
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington D.C. 20549

Form 10-Q

(Mark One)

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2005

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____.

Commission file number 000-50041

USI Holdings Corporation

(Exact name of registrant as specified in its charter)

Delaware
*(State or other jurisdiction of
incorporation or organization)*

13-3771733
*(IRS Employer
Identification No.)*

**555 Pleasantville Road
Suite 160 South
Briarcliff Manor, New York 10510**
(Address of principal executive offices, including zip code)

(914) 749-8500
(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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☒ No ☐.

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

As of November 2, 2005, the number of outstanding shares of the Registrant's common stock, \$.01 par value, was 57,538,772 shares.

USI HOLDINGS CORPORATION

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FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of that term in the Private Securities Litigation Reform Act of 1995 found at Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Additional written or oral forward-looking statements may be made by us from time to time in filings with the Securities and Exchange Commission (the “SEC”), press releases, or otherwise (use of “we,” “us” and “USI” and variations thereof refers to USI Holdings Corporation and its consolidated subsidiaries). Statements contained in this report that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of these Acts. Forward-looking statements may include, but are not limited to, discussions concerning revenues, expenses, earnings, cash flow, capital structure, financial losses, as well as market and industry conditions, premium rates, financial markets, interest rates, contingencies and matters relating to our operations and income taxes. In addition, when used in this report, the words “anticipates,” “believes,” “should,” “estimates,” “expects,” “intends,” “plans” and variations thereof and similar expressions are intended to identify forward-looking statements. Such forward-looking statements are based on available current market and industry material, experts’ reports and opinions and long-term trends, as well as Management’s expectations concerning future events impacting us.

Forward-looking statements are not historical facts, but instead represent Management’s belief regarding future events, many of which, by their nature, are inherently uncertain and outside of our control. It is possible that our actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these forward-looking statements. Further information concerning us, including factors that potentially could materially affect our financial results, are contained in our filings with the SEC. Some factors include: our ability to meet our objective of growing cash earnings per share at least 15% per year; our ability to meet our objective of growing revenues organically and expanding our margins; successful consummation and integration of acquisitions; resolution of regulatory issues and other claims, including errors and omissions claims and claims related to our compensation arrangements with insurance companies; the actual cost of resolution of contingent liabilities and passage of new legislation affecting our business; determinations of effectiveness of internal control over financial reporting and disclosure controls and procedures; our ability to attract and retain key sales and management professionals; our level of indebtedness and debt service requirements; downward commercial property and casualty premium pressures; the competitive environment; future expenses for integration and margin improvement efforts; and general economic conditions around the country. Our ability to grow has been largely attributable to acquisitions, which may or may not be available on acceptable terms in the future and which, if consummated, may or may not be advantageous to us. Accordingly, actual results may differ materially from those set forth in the forward-looking statements.

Readers are cautioned not to place undue reliance on any forward-looking statements contained in this report, which speaks only as of the date set forth on the signature page hereto. We undertake no obligation to publicly release the result of any revisions to these forward-looking statements that may be made to reflect events or circumstances after such date or to reflect the occurrence of anticipated or unanticipated events.

Item 1. Financial Statements

USI HOLDINGS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Amounts in Thousands Except Per Share Data)

	September 30, 2005 (Unaudited)	December 31, 2004
Assets		
Current assets:		
Cash and cash equivalents	\$ 30,099	\$ 2,867
Fiduciary funds – restricted	93,757	99,627
Premiums and commissions receivable, net of allowance for bad debts and policy cancellations of \$6,521 and \$4,745, respectively	220,184	200,084
Other	13,837	17,181
Deferred tax asset	20,981	10,210
Current assets held for discontinued operations	2,232	7,534
Total current assets	381,090	337,503
Goodwill	393,291	309,195
Expiration rights	306,769	236,769
Other intangible assets	49,852	45,560
Accumulated amortization	(188,228)	(167,487)
Expiration rights and other intangible assets, net	168,393	114,842
Property and equipment, net	27,127	24,570
Other assets	4,647	3,565
Other assets held for discontinued operations	7,456	10,299
Total Assets	\$ 982,004	\$ 799,974
Liabilities and Stockholders' Equity		
Current liabilities:		
Premiums payable to insurance companies	\$ 232,700	\$ 226,746
Accrued expenses	66,555	47,900
Current portion of long-term debt	11,981	11,617
Other	10,816	14,782
Current liabilities held for discontinued operations	3,682	3,727
Total current liabilities	325,734	304,772
Long-term debt	225,969	144,707
Deferred tax liability	18,918	15,656
Other liabilities	6,172	6,745
Other liabilities held for discontinued operations	719	529
Total Liabilities	577,512	472,409
Commitments and contingencies		
Stockholders' equity:		
Preferred stock—voting—par \$.01, 87,000 shares authorized; no shares issued and outstanding	—	—
Common stock—voting—par \$.01, 300,000 shares authorized; 58,139 and 51,453 shares issued, respectively	581	515
Common stock—non-voting—par \$.01, 10,000 shares authorized; no shares issued and outstanding	—	—
Additional paid-in capital	670,836	590,251
Accumulated deficit	(249,404)	(253,877)
Less treasury stock at cost, 547 and 283 shares, respectively	(7,007)	(3,943)
Less unearned compensation, restricted stock	(10,514)	(5,381)
Total Stockholders' Equity	404,492	327,565
Total Liabilities and Stockholders' Equity	\$ 982,004	\$ 799,974

See notes to condensed consolidated financial statements.

USI HOLDINGS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in Thousands Except Per Share Data)
(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenues:				
Net commissions and fees.....	\$122,955	\$100,767	\$343,277	\$271,736
Contingents and overrides.....	1,738	1,210	22,666	16,973
Other income.....	2,574	1,040	5,891	3,261
Total Revenues	127,267	103,017	371,834	291,970
Expenses:				
Compensation and employee benefits.....	75,110	59,100	226,407	168,374
Non-cash stock-based compensation	839	139	1,708	278
Other operating expenses	27,821	24,269	81,857	65,704
Amortization of intangible assets.....	7,230	6,434	21,238	17,503
Depreciation.....	2,467	2,208	7,168	6,397
Interest	4,012	2,296	10,781	6,109
Total Expenses	117,479	94,446	349,159	264,365
Income from continuing operations before income tax expense	9,788	8,571	22,675	27,605
Income tax expense	4,298	3,377	9,907	11,363
Income from Continuing Operations	5,490	5,194	12,768	16,242
Loss from discontinued operations, net	(3,603)	(290)	(8,295)	(451)
Net Income	\$ 1,887	\$ 4,904	\$ 4,473	\$ 15,791
Per Share Data – Basic and Diluted				
Basic:				
Income from continuing operations	\$ 0.10	\$ 0.11	\$ 0.23	\$ 0.34
Loss from discontinued operations, net	(0.07)	(0.01)	(0.15)	(0.01)
Net Income Per Common Share	\$ 0.03	\$ 0.10	\$ 0.08	\$ 0.33
Diluted:				
Income from continuing operations	\$ 0.09	\$ 0.10	\$ 0.23	\$ 0.33
Loss from discontinued operations, net	(0.06)	—	(0.15)	(0.01)
Net Income Per Common Share	\$ 0.03	\$ 0.10	\$ 0.08	\$ 0.32

See notes to condensed consolidated financial statements.

USI HOLDINGS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Amounts in Thousands)
(UNAUDITED)

	Nine Months Ended September 30,	
	2005	2004
Operating Activities		
Income from continuing operations	\$ 12,768	\$ 16,242
Adjustments to reconcile income from continuing operations to net cash provided by operating activities:		
Amortization of intangible assets	21,238	17,503
Depreciation	7,168	6,397
Non-cash stock-based compensation.....	1,708	278
(Benefit from) provision for deferred income taxes	(1,289)	4,715
Gain on disposal of assets	(223)	(543)
Provision for bad debts and policy cancellations.....	978	440
Other non-cash items.....	1,199	767
Changes in operating assets and liabilities (net of purchased/divested companies):.....		
Fiduciary funds-restricted	20,108	11,408
Premiums and commissions receivable	8,922	12,276
Other assets	4,763	3,546
Premiums payable to insurance companies	(29,511)	(24,594)
Accrued expenses and other liabilities	(1,453)	(7,708)
Net cash provided by continuing operating activities	46,376	40,727
Loss from discontinued operations, net	(8,295)	(451)
Non-cash charges included in loss from discontinued operations, net.....	4,800	818
Changes in discontinued operating assets and liabilities.....	1,770	(355)
Net Cash Provided by Operating Activities	44,651	40,739
Investing Activities		
Cash paid for businesses acquired and related costs	(121,005)	(75,533)
Cash obtained from businesses acquired	(1,925)	2,489
Purchases of property and equipment	(6,741)	(8,162)
Proceeds from sale of assets	3	551
Net cash used in continuing investing activities	(129,668)	(80,655)
Proceeds from sale of discontinued operations	6,167	—
Net Cash Used in Investing Activities	(123,501)	(80,655)
Financing Activities		
Proceeds from issuance of long-term debt.....	94,533	24,993
Payments of long-term debt issuance costs.....	(819)	(450)
Payments of long-term debt.....	(19,167)	(19,737)
Proceeds from issuance of common stock	36,163	4,087
Payments for repurchases of common stock.....	(3,064)	(3,297)
Net cash provided by continuing financing activities	107,646	5,596
Payment of discontinued operations' long-term debt	(1,564)	(1,388)
Net Cash Provided by Financing Activities	106,082	4,208
Increase (decrease) in cash and cash equivalents.....	27,232	(35,708)
Cash and cash equivalents at beginning of period	2,867	45,570
Cash and Cash Equivalents at End of Period	\$ 30,099	\$ 9,862
Supplemental disclosures of cash flow information:		
Cash paid for interest.....	\$ 8,256	\$ 4,432
Cash paid for taxes	\$ 3,696	\$ 6,834
Supplemental schedule of non-cash activities:		
Common stock issued for acquisitions, primarily intangibles	\$ 28,792	\$ 27,979
Debt and other liabilities issued/assumed for acquisitions, primarily intangibles.....	\$ 32,280	\$ 13,627
Other long-term debt issued primarily for earn-out payments	\$ 658	\$ 958
Common stock issued for reduction in liabilities	\$ 8,173	\$ 1,000

See notes to condensed consolidated financial statements.

USI HOLDINGS CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(Amounts in Thousands, Except Per Share Data)

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

USI Holdings Corporation, a Delaware corporation, and subsidiaries (collectively, the Company) is a distributor of insurance and financial products and services primarily to small and mid-sized businesses. The Company has two operating segments—Insurance Brokerage and Specialized Benefits Services—and a third administrative segment—Corporate. The Insurance Brokerage segment focuses primarily on general and specialty property and casualty (“P&C”) insurance, individual and group health, life and disability insurance and core benefits (“retirement services”). The Specialized Benefits Services segment focuses primarily on enrollment and communication services related to employee benefits and workplace marketing of individual voluntary benefits insurance products. The Corporate segment provides corporate management, acquisition processes, sales management, human resources, legal, capital planning, financial and reporting support.

Basis of Presentation and Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, and include all normal recurring adjustments that the Company considers necessary for a fair presentation of the financial statements of such periods. Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been omitted pursuant to such rules and regulations. The unaudited condensed consolidated financial statements include the accounts of USI Holdings Corporation and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation. Operating results for the nine-month period ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

Refer to the audited consolidated financial statements and related notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2004 for additional details of the Company’s financial position, as well as a description of the Company’s significant accounting policies which have been continued without material change, except as discussed herein. The details included in the notes have not changed except as a result of normal transactions in the interim period and the events mentioned in the notes below.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of assets and liabilities at the date of the unaudited condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

As reported in the Company’s Form 10-Q for the quarterly periods ended September 30, 2004 and June 30, 2005, as part of the Company’s review of internal controls in compliance with Sarbanes-Oxley Section 404, it determined the need to enhance field office and corporate controls over its receivables (and related producer compensation expense) recorded for revenue on policies billed directly by insurance companies, or “direct bill” receivables. Beginning in the third quarter of 2004, the Company implemented a new system called Captiva, which will, when it is fully populated with all direct bill policy details, directly calculate and record receivables and revenue and the related compensation payable and expense for each commercial lines property and casualty direct bill policy at the time it is effective. As a result of this process, the Company has obtained additional information which Management has utilized to determine its estimate of the direct bill receivable and related compensation payable. For the three and nine-month periods ended September 30, 2005, the effect of the change in estimate was a decrease to the Company’s direct bill revenues of \$756 and \$2,925, respectively, and a decrease in the related producer compensation expense of \$359 and \$467, respectively.

USI HOLDINGS CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(Amounts in Thousands, Except Per Share Data)

New Accounting Pronouncement

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123 (Revised), "Share Based Payment" ("SFAS No. 123 R"). SFAS No. 123 R requires companies to recognize in compensation expense the cost of employee services received in exchange for awards of equity based on the grant date fair value of those awards. SFAS No. 123 R supersedes SFAS No. 123, which allowed companies to choose between expensing such equity awards and disclosing only the pro forma effects of having expensed them. In April 2005, the Securities and Exchange Commission delayed the required adoption date of SFAS No. 123 R, which is now effective for public companies at the beginning of the next fiscal year instead of the first interim or annual period beginning after June 15, 2005. The Company will adopt SFAS No. 123 R effective January 1, 2006. The Company is currently evaluating the methodology for implementation of SFAS No. 123 R.

Stock-Based Compensation

SFAS No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure," an amendment of SFAS No. 123 "Accounting for Stock-Based Compensation" (collectively SFAS No. 148), establishes accounting and disclosure requirements using the fair-value based method of accounting for employee stock-based compensation. SFAS No. 148 encourages, but does not require, companies to record compensation cost for stock-based compensation plans at fair value.

The Company accounts for stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"). Under the intrinsic value method, compensation cost for stock options is recognized only to the extent the fair market value of the stock at grant date is in excess of the amount that the employee must pay to acquire the stock. To date, no compensation expense has been recorded for stock options since the market price at the date of grant equaled the amount the employee must pay. Additionally, in accordance with APB No. 25, compensation expense related to restricted stock is recorded ratably over the vesting period based on the fair market value on the date of grant.

USI HOLDINGS CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(Amounts in Thousands, Except Per Share Data)

The following table illustrates the effect on the Company's operating results and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 148 to stock-based compensation. Assumptions in the valuation model are consistent with those used for 2004 (please read Note 1 "Nature of Operations and Summary of Significant Accounting Policies" and Note 9 "Stock Option Plan" to the Company's consolidated financial statements included in its Annual Report on Form 10-K for the year ended December 31, 2004).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income, as reported	\$ 1,887	\$ 4,904	\$ 4,473	\$ 15,791
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects.....	472	80	962	161
Deduct: Total stock-based compensation expense determined under fair-value based method for all awards, net of related tax effects.....	(962)	(661)	(2,242)	(1,510)
Pro forma net income.....	<u>\$ 1,397</u>	<u>\$ 4,323</u>	<u>\$ 3,193</u>	<u>\$ 14,442</u>
Earnings per share – basic:.....				
As reported	<u>\$ 0.03</u>	<u>\$ 0.10</u>	<u>\$ 0.08</u>	<u>\$ 0.33</u>
Pro forma.....	<u>\$ 0.02</u>	<u>\$ 0.09</u>	<u>\$ 0.06</u>	<u>\$ 0.30</u>
Earnings per share – diluted:.....				
As reported	<u>\$ 0.03</u>	<u>\$ 0.10</u>	<u>\$ 0.08</u>	<u>\$ 0.32</u>
Pro forma.....	<u>\$ 0.02</u>	<u>\$ 0.09</u>	<u>\$ 0.06</u>	<u>\$ 0.29</u>

Discontinued Operations

Certain amounts have been reclassified and presented in all periods as discontinued operations to reflect decisions announced in the fourth quarter of 2004 and in 2005 to sell seven operations that either exhibited significant earnings volatility or that do not fit with the Company's core business strategy (see Note 5 "Discontinued Operations"). Three of the seven operations were acquired in the first quarter of 2005 in connection with the Summit Global Partners ("SGP") acquisition.

