

HILB ROGAL & HOBBS CO  
Form 10-Q  
November 01, 2006  
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# SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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## FORM 10-Q

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

For the quarterly period ended September 30, 2006

Commission File Number **0-15981**

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## HILB ROGAL & HOBBS COMPANY

(Exact name of registrant as specified in its charter)

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

**54-1194795**  
(I.R.S. Employer

Identification No.)

**4951 Lake Brook Drive, Suite 500**

**Glen Allen, Virginia**  
(Address of principal executive offices)

**23060**  
(Zip Code)

**(804) 747-6500**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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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.

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

Yes  No

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

	Class	Outstanding at October 31, 2006
Common Stock, no par value		36,167,918

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**HILB ROGAL & HOBBS COMPANY**

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS.  
STATEMENT OF CONSOLIDATED INCOME****HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES****(UNAUDITED)**

<i>(in thousands, except per share amounts)</i>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>REVENUES</b>				
Commissions and fees	\$ 169,393	\$ 161,119	\$ 521,664	\$ 499,808
Investment income	3,131	1,633	7,695	4,221
Other	641	1,739	6,014	5,834
	173,165	164,491	535,373	509,863
<b>OPERATING EXPENSES</b>				
Compensation and employee benefits	97,776	90,742	294,890	274,597
Other operating expenses	32,430	29,893	97,023	95,423
Depreciation	2,090	2,122	6,217	6,402
Amortization of intangibles	5,571	4,783	15,376	14,197
Interest expense	4,987	4,300	14,180	12,097
Loss on extinguishment of debt			897	
Integration costs	(243)		(243)	764
Regulatory charge and related costs		42,320		42,320
Severance charge				1,303
	142,611	174,160	428,340	447,103
<b>INCOME (LOSS) BEFORE INCOME TAXES</b>	30,554	(9,669)	107,033	62,760
Income tax expense (benefit)	11,486	(2,821)	41,412	26,083
<b>NET INCOME (LOSS)</b>	<b>\$ 19,068</b>	<b>\$ (6,848)</b>	<b>\$ 65,621</b>	<b>\$ 36,677</b>
Net Income (Loss) Per Share:				
Basic	\$ 0.53	\$ (0.19)	\$ 1.83	\$ 1.03
Assuming Dilution	\$ 0.53	\$ (0.19)	\$ 1.81	\$ 1.01

See notes to consolidated financial statements.

**Table of Contents****CONSOLIDATED BALANCE SHEET****HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES**

	September 30,	December 31,
<i>(in thousands)</i>	2006 (UNAUDITED)	2005
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents, including \$64,068 and \$54,611, respectively, of restricted funds	\$ 241,260	\$ 224,471
Receivables:		
Premiums and commissions, less allowance for doubtful accounts of \$4,522 and \$4,180, respectively	198,470	224,201
Other	31,024	28,887
	229,494	253,088
Prepaid expenses and other current assets	24,257	37,888
<b>TOTAL CURRENT ASSETS</b>	<b>495,011</b>	<b>515,447</b>
PROPERTY AND EQUIPMENT, NET	22,993	24,765
GOODWILL	667,813	625,349
OTHER INTANGIBLE ASSETS	229,177	188,645
Less accumulated amortization	65,798	50,458
	831,192	763,536
<b>OTHER ASSETS</b>	<b>32,008</b>	<b>26,019</b>
	\$ 1,381,204	\$ 1,329,767
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Premiums payable to insurance companies	\$ 303,597	\$ 339,088
Accounts payable	15,503	16,150
Accrued expenses	65,160	49,618
Premium deposits and credits due customers	47,892	40,454
Current portion of long-term debt	10,530	12,511
<b>TOTAL CURRENT LIABILITIES</b>	<b>442,682</b>	<b>457,821</b>
LONG-TERM DEBT	256,367	251,507
DEFERRED INCOME TAXES	28,904	23,307
OTHER LONG-TERM LIABILITIES	44,811	50,875
<b>SHAREHOLDERS EQUITY</b>		
Common Stock, no par value; authorized 100,000 shares; outstanding 36,122 and 35,955 shares, respectively	241,375	233,292
Retained earnings	364,884	312,040
Accumulated other comprehensive income		
Unrealized gain on interest rate swaps, net of deferred tax expense of \$443 and \$308, respectively	665	462
Foreign currency translation adjustments	1,516	463
	608,440	546,257
	\$ 1,381,204	\$ 1,329,767

See notes to consolidated financial statements.



