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

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**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 March 31, 2006

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 000-51124

**SeaBright Insurance Holdings, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation  
or organization)

**56-2393241**

(IRS Employer Identification No.)

**2101 4<sup>th</sup> Avenue, Suite 1600  
Seattle, Washington 98121**

(Address of principal executive offices, including zip code)

**(206) 269-8500**

(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 past 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

**Class**  
Common Stock, \$0.01 Par Value

**Shares outstanding as of May 12, 2006**  
20,542,900

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**SeaBright Insurance Holdings, Inc.**

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# PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

### SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

#### CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2006 (Unaudited)	December 31, 2005
	(in thousands)	
ASSETS		
Fixed income securities available-for-sale, at fair value (amortized cost \$332,645 in 2006 and \$260,015 in 2005) .....	\$ 326,795	\$ 258,049
Equity securities available-for-sale, at fair value (amortized cost \$3,076 in 2006 and \$3,037 in 2005) .....	3,106	3,054
Cash and cash equivalents .....	23,822	12,135
Accrued investment income .....	3,587	3,059
Premiums receivable, net of allowance .....	8,410	9,863
Deferred premiums .....	94,329	88,982
Federal income tax recoverable .....	—	62
Service income receivable .....	594	472
Reinsurance recoverables .....	14,372	14,375
Receivable under adverse development cover .....	3,352	3,352
Prepaid reinsurance .....	1,878	2,019
Property and equipment, net .....	907	870
Deferred federal income taxes, net .....	12,524	9,323
Deferred policy acquisition costs, net .....	10,929	10,299
Intangible assets, net .....	1,382	1,464
Goodwill .....	1,527	1,527
Other assets .....	8,871	8,370
Total assets .....	<u>\$ 516,385</u>	<u>\$ 427,275</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Unpaid loss and loss adjustment expense .....	\$ 160,063	\$ 142,211
Unearned premiums .....	90,670	86,863
Reinsurance funds withheld and balances payable .....	248	333
Premiums payable .....	2,967	3,101
Accrued expenses and other liabilities .....	33,540	27,089
Surplus notes .....	12,000	12,000
Total liabilities .....	<u>299,488</u>	<u>271,597</u>
Commitments and contingencies		
Stockholders' equity:		
Series A preferred stock, \$0.01 par value; 750,000 shares authorized; no shares issued and outstanding .....	—	—
Undesignated preferred stock, \$0.01 par value; 10,000,000 shares authorized; no shares issued and outstanding .....	—	—
Common stock, \$0.01 par value; 75,000,000 shares authorized; issued and outstanding — 20,539,974 shares at March 31, 2006 and 16,411,143 shares at December 31, 2005 .....	205	164
Paid-in capital .....	189,211	131,485
Accumulated other comprehensive loss .....	(3,783)	(1,267)
Retained earnings .....	31,264	25,296
Total stockholders' equity .....	<u>216,897</u>	<u>155,678</u>
Total liabilities and stockholders' equity .....	<u>\$ 516,385</u>	<u>\$ 427,275</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

**SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	<b><u>Three Months Ended March 31,</u></b>	
	<b><u>2006</u></b>	<b><u>2005</u></b>
	<b>(in thousands, except income per share information)</b>	
Revenue:		
Premiums earned .....	\$ 43,963	\$ 29,159
Net investment income .....	3,125	1,299
Net realized loss .....	(227)	(56)
Claims service income .....	523	582
Other service income .....	28	50
Other income .....	<u>756</u>	<u>1,174</u>
	<u>48,168</u>	<u>32,208</u>
Losses and expenses:		
Loss and loss adjustment expenses .....	28,447	20,267
Underwriting, acquisition and insurance expenses .....	9,598	6,379
Other expenses .....	<u>1,536</u>	<u>1,721</u>
	<u>39,581</u>	<u>28,367</u>
Income before federal income taxes .....	<u>8,587</u>	<u>3,841</u>
Federal income tax expense (benefit):		
Current .....	4,464	2,720
Deferred .....	<u>(1,845)</u>	<u>(1,587)</u>
	<u>2,619</u>	<u>1,133</u>
Net income .....	<u>\$ 5,968</u>	<u>\$ 2,708</u>
Basic earnings per share .....	\$ 0.31	\$ 0.21
Diluted earnings per share .....	\$ 0.31	\$ 0.18
Weighted average basic shares outstanding .....	18,968,695	12,757,740
Weighted average diluted shares outstanding .....	19,223,784	14,684,044

*See accompanying notes to unaudited condensed consolidated financial statements.*

**SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
Cash flows from operating activities:		
Net income.....	\$ 5,968	\$ 2,708
Adjustments to reconcile net income to cash provided by operating activities:		
Amortization of deferred policy acquisition costs .....	5,621	4,226
Policy acquisition costs deferred .....	(6,251)	(5,230)
Provision for depreciation and amortization.....	660	544
Net realized loss on investments.....	227	56
Benefit for deferred federal income taxes.....	(1,845)	(1,587)
Other .....	159	—
Changes in certain assets and liabilities:		
Federal income tax recoverable and payable .....	4,162	2,784
Unpaid loss and loss adjustment expense .....	17,852	14,864
Reinsurance recoverables, net of reinsurance withheld .....	(888)	(1,966)
Unearned premiums, net of deferred premiums and premiums receivable .....	(88)	(2,217)
Accrued investment income .....	(528)	(872)
Other assets and other liabilities .....	(522)	2,086
Net cash provided by operating activities .....	<u>24,527</u>	<u>15,396</u>
Cash flows from investing activities:		
Purchases of investments .....	(173,022)	(138,682)
Sales of investments .....	86,472	51,668
Maturities and other.....	16,245	1,873
Purchases of property and equipment.....	(142)	(103)
Net cash used in investing activities .....	<u>(70,447)</u>	<u>(85,244)</u>
Cash flows from financing activities:		
Proceeds from exercise of stock options.....	12	—
Proceeds from issuance of common stock .....	57,595	80,356
Net cash provided by financing activities .....	<u>57,607</u>	<u>80,356</u>
Net increase in cash and cash equivalents .....	11,687	10,508
Cash and cash equivalents at beginning of period .....	12,135	8,279
Cash and cash equivalents at end of period .....	<u>\$ 23,822</u>	<u>\$ 18,787</u>
Supplemental disclosures:		
Interest paid on surplus notes.....	\$ 257	\$ 195

*See accompanying notes to unaudited condensed consolidated financial statements.*

## SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

#### 1. Organization

SeaBright Insurance Holdings, Inc. ("SIH"), a Delaware corporation, was formed in June 2003. On July 14, 2003, SIH entered into a purchase agreement with Kemper Employers Group, Inc. ("KEG"), Eagle Pacific Insurance Company, Inc. and Pacific Eagle Insurance Company, Inc. (collectively "Eagle" or the "Eagle Entities"), and Lumbermens Mutual Casualty Company ("LMC") (the "Acquisition"). Under this agreement, SIH acquired Kemper Employers Insurance Company ("KEIC"), PointSure Insurance Services, Inc. ("PointSure"), and certain assets of Eagle, primarily renewal rights.

SeaBright Insurance Company ("SBIC"), formerly KEIC, is licensed to write workers' compensation insurance in 43 states and the District of Columbia. Domiciled in the State of Illinois and commercially domiciled in the State of California, SBIC focuses on employers with complex workers' compensation exposures and provides coverage under multiple state and federal acts, applicable common law or negotiated agreements. Prior to the Acquisition, beginning in 2000, KEIC wrote business only in California. In May 2002, KEIC ceased writing business and by December 31, 2003, all premiums related to business prior to the Acquisition were 100% earned.

PointSure is engaged primarily in administrative and wholesale insurance brokerage activities. The Eagle Entities, from whom the Company purchased certain assets, were both writers of state act workers' compensation insurance and United States Longshore and Harbor Workers' Compensation Act ("USL&H") insurance, whose policies went into run-off on September 30, 2003.

Under new ownership, KEIC resumed writing business effective October 1, 2003, primarily targeting policy renewals for former Eagle business in the states of California, Hawaii and Alaska. In November 2003, the Illinois Department of Financial and Professional Regulation, Division of Insurance (the "Illinois Division of Insurance") granted permission for KEIC to change its name to SeaBright Insurance Company.

#### 2. Summary of Significant Accounting Policies

##### *a. Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements include the accounts of SIH and its wholly owned subsidiaries, PointSure and SBIC (collectively, the "Company"). All significant intercompany transactions among these affiliated entities have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and pursuant to the instructions to Form 10-Q and Regulation S-K. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. The condensed consolidated balance sheet at December 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and notes required by GAAP for complete financial statements. These unaudited condensed consolidated financial statements and notes should be read in conjunction with the audited financial statements and accompanying notes as of and for the year ended December 31, 2005 included in the Company's Annual Report on Form 10-K, which was filed with the U.S. Securities and Exchange Commission on March 29, 2006.

In the opinion of management, the unaudited condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, necessary to state fairly the financial information set forth therein. Results of operations for the three months ended March 31, 2006 are not necessarily indicative of the results expected for the full fiscal year or for any future period.

