101,595	94
years				571,403	366,819	259,160	244,650	171,165	110,673	97,353	85
years					418,781	267,651	258,122	163,349	107,138	95,118	80
years						296,396	254,579	155,931	103,243	93,528	79
ears							271,563	157,316	101,538	91,413	79
years								156,376	99,872	90,951	78
years									97,965	90,534	78
years										90,011	78
ears											77
ulative ndancy iency)		$ (25,394)	$ (65,297)	$ (107,114)	$ (105,684)	$ (52,572)	$ (1,300)	$ 25,977	$ 36,677	$ 29,908	$ 22

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The table below provides a reconciliation of the liability for loss and loss adjustment expense payable, net of reinsurance ceded, on the basis of generally accepted accounting principles (in thousands):

	2005 (As restated)	2004	2003 (As restated)
Net reserves for loss and loss adjustment expense payable at beginning of year	$ 1,059,283	$ 705,200	$ 458,702
Net reserve additions from acquisition of subsidiaries	12,491	11,647	5,587
Incurred loss and loss adjustment expense:			
Provision for loss and loss adjustment expense for claims occurring in current year	894,303	614,752	464,886
Increase in estimated loss and loss adjustment expense for claims occurring in prior years *	25,394	30,478	23,114
Incurred loss and loss adjustment expense	919,697	645,230	488,000
Loss and loss adjustment expense payments for claims occurring during:			
Current year	285,814	161,117	110,528
Prior years	172,224	141,677	136,561
Loss and loss adjustment expense payments	458,038	302,794	247,089
Net reserves for loss and loss adjustment expense payable at end of year	$ 1,533,433	$ 1,059,283	$ 705,200

* Changes in loss and loss adjustment expense reserves for losses occurring in prior years reflect the net effect of the resolution of losses for other than the reserve value and the subsequent adjustments of loss reserves.

We had net loss and loss adjustment expense adverse development relating to prior year losses of $25.4 million in 2005, $30.5 million in 2004 and $23.1 million in 2003. The 2005 development resulted from a commutation charge of $26.0 million, which primarily related to the 2001 and 2000 accident years, and a net redundancy of $0.6 million from all other sources. In 2004, as a result of adverse development in certain assumed accident and health business in our discontinued line of business, we strengthened our reserves on this line to bring them above our actuarial point estimate. Our 2004 deficiency included $27.3 million related to this charge, which primarily affected the 2001 and 2000 accident years, and we had a net deficiency of $3.2 million from all other sources. The 2003 development resulted from a commutation charge of $28.8 million, which primarily affected the 1999 and 2000 accident years, partially offset by a net redundancy of $5.7 million from all other sources. Deficiencies and redundancies in the reserves occur as we continually review our loss reserves with our actuaries, increasing or reducing loss reserves as a result of such reviews and as losses are finally settled and claims exposures are reduced. We believe we have provided for all material net incurred losses.

We have no material exposure to environmental pollution losses. Our largest insurance company subsidiary only began writing business in 1981 and its policies normally contain pollution exclusion clauses which limit pollution coverage to sudden and accidental losses only, thus excluding intentional dumping and seepage claims. Policies issued by our other insurance company subsidiaries do not have significant environmental exposures because of the types of risks covered. Therefore, we do not expect to experience any material loss development for environmental pollution claims. Likewise, we have no material exposure to asbestos claims.

Regulation

The business of insurance is extensively regulated by the government. At this time, the insurance business in the United States is regulated primarily by the individual states. Additional federal regulation of the insurance industry may occur in the future.

Our business depends on our compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. We devote a significant effort toward obtaining and maintaining our licenses and compliance with a diverse and complex regulatory structure. In all jurisdictions, the applicable laws and regulations are subject to amendment or interpretation by regulatory authorities. Generally, regulatory authorities are vested with broad discretion to grant, renew and revoke licenses and approvals and to implement regulations governing the business and operations of insurers and insurance agents.

Insurance Companies

Our insurance companies are subject to regulation and supervision by the states and by other jurisdictions in which they do business. Regulation by the states varies, but generally involves regulatory and supervisory powers of a state insurance official. In the United States, the regulation and supervision of our insurance operations relates primarily to:

- approval of policy forms and premium rates;
- licensing of insurers and their agents;
- periodic examinations of our operations and finances;
- prescribing the form and content of records of financial condition required to be filed;
- requiring deposits for the benefit of policyholders;
- requiring certain methods of accounting;
- requiring reserves for unearned premium, losses and other purposes;
- restrictions on the ability of our insurance companies to pay dividends;
- restrictions on the nature, quality and concentration of investments;
- restrictions on transactions between insurance companies and their affiliates;
- restrictions on the size of risks insurable under a single policy; and
- standards of solvency, including risk-based capital measurement (which is a measure developed by the National Association of Insurance Commissioners and used by state insurance regulators to identify insurance companies that potentially are inadequately capitalized).

In the United States, state insurance regulations are intended primarily for the protection of policyholders rather than shareholders. The state insurance departments monitor compliance with regulations through periodic reporting procedures and examinations. The quarterly and annual financial reports to the state insurance regulators utilize accounting principles that are different from the generally accepted accounting principles we use in our reports to shareholders. Statutory accounting principles, in keeping with the intent to assure the protection of policyholders, are generally based on a liquidation concept, while generally accepted accounting principles are based on a going-concern concept.

In the United States, state insurance regulators classify primary insurance companies and some individual lines of business as admitted, also known as licensed, insurance, or non-admitted, also known as surplus lines, insurance. Surplus lines insurance is offered by non-admitted companies on risks that are not insured in the particular state by admitted companies. All surplus lines insurance is required to be written through licensed surplus lines insurance brokers, who are required to be knowledgeable of and follow specific state laws prior to placing a risk with a surplus lines insurer. Our insurance companies offer products on both an admitted and surplus lines basis.