2. Goodwill and Other Intangible Assets

The changes in the carrying amount of goodwill by reportable segment are as follows:

	Insurance Brokerage	Specialized Benefits Services	Corporate	Total
December 31, 2004	\$ 225,297	\$ 37,582	\$ 46,316	\$ 309,195
Goodwill acquisitions/adjustments	91,165	1,560	(8,629)	84,096
September 30, 2005	<u>\$ 316,462</u>	<u>\$ 39,142</u>	<u>\$ 37,687</u>	<u>\$ 393,291</u>

Changes in goodwill arise primarily from acquisitions and contingent purchase price payments on previous acquisitions. The Company records contingent purchase price payments as adjustments to goodwill when determined. Goodwill adjustments may also arise from reclassifications with other intangible assets upon completion of acquisition asset valuations, divestitures and impairments. The reduction in goodwill recorded in the Corporate segment for the nine months ended September 30, 2005 is primarily attributed to a reclassification of identified deferred tax assets out of the preliminary purchase price allocation to goodwill in the SGP acquisition.

USI HOLDINGS CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(Amounts in Thousands, Except Per Share Data)

The Company's amortizable intangible assets by asset class are as follows:

	Gross carrying value	Accumulated amortization	Net carrying value	Amortization period
September 30, 2005				
Expiration rights	\$ 306,769	\$ 149,585	\$ 157,184	10 years
Covenants not-to-compete	46,876	38,643	8,233	7 years
Other	2,976	—	2,976	5 years
Total.....	<u>\$ 356,621</u>	<u>\$ 188,228</u>	<u>\$ 168,393</u>	
December 31, 2004				
Expiration rights	\$ 236,769	\$ 130,464	\$ 106,305	10 years
Covenants not-to-compete	42,501	37,023	5,478	7 years
Other	3,059	—	3,059	5 years
Total.....	<u>\$ 282,329</u>	<u>\$ 167,487</u>	<u>\$ 114,842</u>	

Amortization expense for amortizable intangible assets was \$7,230 and \$6,434 for the three months ended September 30, 2005 and 2004, respectively, and \$21,238 and \$17,503 for the nine months ended September 30, 2005 and 2004, respectively. Amortization expense for amortizable intangible assets for the years ending December 31, 2005, 2006, 2007, 2008 and 2009 is estimated to be \$28,457, \$26,888, \$23,859, \$21,298 and \$17,570, respectively.

At September 30, 2005, other intangible assets were comprised of deferred financing costs related to the Company's credit facility (see Note 4 "Long-Term Debt"). The Company charged \$286 and \$225 to interest expense for the amortization of these costs in the three months ended September 30, 2005 and 2004, respectively, and \$847 and \$655 for the nine months ended September 30, 2005 and 2004, respectively.

With the exception of goodwill, the Company has no intangible assets with indefinite lives.

In the third quarter of 2005, the Company recorded an additional impairment charge of \$1,054 on the intangible assets of one operation classified in discontinued operations as a result of a revision in the estimate of the operation's fair value (see Note 5 "Discontinued Operations"). Except as discussed above, there were no indicators of possible impairment in the Company's goodwill and intangible assets during the nine-month period ended September 30, 2005. The Company will complete its annual goodwill impairment test in the fourth quarter of 2005.

USI HOLDINGS CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(Amounts in Thousands, Except Per Share Data)

3. Acquisitions

During the nine-month period ended September 30, 2005, the Company acquired the stock or substantially all of the assets of the following companies in exchange for its common stock, notes issued, debt assumed and cash. These acquisitions have been accounted for using the purchase accounting method for recording business combinations (the "Other" row includes six acquisitions made in 2005, none of which had acquired assets greater than \$5,000):

Name and effective date of acquisition	Common shares issued	Common share value	Cash paid/ to be paid	Debt and other liabilities issued/ assumed	Total purchase price	Contingent earn-out payables
Patterson//Smith Associates (PSA), 2/1/05	177	\$ 2,000	\$ 16,933	\$ 2,000	\$ 20,933	\$ —
Summit Global Partners (SGP), 2/3/05	2,368	26,547	65,176	28,224	119,947	—
Richard Cross & Associates (CRO), 9/1/05	—	—	11,715	2,056	13,771	2,400
Other	19	245	10,277	—	10,522	27,206
Total	2,564	\$ 28,792	\$ 104,101	\$ 32,280	\$ 165,173	\$ 29,606

Common shares of the Company issued in connection with acquisitions are valued using the five-day average closing price of the Company's common stock beginning two days prior to the measurement date. The measurement date is the earliest date on which the number of shares to be issued in an acquisition is determinable based on mutual agreement of the parties and as documented by a formula in the respective acquisition agreement. Debt and other liabilities issued/assumed includes notes issued and assumed, as well as other liabilities specifically assumed but not considered in the required working capital calculation. These other liabilities are typically treated as deductions from cash purchase consideration at closing. Included in common shares or cash may be amounts in escrow pending the resolution of certain pre-acquisition contingencies or final calculation of acquired working capital. Any amounts returned to the Company out of escrow are recorded as adjustments to goodwill when the escrow is settled.

In connection with certain acquisitions, there are contingent purchase price payments which are primarily based upon future revenues of the acquired entities. The contingent payments are not included in the purchase price that is recorded for these acquisitions at their respective acquisition dates because they are not fixed and determinable. Future payments made under these arrangements, if any, generally will be recorded as adjustments to goodwill when the amounts are determined. Additionally, the Company may acquire books of business from time to time, paying a percentage of retained revenues over a number of years. These contingent payments are typically in cash and are recorded to expiration rights when determinable. The aggregate amount of unrecorded contingent purchase price obligations for earn-outs and books of business as of September 30, 2005 is estimated to be between \$26,829 and \$45,665, with payments expected to be made from 2005 through 2010. In the nine months ended September 30, 2005, the Company made contingent purchase price payments of \$2,811.

The following is a summary of the estimated fair values of the net assets acquired at the date of each acquisition based on preliminary purchase price allocations:

	<u>PSA</u>	<u>SGP</u>	<u>CRO</u>	<u>Other</u>	<u>Total</u>
Current Assets	\$ 7,752	\$ 39,138	\$ 555	\$ 1,052	\$ 48,497
Property and equipment, net	223	1,899	167	878	3,167
Other long-term assets	2	709	—	—	711
Expiration rights	8,550	50,145	5,288	4,992	68,975
Covenants not-to-compete	500	3,134	397	283	4,314
Goodwill	11,241	69,668	7,535	5,474	93,918
Total assets acquired	<u>\$28,268</u>	<u>\$164,693</u>	<u>\$13,942</u>	<u>\$ 12,679</u>	<u>\$219,582</u>
Total liabilities assumed, less debt and other liabilities issued/assumed	<u>\$ 7,335</u>	<u>\$ 44,746</u>	<u>\$ 171</u>	<u>\$ 2,157</u>	<u>\$ 54,409</u>
Total net assets acquired	<u>\$20,933</u>	<u>\$119,947</u>	<u>\$13,771</u>	<u>\$ 10,522</u>	<u>\$165,173</u>

Included in liabilities in the table above is \$2,585 of acquisition-related expenses. Additionally, in 2005, the Company reduced goodwill and recorded a deferred tax asset in the Corporate segment of \$7,672 related to these acquisitions and to other acquisition-related intangible adjustments.

USI HOLDINGS CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(Amounts in Thousands, Except Per Share Data)

These acquisitions allow the Company to enlarge its footprint in geographic locations where it already has a presence and expand its presence in the employee benefits and retail P&C insurance brokerage services industries. The excess of the purchase price over the estimated fair value of the tangible net assets valued as of the acquisition date was allocated to expiration rights and covenants not-to-compete, with the remaining balance to goodwill, in the amounts of \$68,975, \$4,314 and \$93,918, respectively (of these amounts, \$27,909, \$1,377 and \$37,013, respectively, are expected to be deductible for income tax purposes). Preliminary purchase price allocations are established at the time of the acquisition and are reviewed within the first year of ownership upon completion of an acquired asset valuation or for other required adjustments. The Company is currently in the process of performing asset valuations on several of its 2005 acquisitions. Accordingly, amounts preliminarily allocated to goodwill and other intangible assets may be adjusted upon completion of the valuations. Such amounts may be material and would primarily represent reclassifications between goodwill and other intangible assets.

The Company's consolidated financial statements for the nine months ended September 30, 2005 include the results of operations of these companies from the date of their respective acquisitions. The following is a summary of the unaudited pro forma historical results, as if these purchased entities had been acquired at January 1, 2004:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Total revenues.....	\$ 128,361	\$ 126,765	\$ 391,199	\$ 368,952
Income from continuing operations before income tax expense.....	10,039	12,113	25,298	34,013
Net income.....	2,028	7,064	5,950	19,564
Net income per share:				
Basic.....	0.04	0.14	0.11	0.38
Diluted.....	0.04	0.13	0.10	0.37
Weighted-average shares outstanding:.....				
Basic.....	56,686	52,141	56,334	51,287
Diluted.....	57,414	53,035	56,925	52,295

The unaudited pro forma results above have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which actually would have resulted had the acquisitions occurred at January 1, 2004, nor are they necessarily indicative of future operating results.

Additionally, in 2005 the Company acquired all membership interests or certain assets from seven agencies/individuals that were not included in the information presented above. These interests/assets were purchased for consideration of \$1,121 in cash and \$65 in promissory notes and were allocated primarily to expiration rights and other intangible assets.

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4. Long-Term Debt

Long-term debt consists of the following as of September 30, 2005 and December 31, 2004:

	September 30, 2005	December 31, 2004
Senior credit facility:		
Term loan	\$ 212,050	\$ 123,438
Revolving credit facility	—	5,000
Other debt:		
Notes issued in connection with acquisitions, due various dates through 2010 at interest rates from 5% to 10%	21,893	23,073
Other long-term debt, primarily capital leases	4,007	4,813
Total debt	237,950	156,324
Current portion of long-term debt	(11,981)	(11,617)
Long-term debt	<u>\$ 225,969</u>	<u>\$ 144,707</u>

Substantially all of the assets of the Company are pledged as collateral securing its long-term debt.

In August 2003, the Company entered into a \$155,000 senior secured credit facility with several lending institutions. The credit facility is structured as follows: a \$30,000 revolving credit facility maturing in August 2007, and, initially, a \$125,000 term loan, payable in quarterly installments that commenced on October 31, 2003. The last quarterly installment is due in August 2008, the maturity date of the term loan. The proceeds from borrowings under the credit facility were drawn to: (i) repay all amounts under the previously existing credit facility; (ii) repay a portion of certain notes issued for acquisitions; (iii) pay fees and expenses in connection with the credit facility including a prepayment penalty in connection with the prepayment of the previously existing credit facility; and (iv) for general corporate purposes. The Company incurred approximately \$3,766 in fees and expenses related to the credit facility, which have been capitalized and are being recorded to interest expense over the term of the credit facility.

The revolving credit facility is available for loans denominated in U.S. dollars and for letters of credit. Borrowings under the revolving credit facility bear interest, at the Company's option, at either a base rate plus an applicable margin ranging from 1.5% to 2.5% per annum or the Eurodollar rate plus an applicable margin ranging from 2.5% to 3.5% per annum, depending on the Company's credit ratings as determined by Standard & Poor's and Moody's Investors Service credit rating services at the time of borrowing. Borrowings under the term loan bear interest, at the Company's option, at a base rate plus 2.0% per annum or the Eurodollar rate plus 3.0% per annum. The base rate and the Eurodollar rate are effectively the Prime Rate and the London Interbank Offering Rate, respectively. There is also a commitment fee on the unused portion of the revolving credit facility of 0.5% per annum. The revolving credit facility may be used for acquisition financing and general corporate purposes. At September 30, 2005, availability under the revolving credit facility was \$28,800, having been reduced \$1,200 for outstanding letters of credit.

On March 26, 2004, the Company executed a first amendment to its credit facility, providing for a 0.5% reduction to the applicable term loan interest rate effective April 1, 2004. As amended, borrowings under the term loan bear interest, at the Company's option, at either a base rate plus 1.5% per annum or the Eurodollar rate plus 2.5% per annum. The base rate and the Eurodollar rate are effectively the Prime Rate and the London Interbank Offering Rate for the applicable period, respectively.

On March 26, 2004, the Company executed a first waiver to the credit agreement. The credit agreement has various limitations on acquisitions, including, but not limited to, aggregate cash payments for acquisitions each year, the aggregate amount of total consideration for acquisitions each year and the amount of indebtedness assumed on a given acquisition. In

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order to proceed with the Company's acquisition strategy the Company requested and received a waiver that specifically excludes two significant acquisitions from its credit facility limitations on aggregate cash payments, aggregate total consideration and assumed indebtedness. No other covenants were waived or amended.

On January 11, 2005, the Company received approval from its lending institutions for a second amendment to its credit facility, which allowed for a \$90,000 increase to its existing term loan and a waiver and amendment of certain covenants. The incremental \$90,000 term loan was issued under the same terms and conditions as the Company's existing term loan and will mature contemporaneously in August, 2008. The proceeds were used to fund a portion of the SGP acquisition and for general corporate purposes. The second amendment provided for an amendment of the limitation on aggregate cash consideration and a waiver of the limitations on total consideration and permitted seller debt to allow for the acquisition of SGP. Further, the Company's leverage ratio was amended to allow for the term loan increase, the SGP acquisition and certain one-time cash charges related to its margin improvement plan and acquisition integration costs.

The credit facility contains various limitations, including limitations on the payment of dividends, buy-back of the Company's common stock and other distributions to stockholders, borrowing, acquisitions and financial covenants that must be met, including those with respect to fixed charges coverage and limitations on consolidated debt, net worth and capital expenditures. Failure to comply with the covenants may result in an acceleration of the borrowings outstanding under the facility. Additionally, all of the stock of the Company's subsidiaries and certain other identified assets of the Company are pledged as collateral to secure the credit facility and each subsidiary guarantees the Company's obligations under the credit facility. In the third quarter of 2005, the Company received a waiver from its lending institutions related to the sale of stock of one subsidiary classified in discontinued operations. At September 30, 2005, the Company was in compliance with all such covenants.

The weighted-average interest rate on the term loan for the three months ended September 30, 2005 and 2004 was 6.02% and 4.01%, respectively. The weighted-average interest rate on the term loan for the nine months ended September 30, 2005 and 2004 was 5.55% and 3.93%, respectively. The interest rate on the term loan at September 30, 2005 was 6.18%.

5. Discontinued Operations

In December 2004, the Company's Board of Directors approved plans to sell, or otherwise dispose of, three operations in the Company's Insurance Brokerage and Specialized Benefits Services segments that exhibited significant earnings volatility or that did not fit with the Company's core business strategy. In the first quarter of 2005, the Company classified as discontinued operations two operations newly acquired in the SGP acquisition that were determined not to fit with the Company's core business strategy. In June 2005, the Company approved a plan to sell or otherwise dispose of two additional operations in the Insurance Brokerage segment that exhibited significant earnings volatility or that did not fit with the Company's core business strategy, one of which was acquired in the first quarter of 2005 in the SGP acquisition. As a result of these actions, the Company classified these entities as discontinued operations.

Pursuant to an agreement entered into on January 2, 2005, the Company sold substantially all of the assets of its Ocala, Florida operation for cash of \$2,065. Pursuant to an agreement entered into on February 28, 2005, the Company sold substantially all of the assets of its Strategic Asset Management Group for cash of \$2 and a promissory note of \$424. The note bears interest at 5.25% per annum and is due on March 1, 2009. Pursuant to an agreement entered into on April 1, 2005, the Company sold substantially all of the assets of its Troy, Michigan office, acquired in the SGP acquisition, in exchange for a promissory note of \$969. The promissory note was valued at zero. The note bears interest at 5.25% per annum and is due on July 1, 2010. The Company recorded a pre-tax gain on the sales of these operations of \$1,295 in discontinued operations in the first quarter of 2005.

Pursuant to an agreement entered into on July 1, 2005, the Company sold substantially all of the assets of its San Antonio, Texas office, acquired as part of the SGP acquisition, to CRC Insurance Services, Inc. The aggregate sales price was \$4,000 and was paid in cash. Additional sales price consideration may become payable to the Company contingent on the assets sold achieving certain defined performance criteria. Pursuant to an agreement entered into on August 31, 2005, the company sold the stock of its Woburn, Massachusetts based executive benefits operation to a former employee. The

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aggregate sales price was \$630, with \$100 paid in cash and \$530 in the form of a promissory note. The note bears interest at 6.25% per annum and is due on August 31, 2011.