##### *b. Use of Estimates*

The preparation of the unaudited condensed consolidated financial statements in conformity with GAAP requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the unaudited condensed consolidated financial statements and the reported amounts of revenues and expenses during the period. For example, the Company used significant estimates in determining the unpaid loss and loss adjustment expenses, goodwill and other intangibles, earned premiums on retrospectively rated policies, earned but unbilled premiums, federal income taxes and amounts related to reinsurance and stock-based compensation arrangements. Actual results

## SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

could differ from those estimates. Such estimates and judgments could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

#### *c. Revenue Recognition*

Premiums for primary and reinsured risks are included in revenue over the lives of the contracts in proportion to the amount of insurance protection provided (i.e., ratably over the policy periods). The portions of premiums that are applicable to the unexpired periods of the policies in-force are not included in revenue but are deferred and recorded as unearned premium in the liability section of the balance sheet. Deferred premiums represent the unbilled portion of annual premiums.

Earned premiums on retrospectively rated policies are based on the Company's estimate of loss experience as of the measurement date. Loss experience includes known losses specifically identifiable to a retrospective policy as well as provisions for future development on known losses and for losses incurred but not yet reported, which are developed using actuarial loss development factors that are consistent with how the Company projects losses in general. For retrospectively rated policies, the governing contractual minimum and maximum rates are established at policy inception and are made a part of the insurance contract. For the three month periods ended March 31, 2006 and 2005, approximately 27.1% and 25.9%, respectively, of premiums written related to retrospectively rated policies.

#### *d. Unpaid Loss and Loss Adjustment Expense*

Unpaid loss and loss adjustment expense represents an estimate of the ultimate net cost of all unpaid losses incurred through the specified period. The loss adjustment expense component is an estimate of unpaid expenses to be incurred in settlement of the claims included in the liability for unpaid losses. These liabilities, which anticipate salvage and subrogation recoveries and are presented gross of amounts recoverable from reinsurers, include estimates of future trends in claim severity and frequency and other factors that could vary as the losses are ultimately settled.

The Company uses an independent actuary to assist in the evaluation of the adequacy of its liability for unpaid loss and loss adjustment expense. In light of the Company's short operating history and uncertainties concerning the effects of recent legislative reform specifically as it relates to the Company's California workers' compensation class of business, actuarial techniques are applied that use the historical experience of the Company's predecessor as well as industry information in the analysis of unpaid loss and loss adjustment expense. These techniques recognize, among other factors:

- the Company's claims experience and that of its predecessor;
- the industry's claims experience;
- historical trends in reserving patterns and loss payments;
- the impact of claim inflation;
- the pending level of unpaid claims;
- the cost of claim settlements;
- legislative reforms affecting workers' compensation; and
- the environment in which insurance companies operate.

Although it is not possible to measure the degree of variability inherent in such estimates, management believes that the liability for unpaid loss and loss adjustment expense is adequate. Estimates are reviewed periodically and any necessary adjustment is included in the results of operations of the period in which the adjustment is determined.

#### *e. Reinsurance*

The Company protects itself from excessive losses by reinsuring with nonaffiliated reinsurers certain levels of risk in various areas of exposure. Reinsurance premiums, commissions, expense reimbursements and liabilities related to ceded business are accounted for on a basis consistent with that used in accounting for original policies

# SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

issued and the terms of the reinsurance contracts. The unpaid loss and loss adjustment expense subject to the adverse development cover with LMC is calculated on a quarterly basis using generally accepted actuarial methodology. Amounts recoverable in excess of acquired insurance liabilities at September 30, 2003 are recorded gross in unpaid loss and loss adjustment expense in accordance with Statement of Financial Accounting Standards ("SFAS") No. 141, *Business Combinations*, with a corresponding amount receivable from the seller. Amounts are shown net in the statement of operations. Premiums ceded to other companies are reported as a reduction of premiums written and earned. Reinsurance recoverables are determined based on the terms and conditions of the reinsurance contracts.

### *f. Income Taxes*

The asset and liability method is used in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse, net of any applicable valuation allowances.

### *g. Earnings Per Share*

The following table provides the reconciliation of basic and diluted weighted average shares outstanding used in calculating earnings per share for the three month periods ended March 31, 2006 and 2005:

	<b>Three Months Ended March 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
Basic weighted average shares outstanding.....	18,969	12,758
Weighted average shares issuable upon:		
Conversion of preferred stock outstanding prior to initial public offering .....	—	1,728
Exercise of stock options and vesting of restricted stock .....	255	198
Diluted weighted average shares outstanding.....	<u>19,224</u>	<u>14,684</u>

### *h. Stock-Based Compensation*

The Company adopted SFAS No. 123R, *Share-Based Payment*, on January 1, 2006, using the modified-prospective transition method. Prior to adoption, the Company measured its employee stock-based compensation arrangements using the provisions outlined in Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, which is an intrinsic value-based method of recognizing compensation costs, and adopted the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-based Compensation*. None of the Company's stock options granted prior to adoption had an intrinsic value at grant date and, accordingly, no compensation cost was recognized for its stock option plan activity prior to adoption.

Under the modified-prospective transition method, stock-based compensation cost is recognized in the unaudited condensed consolidated financial statements for granted, modified, or settled share-based payments. Compensation cost recognized includes the estimated cost for stock options granted on or after January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R, and the estimated expense for the portion of awards granted prior to January 1, 2006 vesting in the current period, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123. Results for prior periods have not been restated, as provided for under the modified-prospective method.

Total stock-based compensation expense recognized in the unaudited condensed consolidated statement of operations for the quarter ended March 31, 2006 was approximately \$159,500 before income taxes and consisted of approximately \$102,100 related to stock options and approximately \$57,400 related to nonvested stock. The related total tax benefit was approximately \$21,900. No compensation cost was capitalized during the quarter ended March 31, 2006.

The following table shows the effect on net income and earnings per share for the quarter ended March 31, 2005 as if compensation cost had been recognized based upon the estimated fair value on the grant date of stock options in accordance with SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, and as if such cost had been determined in accordance with SFAS No. 123R (in thousands, except income per share data):



# SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### Information as previously reported:

Net income .....	\$ 2,708
Less SFAS No. 123 compensation costs, net of taxes .....	(60)
Pro forma net income .....	<u>\$ 2,648</u>

### Net income per common share:

Basic – as reported .....	\$ 0.21
Basic – pro-forma .....	\$ 0.21
Diluted – as reported .....	\$ 0.18
Diluted – pro-forma .....	\$ 0.18

### Information calculated as if the fair value method had been applied to all awards:

Net income .....	\$ 2,708
Less SFAS No. 123R compensation costs, net of taxes .....	(86)
Pro forma net income .....	<u>\$ 2,622</u>

### Net income per common share:

Basic – as reported .....	\$ 0.21
Basic – pro-forma .....	\$ 0.21
Diluted – as reported .....	\$ 0.18
Diluted – pro-forma .....	\$ 0.18

Disclosures for the quarter ended March 31, 2006 are not presented because the amounts are recognized in the unaudited condensed consolidated financial statements.

### *i. Comprehensive Income*

The following table summarizes the Company's comprehensive income for the three month periods ended March 31, 2006 and 2005:

	<u>Three Months Ended March 31,</u>	
	<u>2006</u>	<u>2005</u>
	(in thousands)	
Net income .....	\$ 5,968	\$ 2,708
Reclassification adjustment for realized losses recorded into income, net of tax benefit of \$79 in 2006 and \$19 in 2005 .....	(148)	(37)
Increase in unrealized losses on investment securities available-for-sale, net of tax benefit of \$1,275 in 2006 and \$952 in 2005 .....	(2,368)	(1,767)
Total comprehensive income .....	<u>\$ 3,452</u>	<u>\$ 904</u>

# SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### 3. Investments

The consolidated cost or amortized cost, gross unrealized gains and losses, and estimated fair value of investment securities available-for-sale at March 31, 2006 are as follows:

	<u>Cost or Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Estimated Fair Value</u>
	(in thousands)			
U.S. Treasury securities.....	\$ 20,569	\$ —	\$ (542)	\$ 20,027
Government sponsored agency securities.....	13,104	—	(375)	12,729
Corporate securities.....	29,494	—	(1,025)	28,469
Tax-exempt municipal securities.....	194,552	60	(2,645)	191,967
Mortgage pass-through securities.....	53,971	—	(985)	52,986
Collateralized mortgage obligations.....	3,352	1	(56)	3,297
Asset-backed securities.....	17,603	—	(283)	17,320
Total fixed income securities available for sale.....	332,645	61	(5,911)	326,795
Equity securities.....	3,076	30	—	3,106
Total investment securities available-for-sale.....	<u>\$ 335,721</u>	<u>\$ 91</u>	<u>\$ (5,911)</u>	<u>\$ 329,901</u>

Equity securities consist of investments in a high-yield municipal bond mutual fund. The Company had no direct investments in equity securities at March 31, 2006. The unrealized loss on temporarily impaired investments totaled \$5.9 million at March 31, 2006 for investment securities available-for-sale with a fair value of \$294.6 million. All were impaired for less than one year. The Company evaluated investment securities with March 31, 2006 fair values less than amortized cost and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase.

The amortized cost and estimated fair value of fixed income securities available-for-sale at March 31, 2006, by contractual maturity, are set forth below. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

<u>Maturity</u>	<u>Cost or Amortized Cost</u>	<u>Estimated Fair Value</u>
	(in thousands)	
Due in one year or less.....	\$ 14,219	\$ 14,208
Due after one year through five years.....	64,986	63,694
Due after five years through ten years.....	146,851	144,342
Due after ten years.....	31,663	30,948
Securities not due at a single maturity date.....	74,926	73,603
Total investment securities available for sale.....	<u>\$ 332,645</u>	<u>\$ 326,795</u>

The consolidated amortized cost of investment securities available-for-sale deposited with various regulatory authorities at March 31, 2006 was \$119.4 million.

