

HCC INSURANCE HOLDINGS INC/DE/

Form 10-Q/A

December 27, 2006

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

- Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarter Ended March 31, 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 April 30, 2006, there were approximately 111.2 million shares of common stock, \$1.00 par value issued and outstanding.

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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 FINANCIAL STATEMENTS

HCC Insurance Holdings, Inc. is amending its quarterly report on Form 10-Q for the quarter ended March 31, 2006 (the Form 10-Q or the Original Filing). We are restating our condensed consolidated financial statements to reflect certain adjustments as discussed below. The amendment reflects the restatement of our condensed consolidated financial statements as of and for the three months ended March 31, 2006 and 2005.

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.

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Before the Board of Directors reviewed the results of the investigation, the Chairman of the 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 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 2, 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 Condensed 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 that we needed to amend this Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 as filed on May 10, 2006 (the Original Filing), to restate our condensed consolidated financial statements for the three months ended March 31, 2006 and 2005 and the related disclosures. For this reason, the condensed consolidated financial statements and related financial information contained in such previously filed report should no longer be relied upon. 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.

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. 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.

The increase (decrease) on net earnings of 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
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Three months ended
March 31,

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2006	\$	78,551	\$	(530)	\$	684	\$	437	\$	591	\$	79,142
2005		57,318		(728)		(2,153)		951		(1,930)		55,388

The restatement adjustments increased (reduced) previously reported diluted net earnings per share by \$0.01 and \$(0.02) for the three months ended March 31, 2006 and 2005, respectively.

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All information in this Form 10-Q/A is as of March 31, 2006 and does not reflect events occurring after the date of the Original Filing, other than the restatement, and updating of disclosures affected by events subsequent to the date of the Original Filing. For the convenience of the reader, this Form 10-Q/A sets forth the Original Filing in its entirety, as amended and modified to reflect the restatement. The following sections of this Form 10-Q/A were amended to reflect the determinations of the Special Committee and the restatement:

- Part I Item 1 Financial Statements;
- Part I Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations;
- Part I Item 4 Controls and Procedures;
- Part II Item 1 Legal Proceedings; and
- Part II Item 6 Exhibits

This Form 10-Q/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-Q/A includes updated certifications from our current Chief Executive Officer and Chief Financial Officer as Exhibits 31.1, 31.2 and 32.1.

This report on Form 10-Q/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;

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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; and

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

	March 31, 2006 (As restated)	December 31, 2005 (As restated)
ASSETS		
Investments:		
Fixed income securities, at fair value (amortized cost: 2006 \$2,573,727; 2005 \$2,277,139)	\$ 2,541,316	\$ 2,268,624
Short-term investments, at cost, which approximates fair value	592,831	839,581
Other investments, at fair value (cost: 2006 \$216,020; 2005 \$144,897)	230,187	149,223
Total investments	3,364,334	3,257,428
Cash	51,111	73,935
Restricted cash and cash investments	182,568	170,978
Premium, claims and other receivables	855,880	884,654
Reinsurance recoverables	1,349,351	1,361,983
Ceded unearned premium	239,530	239,416
Ceded life and annuity benefits	73,213	73,415
Deferred policy acquisition costs	161,329	156,253
Goodwill	531,286	532,947
Other assets	298,604	277,791
Total assets	\$ 7,107,206	\$ 7,028,800
LIABILITIES		
Loss and loss adjustment expense payable	\$ 2,837,495	\$ 2,813,720
Life and annuity policy benefits	73,213	73,415
Reinsurance balances payable	149,897	176,954
Unearned premium	825,375	807,109
Deferred ceding commissions	66,900	67,886
Premium and claims payable	735,131	753,859
Notes payable	309,426	309,543
Accounts payable and accrued liabilities	354,132	335,879
Total liabilities	5,351,569	5,338,365
SHAREHOLDERS EQUITY		
Common stock, \$1.00 par value; 250.0 million shares authorized (shares issued and outstanding: 2006 111,173; 2005 110,803)	111,173	110,803
Additional paid-in capital	772,718	762,170
Retained earnings	869,192	798,388
Accumulated other comprehensive income	2,554	19,074

Total shareholders equity	1,755,637	1,690,435
Total liabilities and shareholders equity	\$ 7,107,206	\$ 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)