The assets and liabilities of discontinued operations at September 30, 2005 and December 31, 2004 are as follows:

	September 30, 2005	December 31, 2004
Assets.....		
Cash and cash equivalents.....	\$ 1,267	\$ 789
Premiums and commissions receivable.....	808	6,118
Other current assets	157	627
Total current assets	2,232	7,534
Intangible assets, net	—	6,505
Property and equipment, net	195	323
Other assets	7,261	3,471
Total other assets	7,456	10,299
Total assets.....	<u>\$ 9,688</u>	<u>\$ 17,833</u>
Liabilities		
Premiums payable to insurance companies.....	\$ 40	\$ 157
Accrued expenses.....	1,431	1,437
Current portion of long-term debt	1,048	2,083
Other current liabilities.....	1,163	50
Total current liabilities.....	3,682	3,727
Long-term debt	—	529
Other liabilities	719	—
Total other liabilities.....	719	529
Total liabilities	<u>\$ 4,401</u>	<u>\$ 4,256</u>

The results of discontinued operations for the three and nine months ended September 30, 2005 and 2004 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenues	\$ 248	\$ 1,931	\$ 4,228	\$ 6,185
Expenses.....				
Compensation and employee benefits.....	646	1,553	3,895	4,400
Other operating expenses.....	4,525	556	8,268	1,549
Amortization of intangible assets.....	—	245	152	697
Depreciation.....	30	40	67	121
Interest	23	64	106	208
Impairment of long-lived assets.....	1,054	—	5,688	—
Total expenses	<u>\$ 6,278</u>	<u>\$ 2,458</u>	<u>\$ 18,176</u>	<u>\$ 6,975</u>
Loss from discontinued operations.....	(6,030)	(527)	(13,948)	(790)
Income tax benefit.....	2,427	237	5,653	339
Loss from discontinued operations, net.....	<u>\$ (3,603)</u>	<u>\$ (290)</u>	<u>\$ (8,295)</u>	<u>\$ (451)</u>

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6. Common Stock

On May 10, 2004, the Company announced that its Board of Directors authorized a stock repurchase plan. Using only proceeds, and any related tax benefit amounts from the exercise of stock options and warrants, the Company may, at its discretion, repurchase shares on the open market or in private transactions in order to help offset dilution from its equity compensation plans and previously issued warrants to purchase its common stock. The amount and timing of repurchases will be based upon the number of shares of common stock which may be issued from time to time upon the exercise of stock options and warrants, market conditions and other factors. During the three and nine-month periods ended September 30, 2005, the Company purchased 166 and 256 shares of its common stock on the open market under this plan at a total cost of \$1,902 and \$2,971, respectively.

On December 20, 2004, the Company announced that its Board of Directors authorized an expanded stock repurchase program that permits it to purchase shares of its common stock up to certain limits set forth within its credit facility. In 2004, the Company had the capacity under its credit facility to purchase up to \$11,125, but did not purchase any shares. The Company has the capacity under its credit facility to purchase up to \$9,723 of its common stock during 2005. During the three and nine-month periods ended September 30, 2005, the Company purchased zero and 8 shares of its common stock on the open market under the expanded stock repurchase program at a total cost of zero and \$93, respectively. For the balance of 2005, the Company has the ability to repurchase up to \$9,630 of its common stock under this expanded stock repurchase program.

7. Segment Reporting

The Company has two operating segments - Insurance Brokerage and Specialized Benefits Services and a third administrative segment - Corporate. The Company's reportable segments are separately managed strategic business units.

The Insurance Brokerage segment offers general and specialty property and casualty insurance, employee benefit-related insurance, wholesale insurance brokerage services and retirement services such as 401(k) plan administration and defined benefit actuarial services. The Specialized Benefits Services segment offers enrollment and communication services related to employee benefits and workplace marketing of individual voluntary insurance products. The Corporate segment provides corporate management, acquisition processes, sales management, human resources, legal, capital planning, financial and reporting support.

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Income (loss) from continuing operations before income tax expense by reporting segment for the three and nine months ended September 30, 2005 and 2004 were as follows:

Three Months Ended September 30,				
	Insurance Brokerage	Specialized Benefits Services	Corporate	Total
2005				
Revenues.....	\$ 116,016	\$ 10,844	\$ 407	\$ 127,267
Expenses	87,987	7,900	7,044	102,931
Depreciation	1,951	150	366	2,467
Amortization.....	6,548	682	—	7,230
Interest	255	86	3,671	4,012
Non-cash stock-based compensation	713	13	113	839
Income (loss) from continuing operations before income tax expense	<u>\$ 18,562</u>	<u>\$ 2,013</u>	<u>\$ (10,787)</u>	<u>\$ 9,788</u>
2004				
Revenues.....	\$ 95,893	\$ 7,062	\$ 62	\$ 103,017
Expenses	72,497	5,274	5,598	83,369
Depreciation	1,713	123	372	2,208
Amortization.....	5,814	620	—	6,434
Interest	295	143	1,858	2,296
Non-cash stock-based compensation	68	6	65	139
Income (loss) from continuing operations before income tax expense	<u>\$ 15,506</u>	<u>\$ 896</u>	<u>\$ (7,831)</u>	<u>\$ 8,571</u>
Nine Months Ended September 30,				
	Insurance Brokerage	Specialized Benefits Services	Corporate	Total
2005				
Revenues.....	\$ 346,655	\$ 24,178	\$ 1,001	\$ 371,834
Expenses	265,340	19,404	23,520	308,264
Depreciation	5,692	397	1,079	7,168
Amortization.....	19,194	2,044	—	21,238
Interest	810	275	9,696	10,781
Non-cash stock-based compensation	1,402	30	276	1,708
Income (loss) from continuing operations before income tax expense	<u>\$ 54,217</u>	<u>\$ 2,028</u>	<u>\$ (33,570)</u>	<u>\$ 22,675</u>
2004				
Revenues.....	\$ 280,641	\$ 11,088	\$ 241	\$ 291,970
Expenses	205,006	10,925	18,147	234,078
Depreciation	4,851	302	1,244	6,397
Amortization.....	16,417	1,086	—	17,503
Interest	867	259	4,983	6,109
Non-cash stock-based compensation	136	12	130	278
Income (loss) from continuing operations before income tax expense	<u>\$ 53,364</u>	<u>\$ (1,496)</u>	<u>\$ (24,263)</u>	<u>\$ 27,605</u>

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	<u>September 30, 2005</u>	<u>December 31, 2004</u>
Segment Assets:		
Insurance Brokerage	\$ 815,181	\$ 645,259
Specialized Benefits Services	88,740	85,017
Corporate	<u>68,395</u>	<u>51,865</u>
Total assets for use in continuing operations	972,316	782,141
Reconciling items:		
Assets held for discontinued operations	<u>9,688</u>	<u>17,833</u>
Total assets	<u><u>\$ 982,004</u></u>	<u><u>\$ 799,974</u></u>

8. Contingencies

The Company is subject to various claims, lawsuits and proceedings that arise in the normal course of business. These matters principally consist of alleged errors and omissions in connection with the placement of insurance and rendering administrative or consulting services and are generally covered in whole or in part by insurance. Except as qualified by the discussion below, on the basis of present information, anticipated insurance coverage and advice received from counsel, it is the opinion of the Company's management that the disposition or ultimate determination of these claims, lawsuits or proceedings will not have a material adverse effect on the Company's consolidated financial position or results of operations.

Since October, 2004, the insurance industry has been under a significant level of scrutiny by various regulatory bodies, including state Attorneys General and the departments of insurance for various states, with respect to industry practices, including contingent compensation arrangements. The Company has received subpoenas from the Office of the Attorney General of the State of Connecticut, the Office of the Attorney General of the State of New York and the Florida Attorney General's Office requesting documents and seeking information as part of their industry-wide investigations relating to pricing and placement of insurance. The Company has also received an Investigative Demand from the Department of Justice of the State of North Carolina seeking similar information. While these investigations are continuing and the ultimate outcome cannot be predicted, the investigations center upon, among other items, allegations of bid rigging, tying arrangements and other fraudulent or unlawful business practices. The Company has cooperated fully with these requests and will continue to cooperate with regulators as they refine, prioritize and/or expand the areas of inquiry in their subpoenas and information requests.

In addition to the state Attorney General investigations described above, a number of state departments of insurance have begun inquiries into compensation practices of brokers, agents and insurers as they affect consumers in their respective states. The Company has received and responded, or is in the process of responding, to inquiries from insurance regulators in several states.

The Company cannot currently predict the impact or resolution of these matters or reasonably estimate a range of possible loss, which could be material, and the resolution of these matters may harm the Company's business and/or lead to a decrease in or elimination of contingent commissions and override commissions, which could have a material adverse impact on the Company's consolidated financial condition.

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Following the allegations of bid rigging and price fixing in the lawsuit filed by the Office of the Attorney General of the State of New York against Marsh and McLennan Companies, Inc., the Company retained outside counsel, Akin Gump Strauss Hauer & Feld, LLP (“Akin Gump”), to render legal advice in connection with an internal review of its operations. Since that time, Akin Gump has assisted the Company in responding to the subpoenas and inquiries described above. In connection with this internal review, Akin Gump has interviewed more than 90 of the Company’s employees, including corporate management, and is continuing its review of documents. The Company is continuing to review its business and expects that its review will not only address the areas that the regulators are examining, but will also help the Company evaluate where it can make additional operational or business practice changes or improvements.

Since October 2004, the industry’s long-standing contingent commission compensation arrangements have been a focal point of scrutiny by various regulators and, in fact, some of the largest brokers within the industry have abandoned the practice of receiving such contingent commissions. In 2005, the Company received substantially all of its contingent commissions under its arrangements in place for 2004. Additionally, the Company’s carriers with whom it has historically had contingent arrangements have tendered their 2005 contingent commission agreements in a form and structure generally consistent with the Company’s prior agreements. While the Company is not able to predict whether regulatory, market or other external forces will ultimately cause contingent commission arrangements to cease or be substantively restructured, Management does expect to receive contingent commissions in 2006 for arrangements established in 2005. The Company’s revenues from contingent and override commissions were \$1,738 and \$1,210 for the three months ended September 30, 2005 and 2004, respectively, and \$22,666 and \$16,973 for the nine months ended September 30, 2005 and 2004, respectively. The Company’s revenues from contingent and override commissions were \$18,979, \$17,695 and \$14,663 for 2004, 2003 and 2002, respectively. Contingent and override commissions’ contribution to the Company’s income from continuing operations before income taxes for the three and nine-month periods ended September 30, 2005 and 2004 was approximately equivalent to the revenues from contingent and override commissions for each period.

Industry Class Action Litigation. The Company has been named as one of more than 30 insurance company and insurance brokerage defendants in an amended complaint filed in the United States District Court Southern District of New York in a putative class action lawsuit captioned *Opticare Health Systems, Inc. v. Marsh & McLennan Companies, Inc., et al.* (Civil Action No. CV 06954 (DC)). The amended complaint focuses on the payment of contingent commissions by insurers to insurance brokers who sell their insurance and alleged bid rigging in the setting of insurance premium levels. The amended complaint purports to allege violations of numerous laws including the Racketeer Influenced and Corrupt Organizations (“RICO”) and federal restraint of trade statutes, state restraint of trade, unfair and deceptive practices statutes and state breach of fiduciary duty and unjust enrichment laws. The amended complaint seeks class certification, treble damages for the alleged injury suffered by the putative plaintiff class and other damages. The Company is also a defendant in “copycat” or tag-along lawsuits in the United States District Court for the Northern District of Illinois: *Lewis v. Marsh & McLennan Companies, Inc., et al.*, 04 C 7847 and *Preuss v. Marsh & McLennan Companies, Inc., et al.*, 04 C 7853, and during April 2005, it was served in another copycat class action lawsuit, captioned *Palm Tree Computers Systems, Inc. et al. v. Ace, USA et al.*, and filed in the Circuit Court for the Eighteenth Judicial Circuit in and for Seminole County, Florida, Civil Division, Class Representation, No. 05-CA-373-16-W, with the result that this action has been removed to the United States District Court for the Middle District of Florida, Orlando Division, Case No. 6:05-CV-422-2ZKRS. A similar copycat class action complaint captioned *Bensley Construction, Inc. v. Marsh & McLennan Companies, Inc. et al.*, No. ESCV2005-0277 (Essex Superior Court, Massachusetts) was served upon the Company in May 2005. This action has been removed to the United States District Court for the District of Massachusetts. Like the *Opticare* complaint, these complaints contain no particularized allegations of wrongdoing by the Company. In February 2005, the Judicial Panel on Multidistrict Litigation transferred the actions then pending to the United States District Court for the District of New Jersey for coordinated or consolidated pretrial proceedings. The Judicial Panel on Multidistrict Litigation has transferred the *Palm Tree* lawsuit to the same court for the same purposes. The Judicial Panel on Multidistrict Litigation has not yet ruled on whether the Bensley lawsuit will be similarly transferred.

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On August 1, 2005, in the multidistrict litigation pending in the United States District Court for the District of New Jersey, the plaintiffs filed a First Consolidated Amended Commercial Class Action Complaint and a First Consolidated Employee Benefits Class Action Complaint (the "Consolidated MDL Complaints") that purport to allege claims against the Company based upon RICO, federal and state antitrust laws, breach of fiduciary duty and aiding and abetting breaches of fiduciary and unjust enrichment. The Consolidated MDL Complaints, like the predecessor complaints, focus the allegations of fact upon defendants other than the Company. It is anticipated that the Company will move to dismiss the Consolidated MDL Complaints. None of the plaintiffs in any of the actions has set forth the amounts being sought in the particular actions.

The Company believes it has substantial defenses to the claims made in these class action proceedings, intends to defend itself vigorously and has not recorded a loss contingency for any of these lawsuits, as it believes the probability of exposure to a loss is remote at this time.

Near North Insurance Litigation ("Near North"). In October 2002, a group of affiliated plaintiffs, who are competitors of the Company in the insurance brokerage and risk management business, filed a complaint in the Chancery Court of the Circuit Court of Cook County, Illinois, against the Company and two of its Illinois-based and one of its California-based officers/employees who previously worked for one of the plaintiffs, various other third-party individuals and an insurance brokerage. Plaintiffs' complaint seeks from all defendants unspecified compensatory damages and punitive damages related to claims for, among other things, tortious interference with client relationships, violation of state trade secrets laws and civil conspiracy. The Company, its officers and employees asserted various defenses to this action, and the Company's insurance carriers are involved in the defense of the litigation. In March 2003, the Company's California-based officer was dismissed from the litigation. In November 2003, the Illinois court dismissed all of the claims asserted against the Company and its officers and employees for failing to meet Illinois pleading requirements and the court gave plaintiffs an additional opportunity to attempt to meet those requirements. In December 2003, plaintiffs filed a third amended complaint and in February 2004, the Company filed another motion to dismiss all claims asserted against the Company and its officers and employees based on several grounds, including the grounds previously accepted by the court. On October 1, 2004, the Illinois court again dismissed all of the claims asserted against the Company and its officers and employees. A hearing was held before the Illinois court on October 15, 2004 at which the judge ruled that the plaintiffs could not seek to re-plead certain claims against the Company. However, as to certain remaining claims, the judge granted leave to file a fourth amended pleading against the Company and its officers and employees.

Plaintiffs filed a fourth amended complaint, which the Company believes failed to state any amended claims against the Company, and the Company has filed a motion to dismiss that complaint. On September 5, 2005, the court dismissed all claims against the Company with prejudice. Near North will be able to appeal from this dismissal after a final appealable order is entered by the court. The Company continues to believe that the plaintiffs' allegations against the Company are without merit.

9. Integration Efforts, Margin Improvement Plan and Other Accruals

In the fourth quarter of 2004, the Company announced that its Board of Directors had approved a margin improvement plan in order to reduce ongoing operating expenses. As a result of this plan, the Company recorded expense of \$12,371 in the fourth quarter of 2004. The expenses related to employee severance and related benefits for 28 employees of \$3,384, facilities closures of \$3,444, the modification of 34 sales professionals' agreements of \$2,894 and service contract termination fees of \$2,650.

For the three and nine months ended September 30, 2005, the Company recorded an additional \$2,921 and \$6,951, respectively, in expenses primarily for employee severance and related benefits in connection with the margin improvement plan. There were no such expenses in the same periods in the prior year.