### 4. Premiums

Direct premiums written totaled \$51.2 million and \$44.1 million for the three month periods ended March 31, 2006 and 2005, respectively.

Premiums receivable consist of the following at March 31, 2006 and December 31, 2005:

	<u>March 31, 2006</u>	<u>December 31, 2005</u>
	(in thousands)	
Premiums receivable.....	\$ 9,323	\$ 10,750
Allowance for doubtful accounts.....	(913)	(887)
	<u>\$ 8,410</u>	<u>\$ 9,863</u>

# SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### 5. Reinsurance

#### *a. Reinsurance Ceded*

Under reinsurance agreements, the Company cedes various amounts of risk to nonaffiliated insurance companies for the purpose of limiting the maximum potential loss arising from the underlying insurance risks. Effective October 1, 2005, the Company entered into reinsurance agreements with nonaffiliated reinsurers that provide coverage up to \$50.0 million per loss occurrence, subject to certain limitations. Under the agreements, the Company retains the first \$500,000 of losses per occurrence. The next \$500,000 of losses per occurrence (excess of the first \$500,000 of losses per occurrence retained by the Company) are 50% reinsured, subject to an annual aggregate deductible of \$1.5 million. The next \$4.0 million of losses per occurrence (excess of the first \$1.0 million of losses per occurrence) are reinsured, subject to an annual aggregate deductible of \$2.0 million. Policies covering losses per occurrence in excess of \$5.0 million up to \$50.0 million contain no annual aggregate deductibles.

As part of the Acquisition, SIH and LMC entered into an adverse development excess of loss reinsurance agreement (the "Agreement"). The Agreement, after taking into account any recoveries from third party reinsurers, requires LMC to reimburse SBIC 100% of the excess of the actual loss at December 31, 2011 over the initial insurance liabilities at September 30, 2003. The Agreement also requires SBIC to reimburse LMC 100% of the excess of the initial insurance liabilities at September 30, 2003 over the actual loss results at December 31, 2011. The amount of adverse loss development under the Agreement was \$3.4 million at March 31, 2006. The increase in the amount due from LMC is netted against loss and loss adjustment expense in the accompanying unaudited condensed consolidated statements of operations.

As part of the Agreement, LMC placed into trust (the "Trust") an amount equal to 10% of the balance sheet insurance liabilities of SBIC on the date of the Acquisition. Thereafter, the Trust shall be adjusted each quarter, if warranted, to an amount equal to 102% of LMC's obligations under the Agreement. Initial loss liabilities were \$16.0 million. The balance of the Trust was \$5.0 million at March 31, 2006 and \$4.9 million at December 31, 2005.

#### *b. Reinsurance Assumed*

The Company assumes business from the National Council for Compensation Insurance in the states of Alabama, Alaska, Arizona, Illinois, Nevada, New Jersey, Oregon and South Carolina as part of the Residual Market Pool program.

#### *c. Reinsurance Recoverables and Income Statement Effects*

Balances affected by reinsurance transactions are reported gross of reinsurance in the accompanying unaudited condensed consolidated balance sheets. Reinsurance recoverables are comprised of the following amounts at March 31, 2006 and December 31, 2005:

	March 31, 2006	December 31, 2005
	(In thousands)	
Reinsurance recoverables on unpaid loss and loss adjustment expenses.....	\$ 13,777	\$ 13,745
Reinsurance recoverables on paid losses.....	595	630
Total reinsurance recoverables .....	<u>\$ 14,372</u>	<u>\$ 14,375</u>

The effects of reinsurance on income statements amounts are as follows for the three month periods ended March 31, 2006 and 2005:

# SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	<u>Three Months Ended March 31,</u>	
	<u>2006</u>	<u>2005</u>
	<u>(in thousands)</u>	
Reinsurance assumed:		
Written premiums .....	\$ 3,544	\$ 219
Earned premiums .....	3,603	225
Losses and loss adjustment expenses incurred .....	2,039	128
Reinsurance ceded:		
Written premiums .....	\$ 3,869	\$ 5,263
Earned premiums .....	4,028	5,450
Losses and loss adjustment expenses incurred .....	487	2,177

### 6. Unpaid Loss and Loss Adjustment Expenses

The following table summarizes the activity in unpaid loss and loss adjustment expense for the three month periods ended March 31, 2006 and 2005:

	<u>Three Months Ended March 31,</u>	
	<u>2006</u>	<u>2005</u>
	<u>(in thousands)</u>	
Beginning balance, net of reinsurance recoverables of \$13,745 in 2006 and \$12,582 in 2005 .....	\$ 128,466	\$ 55,646
Incurred related to:		
Current period .....	30,150	20,267
Prior periods .....	(1,703)	—
Total incurred .....	<u>28,447</u>	<u>20,267</u>
Paid related to:		
Current period .....	(1,543)	(2,509)
Prior periods .....	(9,084)	(4,221)
Total paid .....	<u>(10,627)</u>	<u>(6,730)</u>
Ending balance, net of reinsurance recoverables of \$13,777 in 2006 and \$13,909 in 2005 .....	<u>\$ 146,286</u>	<u>\$ 69,183</u>

### 7. Surplus Notes

In a private placement on May 26, 2004, SBIC issued \$12.0 million in subordinated floating rate surplus notes due in 2034. Interest, paid quarterly in arrears, is calculated at the beginning of the interest payment period using the 3-month LIBOR rate plus 400 basis points, subject to certain limitations. Interest expense for the three month periods ended March 31 totaled \$256,000 in 2006 and \$197,000 in 2005.

The notes are redeemable prior to 2034 by the Company, in whole or in part, from time to time, on or after May 24, 2009 on an interest payment date or at any time prior to May 24, 2009, in whole but not in part, upon the occurrence and continuation of a tax event as defined in the agreement. The Company may not exercise its option to redeem with respect to a tax event unless it pays a premium in addition to the redemption price.

### 8. Contingencies

a. SBIC is subject to guaranty fund and other assessments by the states in which it writes business. Guaranty fund assessments are accrued at the time premiums are written. Other assessments are accrued either at the time of assessment or in the case of premium-based assessments, at the time the premiums are written, or in the case of loss-based assessments, at the time the losses are incurred. As of March 31, 2006, SBIC had a liability for guaranty fund and other assessments of \$4.2 million and a guaranty fund receivable of \$1.7 million. These amounts represent management's best estimate based on information received from the states in which it writes business and may change due to many factors, including the Company's share of the ultimate cost of current and future insolvencies. The majority of assessments are paid out in the year following the year in which the premium is written or the losses are paid. Guaranty fund receivables and other surcharge items are generally realized by a charge to new and renewing policyholders in the year following the year in which the related assessments were paid.

## SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

b. In June 2004, the Company was notified of a claim for damages brought by an individual against PointSure. In April 2005, a complaint against PointSure in connection with this matter was filed in the Superior Court of Washington for King County. The complaint alleges breach and unjust enrichment related to the termination of an alleged contract between PointSure and the plaintiff and seeks a judgment awarding damages to the plaintiff in an amount to be proven at trial, plus attorneys' fees and costs. The Company disputes the allegations in the complaint and is defending this case vigorously. Management believes the outcome of this matter will not have a material adverse effect on the Company's consolidated financial position.

c. The Company is involved in various claims and lawsuits arising in the ordinary course of business. Management believes the outcome of these matters will not have a material adverse effect on the Company's consolidated financial position.

#### 9. Follow-on Public Offering

On February 1, 2006, the Company closed a follow-on public offering of 3,910,000 shares of common stock, including the underwriters' over-allotment option to purchase 510,000 shares of common stock, at a price of \$15.75 per share for net proceeds of approximately \$57.6 million, after deducting underwriters' fees, commissions and offering costs totaling approximately \$4.0 million. The Company contributed \$50.0 million of the net proceeds to SeaBright Insurance Company, which intends to use the capital to expand its business in its core markets and to new territories. The remaining proceeds will be used for general corporate purposes, including supporting the growth of PointSure. The use of proceeds from the offering does not represent a material change from the use of proceeds described in the prospectus that was included in the related Registration Statement on Form S-1. Except for the contribution of proceeds to SBIC, no proceeds or expenses were paid to the Company's directors, officers, ten percent shareholders or affiliates.

#### 10. Share-Based Payment Arrangements

At March 31, 2006, the Company had outstanding stock options and nonvested stock granted according to the terms of two equity incentive plans. The stockholders and board of directors approved the 2003 Stock Option Plan (the "2003 Plan") in September 2003, and amended and restated the 2003 Plan in February 2004, and approved the 2005 Long-Term Equity Incentive Plan (the "2005 Plan" and, together with the 2003 Plan, the "Stock Option Plans") in December 2004.