In the United Kingdom, the Financial Services Authority supervises all securities, banking and insurance businesses,

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including Lloyd s of London. The Financial Services Authority oversees compliance with established periodic auditing and reporting requirements, risk assessment reviews, minimum solvency margins, dividend restrictions, restrictions governing the appointment of key officers, restrictions governing controlling ownership interests and various other requirements. All of our United Kingdom operations, including Houston Casualty Company-London, are authorized and regulated by the Financial Services Authority.

HCC Europe is domiciled in Spain and operates on the equivalent of an admitted basis throughout the European Union. HCC Europe s primary regulator is the General Directorate of Insurance and Pension Funds of the Ministry of the Economy and Treasury (Dirección General de Seguros y Fondos de Pensiones del Ministerio de Economía y Hacienda).

U.S. state insurance regulations also affect the payment of dividends and other distributions by insurance companies to their shareholders. Generally, insurance companies are limited by these regulations to the payment of dividends above a specified level. Dividends in excess of those thresholds are extraordinary dividends and are subject to prior regulatory approval.

Underwriting Agencies and Reinsurance and Insurance Brokers

In addition to the regulation of insurance companies, the states impose licensing and other requirements on the underwriting agency and service operations of our other subsidiaries. These regulations relate primarily to:

- advertising and business practice rules;
- contractual requirements;
- financial security;
- licensing as agents, brokers, reinsurance brokers, managing general agents or third party administrators;
- limitations on authority; and
- recordkeeping requirements.

Statutory Accounting Principles

The principal differences between statutory accounting principles for our domestic insurance company subsidiaries and generally accepted accounting principles, the method by which we report our financial results to our shareholders, are as follows:

- a liability is recorded for certain reinsurance recoverables under statutory accounting principles whereas, under generally accepted accounting principles, there is no such provision unless the recoverables are deemed to be doubtful of collection;
- certain assets which are considered non-admitted assets are eliminated from a balance sheet prepared in accordance with statutory accounting principles but are included in a balance sheet prepared in accordance with generally accepted accounting principles;
- only some of the deferred tax asset is recognized under statutory accounting principles;
- fixed-income investments classified as available for sale are recorded at market value for generally accepted accounting principles and at amortized cost under statutory accounting principles;

outstanding losses and unearned premium are reported on a gross basis under generally accepted accounting principles and on a net basis under statutory accounting principles; and

under statutory accounting principles, policy acquisition costs are expensed as incurred and, under generally accepted accounting principles, such costs are deferred and amortized to expense as the related premium is earned.

Our international insurance company subsidiaries accounting principles are prescribed by regulatory authorities in each country. The prescribed principles do not vary significantly from generally accepted accounting principles.

Insurance Holding Company Acts

Because we are an insurance holding company, we are subject to the insurance holding company system regulatory requirements of a number of states. Under these regulations, we are required to report information regarding our capital structure, financial condition and management. We are also required to provide prior notice to, or seek the prior approval of, insurance regulatory authorities of certain agreements and transactions between our affiliated companies. These agreements and transactions must satisfy certain regulatory requirements.

Assessments

Many states require insurers licensed to do business in their state to bear a portion of the loss suffered by some insureds as a result of the insolvency of other insurers or to bear a portion of the cost of insurance for high-risk or otherwise uninsured individuals. Depending upon state law, insurers can be assessed an amount that is generally limited to between 1% and 2% of premiums written for the relevant lines of insurance in that state. Part of these payments may be recoverable through premium rates, premium tax credits or policy surcharges. Significant increases in assessments could limit the ability of our insurance subsidiaries to recover such assessments through tax credits or other means. In addition, there have been some legislative efforts to limit policy surcharges or repeal the tax offset provisions. We cannot predict the extent to which such assessments may increase or whether there may be limits imposed on our ability to recover or offset such assessments.

Insurance Regulations Concerning Change of Control

Many state insurance regulatory laws contain provisions that require advance approval by state agencies of any change of control of an insurance company that is domiciled or, in some cases, has substantial business in that state. Control is generally presumed to exist through the ownership of 10% or more of the voting securities of a domestic insurance company or of any company that controls a domestic insurance company. HCC owns, directly or indirectly, all of the shares of stock of insurance companies domiciled in a number of states. Any purchaser of shares of common stock representing 10% or more of the voting power of our common stock will be presumed to have acquired control of our domestic insurance subsidiaries unless, following application by that purchaser, the relevant state insurance regulators determine otherwise. Any transactions that would constitute a change in control of any of our individual insurance subsidiaries would generally require prior approval by the insurance departments of the states in which the insurance subsidiary is domiciled. Also, one of our insurance subsidiaries is domiciled in the United Kingdom and another in Spain. Insurers in those countries are also subject to change of control restrictions under their individual regulatory frameworks. These requirements may deter or delay possible significant transactions in our common stock or the disposition of our insurance companies to third parties, including transactions which could be beneficial to our shareholders.

Risk-Based Capital

The National Association of Insurance Commissioners has developed a formula for analyzing insurance companies called risk-based capital. The risk-based capital formula is intended to establish minimum capital thresholds that vary with the size and mix of a company s business and assets. It is designed to identify companies with capital levels that may require regulatory attention. At December 31, 2005, each of our domestic insurance companies total adjusted capital was significantly in excess of the authorized control level risk-based capital.

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Insurance Regulatory Information System

The National Association of Insurance Commissioners has developed a rating system, the Insurance Regulatory Information System, primarily intended to assist state insurance departments in overseeing the financial condition of all insurance companies operating within their respective states. The Insurance Regulatory Information System consists of eleven key financial ratios that address various aspects of each insurer s financial condition and stability. Our insurance companies Insurance Regulatory Information System ratios generally fall within the usual prescribed ranges.