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For the three and nine months ended September 30, 2005, the Company recorded acquisition integration expenses of \$31 and \$8,463, respectively. Included in these amounts for the three and nine months ended September 30, 2005, were zero and \$8,122, respectively, related to the restructuring of certain SGP sales professionals' and executives' employment agreements. In exchange for cash and/or restricted stock consideration, existing employment agreements were amended to conform to the Company's standard compensation structure for sales professionals and regional executives. The \$8,122 in consideration to the SGP individuals was not included in purchase price for accounting purposes, but was deducted from the agreed upon purchase consideration. There were no such expenses in the same periods in the prior year.

For the three and nine months ended September 30, 2005 and 2004, the Company recorded charges of \$128 and \$489, respectively, and \$203 and \$1,617, respectively, for severance and moving costs related to its corporate office move from San Francisco to New York.

The following table summarizes transactions related to the employee termination benefits, producer compensation restructuring costs and terminated office lease costs:

	Terminated employee severance liability	Compensation restructuring liability	Terminated office lease costs liability	Other	Total
Liability at December 31, 2004	\$ 3,677	\$ 2,894	\$ 3,444	\$ —	\$ 10,015
Margin improvement plan (addition)	5,256	1,674	21	—	6,951
SGP acquisition compensation	—	8,122	—	—	8,122
Integration expense (addition).....	17	—	309	15	341
Paid in 2005 (deduction).....	(4,449)	(10,502)	(3,182)	(15)	(18,148)
Liability at September 30, 2005	<u>\$ 4,501</u>	<u>\$ 2,188</u>	<u>\$ 592</u>	<u>\$ —</u>	<u>\$ 7,281</u>

The employee termination benefits and the future producer compensation restructuring charges reflected above are included in compensation and employee benefits in the accompanying unaudited condensed consolidated statements of operations. The terminated office lease charges are included in other operating expenses in the accompanying unaudited condensed consolidated statements of operations.

Of the \$15,414 in expense recorded in the first nine months of 2005, \$5,277 related to exit activity, as defined in SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The following table summarizes transactions related to this exit activity:

	Terminated employee severance liability	Terminated office lease costs liability	Total
Liability at December 31, 2004	\$ 2,344	\$ 3,444	\$ 5,788
Expense related to exit activity (addition).....	5,256	21	5,277
Amount paid related to exit activity (deduction).....	(4,163)	(2,873)	(7,036)
Liability at September 30, 2005	<u>\$ 3,437</u>	<u>\$ 592</u>	<u>\$ 4,029</u>

Expense related to this exit activity by reportable segment is as follows:

	Insurance Brokerage	Specialized Benefits Services	Corporate	Total
Expense related to exit activity	\$ 3,643	\$ 82	\$ 1,552	\$ 5,277

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(Amounts in Thousands, Except Per Share Data)

10. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended September 30,	
	2005	2004
Numerator:		
Income from continuing operations	\$ 5,490	\$ 5,194
Loss from discontinued operations, net.....	(3,603)	(290)
Numerator for basic earnings per share-income available to common stockholders	\$ 1,887	\$ 4,904
Denominator:		
Weighted-average shares outstanding used in calculation of basic earnings per share	56,681	48,841
Dilutive effect of potential common share issuances using the treasury stock method.....	728	894
Weighted-average shares outstanding used in calculation of diluted earnings per share	57,409	49,735
Earnings per share - basic:		
Income from continuing operations	\$ 0.10	\$ 0.11
Loss from discontinued operations, net.....	(0.07)	(0.01)
Net income.....	\$ 0.03	\$ 0.10
Earnings per share - diluted:		
Income from continuing operations	\$ 0.09	\$ 0.10
Loss from discontinued operations, net.....	(0.06)	—
Net income.....	\$ 0.03	\$ 0.10
	Nine Months Ended September 30,	
	2005	2004
Numerator:		
Income from continuing operations	\$ 12,768	\$ 16,242
Loss from discontinued operations, net.....	(8,295)	(451)
Numerator for basic earnings per share-income available to common stockholders	\$ 4,473	\$ 15,791
Denominator:		
Weighted-average shares outstanding used in calculation of basic earnings per share	55,712	47,987
Dilutive effect of potential common share issuances using the treasury stock method.....	591	1,008
Weighted-average shares outstanding used in calculation of diluted earnings per share.....	56,303	48,995
Earnings per share - basic:		
Income from continuing operations	\$ 0.23	\$ 0.34
Loss from discontinued operations, net.....	(0.15)	(0.01)
Net income.....	\$ 0.08	\$ 0.33
Earnings per share - diluted:		
Income from continuing operations	\$ 0.23	\$ 0.33
Loss from discontinued operations, net.....	(0.15)	(0.01)
Net income.....	\$ 0.08	\$ 0.32

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Basic earnings per share ("EPS") is calculated using income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted EPS is similar to basic EPS except that the weighted-average number of common shares outstanding is increased under the treasury stock method to include the number of additional common shares that would have been outstanding if dilutive potential common shares, such as options and warrants had been exercised.

11. *Subsequent Events*

On October 1, 2005, the company acquired substantially all of the operating assets of the New York, New York based group benefits general agent Dascit/White & Winston, Inc. from National Financial Partners Corp. The aggregate preliminary purchase price consisted of a cash payment of \$8,350 and a promissory note of \$750. This acquisition will be included in the Insurance Brokerage segment.

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

The following discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements and accompanying notes included in Part I, Item 1. Certain information contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations" are forward-looking statements that involve risks and uncertainties. See "Forward-Looking Statements" included in this report. Our actual results may differ materially from the results discussed in the forward-looking statements because of various factors, including those discussed above and elsewhere herein.

Management Overview

Business

We are a distributor of insurance and financial products and services primarily to small and mid-sized business clients.

We generate revenues primarily from:

- commissions paid by insurance companies on the placement of property and casualty ("P&C") and employee benefits insurance; and
- fees paid directly by clients and other third-parties for employee benefit-related services (which we refer to as Health & Welfare when combined with employee benefits).

Commissions on P&C, health, group life and group disability insurance are typically calculated as a percentage, ranging from approximately 3% to 20%, of the annual premium. These commissions generally recur at the same rate as long as the insurance is in force. Commissions earned from the placement of individual and corporate-owned life and individual disability insurance are calculated as a percentage of corresponding premiums over the duration or term of the underlying policies. Traditionally, most of the commission revenue on these life and individual products, as well as on other traditional voluntary benefit products, is recognized in the first year the insurance is placed, with the commissions paid in renewal years being relatively insignificant.

We also receive contingent commissions, which are incremental compensation for achieving specified loss experience and/or account retention and premium volume goals set by the insurance companies for the business we place with them. Contingent commissions are recorded on the earlier of receipt of cash or when we receive data from the insurance companies that allows us to reasonably determine the amount. Please refer to further discussion below under "Insurance Industry Investigations and Other Developments." Fee-based revenues related to employee benefits services are generally billed and recorded as services are rendered and may vary with factors such as the client's headcount or assets under management.

We have two operating segments—Insurance Brokerage and Specialized Benefits Services—and a third administrative segment—Corporate. See discussion under "Results of Operations" below.

Insurance Industry Investigations and Other Developments

We are subject to various claims, lawsuits and proceedings that arise in the normal course of business. These matters principally consist of alleged errors and omissions in connection with the placement of insurance and rendering administrative or consulting services and are generally covered in whole or in part by insurance. Except as qualified by the discussion below, on the basis of present information, anticipated insurance coverage and advice received from counsel, it is our opinion that the disposition or ultimate determination of these claims, lawsuits or proceedings will not have a material adverse effect on our consolidated financial position or results of operations.

Since October 2004, the insurance industry has been under a significant level of scrutiny by various regulatory bodies, including state Attorneys General and the departments of insurance for various states, with respect to industry practices, including contingent compensation arrangements. Along with a number of other insurance brokers, we have received subpoenas from the Office of the Attorney General of the State of Connecticut, the Office of the Attorney General of the State of New York and the Florida Attorney General's Office requesting documents and seeking information as part of their industry-wide investigations relating to pricing and placement of insurance. We have also received an Investigative Demand from the Department of Justice of the State of North Carolina seeking similar information. While these investigations are continuing and the ultimate outcome cannot be predicted, the investigations center upon, among other items, allegations of bid rigging, tying arrangements and other fraudulent or unlawful business practices. We have cooperated fully with these requests and will continue to cooperate with regulators as they refine, prioritize and/or expand the areas of inquiry in their subpoenas and information requests.

In addition to the state Attorney General investigations described above, a number of state departments of insurance have begun inquiries into compensation practices of brokers, agents and insurers as they affect consumers in their respective states. We have received and responded, or are in the process of responding, to inquiries from insurance regulators in several states.

We cannot currently predict the impact or resolution of these matters or reasonably estimate a range of possible loss, which could be material, and the resolution of these matters may harm our business and/or lead to a decrease in or elimination of contingent commissions and override commissions, which could have a material adverse impact on our consolidated financial condition.

Following the allegations of bid rigging and price fixing in the lawsuit filed by the Office of the Attorney General of the State of New York in 2004 against Marsh and McLennan Companies, Inc., we retained outside counsel, Akin Gump Strauss Hauer & Feld, LLP (“Akin Gump”), to render legal advice in connection with an internal review of our operations. Since that time, Akin Gump has assisted us in responding to the subpoenas and inquiries described above. In connection with this internal review, Akin Gump has interviewed more than 90 of our employees, including corporate management, and is continuing its review of documents. We are continuing to review our business and expect that our review will not only address the areas that the regulators are examining, but will also help us evaluate where we can make additional operational or business practice changes or improvements.

Since October 2004, the industry’s long-standing contingent commission compensation arrangements have been a focal point of scrutiny by various regulators and, in fact, some of the largest brokers within the industry have abandoned the practice of receiving such contingent commissions. In 2005, we received substantially all of our contingent commissions under the arrangements in place for 2004. Additionally, our carriers with whom we have historically had contingent arrangements have tendered their 2005 contingent commission agreements in a form and structure generally consistent with our prior agreements. While we are not able to predict whether regulatory, market or other external forces will ultimately cause contingent commission arrangements to cease or be substantively restructured, Management does expect to receive contingent commissions in 2006 for arrangements established in 2005. Revenues from contingent and override commissions were \$1.7 million and \$1.2 million for the three months ended September 30, 2005 and 2004, respectively, and \$22.7 million and \$17.0 million for the nine months ended September 30, 2005 and 2004, respectively. Revenues from contingent and override commissions were \$19.0 million, \$17.7 million and \$14.7 million for 2004, 2003 and 2002, respectively. Contingent and override commissions’ contribution to income from continuing operations before income taxes for the three and nine-month periods ended September 30, 2005 and 2004 was approximately equivalent to the revenues from contingent and override commissions for each period.

Industry Class Action Litigation. We have been named as one of more than 30 insurance company and insurance brokerage defendants in an amended complaint filed in the United States District Court Southern District of New York in a putative class action lawsuit captioned *Opticare Health Systems, Inc. v. Marsh & McLennan Companies, Inc., et al.* (Civil Action No. CV 06954 (DC)). The amended complaint focuses on the payment of contingent commissions by insurers to insurance brokers who sell their insurance and alleged bid rigging in the setting of insurance premium levels. The amended complaint purports to allege violations of numerous laws including the Racketeer Influenced and Corrupt Organizations (“RICO”) and federal restraint of trade statutes, state restraint of trade, unfair and deceptive practices statutes and state breach of fiduciary duty and unjust enrichment laws. The amended complaint seeks class certification, treble damages for the alleged injury suffered by the putative plaintiff class and other damages. We are also a defendant in “copycat” or tag-along lawsuits in the United States District Court for the Northern District of Illinois: *Lewis v. Marsh & McLennan Companies, Inc., et al.*, 04 C 7847 and *Preuss v. Marsh & McLennan Companies, Inc., et al.*, 04 C 7853, and during April 2005, we were served in another copycat class action lawsuit, captioned *Palm Tree Computers Systems, Inc. et al. v. Ace, USA et al.*, and filed in the Circuit Court for the Eighteenth Judicial Circuit in and for Seminole County, Florida, Civil Division, Class Representation, No. 05-CA-373-16-W, with the result that this action has been removed to the United States District Court for the Middle District of Florida, Orlando Division, Case No. 6:05-CV-422-2ZKRS. A similar copycat class action complaint captioned *Bensley Construction, Inc. v. Marsh & McLennan Companies, Inc. et al.*, No. ESCV2005-0277 (Essex Superior Court, Massachusetts) was served upon the Company in May 2005. This action has been removed to the United States District Court for the District of Massachusetts. Like the *Opticare* complaint, these complaints contain no particularized allegations of wrongdoing on our part. In February 2005, the Judicial Panel on Multidistrict Litigation transferred the actions then pending to the United States District Court for the District of New Jersey for coordinated or consolidated pretrial proceedings. The Judicial Panel on Multidistrict Litigation has transferred the *Palm Tree* lawsuit to the same court for the same purposes. The Judicial Panel on Multidistrict Litigation has not yet ruled on whether the *Bensley* lawsuit will be similarly transferred.

On August 1, 2005, in the multidistrict litigation pending in the United States District Court for the District of New Jersey, the plaintiffs filed a First Consolidated Amended Commercial Class Action Complaint and a First Consolidated Employee Benefits Class Action Complaint (the “Consolidated MDL Complaints”) that purport to allege claims against us based upon RICO, federal and state antitrust laws, breach of fiduciary duty and aiding and abetting breaches of fiduciary and unjust enrichment. The Consolidated MDL Complaints, like the predecessor complaints, focus the allegations of fact upon defendants other than ourselves. It is anticipated that we will move to dismiss the Consolidated MDL Complaints. None of the plaintiffs in any of the actions has set forth the amounts being sought in the particular actions.

We believe we have substantial defenses to the claims made in these class action proceedings, intend to defend ourselves vigorously and have not recorded a loss contingency for any of these lawsuits, as we believe the probability of exposure to a loss is remote at this time.

Near North Insurance Litigation (“Near North”). In October 2002, a group of affiliated plaintiffs, who are our competitors in the insurance brokerage and risk management business, filed a complaint in the Chancery Court of the Circuit Court of Cook County, Illinois, against us and two of our Illinois-based and one of our California-based officers/employees who previously worked for one of the plaintiffs, various other third-party individuals and an insurance brokerage. Plaintiffs’ complaint seeks from all defendants unspecified compensatory damages and punitive damages related to claims for, among other things, tortious interference with client relationships, violation of state trade secrets laws and civil conspiracy. We, our officers and employees asserted various defenses to this action, and our insurance carriers are involved in the defense of the litigation. In March 2003, our California-based officer was dismissed from the litigation. In November 2003, the Illinois court dismissed all of the claims asserted against us and our officers and employees for failing to meet Illinois pleading requirements and the court gave plaintiffs an additional opportunity to attempt to meet those requirements. In December 2003, plaintiffs filed a third amended complaint and in February 2004, we filed another motion to dismiss all claims asserted against us and our officers and employees based on several grounds, including the grounds previously accepted by the court. On October 1, 2004, the Illinois court again dismissed all of the claims asserted against us and our officers and employees. A hearing was held before the Illinois court on October 15, 2004, at which the judge ruled that the plaintiffs could not seek to re-plead certain claims against us. However, as to certain remaining claims, the judge granted leave to file a fourth amended pleading against us and our officers and employees.

Plaintiffs filed a fourth amended complaint which we believe failed to state any amended claims against us, and we have filed a motion to dismiss that complaint. On September 5, 2005, the court dismissed all claims against us with prejudice. Near North will be able to appeal from this dismissal after a final appealable order is entered by the court. We continue to believe that the plaintiffs’ allegations against us are without merit.

Market

Property & Casualty

Insurance premium pricing within the commercial P&C insurance industry has historically been cyclical, based on the underwriting capacity of the insurance industry and economic conditions. We use the terms “soft market” and “hard market” to describe the business cycles experienced by the industry. A soft market is an insurance market characterized by a period of declining premium rates, which negatively affect commissions earned by insurance brokers. A hard market is an insurance market characterized by a period of rising premium rates which, absent other changes, positively affects commissions earned by insurance brokers. Additionally, the insurance industry was affected by the events of September 11, 2001, resulting in one of the largest insurance losses in America’s history, which accelerated increases in premium rates for particular lines of commercial P&C insurance. In response to rising premiums, some of our customers increased their deductibles and/or reduced their insurance coverage in order to reduce the impact of the premium increases. These trends prompted by the hard market negatively impacted our revenues. The hard market, for many lines of insurance, began to slow in the second half of 2002. By the second half of 2003, premiums in most P&C lines of insurance began to flatten or decrease, with some, such as property, by as much as 20%. In 2004 and to date in 2005, the soft market persisted, negatively affecting brokers’ revenue. Some clients use the savings on insurance premiums to purchase more coverage, somewhat offsetting the negative impact in our commissions due to falling premiums. Up to this point in 2005, the competitive pricing dynamic has been consistent throughout most account sizes and most geographic regions, with the workers compensation market in California a notable exception where we have seen premiums decline by as much as 50%. We are not able to predict whether the soft market will continue; however, if it does, our P&C insurance brokerage revenues may continue to be negatively impacted.