The board of directors reserved an initial total of 776,458 shares of common stock under the 2003 Plan and 1,047,755 shares of common stock under the 2005 Plan, plus an automatic annual increase on the first day of each fiscal year beginning in 2006 and ending in 2015 equal to the lesser of: (i) 2% of the shares of common stock outstanding on the last day of the immediately preceding fiscal year or; (ii) such lesser number of shares as determined by the board of directors. At March 31, 2006, the Company reserved 776,458 shares of common stock for issuance under the 2003 Plan, of which options to purchase 489,595 shares had been granted, and 1,375,978 shares for issuance under the 2005 Plan, of which 616,913 shares had been granted. In January 2006, the Compensation Committee of the Board of Directors terminated the ability to grant future stock options awards under the 2003 Plan. Therefore, the Company anticipates that all future awards will be made under the 2005 Plan.

The 2005 Plan provides for the grant of incentive or non-qualified stock options, restricted stock, restricted stock units, deferred stock units, performance awards, or any combination of the foregoing. The Board of Directors has the authority to determine all matters relating to awards granted under the Stock Option Plans, including designation as incentive or nonqualified stock options, the selection of individuals to be granted options, the number of shares subject to each grant, the exercise price, the term and vesting period, if any. Options to purchase the Company's common stock are granted at prices at or above the fair value of the common stock on the date of grant, generally vest 25% per year on each of the first four anniversaries of the vesting start date, and expire 10 years from the date of grant. Options granted to non-employee directors generally vest one-third on the first anniversary of the grant date and the remaining two-thirds monthly over the next 24 months. Nonvested stock issued to employees and directors generally vests on the third anniversary of the grant date, assuming the holder is still employed by or providing service to the Company and satisfies all other conditions of the grant. All stock options granted to employees are incentive stock options, while options granted to non-employee directors are non-qualified stock options.

# SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company issues new shares of common stock upon exercise of stock options or award of nonvested shares.

### a. Stock Options

The fair values of stock options granted during the quarters ended March 31, 2006 and 2005 were determined on the dates of grant using the Black-Scholes-Merton ("Black-Scholes") option valuation model with the following weighted average assumptions:

	<b>Three Months Ended March 31,</b>	
	<b>(Pro forma)</b>	
	<b>2006</b>	<b>2005</b>
Expected term (years).....	6.3	7.0
Expected stock price volatility.....	26.1%	15.5%
Risk-free interest rate.....	4.63%	3.96%
Expected dividend yield .....	—	—
Estimated fair value per option.....	\$6.47	\$3.09

For 2006, the expected term of options was determined using the "simplified method," which averages an award's weighted average vesting period and its contractual term. For 2006, expected stock price volatility was based on a weighted average of the Company's historical stock price volatility since the initial public offering of its common stock in January 2005 and the historical volatility of a peer company's stock for a period of time equal to the expected term of the option. Prior to the adoption of SFAS No. 123R, expected term was based on the Company's historical experience and future expectations and price volatility was estimated using the Company's historical volatility. The risk-free interest rate is based on the yield of U.S. Treasury securities with an equivalent remaining term. The Company has not paid dividends in the past and does not plan to pay any dividends in the near future.

The assumptions used to calculate the fair value of options granted are evaluated and revised, as necessary, to reflect market conditions and the Company's historical experience and future expectations. The calculated fair value is recognized as compensation cost in the Company's financial statements over the requisite service period of the entire award. Compensation cost is recognized only for those options expected to vest, with forfeitures estimated at the date of grant and evaluated and adjusted periodically to reflect the Company's historical experience and future expectations. Any change in the forfeiture assumption is accounted for as a change in estimate, with the cumulative effect of the change on periods previously reported being reflected in the financial statements of the period in which the change is made.

The following table summarizes stock option activity for the quarter ended March 31, 2006:

	<b>Shares Subject to Options</b>	<b>Weighted Average Exer- cise Price per Share</b>	<b>Weighted Average Re- maining Con- tractual Life (years)</b>	<b>Aggregate Intrinsic Value (in thousands)</b>
Outstanding at December 31, 2005.....	804,524	\$ 8.13	8.3	\$ —
Granted .....	79,600	17.49	—	—
Forfeited .....	(3,348)	8.80	—	—
Exercised .....	(956)	10.50	—	—
Cancelled .....	(478)	6.54	—	—
Outstanding at March 31, 2006 .....	<u>879,342</u>	8.98	8.3	7,426.0
Exercisable at March 31, 2006 .....	301,100	7.64	7.9	2,944.3

The aggregate intrinsic values in the table above are before applicable income taxes and are based on the Company's closing stock price of \$17.42 on March 31, 2006. As of March 31, 2006, total unrecognized stock-based compensation cost related to nonvested stock options was approximately \$1.3 million, which is expected to be recognized over a weighted average period of approximately 35.8 months. During the three months ended March 31, 2006, the total intrinsic value of stock options exercised was approximately \$6,100. During the three months ended March 31, 2006, the Company received approximately \$10,000 from the exercise of incentive stock options. There

# SEABRIGHT INSURANCE HOLDINGS, INC. AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

were no associated tax benefits.

As of March 31, 2006, there were 759,065 shares of common stock available for issuance of future share-based awards. The following table presents additional information regarding options outstanding as of March 31, 2006:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted- Average Remaining Contractual Life (years)	Weighted- Average Exercise Price	Number Outstanding	Weighted- Average Exercise Price
\$ 6.54	487,260	7.6	\$ 6.54	220,947	\$ 6.54
10.50-12.54	312,482	8.8	10.60	80,153	10.68
15.96-17.64	<u>79,600</u>	10.0	17.49	<u>—</u>	—
	<u>879,342</u>	8.3	8.98	<u>301,100</u>	7.64

### b. Nonvested Stock

The following table summarizes nonvested stock activity for the quarter ended March 31, 2006:

	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2005.....	6,000	\$ 11.40
Granted .....	217,875	17.64
Vested.....	—	—
Forfeited .....	—	—
Outstanding at March 31, 2006 .....	<u>223,875</u>	17.47

As of March 31, 2006, there was \$3.8 million of total unrecognized compensation cost related to nonvested stock granted under the 2005 Plan. That cost is expected to be recognized over a weighted-average period of 35.4 months. No shares vested during the quarter ended March 31, 2006.

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

### Cautionary Statement

You should read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and the related notes thereto included in Item 1 of this Part I. The information contained in this quarterly report is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this quarterly report and in our other reports filed with the U.S. Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the SEC on March 29, 2006.

The discussion under the heading "Risk Factors" in Part II, Item 1A of this quarterly report, and similar discussions in our other SEC filings, describe some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this report and in our other filings with the SEC, before deciding to purchase, hold or sell our common stock.

Some of the statements in this Item 2 and elsewhere in this quarterly report may include forward-looking statements that reflect our current views with respect to future events and financial performance. These statements include forward-looking statements both with respect to us specifically and the insurance sector in general. Statements that include the words "expect," "intend," "plan," "believe," "project," "estimate," "may," "should," "anticipate," "will" and similar statements of a future or forward-looking nature identify forward-looking statements for purposes of the federal securities laws or otherwise.

All forward-looking statements address matters that involve risks and uncertainties. Accordingly, there are or will be important factors that could cause our actual results to differ materially from those indicated in these statements. We believe that these factors include but are not limited to the following:

- ineffectiveness or obsolescence of our business strategy due to changes in current or future market conditions;
- increased competition on the basis of pricing, capacity, coverage terms or other factors;
- greater frequency or severity of claims and loss activity, including as a result of natural or man-made catastrophic events, than our underwriting, reserving or investment practices anticipate based on historical experience or industry data;
- the effects of acts of terrorism or war;
- developments in financial and capital markets that adversely affect the performance of our investments;
- changes in regulations or laws applicable to us, our subsidiaries, brokers or customers;
- our dependency on a concentrated geographic market;
- changes in the availability, cost or quality of reinsurance and failure of our reinsurers to pay claims timely or at all;
- decreased demand for our insurance products;
- loss of the services of any of our executive officers or other key personnel;
- the effects of mergers, acquisitions and divestitures that we may undertake;
- changes in rating agency policies or practices;
- changes in legal theories of liability under our insurance policies;
- changes in accounting policies or practices; and
- changes in general economic conditions, including inflation and other factors.

The foregoing factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements that are included in this quarterly report. We undertake no obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise.

If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary materially from what we project. Any forward-looking statements you read in this quarterly report reflect our views as of the date of this quarterly report with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. Before making an investment decision, you should carefully consider all of the factors identified in this quarterly report that could cause actual results to differ.

Additional information concerning these and other factors is contained in our SEC filings, including, but not limited to, our 2005 Annual Report on Form 10-K.

## **Overview**

We are a specialty provider of multi-jurisdictional workers' compensation insurance. We are domiciled in Illinois, commercially domiciled in California and headquartered in Seattle, Washington. We are licensed in 43 states and the District of Columbia to write workers' compensation insurance. Traditional providers of workers' compensation insurance provide coverage to employers under one or more state workers' compensation laws, which prescribe benefits that employers are obligated to provide to their employees who are injured arising out of or in the course of employment. We focus on employers with complex workers' compensation exposures and provide coverage under multiple state and federal acts, applicable common law or negotiated agreements. We also provide traditional state act coverage in markets we believe are underserved. Our workers' compensation policies are issued



to employers who also pay the premiums. The policies provide payments to covered, injured employees of the policyholder for, among other things, temporary or permanent disability benefits, death benefits and medical and hospital expenses. The benefits payable and the duration of such benefits are set by statute and vary by jurisdiction and with the nature and severity of the injury or disease and the wages, occupation and age of the employee.