Terrorism Risk Insurance Act

The Federal Terrorism Risk Insurance Act was initially enacted in 2002, and subsequently extended through the end of 2007, for the purpose of ensuring the availability of insurance coverage for terrorist acts in the United States. The law establishes a financial backstop program to assist the commercial property and casualty insurance industry in providing coverage related to future acts of terrorism within the United States. It is unknown at this time whether or not the law will be extended beyond December 31, 2007 or on what terms. If it is not renewed, our current policies allow us to cancel the terrorism coverage in force at that time and we will no longer be required to offer the coverage. Under the Act, we are required to offer terrorism coverage to our commercial policyholders in certain lines of business written in the United States, for which we may, when warranted, charge an additional premium. The policyholders may or may not accept such coverage. This law also established a deductible that each insurer would have to meet before U.S. Federal reimbursement would occur. For 2006, our deductible is approximately $91.9 million. The Federal government would provide reimbursement for 90% of any additional covered losses in 2006 up to the maximum amount set out in the Act.

Legislative Initiatives

In recent years, state legislatures have considered or enacted laws that modify and, in many cases, increase state authority to regulate insurance companies and insurance holding company systems. State insurance regulators are members of the National Association of Insurance Commissioners, which seeks to promote uniformity of and to enhance the state regulation of insurance. In addition, the National Association of Insurance Commissioners and state insurance regulators, as part of the National Association of Insurance Commissioners state insurance department accreditation program and in response to new federal laws, have re-examined existing state laws and regulations, specifically focusing on insurance company investments, issues relating to the solvency of insurance companies, licensing and market conduct issues, streamlining agent licensing and policy form approvals, adoption of privacy rules for handling policyholder information, interpretations of existing laws, the development of new laws and the definition of extraordinary dividends.

In recent years, a variety of measures have been proposed at the federal level to reform the current process of federal and state regulation of the financial services industries in the United States, which include the banking, insurance and securities industries. These measures, which are often referred to as financial services modernization, have as a principal objective the elimination or modification of regulatory barriers to cross-industry combinations involving banks, securities firms and insurance companies. A form of financial services modernization legislation was enacted at the federal level in 1999 through the Gramm-Leach-Bliley Act. That federal legislation was expected to have significant implications on the banking, insurance and securities industries and to result in more cross-industry consolidations among banks, insurance companies and securities firms and increased competition in many of the areas of operations. Such wide-spread cross-industry consolidation has not occurred to date. It also mandated the adoption of laws allowing reciprocity among the states in the licensing of agents and, along with other federal laws, mandated the adoption of laws and regulations dealing with the protection of the privacy of policyholder information. Also, the federal government has from time to time considered whether to impose overall federal regulation of insurers. If so, we believe state regulation of the insurance business would likely continue. This could result in an additional layer of federal regulation. In addition, some insurance industry trade groups are actively lobbying for legislation that would allow an option for a separate federal charter for insurance companies. The full extent to which the federal government could decide to directly regulate the business of insurance has not been determined by lawmakers.

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Recently, state regulators in many states have initiated or are participating in industry-wide investigations of sales and marketing practices in the insurance industry. Such investigations have resulted in restitution and settlement payments by some companies and criminal charges against some individuals. The investigations are expected to lead to changes in the structure of compensation arrangements, the offering of certain products and increased transparency in the marketing of many insurance products, some of which changes may be legally required. We have cooperated fully with any such investigations and, based on presently available information, do not expect any adverse results from such investigations.

We do not know at this time the full extent to which these federal or state legislative or regulatory initiatives will or may affect our operations and no assurance can be given that they would not, if adopted, have a material adverse effect on our business or our results of operations.

Employees

At December 31, 2005, we had 1,448 employees. Of this number, 770 are employed by our insurance companies, 433 are employed by our underwriting agencies, 101 are employed by our reinsurance and insurance brokers and 144 are employed at the corporate headquarters and elsewhere. We are not a party to any collective bargaining agreement and have not experienced work stoppages or strikes as a result of labor disputes. We consider our employee relations to be good.

ITEM 1A. RISK FACTORS

RISKS RELATING TO OUR INDUSTRY

Because we are a property and casualty insurer, our business may suffer as a result of unforeseen catastrophic losses.

Property and casualty insurers are subject to claims arising from catastrophes. Catastrophic losses have had a significant impact on our historical results. Catastrophes can be caused by various events, including hurricanes, tsunamis, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires and may include man-made events, such as terrorist attacks. The incidence, frequency and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Insurance companies are not permitted to reserve for a catastrophe until it has occurred. Catastrophes can cause losses in a variety of our property and casualty lines, and most of our past catastrophe-related claims have resulted from hurricanes and earthquakes; however, we experienced a significant loss as a result of the September 11, 2001 terrorist attack. Most of our exposure to catastrophes comes from our London market account. Although we typically purchase reinsurance protection for risks we believe bear a significant level of catastrophe exposure, the nature or magnitude of losses attributed to a catastrophic event or events may result in losses which exceed our reinsurance protection. It is therefore possible that a catastrophic event or multiple catastrophic events could have a material adverse effect on our financial position, results of operations and liquidity.

The insurance and reinsurance business is historically cyclical, and we expect to experience periods with excess underwriting capacity and unfavorable premium rates, which could cause our results to fluctuate.