**Table of Contents****STATEMENT OF CONSOLIDATED SHAREHOLDERS' EQUITY****HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES****(UNAUDITED)**

	<b>Common</b>	<b>Retained</b>	<b>Accumulated Other Comprehensive</b>
<i>(in thousands, except per share amounts)</i>	<b>Stock</b>	<b>Earnings</b>	<b>Income (Loss)</b>
Balance at January 1, 2006	\$ 233,292	\$ 312,040	\$ 925
Issuance of 800 shares of Common Stock	23,699		
Repurchase of 633 shares of Common Stock	(24,967)		
Stock-based compensation	7,090		
Income tax benefit from exercise of stock options	2,261		
Payment of dividends (\$0.3550 per share)		(12,777)	
Derivative gain, net of tax			203
Foreign currency translation adjustments			1,053
Net income		65,621	
Balance at September 30, 2006	\$ 241,375	\$ 364,884	\$ 2,181
Balance at January 1, 2005	\$ 233,785	\$ 271,978	\$ 1,393
Issuance of 501 shares of Common Stock	10,987		
Repurchase of 613 shares of Common Stock	(21,848)		
Stock-based compensation	1,848		
Income tax benefit from exercise of stock options	1,863		
Payment of dividends (\$0.3350 per share)		(12,001)	
Derivative gain, net of tax			615
Foreign currency translation adjustments			(787)
Net income		36,677	
Balance at September 30, 2005	\$ 226,635	\$ 296,654	\$ 1,221

See notes to consolidated financial statements.

**Table of Contents****STATEMENT OF CONSOLIDATED CASH FLOWS****HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES****(UNAUDITED)**

	Nine Months Ended	
	September 30,	
<i>(in thousands)</i>	2006	2005
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 65,621	\$ 36,677
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on extinguishment of debt	897	
Integration costs	(243)	764
Regulatory charge and related costs		42,320
Severance charge		1,303
Depreciation	6,217	6,402
Amortization of intangibles	15,376	14,197
Stock-based compensation	7,090	1,848
Provision for losses on receivables	1,028	1,119
Provision for deferred income taxes	2,537	(3,561)
Gain on sale of assets	(3,741)	(2,791)
Income tax benefit from exercise of stock options		1,863
Changes in operating assets and liabilities net of effects from regulatory charge and related costs, severance charge, integration costs and insurance agency acquisitions and dispositions:		
Decrease in receivables	33,192	2,445
Increase in prepaid expenses	(190)	(8,628)
Decrease in premiums payable to insurance companies	(56,255)	(8,956)
Increase (decrease) in premium deposits and credits due customers	7,438	(337)
Decrease in accounts payable	(1,911)	(2,088)
Increase (decrease) in accrued expenses	4,886	(11,140)
Decrease in regulatory charge accrual	(2,434)	
Other operating activities	(2,168)	(71)
<b>Net Cash Provided by Operating Activities</b>	<b>77,340</b>	<b>71,366</b>
<b>INVESTING ACTIVITIES</b>		
Purchase of property and equipment	(4,375)	(7,365)
Purchase of insurance agencies, net of cash acquired	(50,846)	(19,281)
Proceeds from sale of assets	7,680	5,183
Sale of investments	13,800	
Other investing activities	1,664	536
<b>Net Cash Used in Investing Activities</b>	<b>(32,077)</b>	<b>(20,927)</b>
<b>FINANCING ACTIVITIES</b>		
Proceeds from long-term debt	250,625	
Principal payments on long-term debt	(248,323)	(9,475)
Debt issuance costs	(1,728)	(204)
Repurchase of Common Stock	(24,967)	(21,848)
Proceeds from issuance of Common Stock, net of tax payments for options exercised	6,435	2,407
Income tax benefit from exercise of stock options	2,261	
Dividends	(12,777)	(12,001)
<b>Net Cash Used in Financing Activities</b>	<b>(28,474)</b>	<b>(41,121)</b>



