

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q

December 27, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarter Ended September 30, 2006.

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 from \_\_\_ to \_\_\_

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)

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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date.

On November 30, 2006, there were approximately 111.7 million shares of common stock, \$1.00 par value issued and outstanding.

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**EXPLANATORY NOTE LATE FILING OF QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2006**

A Special Committee of our Board of Directors conducted an investigation of our past stock option granting practices and announced its findings on November 17, 2006. Because we did not know the financial impact of the Special Committee's investigation, we were not able to timely file our quarterly report on Form 10-Q for our third quarter ended September 30, 2006. We have completed calculating the financial effect utilizing the results of the investigation and are now filing this Form 10-Q for our third quarter. See Note 2 Restatement of Financial Statements of the notes to the Condensed Consolidated Financial Statements and Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations Restatement of Financial Statements for more information on the investigation and its financial effects.

*This report on Form 10-Q 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 growth of our business and operations, business strategy, competitive strengths, acquisitions, capital expenditures, goals, 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;*

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*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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HCC Insurance Holdings, Inc. and Subsidiaries  
Condensed Consolidated Balance Sheets  
(unaudited, in thousands except per share data)

	September 30, 2006	December 31, 2005
<b>ASSETS</b>		
Investments:		
Fixed income securities, at fair value (amortized cost: 2006 \$2,840,047; 2005 \$2,277,139)	\$ 2,840,610	\$ 2,268,624
Short-term investments, at cost, which approximates fair value	673,406	839,581
Other investments, at fair value (cost: 2006 - \$275,644; 2005 - \$144,897)	290,363	149,223
<b>Total investments</b>	<b>3,804,379</b>	<b>3,257,428</b>
Cash	59,638	73,935
Restricted cash and cash investments	171,501	170,978
Premium, claims and other receivables	867,127	884,654
Reinsurance recoverables	1,305,952	1,361,983
Ceded unearned premium	244,003	239,416
Ceded life and annuity benefits	72,429	73,415
Deferred policy acquisition costs	181,111	156,253
Goodwill	554,430	532,947
Other assets	283,669	277,791
<b>Total assets</b>	<b>\$ 7,544,239</b>	<b>\$ 7,028,800</b>
<b>LIABILITIES</b>		
Loss and loss adjustment expense payable	\$ 2,907,626	\$ 2,813,720
Life and annuity policy benefits	72,429	73,415
Reinsurance balances payable	139,384	176,954
Unearned premium	924,518	807,109
Deferred ceding commissions	67,231	67,886
Premium and claims payable	684,660	753,859
Notes payable	393,167	309,543
Accounts payable and accrued liabilities	394,016	335,879
<b>Total liabilities</b>	<b>5,583,031</b>	<b>5,338,365</b>
<b>SHAREHOLDERS EQUITY</b>		
Common stock, \$1.00 par value; 250.0 million shares authorized (shares issued and outstanding: 2006 111,491; 2005 110,803)	111,491	110,803
Additional paid-in capital	786,759	762,170
Retained earnings	1,029,318	798,388
Accumulated other comprehensive income	33,640	19,074

<b>Total shareholders equity</b>	1,961,208	1,690,435
<b>Total liabilities and shareholders equity</b>	\$ 7,544,239	\$ 7,028,800

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries  
Condensed Consolidated Statements of Earnings  
(unaudited, in thousands except per share data)