The insurance and reinsurance business historically has been a cyclical industry characterized by periods of intense price competition due to excessive underwriting capacity, as well as periods when shortages of capacity permitted an increase in pricing and, thus, more favorable premium levels. An increase in premium levels is often over time offset by an increasing supply of insurance and reinsurance capacity, either by capital provided by new entrants or by the commitment of additional capital by existing insurers or reinsurers, which may cause prices to decrease. Any of these factors could lead to a significant reduction in premium rates, less favorable policy terms and fewer opportunities to underwrite insurance risks, which could have a material adverse effect on our results of operations and cash flows. In addition to these considerations, changes in the frequency and severity of losses suffered by insureds and insurers may affect the cycles of the insurance and reinsurance business significantly. These factors may also cause the price of our common stock to be volatile.

Our loss reserves are based on an estimate of our future liability, which may prove to be inadequate.

We maintain loss reserves to cover our estimated liability for unpaid losses and loss adjustment expenses, including legal and other fees as well as a portion of our general expenses, for reported and unreported claims incurred at the end of each accounting period. Reserves do not represent an exact calculation of liability. Rather, reserves represent an estimate of what we expect the ultimate settlement and administration of claims will cost. These estimates, which generally involve actuarial projections, are based on our assessment of facts and circumstances then known, as well as estimates of future trends in claims severity, frequency, judicial theories of liability and other factors. These variables are affected by both internal and external events, such as changes in claims handling procedures, inflation, judicial trends and legislative changes. Many of these items are not directly quantifiable in advance. Additionally, there may be a significant reporting delay between the occurrence of the insured event and the time it is reported to us. The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to reserves are reflected in our results of operations in the periods in which such estimates are changed. Because setting reserves is inherently uncertain, there can be no assurance that current reserves will prove adequate in light of subsequent events. If actual claims prove to be greater than our reserves, our financial position, results of operations and liquidity may be adversely affected.

The effects of emerging claim and coverage issues on our business are uncertain.

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may adversely affect our business by either extending coverage beyond our underwriting intent or by increasing the number or size of claims. In some instances, these changes may not become apparent until some time after we have issued insurance or reinsurance contracts that are affected by the changes. As a result, the full extent of liability under our insurance or reinsurance contracts may not be known for many years after a contract is issued and our financial position and results of operations may be adversely affected.

We are subject to extensive governmental regulation, which could adversely affect our business.

We are subject to extensive governmental regulation and supervision. Our business depends on compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. Most insurance regulations are designed to protect the interests of policyholders rather than shareholders and other investors. In the United States, this regulation is generally administered by departments of insurance in each state in which we do business and includes a comprehensive framework of oversight of our operations and review of our financial position. U.S. Federal legislation may lead to additional federal regulation of the insurance industry in the coming years. Also, foreign governments regulate our international operations. Each foreign jurisdiction has its own unique regulatory framework which applies to our operations in that jurisdiction. Regulatory authorities have broad discretion to grant, renew or revoke licenses and approvals. Regulatory authorities may deny or revoke licenses for various reasons, including the violation of regulations. In some instances, we follow practices based on our interpretations of regulations, or those we believe to be generally followed by the industry, which may be different from the requirements or interpretations of regulatory authorities. If we do not have the requisite licenses and approvals and do not comply with applicable regulatory requirements, the insurance regulatory authorities could preclude or temporarily suspend us from carrying on some or all of our activities or otherwise penalize us. That type of action could have a material adverse effect on our results of operations. Also, changes in the level of regulation of the insurance industry (whether federal, state or foreign), or changes in laws or regulations themselves or interpretations by regulatory authorities, could have a material adverse effect on our business. Virtually all states require insurers licensed to do business in that state to bear a portion of the loss suffered by some insureds as the result of impaired or insolvent insurance companies. The effect of these arrangements could adversely affect our results of operations.

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Our reliance on brokers subjects us to their credit risk.

In accordance with industry practice, we generally pay amounts owed on claims under our insurance and reinsurance contracts to brokers, and these brokers, in turn, pay these amounts over to the clients that have purchased insurance or reinsurance from us. Although the law is unsettled and depends upon the facts and circumstances of the particular case, in some jurisdictions, if a broker fails to make such a payment, we might remain liable to the insured or ceding insurer for the deficiency. Conversely, in certain jurisdictions, when the insured or ceding insurer pays premiums for these policies to brokers for payment over to us, these premiums might be considered to have been paid and the insured or ceding insurer will no longer be liable to us for those amounts, whether or not we have actually received the premiums from the broker. Consequently, we assume a degree of credit risk associated with brokers with whom we transact business. However, due to the unsettled and fact-specific nature of the law, we are unable to quantify our exposure to this risk. To date, we have not experienced any material losses related to these credit risks.

RISKS RELATING TO OUR BUSINESS

Our increased retentions in various lines of business means that we are exposed to a greater portion of potential losses.

Over the past few years, we have significantly increased our retentions in a number of the lines of business underwritten by our insurance companies. The determination to reduce the amount of reinsurance we purchase or not to purchase reinsurance for a particular risk or line of business is based on a variety of factors including market conditions, pricing, availability of reinsurance, the level of our capital and loss history. Such determinations have the effect of increasing our financial exposure to losses associated with such risks or in the subject line of business and could have a material adverse effect on our financial position, results of operations and cash flows in the event of significant losses associated with such risks or lines of business.

If we are unable to purchase adequate reinsurance protection for some of the risks we have underwritten, we will be exposed to any resulting losses.