	Three months ended March 31,	
	2006 (As restated)	2005 (As restated)
REVENUE		
Net earned premium	\$ 380,571	\$ 320,117
Fee and commission income	31,669	31,623
Net investment income	36,581	22,341
Net realized investment loss	(1,298)	(3)
Other operating income	18,750	4,147
Total revenue	466,273	378,225
EXPENSE		
Loss and loss adjustment expense, net	222,067	185,975
Policy acquisition costs, net	76,232	61,145
Other operating expense	47,333	45,677
Interest expense	2,154	1,808
Total expense	347,786	294,605
Earnings before income tax expense	118,487	83,620
Income tax expense	39,345	28,232
Net earnings	\$ 79,142	\$ 55,388
Basic earnings per share data:		
Net earnings per share	\$ 0.71	\$ 0.54
Weighted average shares outstanding	111,014	103,241
Diluted earnings per share data:		
Net earnings per share	\$ 0.68	\$ 0.52
Weighted average shares outstanding	116,896	105,734
Cash dividends declared, per share	\$ 0.075	\$ 0.057

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
Three months ended March 31, 2006
(As restated)
(unaudited, in thousands, except per share data)

	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance at December 31, 2005 (As previously reported)	\$ 110,803	\$ 747,568	\$ 817,013	\$ 18,312	\$ 1,693,696
Cumulative effect of restatement (Note 2)		14,602	(18,625)	762	(3,261)
Balance at December 31, 2005 (As restated)	110,803	762,170	798,388	19,074	1,690,435
Net earnings			79,142		79,142
Other comprehensive loss				(16,520)	(16,520)
Comprehensive income					62,622
Issuance of 370 shares for exercise of options, including tax benefit of \$1,750	370	7,268			7,638
Stock-based compensation		3,280			3,280
Cash dividends declared, \$0.075 per share			(8,338)		(8,338)
Balance at March 31, 2006	\$ 111,173	\$ 772,718	\$ 869,192	\$ 2,554	\$ 1,755,637

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)

	Three months ended March 31,	
	2006	2005
	(As restated)	(As restated)
Cash flows from operating activities:		
Net earnings	\$ 79,142	\$ 55,388
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Change in premium, claims and other receivables	44,362	(132,208)
Change in reinsurance recoverables	12,632	(824)
Change in ceded unearned premium	(114)	47,218
Change in loss and loss adjustment expense payable	23,775	49,851
Change in reinsurance balances payable	(27,057)	(18,782)
Change in unearned premium	18,266	(16,842)
Change in premium and claims payable, net of restricted cash	(30,318)	99,875
Change in trading portfolio	(47,994)	(41,328)
Depreciation and amortization expense	3,825	3,710
Stock-based compensation expense	2,703	597
Other, net	(1,131)	(12,746)
Cash provided by operating activities	78,091	33,909
Cash flows from investing activities:		
Sales of fixed income securities	65,654	55,681
Maturity or call of fixed income securities	59,226	32,250
Cost of securities acquired	(471,614)	(277,000)
Change in short-term investments	246,750	145,025
Sale of strategic investment	17,363	
Earnout payment for purchase of subsidiary	(24,000)	
Other, net	(2,047)	(1,118)
Cash used by investing activities	(108,668)	(45,162)
Cash flows from financing activities:		
Issuance of notes payable	11,000	
Payments on notes payable	(11,107)	(93)
Sale of common stock	7,638	21,087
Dividends paid	(8,310)	(5,783)
Other	8,532	(3,814)
Cash provided by financing activities	7,753	11,397

Net increase (decrease) in cash	(22,824)	144
Cash at beginning of period	73,935	69,933
Cash at end of period	\$ 51,111	\$ 70,077

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, Bermuda and Ireland, 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 statement of cash flows. None of our reclassifications had an effect on our consolidated net earnings, shareholders' equity or cash flows.

During 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 three months ended March 31, 2005 do not contain any operations of the entities acquired in 2005 prior to their acquisition date.

Income Tax

For the three months ended March 31, 2006 and 2005, the income tax provision was calculated based on an estimated effective tax rate for each fiscal year. Our effective tax rate differs from the United States Federal statutory rate primarily due to tax-exempt municipal bond interest and state income taxes.

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

(2) RESTATEMENT OF FINANCIAL STATEMENTS, SPECIAL COMMITTEE AND COMPANY FINDINGS

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.

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(unaudited, tables in thousands, except per share data)

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

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 that we needed to amend this Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 as filed on May 10, 2006 (the Original Filing), to restate our condensed consolidated financial statements for the three months ended March 31, 2006 and 2005 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. These minor adjustments primarily relate to fee and commission income, loss and loss adjustment expense, policy acquisition costs and other operating expense. In addition, balance sheet reclassifications have been recorded to appropriately present certain reinsurance recoverables and payables.

Related tax effects associated with the recognition of non-cash compensation expense and other adjustments as well as additional taxes that may be due and payable.