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Increase in cash and cash equivalents	16,789	9,318
Cash and cash equivalents at beginning of period	224,471	210,470
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$ 241,260</b>	<b>\$ 219,788</b>

See notes to consolidated financial statements.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES**

**September 30, 2006**

**(UNAUDITED)**

**NOTE A BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements of Hilb Rogal & Hobbs Company (the Company) have been prepared in accordance with United States generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by United States generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain amounts for the prior period have been reclassified to conform to current year presentation. Operating results for the nine-month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Form 10-K for the year ended December 31, 2005.

**NOTE B ACCOUNTING FOR STOCK-BASED COMPENSATION**

At September 30, 2006 and 2005, the Company had three stock-based compensation plans, which are described more fully in Notes A and H to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 (2005 Form 10-K).

Prior to December 2004, Financial Accounting Standards Board Statement No. 123, Accounting for Stock-Based Compensation (Statement 123), as amended by Financial Accounting Standards Board Statement No. 148, established accounting and disclosure requirements using a fair value based method of accounting for stock options. In December 2004, the Financial Accounting Standards Board issued Financial Accounting Standards Board Statement No. 123 (revised 2004), Share-Based Payment (Statement 123R). Statement 123R revises Statement 123. The revised standard requires all companies to recognize compensation costs related to all share-based payments (including stock options) in their financial statements at fair value, thereby, upon adoption, eliminating the use of pro forma disclosures to report such amounts. In April 2005, the Securities and Exchange Commission issued a rule to amend the effective date of Statement 123R. Statement 123R is effective for a public company that is not a small business issuer at the beginning of the first fiscal year beginning after June 15, 2005.

Statement 123R permits public companies to account for the adoption of this revised standard using one of two methods: the modified-prospective method or the modified-retrospective method. The modified-prospective method requires a company to recognize compensation cost based upon fair value for only those share-based awards granted or modified with an effective date subsequent to the company's date of adoption and share-based awards issued in prior periods that remain unvested at the date of adoption. The modified-retrospective method allows a company to restate, based upon pro forma amounts previously disclosed under the requirements of Statement 123, for either all prior periods presented or prior interim periods included in the year of adoption.

Effective January 1, 2006, the Company adopted Statement 123R and accounted for the adoption using the modified-prospective method. For valuation purposes, the Company uses a Black-Scholes option-pricing model to estimate the fair value of stock option awards. The Company's stock options vest and become fully exercisable at various periods up to five years. Statement 123R provides that compensation cost, related to awards with a graded vesting schedule, may be recognized on either (a) a straight-line basis for the entire award or (b) an accelerated basis by applying a straight-line method to each separate vesting portion of the award. Effective with the Company's adoption on January 1, 2006, the Company's policy is to recognize compensation cost on a

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES****September 30, 2006****(UNAUDITED)**

straight-line basis for the entire award for all awards granted after January 1, 2006. For compensation cost related to awards issued prior to January 1, 2006 and that were unvested at that date, the Company will continue to follow its previous policy of recognizing the related compensation cost on an accelerated basis as described above.

Through December 31, 2005, the Company accounted for its stock options using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations. No stock-based compensation cost for stock options was reflected in net income in 2005, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. Results for prior periods have not been restated. Stock-based compensation cost was recognized in both the current and prior periods relating to restricted stock awards.

As a result of adopting Statement 123R and no longer accounting for stock-based compensation under APB 25, the Company's income before income taxes and net income for the three months ended September 30, 2006 were reduced by \$1.8 million and \$1.1 million, respectively, and for the nine months ended September 30, 2006 were reduced by \$5.1 million and \$3.1 million, respectively. Basic and diluted net income per share were each lower for the three months and nine months ended September 30, 2006 by \$0.03 and \$0.09, respectively, due to the Company's adoption of Statement 123R.