We purchase reinsurance for a portion of the risks underwritten by our insurance companies, especially volatile and catastrophe-exposed risks. Market conditions beyond our control determine the availability and cost of the reinsurance protection we purchase. In addition, the historical results of reinsurance programs and the availability of capital also affect the availability of reinsurance. Our reinsurance facilities are generally subject to annual renewal. We cannot assure that we can maintain our current reinsurance facilities or that we can obtain other reinsurance facilities in adequate amounts and at favorable rates. Further, we cannot determine what effect catastrophic losses will have on the reinsurance market in general and on our ability to obtain reinsurance in adequate amounts and at favorable rates in particular. If we are unable to renew or to obtain new reinsurance facilities, either our net exposures would increase or, if we are unwilling to bear such an increase, we would have to reduce the level of our underwriting commitments, especially in catastrophe-exposed risks. Either of these potential developments could have a material adverse effect on our financial position, results of operations and cash flows. The lack of available reinsurance may also adversely affect our ability to generate fee and commission income in our underwriting agency and reinsurance broker operations.

If the companies that provide our reinsurance do not pay all of our claims, we could incur severe losses.

We purchase reinsurance by transferring, or ceding, part of the risk we have assumed as a primary insurer to a reinsurance company in exchange for part of the premium we receive in connection with the risk. The part of the risk we retain for our own account is known as the retention. Through reinsurance, we have the contractual right to collect the amount above our retention from our reinsurers. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us, the reinsured, of our full liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. We cannot assure you that our reinsurers will pay all of our reinsurance claims, or that they will pay our claims on a timely basis. Additionally, catastrophic losses from multiple primary insurers may accumulate within the more concentrated reinsurance market and result in claims which adversely impact the financial condition of such reinsurers and thus their ability to pay such claims. If we become liable for risks we have ceded to reinsurers or if our reinsurers cease to meet their obligations to us, whether because they are in a weakened financial position as a result of incurred losses or otherwise, our financial position, results of operations and cash flows could be materially adversely affected.

As a primary insurer, we may have significant exposure for terrorist acts.

To the extent that reinsurers have excluded coverage for terrorist acts or have priced such coverage at rates that we believe are not practical, we, in our capacity as a primary insurer, do not have reinsurance protection and are exposed for potential losses as a result of any terrorist acts. To the extent an act of terrorism is certified by the Secretary of Treasury, we may be covered under The Terrorism Risk Insurance Act, originally enacted in 2002 and subsequently extended, for up to 90% of our losses in 2006. However, any such coverage would be subject to a mandatory deductible. Our deductible under the Act during 2006 is $91.9 million. If the Act is not extended beyond its currently stated termination date of December 31, 2007 or replaced by a similar program, our liability for terrorist acts could be a material amount.

We may be unsuccessful in competing against larger or more well established business rivals.

In our specialty insurance operations, we compete in narrowly-defined niche classes of business such as the insurance of private aircraft (aviation), directors and officers liability (diversified financial products), employer sponsored, self-insured medical plans (medical stop-loss), professional indemnity (diversified financial products) and surety (diversified financial products), as distinguished from such general lines of business as automobile or homeowners insurance. We compete with a large number of other companies in our selected lines of business, including: Lloyd s, ACE and XL in our London market business; American International Group and U.S. Aviation Insurance Group (a subsidiary of Berkshire Hathaway, Inc.) in our aviation line of business; United Health, Symetra Financial Corp. and Hartford Life in our group life, accident and health business; and American International Group, The Chubb Corporation, ACE, St. Paul Travelers and XL in our diversified financial products business. We face competition from specialty insurance companies, underwriting agencies and reinsurance brokers, as well as from diversified financial services companies that are larger than we are and that have greater financial, marketing and other resources than we do. Some of these competitors also have longer experience and more market recognition than we do in certain lines of business. In addition to competition in the operation of our business, we face competition from a variety of sources in attracting and retaining qualified employees. We cannot assure you that we will maintain our current competitive position in the markets in which we operate, or that we will be able to expand our operations into new markets. If we fail to do so, our results of operations and cash flows could be materially adversely affected.

If the rating agencies downgrade us, our business and competitive position in the industry may suffer.

Ratings have become an increasingly important factor in establishing the competitive position of insurance companies. Our insurance companies are rated by Standard & Poor s Corporation, Fitch Ratings and A.M. Best Company, Inc. whose ratings reflect their opinions of an insurance company s and insurance holding company s financial strength, operating performance, strategic position and ability to meet its obligations to policyholders and are not evaluations directed to investors. Our ratings are subject to periodic review by those entities and the continuation of those ratings cannot be assured. A. M. Best placed our insurance company ratings under review with negative implications as a result of the Special Committee s investigation of our stock option granting practices and subsequent non-compliance with financial reporting and other information delivery requirements under our debt instruments. Standard & Poor s and Fitch Ratings affirmed their ratings of our insurance companies with a stable outlook, after considering our announcement of the substantial completion of the Special Committee s investigation. If our ratings are reduced from their current levels, our financial position and results of operations could be adversely affected.

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 new business successfully and to establish premium rates and reserves at levels sufficient to cover losses. We may need to raise additional funds through financings or curtail our growth and reduce our assets. Any equity or debt financing, if available at all, may be on terms that are not favorable to us. In the case of equity financings, dilution to our shareholders could result and, in any case,

such securities may have rights, preferences and privileges that are senior to those of our common stock. If we cannot obtain adequate capital on favorable terms or at all, our business, results of operations and liquidity could be adversely affected.

As a result of our delayed filing of our Form 10-Q s for the quarters ended June 30, 2006 and September 30, 2006, we are ineligible to register our securities on Form S-3 or use our previously filed shelf registration statement until we have timely filed all periodic reports under the Securities Exchange Act of 1934 for one year. We may use Form S-1 to raise capital and borrow money utilizing public debt or complete acquisitions of other companies, which could increase transaction costs and adversely impact our ability to raise capital and borrow money or complete acquisitions in a timely manner. In addition, the financial strength ratings of our insurance companies and our debt ratings, which A.M. Best placed under review with negative implications and Fitch Ratings and Standard & Poor s affirmed with a stable outlook, if reduced, might significantly impede our ability to raise capital and borrow money.