SeaBright Insurance Holdings, Inc. (“SeaBright” or the “Company”) was formed in 2003 by members of our current management and entities affiliated with Summit Partners, a leading private equity and venture capital firm, for the purpose of completing a management-led buyout that closed on September 30, 2003 (the “Acquisition”). In the Acquisition, we acquired from Lumbermens Mutual Casualty Company (“LMC”) and certain of its affiliates the renewal rights and substantially all of the operating assets and employees of Eagle Pacific Insurance Company and Pacific Eagle Insurance Company (collectively, “Eagle” or the “Eagle Entities”). Eagle began writing specialty workers’ compensation insurance policies in the mid-1980’s. The Acquisition gave us renewal rights to an existing portfolio of business, representing a valuable asset given the renewal nature of our business, and a fully operational infrastructure that would have taken many years to develop. These renewal rights gave us access to Eagle’s customer lists and the right to seek to renew Eagle’s continuing in-force insurance contracts.

In the Acquisition, we also acquired 100% of the issued and outstanding capital stock of Kemper Employers Insurance Company (“KEIC”) and PointSure Insurance Services, Inc. (“PointSure”), a wholesale insurance broker and third party claims administrator. We acquired KEIC, a shell company with no in-force policies or employees, solely for the purpose of acquiring its workers’ compensation licenses in 43 states and the District of Columbia and for its certification with the United States Department of Labor. Subsequent to the Acquisition, KEIC was renamed “SeaBright Insurance Company.” SeaBright Insurance Company received an “A-” (Excellent) rating from A.M. Best following the completion of the Acquisition.

At closing of the Acquisition, \$4.0 million of the purchase price was placed into escrow for a period of two years. These funds were available to us as security for various obligations of LMC pursuant to various agreements entered into in connection with the Acquisition. As of March 31, 2006, the escrow agent had returned approximately \$3.9 million of the funds, including accumulated interest, to Kemper Employers Group, Inc. (“KEG”). The balance of approximately \$223,000 will be retained in escrow until LMC’s outstanding obligations have been satisfied. Any amount remaining after settlement of these obligations will be returned to KEG.

To minimize our exposure to any past business underwritten by KEIC, we entered into an adverse development cover agreement in connection with the Acquisition. Under the terms of this agreement, we and LMC are required to indemnify each other with respect to developments in KEIC’s insurance liabilities as they existed at the date of the Acquisition. Accordingly, if KEIC’s insurance liabilities increase, LMC must indemnify us in the amount of the increase. If KEIC’s insurance liabilities decrease, we must share with LMC the positive development of those reserves. To support LMC’s obligations under the adverse development cover, LMC funded a trust account at the time of the Acquisition in the amount of \$1.6 million as collateral for LMC’s potential future obligations to us under the adverse development cover. The minimum amount that must be maintained in the trust account is equal to the greater of (a) \$1.6 million or (b) 102% of the then existing quarterly estimate of LMC’s total obligations under the adverse development cover. The amount on deposit in the trust account at March 31, 2006 was approximately \$5.0 million. If LMC is placed into receivership and the amount held in the collateralized reinsurance trust is inadequate to satisfy the obligations of LMC to us under the adverse development cover, it is unlikely that we would recover any future amounts owing by LMC to us.

## **Principal Revenue and Expense Items**

We derive our revenue primarily from premiums earned, net investment income and net realized gains and losses from investments, and service income.

### ***Premiums Earned***

Gross premiums written include all premiums billed and unbilled by an insurance company during a specified policy period. Premiums are earned over the terms of the related policies. At the end of each accounting period, the portions of premiums that are not yet earned are included in unearned premiums and are realized as revenue in subsequent periods over the remaining terms of the policies. Our policies typically have terms of 12 months. Thus, for example, for a policy that is written on July 1, 2005, one-half of the premiums would be earned in 2005 and the other half would be earned in 2006.

Premiums earned are the earned portion of our net premiums written. Net premiums written is the difference between gross premiums written and premiums ceded or paid to reinsurers (ceded premiums written). Our gross premiums written is the sum of both direct premiums and assumed premiums before the effect of ceded reinsurance. Assumed premiums are premiums that we have received from an authorized state-mandated pool.

We earn our direct premiums written from our maritime, alternative dispute resolution (“ADR”) and state act customers. We also earn a small portion of our direct premiums written from employers who participate in the Washington USL&H Assigned Risk Plan. We immediately cede 100% of those premiums, net of our expenses, and 100% of the losses in connection with that business back to the plan. Premiums from the Washington USL&H Assigned Risk Plan are included in both direct premiums written and ceded premiums written.

#### ***Net Investment Income and Realized Gains and Losses on Investments***

We invest our statutory surplus and the funds supporting our insurance liabilities (including unearned premiums and unpaid loss and loss adjustment expense) in cash, cash equivalents, fixed income securities and, to a lesser degree, in equity securities. Our investment income includes interest earned on our invested assets. Realized gains and losses on invested assets are reported separately from net investment income. We earn realized gains when invested assets are sold for an amount greater than their amortized cost in the case of fixed maturity securities and recognize realized losses when investment securities are written down as a result of an other-than-temporary impairment or sold for an amount less than their carrying cost.

#### ***Claims Service Income***

The majority of our claims service income is from contracts we have with LMC to provide claims handling services for the policies written by the Eagle Entities prior to the Acquisition. The claims service income we receive for providing these services approximates our costs and will substantially decrease over the next several years as transactions related to the Eagle Entities diminish.

#### ***Other Service Income***

Following the Acquisition, we entered into servicing arrangements with LMC to provide policy administration and accounting services for the policies written by the Eagle Entities prior to the Acquisition. The fee income we receive for providing these services approximates our costs and will substantially decrease over the next several years as transactions related to the Eagle Entities diminish.

Our expenses consist primarily of:

#### ***Loss and Loss Adjustment Expenses***

Loss and loss adjustment expenses represent our largest expense item and include (1) claim payments made, (2) estimates for future claim payments and changes in those estimates for current and prior periods and (3) costs associated with investigating, defending and adjusting claims.

#### ***Underwriting, Acquisition and Insurance Expenses***

We refer to the expenses that we incur to underwrite risks as underwriting, acquisition and insurance expenses. Underwriting expenses consist of commission expenses, premium taxes and fees and other underwriting expenses incurred in writing and maintaining our business.

*Commission Expenses.* We pay commission expense to our brokers for the premiums that they produce for us.

*Premium Taxes and Fees.* We pay state and local taxes based on premiums, as well as licenses, fees, assessments and contributions to workers’ compensation security funds.

*Other Underwriting Expenses.* Other underwriting expenses consist of general administrative expenses such as salaries, rent, office supplies, depreciation and all other operating expenses not otherwise classified separately, and boards, bureaus and assessments of statistical agencies for policy service and administration items such as rating manuals, rating plans and experience data.

## ***Interest Expense***

Included in other expense is interest expense we incur on \$12.0 million of surplus notes that our insurance subsidiary issued in May 2004. Interest is based on the three-month LIBOR rate, plus 400 basis points, and is paid quarterly in arrears.

## **Results of Operations**

### ***Three Months Ended March 31, 2006 and 2005***

***Gross Premiums Written.*** Gross premiums written for the three months ended March 31, 2006 totaled \$54.7 million, an increase of \$10.4 million, or 23.5%, over \$44.3 million of gross premiums written in the same period of 2005. California continues to be our largest market, accounting for approximately 62% of our in-force premiums at March 31, 2006. Gross premiums written in California during the first quarter of 2006 accounted for 58.4% of total premiums written in the quarter, down from approximately 67.0% in the same period of 2005. This reduction is part of our plan to achieve optimal diversification of our book of business. Premiums written in Arizona, Louisiana and Missouri in the first quarter of 2006 increased from the same period in 2005. As of March 31, 2006, our in-force book of business was split as follows between our three primary market segments: state act – 54%, ADR – 31% and maritime – 15%.

On March 24, 2006, the Workers' Compensation Insurance Rating Bureau (the "WCIRB"), an industry-backed private organization that provides statistical analysis, submitted a filing with the California Insurance Commissioner recommending a 16.4% decrease in advisory pure premium rates on new and renewal policies effective July 1, 2006. The filing was based on an analysis of loss experience valued as of December 31, 2005 and was made in response to continued reductions in workers' compensation claim costs in California as a result of reform legislation enacted primarily in 2003 and 2004. The rate is advisory only and requires approval by the California Insurance Commissioner. A public hearing on the matters contained in the WCIRB's filing was held on April 27, 2006 and the California Insurance Commissioner is expected to make his recommendation in June 2006. If the advisory rate reduction is approved, insurance companies may choose whether or not to adopt the new rates. At this time, we are unable to predict the impact that the proposed rate reductions, if approved and adopted by us, might have on our future financial position and results of operations.

***Net Premiums Written.*** Net premiums written totaled \$50.8 million for the three months ended March 31, 2006 compared to \$39.0 million in the same period in 2005, representing an increase of \$11.8 million, or 30.3%. Net premiums written are affected by premiums ceded under reinsurance agreements with external reinsurers. Ceded written premiums for the three months ended March 31, 2005 totaled \$3.9 million (7.1% of gross premiums written) compared to \$5.3 million (12.0% of gross premiums written) in the same period of 2005. Our current reinsurance contracts provide for the ceding of premiums on a gross premiums earned basis.