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

Based on the determinations of the Special Committee and our voluntary internal review, we identified a number of occasions during the period 1997 through 2005 and into 2006 on which we used an incorrect measurement date for financial accounting and reporting purposes for options granted. In accordance with Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*, and its related interpretations, we should have recorded compensation expense related to these options for the excess of the market price of our stock on the actual measurement date over the exercise price of the option. For periods commencing January 1, 2006, compensation expense is being recognized in accordance with Statement of Financial Accounting Standards (SFAS) No. 123(R) (revised), *Share-Based Payment*. However, we determined an incremental amount related to the mis-priced options must be recorded.

The types of errors identified were as follows:

We determined that many block grants to employees during the period 1997 through 2005 were subject to a retroactive look-back period. In all such cases, the price of our stock at the end of the look-back period, which was generally 30 days or less, was higher than the price of our stock on the stated grant date.

In addition to being subject to the retroactive pricing discussed above, we determined that the strike price of block grants in 1999, 2002 and 2005 was determined prior to the final determination of the identity of the employee and/or the number of options to be granted. Further, proper approval, in most cases, had not been given until after the grant date. In all such cases, the price of our stock at the time when all required determinations were final and proper approval had been obtained was higher than the price of our stock on the stated grant date. The time lag between the stated grant date and the finalization of the awards was typically 30-45 days, except in the case of the 2002 grant which was finalized several months subsequent to the stated grant date.

For the period from 1997 to 2005 and into 2006, we determined that there was a regular practice of granting options to newly hired employees and existing employees being promoted after the end of a 30-45 day period following the hire or promotion date. This practice included the use of the 30-45 day period as a look-back period during which the date with the lowest price during that period was selected as the stated grant date.

In several instances, grants to senior executives were determined at a date subsequent to the stated grant date. In most cases, this resulted from extended negotiations of employment agreements and, in some cases, administrative delays. In virtually all cases, the price of our stock at the time the grants were made and properly approved was higher than the price of our stock on the stated grant date.

In a few cases, options were granted and then repriced downward. As a result, variable accounting should have been applied to these options.

We lacked timely or adequate documentation to support the stated grant date in the case of certain of the above errors.

The gross compensation expense recorded to correct the above errors was a non-cash charge and had no impact on our reported net revenue, cash, cash flow or shareholders equity.

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In connection with the investigation, we determined that a number of executive officers received in-the-money options. If such options are ultimately determined to be in-the-money grants for tax purposes, pursuant to Section 162(m) of the Internal Revenue Code and, if in the year of exercise the officers' compensation, including proceeds from options exercised, exceeded \$1.0 million, we would not be entitled to a tax deduction for any amount in excess of such \$1.0 million for officers covered by Section 162(m). We estimate the tax effect of the deduction was \$4.6 million, substantially all of which was recorded as a reduction to shareholders' equity.

There were immaterial adjustments that were not made in the originally filed consolidated financial statements. We have taken the opportunity presented by this restatement to record these adjustments, which amounted to a net \$2.4 million increase in earnings from continuing operations before income tax expense, for the years 2001 through 2005.

The increase (decrease) on net earnings of each type of adjustment was as follows (in thousands):

	Net earnings as	Non-cash stock option compensation	Other	Tax effect	Total adjustments	Net earnings as restated
	previously reported	expense				
Three months ended						
March 31,						
2006	\$ 78,551	\$ (530)	\$ 684	\$ 437	\$ 591	\$ 79,142
2005	57,318	(728)	(2,153)	951	(1,930)	55,388

The restatement adjustments increased (reduced) previously reported diluted net earnings per share by \$0.01 and \$(0.02) for the three months ended March 31, 2006 and 2005, respectively.

We are also amending certain other stock option disclosures in the accompanying notes to the condensed consolidated financial statements.

Enacted October 22, 2004, Section 409A of the Internal Revenue Code significantly changed the rules for nonqualified deferred compensation plans. Section 409A imposes certain restrictions and taxes on stock awards that constitute deferred compensation. Section 409A relates specifically to the personal tax liabilities of our employees that have received discounted options. We are currently reviewing the implications of Section 409A on grants awarded with intrinsic value that vested after December 31, 2004 and modifications made to existing grants after October 3, 2004 along with potential remedial actions.

As of December 15, 2006, we have paid direct costs of approximately \$6.0 million for costs associated with the Special Committee's investigation and additional related professional services and consulting fees associated with the restatement effort.

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The following table sets forth the impact of the above adjustments and the related tax effects on our historical condensed consolidated balance sheets as of March 31, 2006 and December 31, 2005.