	Nine months ended September 30,		Three months ended September 30,	
	2006	2005	2006	2005
		(As restated)		(As restated)
<b>REVENUE</b>				
Net earned premium	\$ 1,204,941	\$ 995,901	\$ 421,050	\$ 338,058
Fee and commission income	104,409	100,999	38,862	32,073
Net investment income	108,959	70,039	36,205	24,998
Net realized investment gain (loss)	(1,193)	2,038	304	38
Other operating income	59,071	26,116	20,276	16,864
<b>Total revenue</b>	<b>1,476,187</b>	<b>1,195,093</b>	<b>516,697</b>	<b>412,031</b>
<b>EXPENSE</b>				
Loss and loss adjustment expense, net	689,122	679,932	236,030	295,768
Policy acquisition costs, net	231,012	187,696	78,203	65,708
Other operating expense	156,279	137,077	59,277	41,206
Interest expense	7,912	5,848	3,475	2,070
<b>Total expense</b>	<b>1,084,325</b>	<b>1,010,553</b>	<b>376,985</b>	<b>404,752</b>
Earnings from continuing operations before income tax expense	391,862	184,540	139,712	7,279
Income tax expense on continuing operations	130,319	59,091	46,455	574
Earnings from continuing operations	261,543	125,449	93,257	6,705
Earnings from discontinued operations, net of income tax expense		707		707
<b>Net earnings</b>	<b>\$ 261,543</b>	<b>\$ 126,156</b>	<b>\$ 93,257</b>	<b>\$ 7,412</b>
<b>Basic earnings per share data:</b>				
Earnings from continuing operations	\$ 2.35	\$ 1.20	\$ 0.84	\$ 0.06
Earnings from discontinued operations		0.01		0.01
<b>Net earnings per share</b>	<b>\$ 2.35</b>	<b>\$ 1.21</b>	<b>\$ 0.84</b>	<b>\$ 0.07</b>
Weighted average shares outstanding	111,198	104,617	111,359	105,623
<b>Diluted earnings per share data:</b>				
Earnings from continuing operations	\$ 2.24	\$ 1.16	\$ 0.80	\$ 0.06

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Earnings from discontinued operations			0.01		0.01			
<b>Net earnings per share</b>	\$	2.24	\$	1.17	\$ 0.80	\$	0.07	
Weighted average shares outstanding		116,986		108,003		117,003		109,818
Cash dividends declared, per share	\$	0.275	\$	0.207	\$	0.100	\$	0.075

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries  
Condensed Consolidated Statement of Changes in Shareholders' Equity  
Nine months ended September 30, 2006  
(unaudited, in thousands except per share data)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
<b>Balance at December 31, 2005</b>	\$ 110,803	\$ 762,170	\$ 798,388	\$ 19,074	\$ 1,690,435
Net earnings			261,543		261,543
Other comprehensive income				14,566	14,566
Comprehensive income					276,109
Issuance of 688 shares for exercise of options, including tax benefit of \$3,291	688	14,285			14,973
Stock-based compensation		10,304			10,304
Cash dividends declared, \$0.275 per share			(30,613)		(30,613)
<b>Balance at September 30, 2006</b>	\$ 111,491	\$ 786,759	\$ 1,029,318	\$ 33,640	\$ 1,961,208

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows  
(unaudited, in thousands)

	Nine months ended September 30,		Three months ended September 30,	
	2006	2005 (As restated)	2006	2005 (As restated)
<b>Cash flows from operating activities:</b>				
Net earnings	\$ 261,543	\$ 126,156	\$ 93,257	\$ 7,412
Adjustments to reconcile net earnings to net cash provided by operating activities:				
Change in premium, claims and other receivables	36,626	(74,007)	46,924	16,604
Change in reinsurance recoverables	56,031	(145,305)	47,336	(126,291)
Change in ceded unearned premium	(4,587)	60,509	(5,722)	14,648
Change in loss and loss adjustment expense payable	93,906	521,365	(10,815)	396,478
Change in reinsurance balances payable	(37,509)	(23,906)	(14,803)	15,744
Change in unearned premium	113,638	42,994	10,559	17,458
Change in premium and claims payable, net of restricted cash	(78,293)	30,585	(61,071)	15,049
Change in trading portfolio	(99,193)	(54,654)	(14,702)	(16,600)
Depreciation and amortization expense	12,242	11,063	4,598	3,703
Stock-based compensation expense	9,463	1,920	3,373	750
Other, net	(4,161)	(43,466)	831	(10,538)
<b>Cash provided by operating activities</b>	<b>359,706</b>	<b>453,254</b>	<b>99,765</b>	<b>334,417</b>
<b>Cash flows from investing activities:</b>				
Sales of fixed income securities	184,175	163,841	20,078	49,071
Maturity or call of fixed income securities	174,758	133,391	57,060	34,923
Cost of securities acquired	(958,822)	(733,400)	(167,437)	(235,256)
Change in short-term investments	171,198	36,234	(47,658)	(145,482)
Sale of strategic investment	40,354	7,758	22,991	7,758
Payments for purchase of subsidiaries, net of cash received	(55,290)	(44,288)	(17,833)	(9,407)
Sale of subsidiary		10,448		10,448
Other, net	(8,612)	(14,627)	(3,515)	(3,249)
<b>Cash used by investing activities</b>	<b>(452,239)</b>	<b>(440,643)</b>	<b>(136,314)</b>	<b>(291,194)</b>
<b>Cash flows from financing activities:</b>				
Issuance of notes payable	140,000	36,000	101,000	3,000
Payments on notes payable	(56,346)	(37,554)	(45,097)	(23,089)
Sale of common stock	14,973	32,684	5,313	3,847
Dividends paid	(27,774)	(19,606)	(11,126)	(7,890)
Other	7,383	(3,814)	1,755	