***Net Premiums Earned.*** Net premiums earned were \$44.0 million for the three months ended March 31, 2006 compared to \$29.2 million for the same period in 2005, representing an increase of \$14.8 million, or 50.7%. As previously discussed, this increase is due to the increase in net premiums written. We record the entire annual policy premium as unearned premium when written and earn the premium over the life of the policy, which is generally twelve months. Net premiums earned in the first quarter of 2006 reflect a reduction of approximately \$2.2 million related to our retrospectively rated policies, reflective of improved loss ratios that generate return premiums. Retrospectively rated policies currently account for approximately one-third of our book of business.

***Net Investment Income.*** Net investment income was \$3.1 million for the three months ended March 31, 2006 compared to \$1.3 million for the same period in 2005, representing an increase of \$1.8 million, or 138.5%. This increase is due primarily to an increase of approximately \$154.0 million (96.6%) in average invested funds for the three months ended March 31, 2006 over the same period in 2005. In January 2005, we completed the initial public offering of our common stock, resulting in net proceeds of approximately \$80.4 million. In February 2006, we completed a follow-on offering of 3,910,000 shares of our common stock, resulting in net proceeds of approximately \$57.6 million. Our yield on average invested assets for the three months ended March 31, 2006 was approximately 4.0% compared to approximately 3.3% for the same period in 2005.

***Service Income.*** Service income totaled \$551,000 for the three months ended March 31, 2006 compared to \$632,000 for the same period in 2005, representing a decrease of \$81,000, or 12.8%. Our service income results primarily from service arrangements we have with LMC for claims processing services, policy administration and

administrative services we perform for the Eagle Entities' insurance policies. Average monthly fees are declining as the volume of work decreases as a result of the run off of our predecessor's business. Approximately 25.8% of our service income in the quarter ended March 31, 2006 came from third party claims administration services that we provide to other independent, unrelated companies, compared to 13.1% of service income from unrelated companies in the same period of 2005.

*Other Income.* Other income totaled \$0.8 million for the three months ended March 31, 2006 compared to \$1.2 million for the same period in 2005, representing a decrease of \$0.4 million, or 33.3%. Other income results primarily from the operations of PointSure, our wholesale insurance broker and third party claims administrator subsidiary. The decrease in other income for the three month period ended March 31, 2006 resulted primarily from a decrease in PointSure's agency and direct billed commission income, which totaled approximately \$756,000 million for the three months ended March 31, 2006 compared to \$1.2 million in the same period of 2005, representing a decrease of \$444,000, or 37.0%. Most of this income is passed through as commission expense to brokers and producers.

*Loss and Loss Adjustment Expenses.* Loss and loss adjustment expenses totaled \$28.4 million for the three months ended March 31, 2006 compared to \$20.3 million for the same period in 2005, representing an increase of \$8.1 million, or 39.9%. The higher loss and loss adjustment expenses for the quarter ended March 31, 2006 are attributable to the increase in premiums earned for the period. Our net loss ratio, which is calculated by dividing loss and loss adjustment expenses less claims service income by premiums earned, for the three months ended March 31, 2006 was 63.5% compared to 67.5% for the same period in 2005. Included in the 2006 loss ratio was a release of approximately \$1.8 million of 2004 accident year loss reserves. During the first quarter of 2006, paid losses totaled \$10.6 million compared to \$6.7 million for the same period in 2005.

As of March 31, 2006, we had recorded a receivable of approximately \$3.4 million for adverse loss development under the adverse development cover since the date of the Acquisition. We do not expect this receivable to have any material adverse effect on our future cash flows if LMC fails to perform its obligations under the adverse development cover. At March 31, 2006, we have access to approximately \$5.0 million under the collateralized reinsurance trust in the event that LMC fails to satisfy its obligations under the adverse development cover.

*Underwriting Expenses.* Underwriting expenses totaled \$9.6 million for the three months ended March 31, 2006, compared to \$6.4 million for the same period in 2005, representing an increase of \$3.2 million, or 50.0%. Our net underwriting expense ratio, which is calculated by dividing underwriting, acquisition and insurance expenses less other service income by premiums earned, for the three months ended March 31, 2006 was 21.8%, compared to 21.7% for the same period in 2005. The slight increase in the net underwriting expense ratio resulted primarily from the effect of business assumed from the National Council on Compensation Insurance ("NCCI") residual market pools. Assumed commissions were \$1.4 million for the three months ended March 31, 2006 compared to \$87,000 for the same period in 2005. Direct commissions in the first quarter of 2006 increased \$1.0 million compared to the same period in 2005. Commissions as a percentage of direct earned premiums increased from 6.0% in the first quarter of 2005 to 6.8% in the same period of 2006.

*Other Expenses.* Other expenses totaled \$1.5 million for the three months ended March 31, 2006, compared to \$1.7 million for same period in 2005, representing a decrease of \$0.2 million, or 11.8%. This decrease resulted primarily from a reduction in PointSure's operating expenses, offset by costs associated with the implementation of SFAS No. 123R. As explained above under "Other Income," the majority of the decrease is due to a reduction in PointSure's commission expense, which totaled \$600,000 for the three months ended March 31, 2006 compared to \$1.2 million in the same period of 2005, representing a decrease of \$600,000, or 50.0%. Most of this expense is a pass-through of agency and direct billed commission income received from insurance companies.

*Federal Income Tax Expense.* The effective tax rate for the three months ended March 31, 2006 was 30.5%, compared to 29.5% for the same period in 2005. At March 31, 2006, approximately 58.7% of our portfolio was invested in tax-exempt securities, compared to approximately 51.4% at March 31, 2005.

*Net Income.* Net income was \$6.0 million for the three months ended March 31, 2006, compared to \$2.7 million for the same period in 2005. The increase in net income resulted primarily from increases in premiums earned and investment income for the period, offset by increases in loss and loss adjustment expenses, underwriting, acquisition and insurance expenses, and realized losses from the sale of securities.

## Liquidity and Capital Resources

Our principal sources of funds are underwriting operations, investment income and proceeds from sales and maturities of investments. Our primary use of funds is to pay claims and operating expenses and to purchase investments.

Our investment portfolio is structured so that investments mature periodically over time in reasonable relation to current expectations of future claim payments. Since we have a limited claims history, we have derived our expected future claim payments from industry and predecessor trends and included a provision for uncertainties. Our investment portfolio as of March 31, 2006 has an effective duration of 5.3 years with individual maturities extending out to 26 years. Currently, we make claim payments from positive cash flow from operations and invest excess cash in securities with appropriate maturity dates to balance against anticipated future claim payments. As these securities mature, we intend to invest any excess funds in investments with appropriate durations to match against expected future claim payments.

At March 31, 2006, our investment portfolio is made up almost entirely of investment grade fixed income securities with market values subject to fluctuations in interest rates. While we have structured our investment portfolio to provide an appropriate matching of maturities with anticipated claim payments, if we decide or are required in the future to sell securities in a rising interest rate environment, we would expect to incur losses from such sales.

Our ability to adequately provide funds to pay claims comes from our disciplined underwriting and pricing standards and the purchase of reinsurance to protect us against severe claims and catastrophic events. On October 1, 2005, we entered into new reinsurance contracts that are effective through October 1, 2006. The contracts provide reinsurance coverage up to \$50.0 million per loss occurrence, subject to certain limitations. We retain the first \$500,000 of losses per loss occurrence. The next \$500,000 of losses per occurrence (excess of the first \$500,000 of losses per occurrence that we retain) are 50% reinsured, subject to an annual aggregate deductible of \$1.5 million. The next \$4.0 million of losses per occurrence (excess of the first \$1.0 million of losses per occurrence) are reinsured, subject to an annual aggregate deductible of \$2.0 million. Policies covering losses per occurrence in excess of \$5.0 million up to \$50.0 million contain no annual aggregate deductibles. We believe that we are sufficiently capitalized to retain the losses described above.

Our insurance subsidiary is required by law to maintain a certain minimum level of surplus on a statutory basis. Surplus is calculated by subtracting total liabilities from total admitted assets. The National Association of Insurance Commissioners has a risk-based capital standard designed to identify property and casualty insurers that may be inadequately capitalized based on inherent risks of each insurer's assets and liabilities and its mix of net premiums written. Insurers falling below a calculated threshold may be subject to varying degrees of regulatory action. As of December 31, 2005, the last date that we were required to update the annual risk-based capital calculation, the statutory surplus of our insurance subsidiary was in excess of the prescribed risk-based capital requirements that correspond to any level of regulatory action.

SeaBright operates as a holding company and has minimal revenue and expenses. Currently, there are no plans to have our insurance subsidiary or PointSure pay a dividend to SeaBright.

Our unaudited consolidated net cash provided by operating activities for the three months ended March 31, 2006 was \$24.5 million, compared to our cash flow from operations of \$15.4 million for the same period in 2005. The increase resulted primarily from the increase in net income and increases in unpaid loss and loss adjustment expense, amortization of deferred policy acquisition costs and federal income tax payable, offset by policy acquisition costs deferred and deferred federal income tax benefit and an increase in balances related to reinsurance recoverables, all as a result of the growth of our business.

We used net cash of \$70.5 million for investing activities in the three months ended March 31, 2006, compared to \$85.2 million for the same period in 2005. The difference between periods is primarily attributable to a reduction in funds available for investing activities. In 2005, we invested net proceeds totaling approximately \$80.4 million resulting from the sale of 8,625,000 shares of common stock in our initial public offering. In 2006, we invested net proceeds totaling approximately \$57.6 million resulting from a follow-on public offering of 3,910,000 shares of our common stock described below.