We may be unable to attract and retain qualified employees.

We depend on our ability to attract and retain experienced underwriting talent and other skilled employees who are knowledgeable about our business. If the quality of our underwriting team and other personnel decreases, we may be unable to maintain our current competitive position in the specialized markets in which we operate and be unable to expand our operations into new markets, which could adversely affect our business.

We invest a significant amount of our assets in fixed income securities that have experienced market fluctuations, which may greatly reduce the value of our investment portfolio.

At December 31, 2005, $2.3 billion of our $3.3 billion investment portfolio was invested in fixed income securities. The fair value of these fixed income securities and the related investment income fluctuate depending on general economic and market conditions. With respect to our investments in fixed income securities, the fair value of these investments generally increases or decreases in an inverse relationship with fluctuations in interest rates, while net investment income realized by us from future investments in fixed income securities will generally increase or decrease with interest rates. In addition, actual net investment income and/or cash flows from investments that carry prepayment risk (such as mortgage-backed and other asset-backed securities) may differ from those anticipated at the time of investment as a result of interest rate fluctuations. An investment has prepayment risk when there is a risk that the timing of cash flows that result from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. Although we maintain an investment grade portfolio (99% are rated A or better), our fixed income securities are also subject to credit risk. If any of the issuers of our fixed income securities suffer financial setbacks, the ratings on the fixed income securities could fall (with a concurrent fall in fair value) and, in a worst case scenario, the issuer could default on its financial obligations. Historically, the impact of market fluctuations has affected our financial statements. Because all of our fixed income securities are classified as available for sale, changes in the fair value of our securities are reflected in our other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our financial position. Unrealized pre-tax net investment losses on investments in fixed income securities were $29.3 million in 2005, $9.3 million in 2004 and $3.7 million in 2003.

Our strategy of acquiring other companies for growth may not succeed.

Our strategy for growth includes growing through acquisitions of insurance industry related companies. This strategy presents risks that could have a material adverse effect on our business and financial performance, including: 1) the diversion of our management s attention, 2) our ability to assimilate the operations and personnel of the acquired companies, 3) the contingent and latent risks associated with the past operations of, and other unanticipated problems arising in, the acquired companies, 4) the need to expand management, administration and operational systems and 5) increased competition for suitable acquisition opportunities and qualified employees. We cannot predict whether we will be able to acquire additional companies on terms favorable to us or if we will be able to successfully integrate the acquired operations into our business. We do not know if we will realize any anticipated benefits of completed acquisitions or if there will be substantial unanticipated costs associated with new acquisitions. In addition, future acquisitions by us may result in potentially dilutive issuances of our equity securities, the incurrence of additional debt and the recognition of potential impairment of goodwill and other intangible assets. Each of these factors could adversely

affect our financial position and results of operations. Moreover, our ability to use equity securities or to incur additional debt for acquisitions may be negatively affected by the effects of our options pricing investigation.

We are an insurance holding company and, therefore, may not be able to receive dividends in needed amounts from our subsidiaries.

Historically, we have had sufficient cash flow from our non-insurance company subsidiaries to meet our corporate cash flow requirements for paying principal and interest on outstanding debt obligations, dividends to shareholders and corporate expenses. However, in the future we may rely on dividends from our insurance companies to meet these requirements. The payment of dividends by our insurance companies is subject to regulatory restrictions and will depend on the surplus and future earnings of these subsidiaries, as well as the regulatory restrictions. As a result, should our other sources of funds prove to be inadequate, we may not be able to receive dividends from our insurance companies at times and in amounts necessary to meet our obligations, which could adversely affect our financial position and liquidity.

Because we operate internationally, fluctuations in currency exchange rates may affect our receivable and payable balances and our reserves.

We underwrite insurance coverages that are denominated in a number of foreign currencies and we establish and maintain our loss reserves with respect to these policies in their respective currencies. Our net earnings could be adversely affected by exchange rate fluctuations, which would adversely affect receivable and payable balances and reserves. Our principal area of exposure relates to fluctuations in exchange rates between the major European currencies (particularly the British pound sterling and the Euro) and the U.S. dollar. Consequently, a change in the exchange rate between the U.S. dollar and the British pound sterling or the Euro could have an adverse effect on our results of operations.

Our information technology systems may fail or suffer a loss of security, which could adversely affect our business.

Our business is highly dependent upon the successful and uninterrupted functioning of our computer and data processing systems. We rely on these systems to perform actuarial and other modeling functions necessary for writing business, as well as to process and make claims payments. We have a highly trained staff that is committed to the development and maintenance of these systems. However, the failure of these systems could interrupt our operations. This could result in a material adverse effect on our business results.

In addition, a security breach of our computer systems could damage our reputation or result in liability. We retain confidential information regarding our business dealings in our computer systems. We may be required to spend significant capital and other resources to protect against security breaches or to alleviate problems caused by such breaches. It is critical that these facilities and infrastructure remain secure. Despite the implementation of security measures, this infrastructure may be vulnerable to physical break-ins, computer viruses, programming errors, attacks by third parties or similar disruptive problems. In addition, we could be subject to liability if hackers were able to penetrate our network security or otherwise misappropriate confidential information.

The SEC s informal inquiry related to our stock option granting procedures is on-going, and the scope and outcome could have a negative impact on the price of our securities and on our business.