<b>Cash provided (used) by financing activities</b>	78,236	7,710	51,845	(24,132)
Net increase (decrease) in cash	(14,297)	20,321	15,296	19,091
Cash at beginning of period	73,935	69,933	44,342	71,163
<b>Cash at end of period</b>	<b>\$ 59,638</b>	<b>\$ 90,254</b>	<b>\$ 59,638</b>	<b>\$ 90,254</b>

See Notes to Condensed Consolidated Financial Statements.

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HCC Insurance Holdings, Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(unaudited, tables in thousands except per share data)

**(1) GENERAL INFORMATION**

HCC Insurance Holdings, Inc. and its subsidiaries (collectively, we, us or our) include domestic and foreign property and casualty and life insurance companies, underwriting agencies and reinsurance brokers. 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 market our products both directly to customers and through a network of independent brokers, producers and agents. Our lines of business include diversified financial products (which includes directors and officers liability, professional indemnity, employment practices liability and surety); group life, accident and health; aviation; London market account (which includes energy, marine, property, and accident and health); and other specialty lines of insurance. We operate primarily in the United States, the United Kingdom, Spain and Bermuda, although some of our operations have a broader international scope.

**Basis of Presentation**

Our unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (generally accepted accounting principles) and include the accounts of HCC Insurance Holdings, Inc. and its subsidiaries. We have made all adjustments that, in our opinion, are necessary for a fair presentation of results of the interim periods, and all such adjustments are of a normal recurring nature. All significant intercompany balances and transactions have been eliminated in consolidation. The condensed consolidated financial statements should be read in conjunction with our annual audited consolidated financial statements and related notes. The condensed consolidated balance sheet at December 31, 2005 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

Management must make estimates and assumptions that affect amounts reported in our financial statements and in disclosures of contingent assets and liabilities. Ultimate results could differ from those estimates. We have reclassified certain amounts in our 2005 condensed consolidated financial statements to conform to the 2006 presentation. The reclassifications included the elimination of certain intercompany premium receivable and premium payable balances and reclassification of the corresponding lines in our 2005 condensed statements of cash flows. None of these reclassifications had an effect on our consolidated net earnings, shareholders' equity or cash flows.

During 2006 and 2005, we completed several acquisitions. The results of operations of the acquired entities are included in our condensed consolidated financial statements beginning on the effective date of each acquisition. Thus, our condensed consolidated statements of earnings and cash flows for the nine months and three months ended September 30, 2006 and 2005 do not contain any operations of the entities acquired in 2006 or 2005 prior to their acquisition date.

**Large Loss Events**

During the third quarter of 2005, catastrophic events occurred related to two major hurricanes, Katrina and Rita, and two minor ones (collectively, the 2005 hurricanes). We recognized a pre-tax loss, after reinsurance, of \$74.4 million in our insurance company segment in that quarter with respect to the 2005 hurricanes. This loss included \$53.7 million recorded in loss and loss adjustment ex