For the three months ended March 31, 2006, financing activities provided cash of \$57.6 million, compared to \$80.4 million in the same period in 2005. As described below, the majority of cash provided by financing activities

resulted from the sale of our common stock and, to a much lesser degree, from the exercise of common stock options by our employees.

On February 1, 2006, we closed a follow-on public offering of 3,910,000 shares of our common stock, including the underwriters' over-allotment option to purchase 510,000 shares of our common stock, at a price of \$15.75 per share for net proceeds of approximately \$57.6 million, after deducting underwriters' fees, commissions and offering costs totaling approximately \$4.0 million. We contributed \$50.0 million of the net proceeds to SeaBright Insurance Company, which intends to use the capital to expand its business in its core markets and to new territories. The remaining proceeds will be used for general corporate purposes, including supporting the planned growth of PointSure.

### Contractual Obligations and Commitments

The following table identifies our contractual obligations by payment due period as of March 31, 2006:

	Payments Due by Period				
	Total	Less than 1 Year	1-3 Years (in thousands)	4-5 Years	More than 5 Years
Long term debt obligations:					
Surplus notes .....	\$ 12,000	\$ —	\$ —	\$ —	\$ 12,000
Loss and loss adjustment expenses .....	160,063	22,889	77,150	23,049	36,975
Operating lease obligations .....	2,825	835	1,964	26	—
Total .....	<u>\$ 174,888</u>	<u>\$ 23,724</u>	<u>\$ 79,114</u>	<u>\$ 23,075</u>	<u>\$ 48,975</u>

The loss and loss adjustment expense payments due by period in the table above are based upon the loss and loss adjustment expense estimates as of March 31, 2006 and actuarial estimates of expected payout patterns and are not contractual liabilities as to time certain. Our contractual liability is to provide benefits under the policies. As a result, our calculation of loss and loss adjustment expense payments due by period is subject to the same uncertainties associated with determining the level of unpaid loss and loss adjustment expenses generally and to the additional uncertainties arising from the difficulty of predicting when claims (including claims that have not yet been reported to us) will be paid. Actual payments of loss and loss adjustment expenses by period will vary, perhaps materially, from the above table to the extent that current estimates of loss and loss adjustment expenses vary from actual ultimate claims amounts and as a result of variations between expected and actual payout patterns.

### Off-Balance Sheet Arrangements

As of March 31, 2006, we had no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### Critical Accounting Policies, Estimates and Judgments

It is important to understand our accounting policies in order to understand our financial statements. We consider some of these policies to be critical to the presentation of our financial results, since they require management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the financial reporting date and throughout the period being reported upon. Some of the estimates result from judgments that can be subjective and complex, and consequently, actual results reflected in future periods might differ from these estimates.

The most critical accounting policies involve the reporting of unpaid loss and loss adjustment expenses, including losses that have occurred but were not reported to us by the financial reporting date; the amount and recoverability of reinsurance recoverable balances; accounting for our adverse development cover; deferred policy acquisition costs; deferred taxes; goodwill and other intangible assets; retrospective premiums; earned but unbilled premiums; and the impairment of investment securities. The following should be read in conjunction with the notes to our financial statements.

#### *Unpaid Loss and Loss Adjustment Expenses*

Unpaid loss and loss adjustment expenses represent our estimate of the expected cost of the ultimate settlement and administration of losses, based on known facts and circumstances. Included in unpaid loss and loss adjustment expenses are amounts for case-based insurance liabilities, including estimates of future developments on these

claims; claims incurred but not yet reported to us; second injury fund assessments; allocated claim adjustment expenses; and unallocated claim adjustment expenses. We use actuarial methodologies to assist us in establishing these estimates, including judgments relative to estimates of future claims severity and frequency, length of time to achieve ultimate resolution, judicial theories of liability and other third-party factors that are often beyond our control. Due to the inherent uncertainty associated with the cost of unsettled and unreported claims, the ultimate liability may differ materially from the original estimates. These estimates are regularly reviewed and updated and any resulting adjustments are included in the current period's operating results. Because of the relative immaturity of our unpaid loss and loss adjustment expense data, actuarial techniques are applied that use the historical experience of our predecessor as well as industry information in the analysis of our unpaid loss and loss adjustment expenses.

### ***Reinsurance Recoverables***

Reinsurance recoverables on paid and unpaid losses represent the portion of the loss and loss adjustment expenses that is assumed by reinsurers. These recoverables are reported on our unaudited condensed consolidated balance sheets separately as assets, as reinsurance does not relieve us of our legal liability to policyholders and ceding companies. We are required to pay losses even if a reinsurer fails to meet its obligations under the applicable reinsurance agreement. Reinsurance recoverables are determined based in part on the terms and conditions of reinsurance contracts, which could be subject to interpretations that differ from ours based on judicial theories of liability. In addition, we bear credit risk with respect to the reinsurers, which can be significant considering that some of the unpaid loss and loss adjustment expenses remain outstanding for an extended period of time.

### ***Adverse Development Cover***

The unpaid loss and loss adjustment expense subject to the adverse development cover with LMC is calculated on a quarterly basis using generally accepted actuarial methodologies. Amounts recoverable in excess of acquired insurance liabilities at September 30, 2003 are recorded gross in unpaid loss and loss adjustment expense in accordance with SFAS No. 141, *Business Combinations*, with a corresponding amount receivable from the seller. Amounts are shown net in the statement of operations.

### ***Deferred Policy Acquisition Costs***

We defer commissions, premium taxes and certain other costs that vary with and are primarily related to the acquisition of insurance contracts. These costs are capitalized and amortized to expense in proportion to the recognition of premiums earned. The method followed in computing deferred policy acquisition costs limits the amount of these deferred costs to their estimated realizable value, which gives effect to the premium to be earned, related investment income, anticipated losses and settlement expenses and certain other costs that we expect to incur as the premium is earned. Judgments as to ultimate recoverability of these deferred costs are highly dependent upon estimated future loss costs associated with the premiums written.

### ***Deferred Taxes***

We use the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry-forwards. Deferred tax assets and liabilities are measured using tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the statement of operations in the period that includes the enactment date.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. If necessary, we would establish a valuation allowance to reduce the deferred tax assets to the amounts more likely than not to be realized.

### ***Goodwill and Other Intangible Assets***

Goodwill represents the excess of costs over fair value of assets of businesses acquired. Goodwill and other intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are

not amortized, but are instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*.

#### ***Retrospective Premiums***

Retrospective premiums for primary and reinsured risks are included in income as earned on a pro rata basis over the effective period of the respective policies. Earned premiums on retrospectively rated policies are based on the Company's estimate of loss experience as of the measurement date. Unearned premiums are deferred and include that portion of premiums written that is applicable to the unexpired period of the policies in force and estimated adjustments of premiums on policies that have retrospective rating endorsements.

#### ***Earned But Unbilled Premiums***

We estimate the amount of premiums that have been earned but are unbilled at the end of the period by analyzing historical earned premium adjustments made and applying an adjustment percentage against premiums earned for the period.

#### ***Impairment of Investment Securities***

Impairment of investment securities results in a charge to operations when the market value of a security declines to below our cost and is deemed to be other-than-temporary. We regularly review our fixed maturity portfolio to evaluate the necessity of recording impairment losses for other-than-temporary declines in the fair value of investments. A number of criteria are considered during this process, including, but not limited to, the following: the current fair value as compared to amortized cost or cost, as appropriate, of the security; the length of time the security's fair value has been below amortized cost; our intent and ability to retain the investment for a period of time sufficient to allow for an anticipated recovery in value; specific credit issues related to the issuer; and current economic conditions. In general, we focus on those securities whose fair values were less than 80% of their amortized cost or cost, as appropriate, for six or more consecutive months. Other-than-temporary impairment losses result in a permanent reduction of the carrying amount of the underlying investment. Significant changes in the factors considered when evaluating investments for impairment losses could result in a significant change in impairment losses reported in the financial statements.

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

Market risk is the potential economic loss principally arising from adverse changes in the fair value of financial instruments. The major components of market risk affecting us are credit risk and interest rate risk.

#### **Credit Risk**

Credit Risk is the potential economic loss principally arising from adverse changes in the financial condition of a specific debt issuer. We address this risk by investing primarily in fixed-income securities which are rated "A" or higher by Standard & Poor's. We also independently, and through our outside investment managers, monitor the financial condition of all of the issuers of fixed-income securities in the portfolio. To limit our exposure to risk, we employ stringent diversification rules that limit the credit exposure to any single issuer or business sector.

#### **Interest Rate Risk**

We had fixed-income investments with a fair value of \$326.8 million at March 31, 2006 that are subject to interest rate risk. We manage the exposure to interest rate risk through a disciplined asset/liability matching and capital management process. In the management of this risk, the characteristics of duration, credit and variability of cash flows are critical elements. These risks are assessed regularly and balanced within the context of the liability and capital position.

The table below summarizes our interest rate risk. It illustrates the sensitivity of the fair value of fixed-income investments to selected hypothetical changes in interest rates as of March 31, 2006. The selected scenarios are not predictions of future events, but rather illustrate the effect that such events may have on the fair value of our fixed-income portfolio and shareholders' equity.