The fair value of options granted during the nine months ended September 30, 2006 was estimated at the grant date using a Black-Scholes option-pricing model with the following weighted average assumptions: risk free rate of 4.662%; dividend yield of 1.167%; volatility factor of 0.276; and an expected life of approximately five years. The weighted average fair value per option granted for the nine months ended September 30, 2006 was \$11.66.

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of Statement 123 to stock-based compensation prior to 2006.

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
<i>(in thousands, except per share amounts)</i>		
Net income as reported	\$ (6,848)	\$ 36,677
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(1,519)	(4,223)
Pro forma net income	\$ (8,367)	\$ 32,454
Net income per share:		
Basic as reported	\$ (0.19)	\$ 1.03
Basic pro forma	\$ (0.23)	\$ 0.91
Assuming dilution as reported	\$ (0.19)	\$ 1.01
Assuming dilution pro forma	\$ (0.23)	\$ 0.89

At September 30, 2006, there was \$9.1 million of total unrecognized compensation cost related to unvested stock options. This cost is expected to be recognized over a weighted-average period of approximately two years.

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Prior to the adoption of Statement 123R, the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Consolidated Cash Flows. Statement 123R

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES**

**September 30, 2006**

**(UNAUDITED)**

requires the cash flows resulting from the benefits of tax deductions in excess of recognized compensation costs be reported as financing cash flows. The \$2.3 million excess tax benefit classified as a financing cash inflow for the nine months ended September 30, 2006 would have been classified as an operating cash inflow if the Company had not adopted Statement 123R.

**NOTE C INCOME TAXES**

Deferred taxes result from temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The Company's effective rate varies from the statutory rate primarily due to higher tax exempt investment income and a favorable mix of state tax rates.

**NOTE D ACQUISITIONS**

During the first nine months of 2006, the Company acquired certain assets and liabilities of four insurance agencies and other accounts. These acquisitions, individually or in aggregate, were not material to the consolidated financial statements. For certain acquisitions, the allocations of purchase price are preliminary and subject to refinement as the valuations of certain intangible assets are not final.

**NOTE E SALE OF ASSETS AND OTHER GAINS**

During the nine months ended September 30, 2006 and 2005, the Company sold certain insurance offices, accounts and other assets resulting in gains of \$3.7 million and \$2.8 million, respectively. These amounts are included in other revenues in the Statement of Consolidated Income. Income taxes related to these gains were \$1.2 million and \$1.3 million for the nine months ended September 30, 2006 and 2005, respectively. Revenues, expenses and assets related to these dispositions were not material to the consolidated financial statements.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES****September 30, 2006****(UNAUDITED)****NOTE F NET INCOME (LOSS) PER SHARE**

The following table sets forth the computation of basic and diluted net income (loss) per share:

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
<i>(in thousands, except per share amounts)</i>				
Numerator for basic and diluted net income (loss) per share Net Income (Loss)	\$ 19,068	\$ (6,848)	\$ 65,621	\$ 36,677
Denominator				
Weighted average shares	35,690	35,446	35,720	35,495
Effect of guaranteed future shares to be issued in connection with agency acquisitions	112	224	128	260
Denominator for basic net income (loss) per share	35,802	35,670	35,848	35,755
Effect of dilutive securities:				
Employee stock options	274		292	288
Employee non-vested stock	129		129	137
Contingent stock acquisitions	75		62	114
Dilutive potential common shares	478		483	539
Denominator for diluted net income (loss) per share - adjusted weighted average shares	36,280	35,670	36,331	36,294
Net Income (Loss) Per Share:				
Basic	\$ 0.53	\$ (0.19)	\$ 1.83	\$ 1.03
Assuming Dilution <sup>1</sup>	\$ 0.53	\$ (0.19)	\$ 1.81	\$ 1.01