	March 31, 2006			December 31, 2005		
	As previously reported	Adjustments	As restated	As previously reported	Adjustments	As restated
ASSETS						
Investments:						
Fixed income securities	\$ 2,541,316	\$	\$ 2,541,316	\$ 2,268,624	\$	\$ 2,268,624
Short-term investments	592,831		592,831	839,581		839,581
Other investments	230,187		230,187	149,223		149,223
Total investments	3,364,334		3,364,334	3,257,428		3,257,428
Cash	51,111		51,111	73,935		73,935
Restricted cash and cash investments	182,568		182,568	170,978		170,978
Premium, claims and other receivables	855,880		855,880	884,654		884,654
Reinsurance recoverables	1,349,351		1,349,351	1,360,483	1,500	1,361,983
Ceded unearned premium	239,530		239,530	239,416		239,416
Ceded life and annuity benefits	73,213		73,213	73,415		73,415
Deferred policy acquisition costs	161,329		161,329	156,253		156,253
Goodwill	531,286		531,286	532,947		532,947
Other assets	297,716	888	298,604	276,557	1,234	277,791
Total assets	\$ 7,106,318	\$ 888	\$ 7,107,206	\$ 7,026,066	\$ 2,734	\$ 7,028,800
LIABILITIES						
Loss and loss adjustment expense payable	\$ 2,837,495	\$	\$ 2,837,495	\$ 2,813,720	\$	\$ 2,813,720
Life and annuity policy benefits	73,213		73,213	73,415		73,415
Reinsurance balances payable	149,897		149,897	176,954		176,954
Unearned premium	825,375		825,375	807,109		807,109
Deferred ceding commissions	66,900		66,900	65,702	2,184	67,886
	735,131		735,131	753,859		753,859

Premium and claims payable						
Notes payable	309,426		309,426	309,543		309,543
Accounts payable and accrued liabilities	350,578	3,554	354,132	332,068	3,811	335,879
Total liabilities	5,348,015	\$ 3,554	\$ 5,351,569	5,332,370	\$ 5,995	\$ 5,338,365
SHAREHOLDERS EQUITY						
Common stock	111,173		111,173	110,803		110,803
Additional paid-in capital	757,850	14,868	772,718	747,568	14,602	762,170
Retained earnings	887,226	(18,034)	869,192	817,013	(18,625)	798,388
Accumulated other comprehensive income	2,054	500	2,554	18,312	762	19,074
Total shareholders equity	\$ 1,758,303	\$ (2,666)	1,755,637	\$ 1,693,696	\$ (3,261)	1,690,435
Total liabilities and shareholders equity	\$ 7,106,318	\$ 888	\$ 7,107,206	\$ 7,026,066	\$ 2,734	\$ 7,028,800

Our restated condensed consolidated balance sheets as of March 31, 2006 and December 31, 2005 reflect a \$18.0 million and \$18.6 million, respectively, decrease to retained earnings and a \$14.9 million and \$14.6 million, respectively, increase to additional paid-in capital primarily due to additional non-cash stock-based compensation and related tax effect recorded in connection with this restatement to correct prior year stock option-related accounting errors as described above. In 2006 and 2005, the \$0.9 million and \$1.2 million, respectively, increase to deferred tax assets (included in other assets) and \$5.6 million and \$5.8 million, respectively, increase to income taxes payable (included in accounts payable and accrued liabilities) resulted primarily due to the timing of the deductibility of certain stock-based compensation costs recorded in connection with the restatement.

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The following table sets forth the impact of the above adjustments and the related tax effects on our historical statements of earnings for the three months ended March 31, 2006 and 2005.

	Quarter ended March 31, 2006			Quarter ended March 31, 2005		
	As previously	Adjustments	As	As previously	Adjustments	As
	reported		restated	reported		restated
REVENUE						
Net earned premium	\$ 380,571		\$ 380,571	\$ 320,117		\$ 320,117
Fee and commission income	31,468	201	31,669	33,076	(1,453)	31,623
Net investment income	36,581		36,581	22,341		22,341
Net realized investment gain	(1,298)		(1,298)	(3)		(3)
Other operating income	18,750		18,750	4,147		4,147
Total revenue	466,072	201	466,273	379,678	(1,453)	378,225
EXPENSE						
Loss and loss adjustment expense, net	220,567	1500	\$ 222,067	186,063	(88)	\$ 185,975
Policy acquisition costs, net	78,215	(1,983)	76,232	59,357	1,788	61,145
Other operating expense	46,803	530	47,333	45,949	(272)	45,677
Interest expense	2,154		2,154	1,808		1,808
Total expense	347,739	47	347,786	293,177	1,428	294,605
Earnings from continuing operations before income tax expense	118,333	154	118,487	86,501	(2,881)	83,620
Income tax expense on continuing operations	39,782	(437)	39,345	29,183	(951)	28,232
Earnings from continuing operations	78,551	591	79,142	57,318	(1,930)	55,388
Earnings from discontinued operations, net of income taxes						