<u>Hypothetical Change in Interest Rates</u>	<u>Estimated Change in Fair Value</u>	<u>Fair Value (\$ in thousands)</u>	<u>Hypothetical Percentage Increase (Decrease) in Portfolio Value</u>
200 basis point increase .....	\$ (26,989)	\$ 299,806	(8.3)%
100 basis point increase .....	(13,535)	313,260	(4.1)%
No change .....	—	326,795	—
100 basis point decrease .....	13,617	340,412	4.2%
200 basis point decrease .....	27,316	354,111	8.4%

#### Item 4. Controls and Procedures

Under the supervision and with the participation of management, including our Chief Executive Officer and our Chief Financial Officer, we have carried out an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report to ensure that information we are required to disclose in reports that are filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms specified by the Securities and Exchange Commission. There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) that occurred during the period covered in this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

#### Item 1A. Risk Factors

*You should carefully consider the risks described below, together with all of the other information included in this quarterly report. The risks and uncertainties described below are not the only ones facing our company. If any of the following risks actually occurs, our business, financial condition or operating results could be harmed. Any of the risks described below could result in a significant or material adverse effect on our financial condition or results of operations, and a corresponding decline in the market price of our common stock. You could lose all or part of your investment. The risks discussed below also include forward-looking statements and our actual results may differ substantially from those discussed in those forward-looking statements. Please refer to the discussion under the heading “Cautionary Statement” in Part I, Item 2.*

The following risk factor has been updated to reflect developments that occurred during the quarter ended March 31, 2006.

#### ***Intense competition could adversely affect our ability to sell policies at rates we deem adequate.***

In most of the states in which we operate, we face significant competition which, at times, is intense. If we are unable to compete effectively, our business and financial condition could be materially adversely affected. Competition in our businesses is based on many factors, including premiums charged, services provided, financial strength ratings assigned by independent rating agencies, speed of claims payments, reputation, perceived financial strength and general experience. We compete with regional and national insurance companies and state-sponsored insurance funds, as well as potential insureds that have decided to self-insure. Our principal competitors include AIG, Alaska National Insurance Company, Signal Mutual Indemnity Association Ltd., Zurich and the State Compensation Insurance Fund of California. Many of our competitors have substantially greater financial and marketing resources than we do, and some of our competitors, including the State Compensation Insurance Fund of California, benefit financially by not being subject to federal income tax. Intense competitive pressure on prices can result from the actions of even a single large competitor, such as the State Compensation Insurance Fund of California or AIG.

In addition, our competitive advantage may be limited due to the small number of insurance products that we offer. Some of our competitors, such as AIG, have additional competitive leverage because of the wide array of insurance products that they offer. For example, it may be more convenient for a potential customer to purchase numerous different types of insurance products from one insurance carrier. We do not offer a wide array of

insurance products due to our targeted market niches, and we may lose potential customers to our larger, more diverse competitors as a result.

On May 31, 2005, the California Insurance Commissioner issued a decision adopting an advisory pure premium rate reduction of 18% for California workers' compensation policies incepting on or after July 1, 2005. Pure premium is that portion of an insurance premium necessary to cover the cost of paying claims, such as medical and indemnity costs and allocated and unallocated loss adjustment expenses. The decision was issued in response to reductions in 2004 workers' compensation claim costs in California, as well as anticipated future claim cost reductions, as a result of reform legislation enacted primarily in 2003 and 2004. The California Insurance Commissioner's decision is advisory only and insurance companies may choose whether or not to adopt the new rates. On June 6, 2005, after completing a study of our California loss data, we filed with the California Department of Insurance our rates for new and renewal workers' compensation insurance policies written in California on or after July 1, 2005. The filing was approved on June 28, 2005. The new rates reflect an average reduction of 14.2% from prior rates and are in response to emerging favorable trends in loss costs resulting from reform legislation. If any of our competitors adopt premium rate reductions that are greater than ours, we may be unable to compete effectively and our business, financial condition and results of operations could be materially adversely affected.

On September 15, 2005, the Workers' Compensation Insurance Rating Bureau ("WCIRB"), an industry-backed private organization that provides statistical analysis, submitted an amended filing with the California Insurance Commissioner recommending a 15.9% decrease in advisory pure premium rates on new and renewal policies effective January 1, 2006. As described above, such rates, if adopted by the California Insurance Commissioner, are advisory only and insurance companies may choose whether or not to adopt the new rates. The rate decrease was proposed following the WCIRB's review of accident year experience valued as of June 30, 2005 and the cost impact of the January 1, 2005 permanent disability rating schedule. On November 10, 2005, the Commissioner recommended a 15.3% decrease in rates, and on November 28, 2005 we filed new rates reflecting an average reduction of 11.8% from prior rates for new and renewal workers' compensation insurance policies written in California on or after January 1, 2006. The filing was approved on December 22, 2005. Rate reductions have also been proposed in other states in which we operate. At this time, we are unable to predict the impact that the proposed rate reductions, if approved and adopted by us, might have on our future financial position and results of operations.

On March 24, 2006, the WCIRB submitted a filing with the California Insurance Commissioner recommending a 16.4% decrease in advisory pure premium rates on new and renewal policies effective July 1, 2006. The filing was based on an analysis of loss experience valued as of December 31, 2005 and was made in response to continued reductions in workers' compensation claim costs in California as a result of reform legislation enacted primarily in 2003 and 2004. The rate is advisory only and requires approval by the California Insurance Commissioner. A public hearing on the matters contained in the WCIRB's filing was held on April 27, 2006 and the California Insurance Commissioner is expected to make his recommendation in June 2006. If the advisory rate reduction is approved, insurance companies may choose whether or not to adopt the new rates. At this time, we are unable to predict the impact that the proposed rate reductions, if approved and adopted by us, might have on our future financial position and results of operations.

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

On January 19, 2005, the SEC declared effective our Registration Statement on Form S-1, as amended (Registration No. 333-119111), as filed with the SEC in connection with the initial public offering of 8,625,000 shares of our common stock. The managing underwriters in the offering were Friedman, Billings, Ramsey & Co., Inc., Piper Jaffray & Co. and Cochran, Caronia & Co. Proceeds to SeaBright, after accounting for approximately \$6.3 million in underwriting discounts and commissions and approximately \$3.9 million in other expenses of the offering, were approximately \$80.4 million. The offering closed on January 26, 2005.

On January 26, 2005, we contributed approximately \$74.8 million of the net proceeds to SeaBright Insurance Company. We intend to use the remaining net proceeds for general corporate purposes, including supporting the growth of PointSure. Except for the capital contribution to SeaBright Insurance Company, as of March 31, 2006, we had not used any of the remaining net proceeds from the offering. Our use of the proceeds from the offering does not represent a material change in the use of proceeds described in the prospectus included as part of the Registration Statement.

We did not purchase any of our equity securities during the three months ended March 31, 2006.

**Item 6. Exhibits**

The list of exhibits in the Exhibit Index to this quarterly report is incorporated herein by reference.

## **SIGNATURES**

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.

SEABRIGHT INSURANCE HOLDINGS, INC.

Date: May 15, 2006

By: /s/ Joseph S. De Vita  
Joseph S. De Vita  
Senior Vice President, Chief Financial Officer and  
Assistant Secretary (Principal Financial Officer)

## **EXHIBIT INDEX**

The list of exhibits in the Exhibit Index to this quarterly report on Form 10-Q is incorporated herein by reference. Exhibits 31.1 and 31.2 are being filed as part of this quarterly report on Form 10-Q. Exhibits 32.1 and 32.2 are being furnished with this quarterly report on Form 10-Q.

<b><u>Exhibit Number</u></b>	<b><u>Description</u></b>
31.1	Rule 13a-14(a) Certification (Chief Executive Officer)
31.2	Rule 13a-14(a) Certification (Chief Financial Officer)
32.1	Section 1350 Certification (Chief Executive Officer)
32.2	Section 1350 Certification (Chief Financial Officer)

### CHIEF EXECUTIVE OFFICER CERTIFICATION

I, John G. Pasqualetto, President and Chief Executive Officer of SeaBright Insurance Holdings, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of SeaBright Insurance Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) [Reserved]
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 15, 2006

/s/ John G. Pasqualetto  
John G. Pasqualetto  
Chairman, President and Chief Executive Officer

## CHIEF FINANCIAL OFFICER CERTIFICATION

I, Joseph S. De Vita, Chief Financial Officer of SeaBright Insurance Holdings, Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of SeaBright Insurance Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) [Reserved]
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 15, 2006

/s/ Joseph S. De Vita  
Joseph S. De Vita  
Senior Vice President, Chief Financial Officer  
and Assistant Secretary

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of SeaBright Insurance Holdings, Inc. (the “Company”) on Form 10-Q for the period ended March 31, 2006, as filed with the Securities and Exchange Commission (the “Report”), I, John G. Pasqualetto, Chairman, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 15, 2006

/s/ John G. Pasqualetto  
John G. Pasqualetto  
Chairman, President and Chief Executive Officer

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



**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of SeaBright Insurance Holdings, Inc. (the “Company”) on Form 10-Q for the period ended March 31, 2006, as filed with the Securities and Exchange Commission (the “Report”), I, Joseph S. De Vita, Senior Vice President, Chief Financial Officer and Assistant Secretary of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 15, 2006

/s/ Joseph S. De Vita  
Joseph S. De Vita  
Senior Vice President, Chief Financial Officer  
and Assistant Secretary

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