**NOTE G REGULATORY CHARGE AND RELATED MATTERS**

The Company and certain other companies in the insurance intermediary industry have been subject to investigations and inquiries by various governmental authorities regarding business practices and broker compensation arrangements. On August 31, 2005, the Company entered into an agreement (the Agreement) with the Attorney General of the State of Connecticut (the Attorney General) and the Insurance Commissioner of the State of Connecticut (the Commissioner) to resolve all issues related to investigations conducted by the Attorney General and the Commissioner into certain insurance brokerage and insurance agency practices (the Investigations) and to settle an action commenced on August 31, 2005 by the Attorney General in the Connecticut Superior Court alleging violations of the Connecticut Unfair Trade Practices Act and the Connecticut Unfair Insurance Practices Act (the Action). In the Agreement, the Company agreed to take certain actions including establishing a \$30.0 million national fund for distribution to certain clients, enhancing disclosure practices for agency and broker clients, and to not accept or request contingent compensation on brokerage business.

In the 2005 third quarter, the Company recorded a \$42.3 million charge, and related income tax benefit of \$16.0 million, primarily relating to the Agreement with the Attorney General and the Commissioner. This charge included the \$30.0 million national fund established by the Agreement; \$5.1 million of estimated legal and

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<sup>1</sup> For the three months ended September 30, 2005, dilutive securities are not included in the calculation of diluted net loss per share as this would be antidilutive.

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administrative costs to be incurred related to the Fund and complying with the Agreement's other provisions; and \$1.4 million of legal costs related to the Agreement incurred in the 2005 third quarter. The regulatory charge also included \$5.8 million of estimated costs for pending regulatory matters. These estimated costs represented the Company's best estimate of the probable outcomes of the various pending regulatory matters and included related legal and administrative costs incurred or expected to be incurred for these regulatory matters. In 2005, the Company made payments related to this charge of \$20.0 million into the national fund and \$2.3 million for legal and administrative matters.

These pending regulatory matters relate to subpoenas issued and/or inquiries made by state attorneys general and insurance departments into, among other things, the industry's commission payment practices. The Company has received subpoenas and/or requests for information from attorneys general and/or insurance departments in fourteen states. In addition to the original regulatory inquiries, the Company has received subsequent subpoenas and/or requests for information from certain of these states, and the Company may receive additional subpoenas and/or requests for information in the future from attorneys general and/or insurance departments of these and/or other states. The Company will continue to evaluate and monitor all such subpoenas and requests.

The current liability portion of this charge as of September 30, 2006 is \$15.7 million and is included in accrued expenses. The remaining liability is included in other long-term liabilities.

A summary of the activity with respect to the regulatory charge liability is as follows (in thousands):

Balance at December 31, 2005	\$ 20,056
Payments-legal and administrative	2,434
Balance at September 30, 2006	\$ 17,622

**NOTE H COMMITMENTS AND CONTINGENCIES***Industry Litigation*

The Company has been named as a defendant in certain legal proceedings against brokers and insurers relating to broker compensation arrangements and other business practices.

*MDL 1663 Class Action*

In August 2004, OptiCare Health Systems Inc. filed a putative class action in the U.S. District Court for the Southern District of New York (Case No. 04-CV-06954) against a number of the country's largest insurance brokers and several large commercial insurers. The Company was named as a defendant in the OptiCare suit in November 2004. In December 2004, two other purported class actions were filed in the U.S. District Court for the Northern District of Illinois, Eastern Division, by Stephen Lewis (Case No. 04-C-7847) and Diane Preuss (Case No. 04-C-7853), respectively, against certain insurance brokers, including the Company, and several large commercial insurers. On February 17, 2005, the Judicial Panel on Multidistrict Litigation (the Panel) ordered that the OptiCare suit, along with three other purported antitrust class actions filed in New York, New Jersey and Pennsylvania against industry participants, be centralized and transferred to the U.S. District Court for the District of New Jersey (District Court of New Jersey). In addition, by Conditional Transfer Order dated March 10, 2005, the Panel conditionally transferred the Lewis and Preuss cases to the District Court of New Jersey. The transfer subsequently became effective and as a result of the Panel's transfer orders, the OptiCare,





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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES**

**September 30, 2006**

**(UNAUDITED)**

Lewis and Preuss cases are proceeding on a consolidated basis with other purported class action suits styled as In re: Insurance Brokerage Antitrust Litigation (MDL 1663).