As described in Note 2 to our Consolidated Financial Statements included in this Form 10-K/A, based on the Special Committee s voluntary independent investigation of our past practices related to granting stock options, we determined that the price on the actual measurement date for a number of our stock option grants during the period 1997 through 2005 and into 2006 did not correspond to the price on the stated grant date and that certain option grants were retroactively priced. The investigation was conducted with the help of a law firm that was not previously involved with our stock option plans and procedures. The SEC has commenced an informal inquiry. In connection with its inquiry, we received a document request from the SEC. We intend to fully cooperate with the informal inquiry. We are unable to predict the outcome of the informal inquiry, but it may result in substantial legal, tax, accounting and other professional services costs, may continue to occupy the time and attention of our management team, could have a material adverse impact on our stock price, including increased stock price volatility, and could negatively impact our business and our ability to raise and borrow additional funds in the future.

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If we do not maintain compliance with the listing requirements of the New York Stock Exchange (NYSE), our common stock could be delisted, which would reduce the price of our common stock and the levels of liquidity available to our shareholders.

In connection with the Special Committee s investigation of our option granting practices and the restatement of our consolidated financial statements, we were delinquent in filing certain of our periodic reports with the SEC. These circumstances could lead to a delisting of our common stock from the NYSE. If we are delisted from the NYSE, the price of our common stock and levels of liquidity available to our stockholders could be reduced. In addition, a delisting from the NYSE could result in other negative implications, including the potential loss of confidence by customers and employees and the loss of institutional investor interest in our company.

The matters relating to the Special Committee of the Board of Directors investigation of our historical stock option granting practices and the restatement of our consolidated financial statements may result in future litigation, which could harm our business and financial condition.

As a result of the Special Committee s investigation of our historical stock option granting practices, we had to record non-cash compensation expense in each year for the period 1997 through 2005 and increase such expense in 2006. To correct these accounting errors, we are amending our Annual Report on Form 10-K for the year ended December 31, 2005 and our Quarterly Report on Form 10-Q for the three months ended March 31, 2006, to restate the consolidated financial statements and condensed consolidated financial statements, respectively, contained in those reports. Our historical stock option granting practices and the restatement of our prior consolidated financial statements have exposed us to greater risks associated with litigation. Publicity resulting from these actions may materially adversely affect us, regardless of the cause or effect of the actions. We cannot assure you that any future litigation will result in the same conclusions reached by the Special Committee. The conduct and resolution of litigation could be time consuming, expensive and may distract management from the conduct of our business. In addition, damages and other remedies awarded in any such litigation could harm our business and financial condition.

The loss of Stephen L. Way as our Chief Executive Officer could weaken our strategic leadership and have a material adverse effect on our business and development.

Since our founding, Stephen L. Way s leadership and strategic direction have been critical elements to our success. On November 17, 2006, Mr. Way resigned as our Chief Executive Officer. However, Mr. Way will remain a director of HCC and serve as the non-executive Chairman of the Board of Directors and as a paid consultant. Although our executive officers have experience in the insurance industry, they do not have the same breadth of experience as Mr. Way in providing the strategic direction for our future growth and development. As a result, the loss of Mr. Way s services as Chief Executive Officer could weaken our strategic leadership and have a material adverse effect upon our business and continuing development.

Our failure to comply with any of the covenants in the indentures for our convertible notes and in our revolving loan facility could have a material adverse impact on our business and our financial condition.

On October 30, 2006, we received a registered letter from U.S. Bank, as trustee for the holders of our 2.00% Convertible Notes due 2021, 1.30% Convertible Notes due 2023 and 2.00% Convertible Exchange Notes due 2021, stating that U.S. Bank, as trustee, had not received our consolidated financial statements for the quarter ended June 30, 2006. If we do not file our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 with the SEC and deliver the report to the trustee within sixty days from the date notice was received from the trustee, such failure to file and deliver will be considered an Event of Default under the indenture governing the notes. If an Event of Default were to occur under the indentures for any series of the notes, the trustee or holders of at least 25% of the aggregate principal of such series then outstanding could declare all the unpaid principal on such series of notes then outstanding to be immediately due and payable. Likewise, we have not timely delivered our Form 10-Q s for the quarters ended June 30 and September 30, 2006 as required by the terms of our Revolving Loan Facility. The banks that are a party to the agreement waived certain Defaults or Events of Default until January 31, 2007. In addition, our restatement of our prior year financial statements might be considered an Event of Default , which has been waived until January 31, 2007 under our Revolving Loan Facility. Our failure to comply with the covenants in the indentures for our convertible notes and our Revolving Loan Facility in the future could have a material adverse effect on our stock price, business and financial condition if we would not have available funds at that time to repay any defaulted debt. A default and acceleration under

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the indentures for our convertible notes and loan agreement may also trigger cross-acceleration under our other debt instruments.

Our certificate of incorporation and our bylaws do not have provisions that could delay or prevent a change in control.

Our certificate of incorporation and bylaws do not have provisions that could make it more difficult for a third party to acquire a majority of our outstanding common stock. As a result, we may be more susceptible to an inadequate or coercive offer that could result in a change in control than a company whose charter documents have provisions that could delay or prevent a change in control.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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ITEM 2. PROPERTIES

Our principal and executive offices are located in Houston, Texas, in buildings owned by Houston Casualty Company. We also maintain offices in over 45 locations elsewhere in the United States, the United Kingdom, Spain, Bermuda and Ireland. The majority of these additional locations are in leased facilities. We are not dependent on our facilities to conduct business and such office space is suitable for the conduct of our business.

Our principal office facilities are as follows:

Subsidiary	Location	Sq. Ft.	Termination Date of Lease
Houston Casualty Company	Houston, Texas	77,000	Owned
HCC and Houston Casualty Company	Houston, Texas	51,000	Owned
Professional Indemnity Agency	Mount Kisco, New York	38,000	Owned
U.S. Specialty Insurance Company Aviation Division	Dallas, Texas	28,000	August 31, 2013
HCC Specialty Underwriters	Wakefield, Massachusetts	28,000	December 31, 2010
HCC Life Insurance Company	Atlanta, Georgia	27,000	December 31, 2011

See also Note 13 to our Consolidated Financial Statements included in this Form 10-K/A.