The recent storms in the Gulf Coast and Florida make it likely that premium rates for property in catastrophe-prone geographic areas will increase in the near term. However, through the third quarter we have not seen a positive impact to our revenues attributable to increasing premiums due to the storm losses. It is also possible that rates for Florida-based risks, one

of the few markets not significantly affected by the soft market, will continue to increase. It is not possible to predict the ultimate affect, if any, of the recent catastrophic storms on the broader P&C market; however, if the soft market slows, or we see rates increase in some or most lines of coverage, our P&C insurance brokerage revenues may be positively impacted.

Health & Welfare

Premium rates in the health insurance industry have generally realized a consistent upward trend due to increasing health care delivery costs. From 2000 to 2003, however, we believe that the upward trend in health care insurance premiums was somewhat offset by the impact of the economic downturn and its resulting negative impact on business and employment levels at our customers. Additionally, reduced spending by our corporate clients has led to benefit cut-backs and lower expenditures on consulting and other fee-based services. Our Health & Welfare business is most affected by employment levels and by the strength of the economy. Factors such as a tight labor market may increase employers' spending on benefits; high employment increases the numbers of lives covered within the benefit plans that we broker; and a strong stock market may increase both existing assets under management and new investments. In 2003, we saw the signs of an improving economy, although we did not see the benefits of sustained growing labor ranks or increased spending on benefits reflected in our Health & Welfare revenues as employers continued to mitigate medical cost increases. In 2004, the economy continued to improve with positive growth in employment, which, in the second half of 2004 and to date in 2005, drove growth in our Health & Welfare revenues. We believe that many employers, however, are still struggling with medical inflation, which may result in continued benefit reductions and cost-shifting to employees, which may serve to reduce insurance premiums or cause participants to opt out of their employer's plan. This unfavorable dynamic for the benefits brokerage business has led to greater opportunity, however, in our workplace marketing business, which is aided by the trend to defined contribution health-care where employees direct their benefit dollars to purchase voluntary benefits a la carte. We cannot predict whether the economy will improve or if employment and spending on employee benefits will increase.

Primary Financial Measures

The financial measures that we use to evaluate our performance are:

- Organic Revenue growth (decline), which excludes the current period's total revenues attributable to acquisitions and the prior period's total revenues from divested businesses during the twelve months following acquisition or divestiture;
- Operating Income, which is revenues, less compensation and employee benefits, stock-based compensation, other operating expenses and depreciation. Compensation and employee benefits and other operating expenses are adjusted to exclude expenses related to our margin improvement plan and acquisition integration efforts which Management does not consider indicative of our run-rate, or normal operating expenses;
- Operating Margin, which we define as Operating Income as a percentage of total revenues; and
- Cash earnings per share, which we define as income from continuing operations adjusted for expenses related to integration efforts, the margin improvement plan and other charges, plus amortization of intangible assets on a diluted per share basis.

You should not consider these financial measures as alternatives to other financial measures determined in accordance with accounting principles generally accepted in the United States of America, which we refer to as GAAP, or as alternatives to cash flows from operating activities, investing activities or financing activities, or as a measure of liquidity. In addition, please note that because not all companies calculate these financial measures similarly, the presentation of these measures in this report is not necessarily comparable to those of other companies.

We strongly urge investors or potential investors in our stock to review the calculation of Organic Revenue growth (decline) and the related reconciliation to GAAP financial measures in "Results of Operations" below.

Management's Strategic Objectives

Our business strategy is to achieve at least 15% growth in cash earnings per share each year. As a means to accomplish this goal, we focus on generating organic growth in revenues, creating efficiencies in our operations and making disciplined and accretive acquisitions.

Organic Revenue Growth

Our strategy for achieving organic growth includes:

- client stewardship and retention best practices;

- consistent and aggressive sales management, including recruitment of new sales professionals;
- cross-selling across all of our major product categories within our business segments;
- new client origination; and
- maintaining a balanced mix of P&C and Health & Welfare revenues to mitigate the impact of fluctuations in market cycles.

We monitor and manage to a number of different operating statistics including, but not limited to, sales opportunities by sales professional, cross-selling within our 400 largest accounts, client retention rates and revenue mix by operating company. All of these metrics are tracked and reported monthly and form the basis of our agenda, among other items, for our monthly operations meetings with each of our business unit executive management teams.

Margin Improvement

We are focused on increasing margins by restructuring the mix of incentive versus guaranteed compensation, consolidating office space and back-office processes, standardizing our sales professionals' compensation formula, implementing best practices in operations, leveraging our purchasing power and lowering the cost of our information technology through the consolidation of data centers. We benchmark all expense categories and work with operating company management to develop and implement remediation plans for business units performing below our standards. Additionally, we continue to capitalize on opportunities to leverage our corporate and other fixed costs across a greater revenue base by acquiring "fold-in" and other accretive businesses within our current geographic footprint.

In the fourth quarter of 2004, we announced that our Board of Directors had approved a margin improvement plan in order to reduce ongoing operating expenses. As a result of this action, we recorded expense of \$12.4 million for employee severance and related benefits for 28 employees of \$3.4 million, facilities closures of \$3.4 million, the modification of 34 sales professionals' agreements of \$2.9 million and service contract termination fees of \$2.7 million. In the first quarter of 2005, we recorded an additional expense of \$4.0 million for employee severance and related benefits of \$3.9 million and the modification of one sales professional's agreement of \$0.1 million and in the third quarter of 2005 we recorded an additional expense of \$2.9 million for the modification of 19 sales professionals' agreements of \$1.4 million, employee severance and related benefits of \$1.3 million and facilities closures of \$0.2 million.

Acquisition Strategy

In most acquisitions, the consideration we pay consists of a combination of cash, seller notes and/or common stock. We also frequently structure our acquisition agreements to include purchase price payments contingent upon reaching specified financial targets, commonly referred to as "earn-outs," which are paid in a combination of cash, seller notes and common stock and are treated as adjustments to purchase price when the contingency is resolved. Additionally, many of our acquisitions have provisions for reduced consideration based on the failure to meet certain financial targets. All acquisitions greater than \$5 million in aggregate purchase price require approval of our Board of Directors and, if greater than \$1.5 million in aggregate purchase price, also require that we give notice to our bank lenders. Please read Note 3 "Acquisitions" to our unaudited condensed consolidated financial statements included in Part I, Item 1 of this report for more information on acquisitions.

We centrally manage our target acquisitions from the point of initial contact through the process of integration within our operations. We only consider transactions that are accretive to our cash earnings per share. All acquisitions are subject to a due diligence process, including an introduction to our culture and business strategy, the seller's commitment to both our sales and client service model and to a post-acquisition integration plan. Currently, we are looking to expand within our current geographic footprint of operations to maximize efficiencies and continue to build-out the balanced revenue mix of P&C and Health & Welfare business; however, we will consider strategic opportunities in new geographies if they are compelling.

On February 1, 2005, we acquired Patterson/Smith Associates ("PSA"), an insurance brokerage operation. The aggregate preliminary purchase price of approximately \$20.9 million, consisting of cash of \$16.9 million, shares of our common stock valued at \$2.0 million and debt issued of \$2.0 million, was allocated primarily to goodwill and other intangible assets. This acquisition is included in the Insurance Brokerage segment.

On February 3, 2005, we acquired Summit Global Partners ("SGP"), an insurance brokerage operation. The aggregate preliminary purchase price of approximately \$119.9 million, consisting of cash of \$65.2 million, shares of our common stock valued at \$26.5 million and assumed liabilities of \$28.2 million, was allocated primarily to goodwill and other intangible

assets. In connection with the SGP acquisition, we recorded \$8.1 million in expense in the first quarter of 2005 related to the restructuring of certain SGP sales professionals' and executives' employment agreements. This consideration was not included in purchase price for accounting purposes, but was deducted from the agreed upon purchase consideration. This acquisition is included in the Insurance Brokerage segment.

On September 1, 2005, we acquired Richard B. Cross & Associates, Inc. ("CRO"), a retail employee benefits operation. The aggregate preliminary purchase price of approximately \$13.8 million, consisting of a cash down-payment of \$11.7 million and debt issued of \$2.1 million, was allocated primarily to goodwill and intangible assets. There is also a potential for contingent consideration based upon specific growth incentives and identified revenues through December 31, 2008. This acquisition is included in the Insurance Brokerage segment.

Six additional acquisitions were made during 2005, none of which had acquired assets greater than \$5.0 million. The total aggregate preliminary purchase price of approximately \$10.5 million, consisting of cash of \$10.3 million and shares of our common stock valued at \$0.2 million, was allocated primarily to goodwill and intangible assets. In substantially all of the acquisitions, there is a contingent consideration portion based upon specific growth incentives and identified revenues. Five of the acquisitions are included in our Insurance Brokerage segment and the sixth acquisition is included in our Specialized Benefits Services segment.

Quarterly Fluctuations

Our quarterly revenues and Operating Income may be volatile. This is attributable to the following:

- a significant percentage of commissions and fees in our Specialized Benefits Services segment is typically earned and recorded in the fourth quarter;
- the timing of certain core benefits and enrollment sales with significant first year commissions; and
- the impact of variations or timing in recording contingent commissions in our Insurance Brokerage segment, primarily in the first and second quarters.

Quarterly fluctuations in revenues and Operating Income make our performance less predictable due to our life insurance, retirement and specialized benefits revenues. The timing of certain aspects of our revenue stream, particularly in the Specialized Benefits Services segment, makes comparisons of any period of less than a full year difficult. We have implemented various strategies to reduce the impact of seasonal and uneven revenue streams, such as diversification of our business model for enrollment business to generate more revenue in the first three quarters of the year and divesting significantly volatile non-core business. We continue to focus on strategies that will provide a more predictable revenue stream; however, we cannot predict if we will be successful in these efforts or if market or other changes will result in a similar or greater level of unpredictability.

Critical Accounting Estimates and Policies

Our unaudited condensed consolidated financial statements are prepared in accordance with GAAP, which require Management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Some of our accounting policies require Management's judgment to estimate values of assets, liabilities, revenues or expenses. In addition, it may require significant judgment to apply complex principles of accounting to certain transactions, such as acquisitions, to determine the most appropriate accounting treatment. We believe the following significant accounting estimates and policies are material to our financial condition or results of operations and are subject to a higher than average degree of subjectivity and/or complexity. We continually evaluate our estimates, which are based on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. If actual performance should differ from historical experience or if our assumptions were to change, it may materially impact our financial condition and results of operations.

Please read Note 1 "Nature of Operations and Summary of Significant Accounting Policies" to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2004 for a description of other significant accounting policies.

Revenue Recognition

Our revenues are derived from commissions, fees and investment income.

We record premiums and commissions receivable from clients, net of sub-broker commissions, premiums payable to insurance companies and the related commission income, on the later of the effective date of the policy or the billing date, net

of an allowance for estimated policy cancellations. We record installment premiums and related commission income periodically as billed. Commissions earned from the placement of individual and corporate-owned life and individual disability insurance are calculated as a percentage of corresponding premiums over the duration or term of the underlying policies. Traditionally, the majority of the commission revenue on these life and individual products, as well as on other traditional voluntary benefit products, is recorded in the first year the insurance is placed, with the commission income recorded in renewal years being relatively insignificant.

We record commission income on premiums billed and collected directly by insurance companies (“direct bill”) on the policy effective date for personal and commercial P&C insurance placements and on the effective date of each installment for employee benefits insurance placements.

As reported in our Form 10-Q for the quarterly periods ended September 30, 2004 and June 30, 2005, as part of our review of internal controls in compliance with Sarbanes-Oxley Section 404, we determined the need to enhance field office and corporate controls over our receivables (and related producer compensation expense) recorded for revenue on policies billed directly by insurance companies, or direct bill receivables. Beginning in the third quarter of 2004, we implemented a new system called Captiva, which will, when it is fully populated with all direct bill policy details, directly calculate and record the receivable and revenue and the related compensation payable and expense for each commercial lines P&C direct bill policy at the time it is effective. As a result of this process, we have obtained additional information which Management has utilized to determine its estimate of the direct bill receivable and related compensation payable. For the three and nine-month periods ended September 30, 2005, the effect of the change in estimate was a decrease to our direct bill revenues of \$0.8 million and \$2.9 million, respectively, and a decrease in the related producer compensation expense of \$0.4 million and \$0.5 million, respectively.

We record contingent commissions when we receive data from the insurance companies that allow us to reasonably determine these amounts. We are able to reasonably determine these amounts when we receive payment, notification of the amount due from the insurance companies or the insurance policy detail from the insurance companies. We receive contingent commissions from insurance companies for achieving specified loss experience and/or account retention and premium volume goals set by the insurance companies for the business we place with them. Please refer to “Insurance Industry Investigations and Other Developments,” above.

We record fees for consulting and administrative services as billed over the period in which services are rendered.

We record fees and/or commissions related to benefit enrollment services when earned. We consider the earnings cycle complete when we have substantially completed our obligations under the service contract, we can reasonably estimate the revenue earned and when there is no significant collection risk. At the completion of an enrollment, we record an estimate of first year fee and/or commission income less an estimate for policy cancellations. The allowance for estimated policy cancellations on benefit enrollment services is established through a charge to revenue and receivables and was \$2.4 million and \$2.3 million at September 30, 2005 and December 31, 2004, respectively.

We maintain an allowance for bad debts and estimated policy cancellations on our Insurance Brokerage business based on our premiums, commissions and fees receivable and historical cancellation trends. The policy cancellations component represents a reserve against receivables for future reversals of commission revenue on insurance policies in force at year-end and is established through a charge to revenues, while the bad debt component is established through a charge to other operating expenses. The allowances are determined based on estimates and assumptions using historical data to project future experience, and, in the case of bad debts, a specific identification of questionable items. We periodically review the adequacy of the allowances and make adjustments as necessary. Future additions to the allowances may be necessary based on changes in the trend of write-offs or cancellations which could increase due to changes in economic conditions and/or our clients’ financial condition and which may have a negative impact on our financial position or results of operations. The allowance for estimated policy cancellations on insurance brokerage business is established through a charge to revenue and receivables and was \$1.4 million and \$0.9 million at September 30, 2005 and December 31, 2004, respectively. Future additions to the allowances may be necessary based on changes in the trend of write-offs or cancellations which could increase due to changes in economic conditions and/or our clients’ financial condition.

Goodwill and Other Intangible Assets Impairment

We assess the recoverability of our goodwill and other long-lived assets at least once a year or as required based on triggering events. A triggering event is a change in business circumstances that indicates that the carrying value of the assets may not be recoverable. The carrying value of goodwill is evaluated at the segment level using an analysis to determine the fair value of the segment using both market valuation data, such as recent transaction multiples of revenue or operating income, and present value techniques. Reviews for triggering events are performed at the operating company level, one level below the segments, and require the use of Management’s judgment. Other long-lived assets are evaluated at the operating

company level, one level below our segments, which is our determination of the lowest level of meaningful cash flows. Reviews for triggering events require the use of Management's judgment. Upon identification of a triggering event, we perform further analysis using discounted cash flows or other market valuation data to determine if the carrying value of an asset is impaired. Both methods require substantial judgment. If, as a result of an impairment review, we find that the carrying value of an asset is in excess of the fair value, we would be required to take a charge against current earnings.

Future events could cause us to conclude that impairment of our goodwill or other intangible assets exists, which may have a material adverse effect on our financial position or results of operations.

Business Acquisitions and Purchase Price Allocations

All of our acquisitions have been accounted for using the purchase method, and the net assets and results of operations of the acquired companies were included in our financial statements on their respective acquisition dates. Frequently, our acquisitions have provisions for a reduction in consideration if the acquired company does not meet targeted financial results. Additionally, our acquisitions frequently have provisions for contingent additional consideration if the acquired company achieves financial targets. Additional or reduced consideration related to acquisition contingency provisions is reflected as an adjustment to goodwill when the contingency is resolved.