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Net earnings	\$ 78,551	\$ 591	\$ 79,142	\$ 57,318	\$ (1,930)	\$ 55,388
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Basic earnings per share data:

Earnings from continuing operations	\$ 0.71	\$	\$ 0.71	\$ 0.56	\$ (0.02)	0.54
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Earnings from discontinued operations						
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Net earnings	\$ 0.71	\$	\$ 0.71	\$ 0.56	\$ (0.02)	0.54
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Weighted average shares outstanding	111,014		111,014	103,241		103,241
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Diluted earnings per share data:

Earnings from continuing operations	\$ 0.67	\$ 0.01	\$ 0.68	\$ 0.54	\$ (0.02)	\$ 0.52
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Earnings from discontinued operations						
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Net earnings	\$ 0.67	\$ 0.01	\$ 0.68	\$ 0.54	\$ (0.02)	\$ 0.52
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Weighted average shares outstanding	116,896		116,896	105,734		105,734
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The restatement created a small change in net cash flows from our operating and financing activities. The following table shows the effect of the restatement on our previously reported cash flows:

	Quarter ended March 31, 2006		Quarter ended March 31, 2005	
	As previously reported	As restated	As previously reported	As restated
Net earnings	\$ 78,551	\$ 79,142	\$ 57,318	\$ 55,388
Adjustments to reconcile net earnings to net cash provided by operating activities:				
Change in premium, claims and other receivables	44,362	44,362	(133,768)	(132,208)
Change in reinsurance recoverables	11,132	12,632	(824)	(824)
Change in ceded unearned premium	(114)	(114)	52,300	47,218
Change in loss and loss adjustment expense payable	23,775	23,775	49,939	49,851
Change in reinsurance balances payable	(27,057)	(27,057)	(29,842)	(18,782)
Stock-based compensation expense		2,703		597
Other, net	3,509	(1,131)	(6,629)	(12,746)
Cash provided by operating activities	77,937	78,091	33,909	33,909
Cash flows from financing activities:				
Sale of common stock	7,792	7,638	21,087	21,087
Cash provided by financing activities	7,907	7,753	11,397	11,397

In connection with the preparation of our restated financial statements, we also determined that the pro forma disclosures for stock-based compensation expense for the three months ended March 31, 2005 required under Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* included in Note 3 of the Notes to Condensed Consolidated Financial Statements, were incorrect. Specifically, the errors related to the effect on the consolidated financial statements resulting from the improper application of APB No. 25 to certain stock option transactions and the use of assumptions for determining the fair value of our stock options on the date of grant. We have corrected these errors in Note 3 to the consolidated financial statements.

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The following table presents the effect of these corrections on our pro forma calculation of our net income and earnings per share for the three months ended March 31, 2005:

	March 31, 2005	
	(As previously reported)	(As restated)
Reported net earnings	\$ 57,318	\$ 55,388
Stock-based compensation included in reported net earnings, net of income taxes		531
Stock-based compensation using fair value method, net of income taxes	(1,277)	(1,610)
Pro forma net earnings	\$ 56,041	\$ 54,309
Reported basic earnings per share	\$ 0.56	\$ 0.54
Fair value stock-based compensation	(0.02)	(0.01)
Pro forma basic earnings per share	\$ 0.54	\$ 0.53
Reported diluted earnings per share	\$ 0.54	\$ 0.52
Fair value stock-based compensation	(0.01)	(0.01)
Pro forma diluted earnings per share	\$ 0.53	\$ 0.51

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(3) STOCK OPTIONS

Our stock option plans, the 2004 Flexible Incentive Plan and 2001 Flexible Incentive Plan, are administered by the Compensation Committee of the Board of Directors. Options granted under these plans may be used to purchase one share of our common stock. Options vest over a period of up to seven years, which is the requisite service period, and expire four to ten years after grant date.

Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, requires companies to charge the fair value of stock-based compensation to earnings. Effective January 1, 2006, we adopted SFAS 123(R) using the modified prospective method. We are recognizing compensation expense in 2006 and thereafter based on our unvested stock options granted before January 1, 2006 and all options granted after that date. The 2005 and prior period financial statements were not restated to reflect the implementation of SFAS 123(R). We will use the Black-Scholes single option pricing model to determine the fair value of an option on its grant date and will expense that value on a straight-line basis over the option's vesting period. We made no modifications to our stock option plans in conjunction with our adoption of SFAS 123(R). In 2005, we accounted for stock options granted to employees in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*.