On August 1, 2005, the plaintiffs in MDL 1663 filed a First Consolidated Amended Commercial Class Action Complaint (the Commercial Complaint) in the District Court of New Jersey (Civil No. 04-5184) against the Company and certain other insurance brokers and insurers. In the Commercial Complaint, the named plaintiffs purport to represent a class consisting of all persons who, between August 26, 1994 and the date on which class certification may occur, engaged the services of any one of the broker defendants or any of their subsidiaries or affiliates to obtain advice with respect to the procurement or renewal of insurance and who entered into or renewed a contract of insurance with one of the insurer defendants. The plaintiffs allege in the Commercial Complaint, among other things, that the broker defendants engaged in improper steering of clients to the insurer defendants for the purpose of obtaining undisclosed additional compensation in the form of contingent commissions from insurers; that the defendants were engaged in a bid-rigging scheme involving the submission of false and/or inflated bids from insurers to clients; that the broker defendants improperly placed their clients' insurance business with insurers through related wholesale entities where an intermediary was unnecessary for the purpose of generating additional commissions from insurers; that the broker defendants entered into unlawful tying arrangements to obtain reinsurance business from the defendant insurers; and that the defendants created centralized internal departments for the purpose of monitoring, facilitating and advancing the collection of contingent commissions, payments and other improper fees. The plaintiffs allege violations of federal and state antitrust laws, violations of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(c) and (d), fraudulent misrepresentation, breach of fiduciary duty, aiding and abetting breach of fiduciary duty and unjust enrichment. The plaintiffs seek monetary relief, including treble damages, injunctive and declaratory relief, restitution, interest, attorneys' fees and expenses, costs and other relief; however, no actual dollar amounts have been stated as being sought.

In addition, the plaintiffs in MDL 1663 also filed on August 1, 2005 a First Consolidated Amended Employee Benefits Class Action Complaint (the Employee Benefits Complaint) in the District Court of New Jersey against the Company; Frank F. Haack & Associates, Inc.; O'Neill, Finnegan & Jordan Insurance Agency Inc.; and certain other insurance brokers and insurers. In the Employee Benefits Complaint (Civil Nos. 04-5184, et al.), the named plaintiffs purport to represent two separate classes consisting of ERISA and non-ERISA plan employees and employers, respectively, that have acquired insurance products from the defendants in connection with an employee benefit plan between August 26, 1994 and the date on which class certification may occur. The plaintiffs allege in the Employee Benefits Complaint, among other things, that the broker defendants secretly conspired with the insurer defendants to steer plaintiffs and members of the classes to the insurer defendants in exchange for undisclosed fees, including communication fees, enrollment fees, service fees, finders fees and/or administrative fees, contingent commissions and other payments, including broker bonuses, trips and entertainment, from the insurer defendants; that the defendants were engaged in a bid-rigging scheme involving the submission of false and/or inflated bids from insurers to clients; that the broker defendants improperly placed their clients' insurance business with insurers through related wholesale entities where an intermediary was unnecessary for the purpose of generating additional commissions from insurers; and that the defendants entered into unlawful tying arrangements under which the broker defendants would place primary insurance contracts with insurers on the condition that the insurers use the broker defendants for placing their reinsurance coverage with reinsurance carriers. The plaintiffs allege violations of federal and state antitrust laws, violations of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(c) and (d), fraudulent misrepresentation, breach of fiduciary duty, aiding and abetting breach of fiduciary duty and unjust enrichment. The plaintiffs seek

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES**

**September 30, 2006**

**(UNAUDITED)**

monetary relief, including treble and punitive damages, injunctive and declaratory relief, restitution, interest, attorneys' fees and expenses, costs and other relief; however, no actual dollar amounts have been stated as being sought.

The Company, along with other defendants, filed a motion to dismiss both the Commercial Complaint and the Employee Benefits Complaint. Also, on February 13, 2006, the plaintiffs filed their motions for class certification in each case. On May 5, 2006, the defendants filed their oppositions to the motions for class certification. On May 31, 2006, the plaintiffs filed a reply brief in support of their motions for class certification. The motion for class certification is fully briefed and awaiting a decision from the District Court of New Jersey.