We estimate the fair value of the expiration rights and other intangible assets at the date of acquisition using a consistent methodology based on an estimate of discounted future cash flows derived from acquired clients lists and attrition rates. For acquisitions in excess of \$5.0 million in purchase price, we obtain an independent appraisal of the fair value of intangible assets acquired. Expiration rights are amortized on a straight-line basis over their estimated lives of five to ten years (with ten years used in most cases), based on historical attrition that has generally been consistent year over year. Non-compete agreements and restrictive covenants are typically valued at their stated contractual amount and are amortized on a straight-line basis over the terms of the agreements, which range from four to seven years. Both the allocation of purchase price and estimation of useful lives require Management's judgment. If historical fact patterns were to change, such as the rate of attrition of acquired client accounts, assuming no adjustment to purchase price, we may be required to allocate more purchase price to goodwill in new acquisitions or accelerate the amortization of existing expiration rights, which may have a material adverse effect on our financial position or results of operations.

Income Taxes

Determining the consolidated provision for income tax expense, deferred tax assets and liabilities and any related valuation allowance involves judgment. GAAP requires deferred tax assets and deferred tax liabilities ("DTAs" and "DTLs," respectively) to be recognized for the estimated future tax effects attributed to temporary differences and carry-forwards based on provisions of the enacted tax law. The effects of future changes in tax laws or rates are not anticipated. Temporary differences are differences between the tax basis of an asset or liability and its reported amount in the financial statements. For example, we have a DTA because the tax bases of our accrued liabilities are smaller than their book bases. Similarly, we have a DTL because the book basis of our goodwill exceeds its tax basis. Carry-forwards primarily include items such as net operating losses, which can be carried forward subject to certain limitations. A summary of the significant DTAs and DTLs relating to our temporary differences and carry-forwards is included in Note 10, "Income Taxes" to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2004.

We are required to reduce DTAs (but not DTLs) by a valuation allowance to the extent that, based on the weight of available evidence, it is "more likely than not" (i.e., a likelihood of more than 50%) that any DTAs will not be realized. Recognition of a valuation allowance would decrease reported earnings on a dollar-for-dollar basis in the year in which any such recognition was to occur. The determination of whether a valuation allowance is appropriate requires the exercise of Management's judgment. In making this judgment, Management is required to weigh the positive and negative evidence as to the likelihood that the DTAs will be realized.

Since the fourth quarter of 2003, Management has determined that our DTAs will be realized and, thus, no valuation allowance has been necessary. In the event of adverse developments in our projections of taxable income or if our estimates and assumptions were to change, Management might be required to reach a different conclusion about the realization of our DTA and re-establish a valuation allowance through a charge to earnings.

Litigation Matters

We are subject to various claims, lawsuits and proceedings that arise in the normal course of business. Except as discussed in Insurance Industry Investigations and Other Developments, we do not believe we are a party to any claims, lawsuits or legal proceedings that will have a material adverse effect on our reported financial position and results of operations. We have accrued a liability in accordance with GAAP for our best estimate of the probable cost of the resolution of those claims where our liability is probable and can be reasonably estimated. This estimate has been developed in consultation with internal and external counsel that is handling our defense in these matters and is based upon a combination of litigation and settlement strategies. The establishment of reserves for claims and litigation requires Management's judgment. To the extent additional information arises or our strategies change, it is possible that our estimate of our accrued liability in these matters may change, which could have a material adverse effect on our financial position and results of operations for any particular quarterly or annual period.

Debt Covenants

Our credit facility requires us to maintain financial covenants, which we set with our lenders, based on our estimates of future operating results at that time. Over time, these financial covenants become more restrictive. Future operating results and continued compliance with our debt covenants cannot be assured and our lenders' actions are not controllable by us. If our projections of future operating results are not achieved, resulting in a violation of our financial covenants for which our lenders do not provide a waiver or amendment, we could experience a material adverse effect on our reported financial position and results of operations for any particular quarterly or annual period.

Results of Operations

	For the Three months ended September 30,		For the Nine months ended September 30,	
	2005	2004	2005	2004
	(Dollars in thousands)			
Total revenues	\$ 127,267	\$ 103,017	\$ 371,834	\$ 291,970
Expenses:.....				
Compensation and employee benefits expense	72,211	59,100	211,340	168,374
Other operating expenses	27,768	24,269	81,510	65,704
Non-cash stock-based compensation.....	839	139	1,708	278
Amortization of intangible assets	7,230	6,434	21,238	17,503
Interest	4,012	2,296	10,781	6,109
Depreciation	2,467	2,208	7,168	6,397
Margin improvement plan expenses.....	2,921	—	6,951	—
SGP acquisition compensation	—	—	8,122	—
Acquisition integration expenses.....	31	—	341	—
Total expenses	117,479	94,446	349,159	264,365
Income from continuing operations, before income tax	9,788	8,571	22,675	27,605
Income tax expense	4,298	3,377	9,907	11,363
Income from continuing operations.....	\$ 5,490	\$ 5,194	\$ 12,768	\$ 16,242

Analysis of organic revenue growth (decline) to total revenue growth in accordance with GAAP.

For the Three months ended September 30,						
	Revenues		Change		Adjustment for net acquired businesses	Organic revenue growth/(decline)
	2005	2004	Amount	Total revenue growth		
(Dollars in thousands)						
Consolidated						
Net commissions and fees – property & casualty	\$ 69,808	\$ 58,984	\$ 10,824	18.4%	\$ (14,455)	(6.2)%
Net commissions and fees – benefits	53,147	41,783	11,364	27.2%	(7,981)	8.1%
Total net commissions and fees	122,955	100,767	22,188	22.0%	(22,436)	(0.2)%
Contingents and overrides	1,738	1,210	528	43.6%	(16)	42.3%
Other income	2,574	1,040	1,534	147.5%	(586)	91.2%
Total Revenues	\$ 127,267	\$ 103,017	\$ 24,250	23.5%	\$ (23,038)	1.2%
Insurance Brokerage						
Net commissions and fees – property & casualty	\$ 69,808	\$ 58,984	\$ 10,824	18.4%	\$ (14,455)	(6.2)%
Net commissions and fees – benefits	42,311	34,722	7,589	21.9%	(5,884)	4.9%
Total net commissions and fees	112,119	93,706	18,413	19.6%	(20,339)	(2.1)%
Contingents and overrides	1,738	1,210	528	43.6%	(16)	42.3%
Other income	2,159	977	1,182	121.0%	(586)	61.0%
Total revenues	\$ 116,016	\$ 95,893	\$ 20,123	21.0%	\$ (20,941)	(0.9)%
Specialized Benefits Services						
Net commissions and fees – benefits	\$ 10,836	\$ 7,061	\$ 3,775	53.5%	\$ (2,097)	23.8%
Contingents and overrides	—	—	—	—	—	—
Other income	8	1	7	700.0%	—	700.0%
Total revenues	\$ 10,844	\$ 7,062	\$ 3,782	53.6%	\$ (2,097)	23.9%
Corporate						
Net commissions and fees	\$ —	\$ —	\$ —	—	\$ —	—
Contingents and overrides	—	—	—	—	—	—
Other income	407	62	345	556.5%	—	556.5%
Total revenues	\$ 407	\$ 62	\$ 345	556.5%	\$ —	556.5%
For the Nine months ended September 30,						
	Revenues		Change		Adjustment for net acquired businesses	Organic revenue growth/(decline)
	2005	2004	Amount	Total revenue growth		
(Dollars in thousands)						
Consolidated						
Net commissions and fees – property & casualty	\$ 197,432	\$ 159,481	\$ 37,951	23.8%	\$ (46,936)	(5.6)%
Net commissions and fees – benefits	145,845	112,255	33,590	29.9%	(23,959)	8.6%
Total net commissions and fees	343,277	271,736	71,541	26.3%	(70,895)	0.2%
Contingents and overrides	22,666	16,973	5,693	33.5%	(5,206)	2.9%
Other income	5,891	3,261	2,630	80.7%	(769)	57.1%
Total revenues	\$ 371,834	\$ 291,970	\$ 79,864	27.4%	\$ (76,870)	1.0%
Insurance Brokerage						
Net commissions and fees – property & casualty	\$ 197,432	\$ 159,481	\$ 37,951	23.8%	\$ (46,936)	(5.6)%
Net commissions and fees – benefits	121,701	101,172	20,529	20.3%	(15,004)	5.5%
Total net commissions and fees	319,133	260,653	58,480	22.4%	(61,940)	(1.3)%
Contingents and overrides	22,647	16,973	5,674	33.4%	(5,206)	2.8%
Other income	4,875	3,015	1,860	61.7%	(769)	36.2%
Total revenues	\$ 346,655	\$ 280,641	\$ 66,014	23.5%	\$ (67,915)	(0.7)%
Specialized Benefits Services						
Net commissions and fees – benefits	\$ 24,144	\$ 11,083	\$ 13,061	117.8%	\$ (8,955)	37.0%
Contingents and overrides	19	—	19	—	—	—
Other income	15	5	10	200.0%	—	200.0%
Total revenues	\$ 24,178	\$ 11,088	\$ 13,090	118.1%	\$ (8,955)	37.3%
Corporate						
Net commissions and fees	\$ —	\$ —	\$ —	—	\$ —	—
Contingents and overrides	—	—	—	—	—	—
Other income	1,001	241	760	315.4%	—	315.4%
Total revenues	\$ 1,001	\$ 241	\$ 760	315.4%	\$ —	315.4%

We define organic revenue growth (decline) as the period-to-period change in revenues, excluding the current period's total revenues attributable to acquisitions and the prior period's total revenues from divested businesses, during the twelve months following acquisition or divestiture. We present organic revenue growth (decline) and believe it is relevant because it allows us to discern year-over-year growth in revenues related to the success or failure of our ability to execute on our sales and client retention strategies. This financial measure should not be considered as an alternative to other financial measures determined in accordance with GAAP.

We believe that many analysts and investors regularly rely on non-GAAP financial measures to provide a financial measure by which to compare a company's assessment of its operating profitability against that of its peers. We believe that investors use organic revenue growth (decline) to provide a financial measure by which to compare a company's internally generated (as opposed to acquired) revenue to that of its peers. Organic revenue growth (decline) may be helpful by eliminating the impact of acquired revenue from total revenues. This financial measure should not be considered as an alternative to other financial measures determined in accordance with GAAP.

Three Months Ended September 30, 2005 compared with Three Months Ended September 30, 2004

Revenues. Revenues increased \$24.3 million, or 23.5%, to \$127.3 million for the three months ended September 30, 2005, from \$103.0 million for the three months ended September 30, 2004. Organic revenue growth was 1.2%. Of the \$24.3 million in revenue growth, \$23.0 million was due to acquisitions, net of disposed businesses. The remaining \$1.3 million in revenue growth was primarily comprised of organic growth in our benefits business of \$3.4 million and organic growth of contingents and other income of \$1.5 million, partially offset by an organic decline in our P&C business of \$3.6 million.

Compensation and employee benefits expense. Compensation and employee benefits expense increased \$13.1 million, or 22.2%, to \$72.2 million for the three months ended September 30, 2005, from \$59.1 million for the three months ended September 30, 2004. As a percentage of revenues, compensation and employee benefits expense was 56.7% for the three months ended September 30, 2005, compared to 57.4% for the three months ended September 30, 2004. The decrease, as a percentage of revenues, was due to the positive impact of our margin improvement plan and accretive acquisitions, partially offset by higher incentive compensation expense in 2005 and the previously discussed \$0.8 million downward adjustment to revenues related to the change in accounting estimate in the third quarter of 2005.

Other operating expenses. Other operating expenses increased \$3.5 million, or 14.4%, to \$27.8 million in the three months ended September 30, 2005, from \$24.3 million for three months ended September 30, 2004. As a percentage of revenues, other operating expenses were 21.8% for the three months ended September 30, 2005, compared to 23.6% for the three months ended September 30, 2004. The improvement was primarily due to the positive impact of our margin improvement efforts and accretive acquisitions.

Total expenses. Total expenses increased \$23.0 million, or 24.4%, to \$117.5 million for the three months ended September 30, 2005, from \$94.4 million for the three months ended September 30, 2004. The increase in expense was due to the items noted above and, primarily, to an increase in margin improvement plan expense of \$2.9 million, an increase in interest expense of \$1.7 million due to greater borrowings at higher interest rates and an increase in amortization expense of \$0.8 million due to the impact of recent acquisitions.

Income from continuing operations. Income from continuing operations increased \$0.3 million to \$5.5 million for the three months ended September 30, 2005, from \$5.2 million for the three months ended September 30, 2004. Comparison of 2005 to 2004 is negatively affected by the impact of the \$2.9 million (\$1.8 million after tax) in expense related to the margin improvement plan and the adjustment related to the change in accounting estimate of \$0.4 million (\$0.2 million after tax). Additionally, other improvements in operating efficiency due to acquisitions and our expense mitigation efforts were offset by a higher effective tax rate in 2005. The effective tax rate from continuing operations for the three months ended September 30, 2005, was 43.9% compared to 39.4% for the three months ended September 30, 2004. The tax rate in 2004 was lower than in 2005 because in 2004 we recorded a benefit based on the results of a study of prior years' deductions related to meals and entertainment expense, which resulted in an additional deduction. Income tax expense for the three months ended September 30, 2005 increased \$0.9 million to \$4.3 million from \$3.4 million for the three months ended September 30, 2004.

Nine Months Ended September 30, 2005 compared with Nine Months Ended September 30, 2004

Revenues. Revenues increased \$79.9 million, or 27.4%, to \$371.8 million for the nine months ended September 30, 2005, from \$292.0 million for the nine months ended September 30, 2004. Organic revenue growth was 1.0%. Of the \$79.9 million in revenue growth, \$76.9 million was due to acquisitions, net of disposed businesses. The remaining \$3.0 million in revenue growth was primarily comprised of organic growth in our benefits business of \$9.6 million and organic growth in other income of \$1.9 million, partially offset by an organic decline in our P&C business and contingents of \$8.5 million.

Compensation and employee benefits expense. Compensation and employee benefits expense increased \$43.0 million, or 25.5%, to \$211.3 million for the nine months ended September 30, 2005, from \$168.4 million for the nine months ended September 30, 2004. The increase was due primarily to the impact of acquisitions. As a percentage of revenues, compensation and employee benefits expense was 56.8% for the nine months ended September 30, 2005, compared to 57.7% for the nine months ended September 30, 2004. The decrease, as a percentage of revenues, was due to the positive impact of our margin improvement plan and accretive acquisitions, partially offset by the higher incentive compensation expense in 2005 and the \$2.9 million downward adjustment to revenues related to the change in accounting estimate for the nine months ended September 30, 2005.

Other operating expenses. Other operating expenses increased \$15.8 million, or 24.1%, to \$81.5 million in the nine months ended September 30, 2005, from \$65.7 million for nine months ended September 30, 2004. As a percentage of revenues, other operating expenses were 21.9% for the nine months ended September 30, 2005, compared to 22.5% for the nine months ended September 30, 2004. The improvement was due to the positive impact of our margin improvement efforts and accretive acquisitions, partially offset by the adjustment to revenues related to the change in accounting estimate.

Total expenses. Total expenses increased \$84.8 million, or 32.1%, to \$349.2 million for the nine months ended September 30, 2005, from \$264.4 million for the nine months ended September 2004. The increase in expense was due to the items noted above, \$8.1 million in SGP acquisition compensation, \$7.0 million in margin improvement plan expenses, an increase in interest expense of \$4.7 million due to greater borrowings at higher interest rates and an increase in amortization expense of \$3.7 million due to the impact of recent acquisitions.

Income from continuing operations. Income from continuing operations decreased \$3.5 million to \$12.8 million for the nine months ended September 30, 2005, from \$16.2 million for the nine months ended September 30, 2004. Comparison of 2005 to 2004 is negatively affected by the \$15.4 million (\$9.1 million after tax) in expense related to the SGP acquisition compensation, acquisition integration and our margin improvement plan and the adjustment related to the change in accounting estimate of \$2.5 million (\$1.5 million after tax). Additionally, other improvements in operating efficiency due to acquisitions and our expense mitigation efforts were somewhat offset by the increase in expenses related to the insurance industry investigations and a higher effective tax rate from continuing operations for the nine months ended September 30, 2005, which was 43.7% compared to 41.2% for the nine months ended September 30, 2004. The tax rate in 2004 was lower than in 2005 due to the benefit related to the previously discussed meals and entertainment study. Income tax expense for the nine months ended September 30, 2005 decreased \$1.5 million to \$9.9 million from \$11.4 million for the nine months ended September 30, 2004. The decrease was primarily due to the lower income from continuing operations before income taxes.