In the first quarter of 2006, we expensed \$2.7 million (\$1.9 million after tax or \$0.02 per diluted share) of stock-based compensation, after the effect of the deferral and amortization of related policy acquisition costs. At March 31, 2006, there was approximately \$38.2 million of total unrecognized compensation expense related to unvested options that is expected to be recognized over a weighted-average period of three years. In 2006, we expect to recognize \$12.1 million of expense, including the amortization of deferred policy acquisition costs, related to stock-based compensation for options currently outstanding.

The table below shows the weighted-average fair value of options granted and the related weighted-average assumptions used in the Black-Scholes model. The risk-free interest rate is based on the U.S. Treasury rate that most closely approximates each option's expected term. We based our expected volatility on the historical volatility of our stock over a period matching each option's expected term. Our dividend yield is based on an average of our historical dividend payments divided by the stock price. We used historical exercise patterns by grant type to estimate the expected option life.

	Three months ended March	
	2006	2005
Fair value of options granted (As restated)	\$ 7.04	\$ 7.85
Risk free interest rate	4.5%	3.8%
Expected volatility	22%	32%
Expected dividend yield	1.0%	1.0%
Expected option life	3.5 years	4.9 years

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The following table details our stock option activity during the three months ended March 31, 2006.

	Number of shares	Weighted- average exercise price	Weighted- average contractual life	Aggregate intrinsic value
Outstanding, beginning of year	8,219	\$ 20.71		
Granted	463	31.64		
Exercised	(373)	15.87		
Forfeited and expired	(106)	20.58		
Outstanding, end of period	8,203	21.55	4.3 years	\$ 108,701
Exercisable, end of period	1,660	17.36	3.0 years	28,953

The aggregate intrinsic value (the amount by which the fair value of the underlying stock exceeds the exercise price) of options exercised during the first quarter of 2006 and 2005 was \$6.0 million and \$13.8 million, respectively. At March 31, 2006, 12.1 million shares of our common stock were authorized and reserved for the exercise of options, of which 8.2 million shares were reserved for options previously granted and 3.9 million shares were reserved for future issuance.

Exercise of options during the first quarter of 2006 and 2005 resulted in cash receipts of \$5.9 million and \$21.1 million, respectively. We generally recognize a tax benefit when our employees exercise options. SFAS 123(R) requires that we report the tax benefit related to the excess of the tax deductible amount over the recognized compensation expense as financing cash flow, rather than as operating cash flow under APB Opinion No. 25. We recorded a \$1.8 million benefit as financing cash flow in the first quarter of 2006 and \$1.8 million as operating cash flow in the first quarter of 2005.

Prior to the adoption of SFAS 123(R), we accounted for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Under APB Opinion No. 25, compensation cost was measured as of the date the number of shares and exercise price became fixed. The terms of an award were generally fixed on the date of grant, requiring the stock option to be accounted for as a fixed award. For fixed awards, compensation expense was measured as the excess, if any, of the quoted market price of our stock at the date of grant over the exercise price of the option granted. Compensation expense for fixed awards, if any, was recognized ratably over the vesting period using the straight-line single option method.

If the number of shares or exercise price was not fixed upon the date of grant, the award was accounted for as a variable award until the number of shares or the exercise price became fixed, or until the award was exercised, canceled, or expired unexercised. For variable awards, intrinsic value was remeasured each period and was equal to the fair market value of our stock as of the end of the reporting period less the grant exercise price. As a result, the amount of compensation expense or benefit to be recognized each period fluctuated based on changes in our closing price from the end of the previous reporting period to the end of the current reporting period. In cases when our closing stock price did not exceed the recipient's exercise price, no compensation expense resulted. Compensation expense for variable awards, if any, was recognized in accordance with FIN No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plan, An Interpretation of APB Opinions No. 15 and 25*.

We accounted for modifications to stock options under APB No. 25, as subsequently interpreted by FIN No. 44. Modifications included, but were not limited to, acceleration of vesting, extension of the exercise period following termination of employment and/or continued vesting while not providing substantive services. Compensation expense

for modified awards was recorded in the period of modification for the intrinsic value of the vested portion of the award, including vesting that occurred while not providing substantive services, after the date of modification. The intrinsic value of the award was the difference between the fair market value of our common stock on the date of modification and the recipient's exercise price.