On October 3, 2006, the District Court of New Jersey denied in part the motion to dismiss the Commercial Complaint and the Employee Benefits Complaint and ordered that plaintiffs provide supplemental information regarding each of their consolidated complaints by October 25, 2006. The District Court of New Jersey further ordered that upon receipt of this supplemental information, the District Court of New Jersey will issue a final ruling on the motion to dismiss plaintiffs' claims under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(c) and (d) and that on November 6, 2006, the defendants will be required to inform the District Court of New Jersey whether they intend to move to dismiss the remaining counts or alternatively to move for judgment on the pleadings or summary judgment on the remaining counts, pursuant to the Federal Rules of Civil Procedure.

The Company believes it has substantial defenses in these cases and intends to defend itself vigorously. However, due to the uncertainty of these cases, the Company is unable to estimate a range of possible loss at this time. In addition, the Company cannot predict the outcome of these cases or their effects on the Company's financial position or results of operations.

*Securities Class Action*

In June 2005, the Iron Workers Local 16 Pension Fund filed a putative class action complaint in the U.S. District Court for the Eastern District of Virginia (Case No. 1:05-CV-00735-GBL-TCB) against the Company and Andrew L. Rogal, Martin L. Vaughan, III, Timothy J. Korman, Carolyn Jones, Robert W. Blanton, Jr. and Robert B. Lockhart. The plaintiff alleged violations by each of the defendants of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder and violations by the individual defendants of Section 20(a) of the Securities Exchange Act of 1934. In October 2005, the appointed Lead Plaintiff filed an amended putative class action complaint. The amended complaint does not state an actual dollar amount that is being sought as damages. On April 27, 2006, an order was entered granting the defendants' motion and dismissing the amended complaint in its entirety with prejudice. On May 23, 2006, the plaintiff appealed this order to the Fourth Circuit, U.S. Court of Appeals. The Company believes it has substantial defenses to the arguments raised by the plaintiff on appeal and intends to defend itself vigorously. However, due to the uncertainty of this appeal and any subsequent litigation of plaintiff's claims, the Company is unable to estimate a range of possible loss at this time. In addition, the Company cannot predict the outcome of these claims or their effects on the Company's financial position or results of operations.

*Lockhart Suit*

On August 18, 2006, Robert B. Lockhart filed a complaint against the Company in the Circuit Court for the County of Henrico, Virginia (Civil Action No. CL06-2141). The plaintiff was the Company's former President

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES**

**September 30, 2006**

**(UNAUDITED)**

and Chief Operating Officer from August 2003 until May 25, 2005. In the complaint, the plaintiff alleges, among other things, that the Company made public statements arising out of the investigation and settlement of an action by the Connecticut Attorney General that were defamatory to the plaintiff. The plaintiff seeks a judgment against the Company in an amount not less than \$30.0 million, including an award for presumed, compensatory and punitive damages, and interest and costs. On September 5, 2006, the Company filed a motion to stay the court proceedings and to compel the plaintiff to arbitrate the matters set forth in the complaint pursuant to the terms of the plaintiff's employment agreement with the Company. On October 24, 2006, the court granted the Company's motion to stay and determined that the matter should be submitted to arbitration. The Company denies any liability to the plaintiff and intends to vigorously defend the allegations contained in this complaint. However, due to the uncertainty of this suit and any subsequent arbitration, the Company is unable to estimate a range of possible loss at this time. In addition, the Company cannot predict the outcome of this suit or its effects on the Company's financial position or results of operations.