ITEM 3. LEGAL PROCEEDINGS

As described in Note 2 to our Consolidated Financial Statements included in this Form 10-K/A, based on the Special Committee s voluntary independent investigation of our past practices related to granting stock options, we determined that the price on the actual measurement date for a number of our stock option grants during the period 1997 through 2005 and into 2006 did not correspond to the price on the stated grant date and that certain option grants were retroactively priced. The investigation was conducted with the help of a law firm that was not previously involved with our stock option plans and procedures. The SEC has commenced an informal inquiry. In connection with its inquiry, we received a document request from the SEC. We intend to fully cooperate with the informal inquiry. We are unable to predict the outcome of or the future costs related to the informal inquiry.

We are party to lawsuits, arbitrations and other proceedings that arise in the normal course of our business. Many of such lawsuits, arbitrations and other proceedings involve claims under policies that we underwrite as an insurer or reinsurer, the liabilities for which, we believe, have been adequately included in our loss reserves. Also, from time to time, we are a party to lawsuits, arbitrations and other proceedings that relate to disputes over contractual relationships with third parties, or that involve alleged errors and omissions on the part of our subsidiaries. We have provided accruals for these items to the extent we deem the losses probable and reasonably estimable.

In April 2006, we were named as a defendant in a complaint related to insurance marketing and producer compensation practices. The lawsuit was filed in Federal District Court in Georgia by a number of corporate plaintiffs against approximately 100 insurance entity defendants. The suit has been transferred to the multi-district litigation proceeding pending in the United States District Court for the District of New Jersey for coordinated or consolidated pre-trial proceedings with suits previously transferred that appear to the court to involve common questions of fact. The complaint alleges violations of Federal antitrust law, the Racketeering Influence and Corrupt Organization Act and various state anti-fraud laws. The lawsuit seeks unspecified damages. We are vigorously contesting this action. Although the ultimate outcome of these matters cannot be determined at this time, based on present information, the

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availability of insurance coverage and advice received from our outside legal counsel, we believe the resolution of these matters will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of security holders during the fourth quarter of 2005.

PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Price Range of Common Stock

Our common stock trades on the New York Stock Exchange under the ticker symbol HCC .

The intra-day high and low sales prices for quarterly periods from January 1, 2003 through December 31, 2005, as reported by the New York Stock Exchange, were as follows:

	2005		2004		2003	
	High	Low	High	Low	High	Low
First quarter	$ 26.17	$ 21.31	$ 23.17	$ 20.01	$ 17.64	$ 14.87
Second quarter	26.96	23.05	22.93	20.30	20.13	17.10
Third quarter	28.89	25.11	22.39	19.23	20.84	19.13
Fourth quarter	32.95	26.91	22.83	18.35	21.39	18.73

On February 28, 2006, the last reported sales price of our common stock as reported by the New York Stock Exchange was $32.19 per share.

Shareholders

We have one class of authorized capital stock: 250.0 million shares of common stock, par value $1.00 per share. On February 28, 2006, there were 111.1 million shares of issued and outstanding common stock held by 853 shareholders of record; however, we estimate there are approximately 55,000 beneficial owners.

Dividend Policy

Cash dividends declared on a quarterly basis for the three years ended December 31, 2005 were as follows:

	2005	2004	2003
First quarter	$ .057	$ .050	$ .043
Second quarter	.075	.050	.043
Third quarter	.075	.057	.050
Fourth quarter	.075	.057	.050

Beginning in June 1996, we announced a planned quarterly program of paying cash dividends to shareholders. Our Board of Directors may review our dividend policy from time to time and any determination with respect to future dividends will be made in light of regulatory and other conditions at that time, including our earnings, financial condition, capital requirements, loan covenants and other related factors. Under the terms of our bank loan facility, we are prohibited from paying dividends in excess of an agreed upon maximum amount in any fiscal year. That limitation should not affect our ability to pay dividends in a manner consistent with our past practice and current expectations.

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ITEM 6. SELECTED FINANCIAL DATA

The selected consolidated financial data set forth below has been derived from the Consolidated Financial Statements. All information contained herein should be read in conjunction with the Consolidated Financial Statements, the related Notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Annual Report on Form 10-K/A.

As described in Note 2 to the audited Consolidated Financial Statements referred to above, our Consolidated Financial Statements have been restated to record adjustments for stock compensation expense and related taxes in connection with stock options that were granted during the period 1997 through 2005 and for other minor adjustments and related taxes that were not recorded in the originally filed financial statements due to their immateriality. These adjustments resulted in after-tax charges of $ 4.7 million, $ 0.3 million, $ 1.5 million, $ 1.5 million and $ 0.2 million for the years ended December 31, 2005, 2004, 2003, 2002 and 2001, respectively. Additionally, the cumulative effect of the related after-tax charges for periods prior to 2001 was $ 10.4 million.

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Years ended December 31,
(in thousands, except per share data) (1) (4) (5)

	2005	2004	2003	2002(2)			2001(2)(7)		
	(As restated)	(As restated)	(As restated)	(As previously reported)	(Adjustments)	(As restated)	(As previously reported)	(Adjustments)	(As restated)
Statement of earnings data:									
Revenue									
Net earned premium	$ 1,369,988	$ 1,010,692	$ 738,272	$ 505,521	$	$ 505,521	$ 342,787	$	$ 342,787
Fee and commission income	132,628	183,802	142,615	115,919	171	116,090	111,016	(171)	110,845
Net investment income	98,851								