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Stock options issued to non-employees were accounted for in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. Compensation expense for stock options issued to non-employees was valued using the Black-Scholes model and was amortized over the vesting period in accordance with FIN No. 28. Prior to adoption of SFAS 123(R), we were required to disclose the effect on net earnings and earnings per share if we had used the fair value method of SFAS No. 123, *Accounting for Stock-Based Compensation*, to value stock options. The effect on our consolidated financial results in the first quarter of 2005 if we had valued our options using the fair value method under SFAS 123 and the assumptions listed above for the three months ended March 31, 2005 is as follows:

	(As restated)
Reported net earnings	\$ 55,388
Stock-based compensation included in reported net earnings, net of income taxes	531
Stock-based compensation using fair value method, net of income taxes	(1,610)
 Pro forma net earnings	 \$ 54,309
 Reported basic earnings per share	 \$ 0.54
Fair value stock-based compensation	(0.01)
 Pro forma basic earnings per share	 \$ 0.53
 Reported diluted earnings per share	 \$ 0.52
Fair value stock-based compensation	(0.01)
 Pro forma diluted earnings per share	 \$ 0.51

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(4) REINSURANCE

In the normal course of business, our insurance companies cede a portion of their premium to domestic and foreign reinsurers through treaty and facultative reinsurance agreements. Although ceding for reinsurance purposes does not discharge the primary insurer from liability to its policyholder, our insurance companies participate in such agreements in order to limit their loss exposure, protect them against catastrophic loss and diversify their business. The following table presents the effect of such reinsurance transactions on our premium and loss and loss adjustment expense.

	Written premium	Earned premium	Loss and loss adjustment expense (As restated)
Three months ended March 31, 2006			
Primary business	\$ 410,191	\$ 422,510	\$ 227,250
Reinsurance assumed	95,867	70,880	45,791
Reinsurance ceded	(113,007)	(112,819)	(50,974)
Net amounts	\$ 393,051	\$ 380,571	\$ 222,067
Three months ended March 31, 2005			
Primary business	\$ 398,281	\$ 412,095	\$ 221,446
Reinsurance assumed	76,838	72,580	48,506
Reinsurance ceded	(117,767)	(164,558)	(83,977)
Net amounts	\$ 357,352	\$ 320,117	\$ 185,975

Ceding commissions netted with policy acquisition costs in the condensed consolidated statements of earnings were \$10.0 million in 2006 and \$30.7 million in 2005.

The table below shows the components of reinsurance recoverables in our condensed consolidated balance sheets.

	March 31, 2006	December 31, 2005 (As restated)
Reinsurance recoverable on paid losses	\$ 102,200	\$ 93,837
Reinsurance recoverable on outstanding losses	730,451	636,225
Reinsurance recoverable on incurred but not reported losses	527,012	644,062
Reserve for uncollectible reinsurance	(10,312)	(12,141)

Total reinsurance recoverables	\$ 1,349,351	\$ 1,361,983
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Our reserve for uncollectible reinsurance covers potential collectibility issues, including disputed amounts and associated expenses. While we believe the reserve is adequate based on information currently available, conditions may change or additional information might be obtained which may require us to change the reserve in the future. We periodically review our financial exposure to the reinsurance market and the level of our reserve and continue to take actions in an attempt to mitigate our exposure to possible loss.

We limit the liquidity exposure related to our reinsurance recoverables by holding funds, letters of credit or other security, such that net balances due are significantly less than the gross balances shown in our condensed consolidated balance sheets. Additionally, our U.S. domiciled insurance companies require their reinsurers not authorized by the respective states of domicile of our insurance companies to collateralize their reinsurance obligations due to us. The table below shows the amounts of letters of credit and cash deposits held by us as collateral, plus other credits available for potential offset.

	March 31, 2006	December 31, 2005
Payables to reinsurers	\$ 293,480	\$ 291,826
Letters of credit	348,292	350,135
Cash deposits	58,025	64,150
Total credits	\$ 699,797	\$ 706,111

The tables below present the calculation of net reserves, net unearned premium and net deferred policy acquisition costs.

	March 31, 2006	December 31, 2005 (As restated)
Loss and loss adjustment expense payable	\$ 2,837,495	\$ 2,813,720
Reinsurance recoverable on outstanding losses	(730,451)	(636,225)
Reinsurance recoverable on incurred but not reported losses	(527,012)	(644,062)
Net reserves	\$ 1,580,032	\$ 1,533,433
Unearned premium	\$ 825,375	\$ 807,109
Ceded unearned premium	(239,530)	(239,416)
Net unearned premium	\$ 585,845	\$ 567,693

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Deferred policy acquisition costs	\$ 161,329	\$ 156,253
Deferred ceding commissions	(66,900)	(67,886)
Net deferred policy acquisition costs	\$ 94,429	\$ 88,367

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(5) EARNINGS PER SHARE

The following table details the numerator and denominator used in the earnings per share calculations.