Our Segments

We have three reporting segments: Insurance Brokerage, Specialized Benefits Services and Corporate.

The Insurance Brokerage segment offers:

- general and specialty property and casualty insurance, which we refer to as P&C insurance;
- individual and group health, life and disability insurance, which we refer to as Employee Benefits insurance; and
- core benefits (retirement services).

The Specialized Benefits Services segment offers:

- sales of workplace benefits insurance products and services; and
- enrollment and communication services related to employee benefits.

The Corporate segment offers:

- corporate management, acquisition processes, sales management, human resources, legal, capital planning, financial and reporting support.

Insurance Brokerage

	Three months ended September 30,	
	2005	2004
	(Dollars in thousands)	
Total revenues.....	\$ 116,016	\$ 95,893
Expenses:.....		
Compensation and employee benefits	65,549	54,146
Non-cash stock-based compensation	713	68
Other operating expenses.....	19,486	18,351
Amortization of intangible assets	6,548	5,814
Depreciation.....	1,951	1,713
Interest	255	295
Margin improvement plan expenses	2,921	—
Acquisition integration expenses	31	—
Total expenses	97,454	80,387
Income from continuing operations before income taxes	\$ 18,562	\$ 15,506

	Nine months ended September 30,	
	2005	2004
	(Dollars in thousands)	
Total revenues.....	\$ 346,655	\$ 280,641
Expenses:.....		
Compensation and employee benefits	192,221	154,958
Non-cash stock-based compensation	1,402	136
Other operating expenses.....	59,339	50,048
Amortization of intangible assets	19,194	16,417
Depreciation.....	5,692	4,851
Interest	810	867
Margin improvement plan expenses	5,317	—
SGP acquisition compensation	8,122	—
Acquisition integration expenses	341	—
Total expenses	292,438	227,277
Income from continuing operations before income taxes	\$ 54,217	\$ 53,364

Three Months Ended September 30, 2005 compared with Three Months Ended September 30, 2004

Revenues in the Insurance Brokerage segment increased \$20.1 million, or 21.0%, to \$116.0 million for the three months ended September 30, 2005, from \$95.9 million for the three months ended September 30, 2004. Of the \$20.1 million increase in revenues, \$20.9 million was the net impact of businesses acquired and divested in the prior twelve months. Organic revenue declined \$0.8 million or 0.9% for the quarter. Included in the organic revenue decline of \$0.8 million is an increase in benefits revenue, contingent revenue and other income of \$2.8 million, offset by a decline in P&C revenue of \$3.6 million. The negative effect of rate and market conditions in our P&C business and the downward adjustment in revenues of \$0.8 million related to the change in accounting estimate contributed to the decline for the quarter. P&C net commissions and fees represented 56.8% and 58.5% of our consolidated net commissions and fees in the three months ended September 30, 2005 and 2004, respectively, and group employee benefits net commissions and fees represented 43.2% and 41.5% of our consolidated net commissions and fees in the three months ended September 30, 2005 and 2004, respectively.

Total expenses in the Insurance Brokerage segment increased \$17.1 million or 21.2% to \$97.5 million for the three months ended September 30, 2005 from \$80.4 million for the three months ended September 30, 2004. As a percentage of revenues, total expenses were 84.0% for the three months ended September 30, 2005, compared to 83.8% for the three months ended September 30, 2004. The increase in total expenses for the three months ended September 30, 2005, as a percentage of revenues, was primarily due to \$3.0 million in expenses related to our margin improvement plan and acquisition integration efforts, a \$0.7 million increase in amortization expense due to acquisitions and the \$0.8 million downward adjustment to revenues related to the change in accounting estimate, somewhat offset by the positive impact of our margin improvement plan.

Income from continuing operations before income taxes in the Insurance Brokerage segment was \$18.6 million and \$15.5 million for the three months ended September 30, 2005 and 2004, respectively. The increase for the three months ended September 30, 2005 is primarily due to the positive affects of acquisitions and our margin improvement plan, as well as the items noted above.

Nine Months Ended September 30, 2005 compared with Nine Months Ended September 30, 2004

Revenues in the Insurance Brokerage segment increased \$66.0 million, or 23.5%, to \$346.7 million for the nine months ended September 30, 2005, from \$280.6 million for the nine months ended September 30, 2004. Of the \$66.0 million increase in revenues, \$67.9 million was the net impact of businesses acquired and divested in the prior twelve months. Organic revenue declined \$1.9 million or 0.7% for the nine months ended September 30, 2005. Included in the organic revenue decline of \$1.9 million is an increase in benefits revenue of \$5.5 million, offset by a decline in P&C revenues of \$9.0 million. Contributing to the organic revenue decline for the nine months was the previously discussed \$2.9 million adjustment to direct bill revenues related to the change in accounting estimate. The negative effect of rate and market conditions in our P&C business offset the growth in benefits for the nine months ended September 30, 2005. P&C net commissions and fees represented 57.5% and 58.7% of our consolidated net commissions and fees in the nine months ended September 30, 2005 and 2004, respectively, and employee benefits net commissions and fees represented 42.5% and 41.3% of our consolidated net commissions and fees in the nine months ended September 30, 2005 and 2004, respectively.

Total expenses in the Insurance Brokerage segment increased \$65.2 million or 28.7% to \$292.4 million for the nine months ended September 30, 2005 from \$227.3 million for the nine months ended September 30, 2004. The increase was primarily due to acquisitions, the \$8.1 million in SGP acquisition compensation expense and the margin improvement and acquisition integration expenses of \$5.7 million. As a percentage of revenues, total expenses were 84.4% for the nine months ended September 30, 2005, compared to 81.0% for the nine months ended September 30, 2004. The increase in total expenses, as a percentage of revenues, was primarily due to the revenue and expense items noted above.

Income from continuing operations before income taxes in the Insurance Brokerage segment was \$54.2 million and \$53.4 million for the nine months ended September 30, 2005 and 2004, respectively. The increase for the nine months ended September 30, 2005 was due to the positive affects of acquisitions and our margin improvement plan, as well as the items noted above.

Specialized Benefits Services

	Three months ended September 30,	
	2005	2004
	(Dollars in thousands)	
Total revenues.....	\$ 10,844	\$ 7,062
Expenses:		
Compensation and employee benefits	3,658	2,978
Non-cash stock-based compensation	13	6
Other operating expenses.....	4,242	2,296
Amortization of intangible assets.....	682	620
Depreciation.....	150	123
Interest	86	143
Total expenses	8,831	6,166
Income from continuing operations before income taxes	\$ 2,013	\$ 896

	Nine months ended September 30,	
	2005	2004
	(Dollars in thousands)	
Total revenues.....	\$ 24,178	\$ 11,088
Expenses:		
Compensation and employee benefits	9,973	6,396
Non-cash stock-based compensation	30	12
Other operating expenses.....	9,349	4,529
Amortization of intangible assets.....	2,044	1,086
Depreciation.....	397	302
Interest	275	259
Margin improvement plan expense.....	82	—
Total expenses	22,150	12,584
Income (loss) from continuing operations before income taxes	\$ 2,028	\$ (1,496)

Three Months Ended September 30, 2005 compared with Three Months Ended September 30, 2004

Revenues in the Specialized Benefits Services segment increased \$3.8 million, or 53.6%, to \$10.8 million for the three months ended September 30, 2005, from \$7.1 million for the three months ended September 30, 2004, due to the positive impact of acquisitions of \$2.1 million and to organic revenue growth of \$1.7 million. Specialized Benefits Services net commissions and fees represented 8.8% and 7.0% of our consolidated net commissions and fees for the three months ended September 30, 2005 and 2004, respectively.

Total expenses in the Specialized Benefits Services segment increased \$2.7 million, or 43.2%, to \$8.8 million for the three months ended September 30, 2005 from \$6.2 million for the three months ended September 30, 2004. The increase is primarily due to acquisitions. As a percentage of revenues, total expenses were 81.4% for the three months ended September 30, 2005, compared to 87.3% for the three months ended September 30, 2004. The decrease in total expenses, as a percentage of revenues, was primarily due to the contribution of revenues from acquisitions with less volatile quarterly revenues.

Income from continuing operations before income taxes in the Specialized Benefits Services segment was \$2.0 million and \$0.9 million for the three months ended September 30, 2005 and 2004, respectively. The improvement for the three months ended September 30, 2005 was due to the items discussed above.

Nine Months Ended September 30, 2005 compared with Nine Months Ended September 30, 2004

Revenues in the Specialized Benefits Services segment increased \$13.1 million, or 118.1%, to \$24.2 million for the nine months ended September 30, 2005, from \$11.1 million for the nine months ended September 30, 2004, due to the positive impact of acquisitions of \$9.0 million and to organic revenue growth of \$4.1 million. Specialized Benefits Services net commissions and fees represented 7.0% and 4.1% of our consolidated net commissions and fees for the nine months ended September 30, 2005 and 2004, respectively.

Total expenses in the Specialized Benefits Services segment increased \$9.6 million, or 76.0%, to \$22.2 million for the nine months ended September 30, 2005 from \$12.6 million for the nine months ended September 30, 2004. The increase is primarily due to acquisitions. As a percentage of revenues, total expenses were 91.6% for the nine months ended September 30, 2005, compared to 113.5% for the nine months ended September 30, 2004. The decrease in total expenses, as a percentage of revenues, was primarily due to the contribution of revenues from acquisitions with less volatile quarterly revenues.

Income (loss) from continuing operations before income taxes in the Specialized Benefits Services segment was \$2.0 million and (\$1.5) million for the nine months ended September 30, 2005 and 2004, respectively. The improvement for the nine months ended September 30, 2005 was due to the items discussed above.

Corporate

	Three months ended September 30,	
	2005	2004
	(Dollars in thousands)	
Total revenues.....	\$ 407	\$ 62
Expenses:		
Compensation and employee benefits.....	3,004	1,976
Non-cash stock-based compensation	113	65
Other operating expenses.....	4,040	3,622
Amortization of intangible assets.....	—	—
Depreciation.....	366	372
Interest	3,671	1,858
Total expenses	11,194	7,893
Loss from continuing operations before income taxes.....	\$ (10,787)	\$ (7,831)

	Nine months ended September 30,	
	2005	2004
	(Dollars in thousands)	
Total revenues.....	\$ 1,001	\$ 241
Expenses:		
Compensation and employee benefits	9,146	7,020
Non-cash stock-based compensation	276	130
Other operating expenses.....	12,822	11,127
Amortization of intangible assets.....	—	—
Depreciation.....	1,079	1,244
Interest	9,696	4,983
Margin improvement plan expenses	1,552	—
Total expenses	34,571	24,504
Loss from continuing operations before income taxes	\$ (33,570)	\$ (24,263)

Three Months Ended September 30, 2005 compared with Three Months Ended September 30, 2004

Revenues at the Corporate segment represent interest income.

Total expenses in the Corporate segment increased \$3.3 million, or 41.8%, to \$11.2 million for the three months ended September 30, 2005, from \$7.9 million for the three months ended September 30, 2004. The increase was primarily due to a \$1.8 million increase in interest expense due to increased borrowings at higher rates and to a \$1.0 million increase in compensation and employee benefits expense principally due to greater incentive compensation. As a percentage of consolidated revenues, total Corporate expenses were 8.8% and 7.7% in the three months ended September 30, 2005 and 2004, respectively.

Loss from continuing operations before income taxes in the Corporate segment was \$10.8 million and \$7.8 million for the three months ended September 30, 2005 and 2004, respectively. The increased loss in 2005 was primarily due to the expenses noted above.

Nine Months Ended September 30, 2005 compared with Nine Months Ended September 30, 2004

Revenues at the Corporate segment represent interest income.

Total expenses in the Corporate segment increased \$10.1 million, or 41.1%, to \$34.6 million for the nine months ended September 30, 2005, from \$24.5 million for the nine months ended September 30, 2004. The increase was primarily due to a \$4.7 million increase in interest expense due to increased borrowings at higher rates, \$2.6 million in expense related to the insurance industry investigations, a \$2.1 million increase in compensation and employee benefits expense principally due to greater incentive compensation and \$1.6 million in expense related to the margin improvement plan. The increases in expense were somewhat offset by a \$1.9 million reduction due to lower Sarbanes-Oxley and Corporate move expenses in 2005. As a percentage of consolidated revenues, total Corporate expenses were 9.3% and 8.4% in the nine months ended September 30, 2005 and 2004, respectively.

Loss from continuing operations before income taxes in the Corporate segment was \$33.6 million and \$24.3 million for the nine months ended September 30, 2005 and 2004, respectively. The increased loss in 2005 was primarily due to the expenses noted above.

Liquidity and Capital Resources

Our debt consists of the following as of September 30, 2005 and December 31, 2004:

	September 30, 2005	December 31, 2004
	(Dollars in Thousands)	
Senior Credit Facility:		
Term loan.....	\$ 212,050	\$ 123,438
Revolving credit facility.....	—	5,000
Other Debt:		
Notes issued in connection with acquisitions, due various dates through 2010	21,893	23,073
Other long-term debt, primarily capital leases	4,007	4,813
Total debt.....	237,950	156,324
Current portion of long-term debt.....	(11,981)	(11,617)
Long-term debt	\$ 225,969	\$ 144,707

In August 2003, we entered into a \$155.0 million senior secured credit facility with several lending institutions. The credit facility was initially structured as follows: a \$30.0 million revolving credit facility expiring in August 2007, and a \$125.0 million term loan, payable in quarterly installments that commenced on October 31, 2003. The last quarterly installment is due in August 2008, the maturity date of the term loan. The proceeds from borrowings under the credit facility were drawn to (i) repay all amounts under the previously existing credit facility, (ii) repay a portion of certain notes issued for acquisitions, (iii) pay fees and expenses in connection with the credit facility including a prepayment penalty in connection with the prepayment of the previously existing credit facility and (iv) for general corporate purposes.

The revolving credit facility is available for loans denominated in U.S. dollars and for letters of credit. Borrowings under the revolving credit facility bear interest, at our option, at either a base rate plus an applicable margin ranging from 1.5% to 2.5% per annum or the Eurodollar rate plus an applicable margin ranging from 2.5% to 3.5% per annum, depending on our credit ratings as determined by Standard & Poor's and Moody's Investors Service credit rating services at the time of borrowing. Additionally, there is a commitment fee on the unused portion of the revolving credit facility of 0.5% per annum.

The revolving credit facility may be used for acquisition financing and general corporate purposes. At September 30, 2005, availability under the revolving credit facility was \$28.8 million having been reduced by \$1.2 million for outstanding letters of credit.

On March 26, 2004, we executed a first amendment to the credit facility, providing for a 0.5% reduction to the applicable term loan interest rate effective April 1, 2004. As amended, borrowings under the term loan bear interest, at our option, at either a base rate plus 1.5% per annum or the Eurodollar rate plus 2.5% per annum. The base rate and the Eurodollar rate are effectively the Prime Rate and the London Interbank Offering Rate for the applicable period, respectively.

On March 26, 2004, we executed a first waiver to the credit agreement. The credit agreement has various limitations on acquisitions, including, but not limited to, aggregate cash payments for acquisitions each year, the aggregate amount of total consideration for acquisitions each year and the amount of indebtedness assumed on a given acquisition. In order to proceed with our acquisition strategy we requested and received a waiver that specifically excludes two significant acquisitions from our credit facility limitations on aggregate cash payments, aggregate total consideration and assumed indebtedness (see Note 4 “Long-Term Debt” in our unaudited condensed consolidated financial statements). No other covenants were waived or amended.

On January 11, 2005, we received approval from our lending institutions for a second amendment to our credit facility, which allowed for a \$90.0 million increase to our existing term loan, a waiver of certain covenant limitations to allow for the acquisition of SGP and an amendment of certain other covenants in our credit agreement indebtedness (see Note 4 “Long-Term Debt” to our unaudited condensed consolidated financial statements).

The credit facility contains various limitations, including limitations on our ability to pay dividends, buy back our common stock and make other distributions to stockholders, borrowing and acquisitions. The credit facility also contains various financial covenants that must be met, including those with respect to fixed charges coverage and limitations on consolidated debt, net worth and capital expenditures. Failure to comply with the covenants may result in an acceleration of the borrowings outstanding under the facility. All of the stock of our subsidiaries and certain other identified assets are pledged as collateral to secure the credit facility. Additionally, each subsidiary guarantees our obligations under the credit facility. In the third quarter of 2005, we received a waiver from our lending institutions related to the sale of stock of one subsidiary classified in discontinued operations. At September 30, 2005, we were in compliance with all such covenants.

The weighted-average interest rate on the term loan for the three months ended September 30, 2005 and 2004 was 6.02% and 4.01%, respectively. The weighted-average interest rate on the term loan for the nine months ended September 30, 2005 and 2004 was 5.55% and 3.93%, respectively. The annual interest rate on the term loan was 6.18% at September 30, 2005.

Working capital increased by \$22.7 million to \$55.4 million at September 30, 2005, compared to \$32.7 million at December 31, 2004, primarily due to cash inflows from our expanded credit facility, settlement of our equity forward sale agreements and cash generated by operations, offset by cash used for acquisitions and debt payments.

On July 24, 2003, Standard & Poor’s raised the counterparty credit and bank loan rating on us to ‘BB-’ from ‘B+.’ On August 12, 2003 Moody’s Investors Service assigned a B1 rating to our credit facility with a stable outlook. On November 1, 2004, Standard & Poor’s placed our ratings on credit watch with negative implications, primarily due to a subpoena we received from the New York Attorney General and related industry announcements. On May 19, 2005, Standard & Poor’s affirmed our ‘BB-’ ratings and removed the ratings from credit watch.

As of September 30, 2005, we were in compliance with the covenants of our credit facility. The significant financial covenants of our credit facility were as follows:

Description of Covenant	Actual	Covenant
Consolidated Indebtedness to Adjusted Pro Forma EBITDA Ratio(a).....	2.40	2.50 maximum
Fixed Charge Coverage Ratio(a).....	2.53	2.00 minimum
Stockholders’ Equity(a) (in millions)	\$ 404,492	\$ 338,750 minimum

(a) As defined in our credit facility. Adjusted Pro Forma EBITDA is our actual trailing twelve months EBITDA adjusted to reflect the full year impact of businesses acquired or divested.

We believe that our projected cash flows generated from operations, cash and cash equivalents on hand of \$30.1 million and availability under our revolving credit facility of \$28.8 million as of September 30, 2005, should be sufficient to fund our estimated \$4.1 million in debt principal repayments, our working capital needs, acquisitions and budgeted \$2.8 million in capital expenditures through at least December 31, 2005. Our liquidity thereafter will depend on our financial results, results of operations, acquisition activity and future available sources of additional equity or debt financing. Our

future operating performance and ability to service our debt will be subject to economic conditions and to financial, business and other factors, many of which are beyond our control.

We hold cash in a fiduciary capacity as a result of premiums received from clients that have not yet been paid to insurance carriers. The fiduciary cash is recorded as an asset on our balance sheet with a corresponding liability for premiums due to insurance carriers. We earn interest on these funds during the time between receipt of the cash and payment to insurance carriers. In some states, fiduciary cash must be kept in separate bank accounts subject to specific guidelines, which generally emphasize capital preservation and liquidity, and is not generally available to service debt or for other corporate purposes. Insurance brokerage transactions typically generate large cash flows and the timing of such cash flows can significantly affect the net cash balances held at month end.

Cash and cash equivalents increased by \$27.2 million and decreased by \$35.7 million for the nine months ended September 30, 2005 and 2004, respectively. Net cash provided by operating activities totaled \$44.7 million and \$40.7 million for the nine months ended September 30, 2005 and 2004, respectively, and is principally dependent upon the timing of collection of premiums receivable and payments of premiums payable. The net effect of discontinued operations was a reduction in cash flow from operating activities of \$1.7 million for the nine months ended September 30, 2005 and netted to zero in the comparable prior year period.

Net cash used in investing activities totaled \$123.5 million and \$80.7 million for the nine months ended September 30, 2005 and 2004, respectively, which principally reflects acquisition activities and capital expenditures. Cash expenditures for acquisitions amounted to \$121.0 million and \$75.5 million for the nine months ended September 30, 2005 and 2004, respectively. The \$121.0 million for the nine months ended September 30, 2005, primarily included the SGP, PSA and CRO transactions. The \$75.5 million for the nine months ended September 30, 2004, primarily included the Bertholon-Rowland, Dodge Warren & Peters and Future Planning Associates transactions. The payment of additional purchase price and retention-based acquisition payments are included in the preceding amounts for the nine months ended September 30, 2005 and 2004. Capital expenditures amounted to \$6.7 million and \$8.2 million for the nine months ended September 30, 2005 and 2004, respectively. Proceeds from the sale of discontinued operations were \$6.2 million for the nine-month period ended September 30, 2005.

Net cash provided by financing activities totaled \$106.1 million and \$4.2 million for the nine months ended September 30, 2005 and 2004, respectively. In the nine months ended September 30, 2005, we increased our existing term loan resulting in gross proceeds of \$90.0 million. We also raised \$36.2 million from the sale of our common stock as a result of the settlement of the remaining portion of our forward sale agreements where we issued 2.2 million shares of our common stock, stock options exercised and employee stock purchase plan transactions. In addition, we made payments of \$19.2 million for debt and \$0.8 million for debt issuance costs. In the nine months ended September 30, 2004, we made payments of \$19.7 million for debt and \$0.5 million for debt issuance costs and raised \$4.1 million in equity from the sale of our common stock as a result of stock options exercised and employee stock purchase plan transactions. The net effect of discontinued operations on financing activities was a reduction in cash flow of \$1.6 million and \$1.4 million for the nine months ended September 30, 2005 and 2004, respectively.

Net income per share, on a diluted basis, was \$0.08 and \$0.32 for the nine months ended September 30, 2005 and 2004, respectively. These amounts are based on approximately 56.3 million and 49.0 million weighted-average shares outstanding as of September 30, 2005 and 2004, respectively. The decrease was primarily due to an increase in acquisition integration expense, including the SGP acquisition compensation expense, of \$8.5 million, an increase in interest and amortization of \$8.4 million and an increase in margin improvement plan expense of \$7.0 million, somewhat offset by the positive impact of acquisitions and our margin improvement plan. Additionally, at September 30, 2005 as compared to September 30, 2004, our weighted-average shares outstanding increased due to share issuances for acquisitions and employee incentives and to sales of our common stock.

Contractual Obligations

The table below summarizes our indebtedness and lease commitments as of September 30, 2005:

Payments due by period	Total	Less than 1 year	2-3 years	4-5 years	After 5 years
(Dollars in Thousands)					
Credit facility	\$ 212,050	\$ 2,150	\$ 209,900	\$ —	\$ —
Other debt and capital lease obligations	25,900	9,831	13,739	2,330	—
Operating lease commitments	80,221	18,576	34,351	18,222	9,072
Variable rate interest obligations	39,441	14,531	24,280	530	100
Fixed rate interest obligations	2,240	1,150	1,050	40	—
Other	1,575	900	675	—	—
Total	<u>\$ 361,427</u>	<u>\$ 47,138</u>	<u>\$ 283,995</u>	<u>\$ 21,122</u>	<u>\$ 9,172</u>

Credit Facility

See discussion above under “Long-Term Debt.”

Other Debt and Capital Lease Obligations

At September 30, 2005 our other debt and capital lease obligations of \$25.9 million consisted primarily of notes payable issued in conjunction with acquisitions. Some of these notes payable may be subject to reduction based on future performance of the respective acquired company to which each of these issuances related. At September 30, 2005, our capital lease obligations of \$2.8 million related to purchases of furniture and equipment. In the past, we have used external financing to fund a portion of such purchases and plan to continue to do so in the future.

Operating Leases

Substantially all of our office space is leased under operating leases. Many of these leases have options permitting renewals for additional periods and provisions for escalations based on an inflation index.

Interest Obligations

At September 30, 2005, we had future interest obligations under fixed rate notes, primarily acquisition related, of \$2.2 million.

Of our \$238.0 million in long-term debt at September 30, 2005, \$214.8 million was subject to variable interest rates, most of which is eligible to be prepaid. The variable interest rate payment projections in the table above assume that interest rates stay fixed at the September 30, 2005 rates and that we do not prepay any long-term debt with variable interest rates.

Other

We have structured our acquisition agreements to include contingent purchase price payments to be treated as adjustments to purchase price and capitalized when the contingency is resolved. At September 30, 2005, we estimate the future significant contingent purchase price payments to be between \$26.8 million and \$45.7 million. These payments would be payable in a combination of cash, common stock and debt. These amounts primarily relate to acquisitions and will be reflected on our financial statements as a liability and additional purchase price when the contingency is resolved. Approximately \$4.8 million of the contingent purchase price payments are projected to be paid through December 31, 2005. Please read Note 2 “Acquisitions” in our notes to condensed consolidated financial statements included herein.

We routinely enter into employment agreements with management and other key employees. Some of these contracts may provide for severance benefits in the event that we terminate the employment relationship without cause. Severance costs are expensed as incurred.

Some of our common stockholders have various put rights that are exercisable upon specific events. Please read Note 7 “Redeemable Securities” to our consolidated financial statements included in our Form 10-K for the period ended December 31, 2004. The number of shares on which put rights exist at September 30, 2005 is not material.

Off-Balance Sheet Commitments

We have one letter of credit in the amount of \$1.2 million established as collateral for our workers' compensation insurance program. Letters of credit which are outstanding reduce the borrowing availability under our revolving credit facility. The letter of credit referred to automatically renews annually on the anniversary date of issuance with a final expiration five business days prior to August 11, 2007, the maturity date of our revolving credit facility. Such off-balance sheet commitments are historically immaterial and we do not anticipate an increase in their importance to us in terms of liquidity or other benefits.

New Accounting Pronouncements

Please read Note 1 "Nature of Operations and Summary of Significant Accounting Policies" to our unaudited condensed consolidated financial statements included in Part I, Item 1 of this report for a discussion on the impact of the adoption of new accounting pronouncements.

Item 3. Quantitative And Qualitative Disclosures About Market Risk

Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest, foreign currency exchange rates and equity prices. We are exposed to interest rate risk in connection with our credit facility. We had approximately \$214.8 million of floating rate debt outstanding at September 30, 2005. Each 100 basis point increase in the interest rates charged on the balance of the outstanding floating rate debt would result in a \$2.1 million annual decrease in income from continuing operations before income tax expense. Except for the previously disclosed forward sale of our common stock and written put options on certain shares of our common stock, we currently do not engage in any derivatives or hedging transactions.

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures.

We conducted an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in the Securities and Exchange Act of 1934 (the "Exchange Act") Rules 13a-15(e) and 15d-15(e)) as of September 30, 2005.

Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, while significant progress has been made on remediating the significant deficiencies noted at December 31, 2004, our disclosure controls and procedures as of the end of the period covered by this report were not effective as a result of the material weakness in internal control over financial reporting discussed below.

Changes in internal control over financial reporting.

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission in connection with the preparation of our Annual Report on Form 10-K for the fiscal year ended December 31, 2004. The *Management Report on Internal Control* is included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2004.

Based on the evaluation for the 2004 fiscal year, Management concluded that our internal control over financial reporting was not effective as of December 31, 2004. Management identified significant deficiencies in our internal control over financial reporting, none of which individually were considered material; but, when considered in the aggregate, in Management's judgment, represented a material weakness in internal control over the financial statement close process. The control deficiencies generally related to (i) segregation of duties around receipts and disbursements in our smaller reporting units, (ii) timely review and approval of account analyses, reconciliations and journal entries, (iii) adequate review of and support for revenue accruals in our core benefits reporting unit and (iv) a lack of operating effectiveness of detection and monitoring controls over the year-end close process. These deficiencies were manifested in a number of adjustments to the financial statements for the year ended December 31, 2004, including those resulting from a complex reclassification of prior years' income taxes related to our decision to discontinue three operations in December 2004. None of the adjustments were material individually or in the aggregate.

Management continues to address the remediation of these deficiencies in internal controls over financial reporting. Actions taken to date include:

- Management expanded the internal audit department from six employees at December 31, 2004 to the current staff of twelve employees, including the newly created position of Director of Internal Controls;
- Management has consolidated the tax department into the corporate headquarters in New York and has hired an experienced Director of Tax and Senior Manager to lead that department;
- Management hired a Director of Financial Reporting to enhance internal technical expertise and provide needed resources in financial reporting;
- Management has initiated a process to critically review and assess field accounting leaders; phase one was completed in the third quarter of 2005 and phase two, which includes training in internal controls, is scheduled for the first quarter of 2006;
- Internal Audit conducted a review of the financial statement close process at the corporate office during the March 31, 2005 close, noting enhanced detection and monitoring controls; and
- As further discussed below, Management has substantially implemented a system and processes around the accrual of direct bill revenues resulting in enhanced controls; this implementation will be complete by December 31, 2005.

Management will continue to address identified deficiencies and is committed to remediating them as quickly as possible, although there can be no assurance that Management will be able to do so.

There have been no significant changes in our internal controls over financial reporting during the quarter ended September 30, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting except as described below.

As reported in our Form 10-Q for the quarterly periods ended September 30, 2004 and June 30, 2005, as part of Management's review of our internal controls in compliance with Sarbanes-Oxley Section 404, Management determined the need to enhance field office and corporate controls over our receivables (and related producer compensation expense) recorded for revenue on policies billed directly by insurance companies, or "direct bill" receivables. Previously, we recorded commissions on direct bill, and the related compensation expenses, on a modified cash-basis, with a corresponding asset and liability recorded on the balance sheet to reflect a reasonable estimate of accrual-basis accounting. Quarterly adjustments to these estimates were historically calculated using a method in each field office and were not applied consistently across all operating companies.

Beginning in the third quarter of 2004, we implemented a new system called Captiva, which will, when it is fully populated with all direct bill policy details by December 31, 2005, directly calculate and record the receivable and revenue and the related compensation payable and expense for each direct bill policy at the time it is effective. As a result of this process, we have obtained additional information as of September 30, 2005 which Management has utilized to revise its estimate of the direct bill receivable and related compensation payable. The effect of the change in estimate was a decrease to our direct bill receivable and revenues of \$0.8 million and \$2.9 million and a reduction in the related producer payable and compensation expense of \$0.4 million and \$0.5 million, as of and for the three and nine months ended September 30, 2005, respectively.

PART II. OTHER INFORMATION

USI HOLDINGS CORPORATION

Item 1. Legal Proceedings

Information regarding legal proceedings is set forth in the Management's Discussion and Analysis of Financial Condition and Results of Operations under "Insurance Industry Investigations and Other Developments," "Industry Class Action Litigation" and "Near North Insurance Litigation ("Near North")" and is incorporated herein by reference.

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

None.

Issuer Purchases of Equity Securities

Plan Category	Total number of shares (or units) purchased	Average price paid per share (or unit)	Total number of shares (or units) purchased as part of publicly announced plans or programs*	Maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under the plans or programs
July 1, 2005 through July 31, 2005	—	—	—	*
August 1, 2005 through August 31, 2005	165,934	\$ 11.42	165,934	*
September 1, 2005 through September 30, 2005 ...	—	—	—	*
Total.....	165,934		165,934	

* The Limited Stock Repurchase Plan was announced on May 10, 2004 under which our Board of Directors approved the use of proceeds, and tax related benefit amounts, from stock option and warrant exercises to repurchase common stock. The dollar amount approved for repurchases is based upon the number of shares of our common stock which may be issued from time to time upon the exercise of stock options and warrants, market conditions and other factors. Additionally, on December 20, 2004, we announced that our Board of Directors authorized an expanded stock repurchase program that permits us to purchase shares of our common stock up to certain limits set forth within our credit facility. In the third quarter of 2005, no shares were purchased under the expanded stock repurchase program. We have the capacity under our credit facility to purchase up to an additional \$9.7 million of our common stock during 2005.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

There were no other actions taken at the Annual Meeting of Shareholders.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit 31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Exchange Act.
Exhibit 31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Exchange Act.
Exhibit 32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

USI HOLDINGS CORPORATION
(Registrant)

DATE: November 9, 2005

BY: /s/ ROBERT S. SCHNEIDER
Robert S. Schneider
Executive Vice President and Chief Financial Officer

USI HOLDINGS CORPORATION

EXHIBIT INDEX

Exhibit No.	Description
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