	Three months ended March 31, 2006 (As restated)	2005 (As restated)
Net earnings	\$ 79,142	\$ 55,388
Weighted average common shares outstanding	111,014	103,241
Dilutive effect of outstanding options (determined using the treasury stock method)	1,528	1,589
Dilutive effect of convertible debt (determined using the treasury stock method)	4,354	904
Weighted average common shares and potential common shares outstanding	116,896	105,734
Anti-dilutive stock options not included in treasury stock method computation	2,563	26

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(6) SEGMENT AND GEOGRAPHIC INFORMATION

The performance of each segment is evaluated by our management based on net earnings. Net earnings is calculated after tax and after all corporate expense allocations, interest expense on debt incurred at the purchase date, and intercompany eliminations have been charged or credited to our individual segments. All stock-based compensation is included in the corporate segment since it is not included in management's evaluation of the other segments. The following tables show information by business segment and geographic location. Geographic location is determined by physical location of our offices and does not represent the location of insureds or reinsureds from whom the business was generated. Effective January 1, 2005, we consolidated our largest underwriting agency (agency segment) into HCC Life Insurance Company (insurance company segment).

	Insurance Company	Agency	Other Operations	Corporate	Total
Three months ended March 31, 2006 (As restated)					
Revenue:					
Domestic	\$ 343,688	\$ 14,769	\$ 19,781	\$ 1,177	\$ 379,415
Foreign	76,849	10,009			86,858
Inter-segment	6	17,958			17,964
Total segment revenue	\$ 420,543	\$ 42,736	\$ 19,781	\$ 1,177	484,237
Inter-segment eliminations					(17,964)
Consolidated total revenue					\$ 466,273
Net earnings (loss):					
Domestic	\$ 49,969	\$ 5,235	\$ 12,989	\$ (3,114)	\$ 65,079
Foreign	10,088	3,689			13,777
Total segment net earnings (loss)	\$ 60,057	\$ 8,924	\$ 12,989	\$ (3,114)	78,856
Inter-segment eliminations					286
Consolidated net earnings					\$ 79,142

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Other items:

Net investment income	\$ 32,007	\$ 2,296	\$ 1,635	\$ 643	\$ 36,581
Depreciation and amortization	1,138	2,013	127	547	3,825
Interest expense (benefit)	375	2,846	114	(1,181)	2,154
Capital expenditures	461	815	438	1,366	3,080
Income tax expense (benefit)	28,096	6,668	6,141	(1,858)	39,047
Inter-segment eliminations					298
Consolidated income tax expense					\$ 39,345

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

	Insurance Company	Agency	Other Operations	Corporate	Total
Three months ended March 31, 2005 (As restated)					
Revenue:					
Domestic	\$ 283,672	\$ 12,762	\$ 1,906	\$ 579	\$ 298,919
Foreign	68,837	10,469			79,306
Inter-segment	96	21,529			21,625
Total segment revenue	\$ 352,605	\$ 44,760	\$ 1,906	\$ 579	399,850
Inter-segment eliminations					(21,625)
Consolidated total revenue					\$ 378,225
Net earnings (loss):					
Domestic	\$ 35,081	\$ 7,044	\$ 1,091	\$ (3,922)	\$ 39,294
Foreign	11,647	2,310			13,957
Total segment net earnings (loss)	\$ 46,728	\$ 9,354	\$ 1,091	\$ (3,922)	53,251
Inter-segment eliminations					2,137
Consolidated net earnings					\$ 55,388
Other items:					
Net investment income	\$ 20,076	\$ 1,356	\$ 539	\$ 370	\$ 22,341
Depreciation and amortization	1,207	1,925	126	452	3,710
Interest expense (benefit)	61	2,030	189	(472)	1,808
Capital expenditures	598	590		402	1,590
Income tax expense	20,226	6,191	224	280	26,921
Inter-segment eliminations					1,311
Consolidated income tax expense					\$ 28,232

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

The following tables present selected revenue items by line of business.

	Three months ended March 31,	
	2006 (As restated)	2005 (As restated)
Diversified financial products	\$ 169,112	\$ 106,851
Group life, accident and health	127,761	128,945
Aviation	33,197	33,817
London market account	21,928	26,711
Other specialty lines	28,640	21,225
Discontinued lines	(67)	2,568
Net earned premium	\$ 380,571	\$ 320,117
Property and casualty	\$ 25,407	\$ 26,066
Accident and health	6,262	5,557
Fee and commission income	\$ 31,669	\$ 31,623

(7) SUPPLEMENTAL INFORMATION

Supplemental cash flow information was as follows.

	Three months ended March	
	2006	31, 2005
Cash received from commutations	\$	\$ 32,635
Income taxes paid	16,038	13,886
Interest		