*Bensley Class Action*

In May 2005, Bensley Construction, Inc. (Bensley Construction) filed a putative class action in the Superior Court of the Commonwealth of Massachusetts (Case No. ESCV2005-00277) against the Company and certain large commercial insurers and brokers. In the amended complaint, the plaintiff alleges, among other things, that the broker defendants entered into contingent commission agreements with the insurer defendants without disclosing the existence and/or terms of the agreements to clients to whom the defendants owed a fiduciary duty and that certain of the defendants engaged in a bid-rigging and customer allocation scheme to maximize their revenues under the contingent commission agreements. The plaintiff alleges breach of fiduciary duty, unjust enrichment, aiding and abetting breaches of fiduciary duty, breach of contract and breach of implied covenant of good faith and fair dealing. The plaintiff seeks monetary damages for each member of the class in an amount not to exceed \$74,999 per class member, costs and other relief. The case does not state an actual dollar amount that is being sought in total for all damages, costs and other relief. The defendants removed the case to federal court and it was transferred to the U.S. District Court for the District of New Jersey to be consolidated with the other cases that comprise MDL 1663. On June 22, 2006, Bensley Construction filed a Notice of Voluntary Dismissal with the U.S. District Court for the District of New Jersey, voluntarily dismissing Bensley Construction's claims in this matter with prejudice.

*Other*

There are in the normal course of business various other outstanding commitments and contingent liabilities. Management does not anticipate material losses as a result of such matters.

**NOTE I LONG-TERM DEBT**

As of December 31, 2005, the Company had under its Amended and Restated Credit Agreement (the Amended Credit Agreement), outstanding term loans of \$243.0 million and no outstanding revolving credit facility borrowings. On April 26, 2006, the Company signed a credit agreement (the Credit Agreement) with Bank of America, N.A. and other lenders which provides for a revolving credit facility of \$325.0 million and a term loan facility of \$100.0 million. Upon entry into the Credit Agreement, the Company borrowed \$140.6 million under the revolving credit facility and \$100.0 million under the term loan facility. The Company used these proceeds to

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES**

**September 30, 2006**

**(UNAUDITED)**

repay its outstanding borrowings under the Amended Credit Agreement. The Credit Agreement replaced the Amended Credit Agreement.

The Credit Agreement permits the Company to request additional facilities in amounts up to \$125.0 million and provides that a portion of the revolving credit facility will be available for the issuance of letters of credit. Borrowings bear interest at variable rates based on LIBOR plus a negotiated spread (1.50% at September 30, 2006). In addition, the Company pays commitment fees (0.3% at September 30, 2006) on the unused portion of the revolving credit facility. The principal payments of the term loan facility are payable quarterly while the principal balance of the revolving credit facility is due and payable upon the maturity date. The revolving credit facility matures on April 26, 2011 and the term loan facility matures on April 26, 2013. Annual payments of the outstanding principal amounts under the term loan facility will total \$0.8 million in 2006, \$1.0 million in 2007, \$1.0 million in 2008, \$1.0 million in 2009, \$1.0 million in 2010, \$1.0 million in 2011, \$1.0 million in 2012, and \$93.2 million in 2013. The Credit Agreement represents senior secured indebtedness and contains, among other provisions, requirements for maintaining certain financial ratios and specific limits or restrictions on acquisitions, indebtedness, investments, payment of dividends and repurchases of common stock.

In the second quarter of 2006, the Company recognized losses of \$0.9 million related to the extinguishment of the debt outstanding under the Amended Credit Agreement. This loss on extinguishment primarily included various financing and professional costs previously deferred in connection with the financing of the Amended Credit Agreement and certain lending fees paid in obtaining the Credit Agreement.

**NOTE J ACCOUNTING PRONOUNCEMENTS**

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an Interpretation of SFAS No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on measurement, derecognition and classification. FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, the Company will adopt FIN 48 as of January 1, 2007, as required. The Company is currently evaluating the impact that the adoption of FIN 48 will have, if any, on its financial position and results of operations.

**NOTE K SEVERANCE CHARGE**

In May 2005, Robert B. Lockhart, the Company's former President and Chief Operating Officer, resigned. In connection with Mr. Lockhart's resignation, the Company recorded a severance charge of \$1.3 million, and related income tax benefit of \$0.5 million, representing estimated payments due to Mr. Lockhart under the terms of his employment agreement. See Note H *Commitments and Contingencies* concerning a complaint subsequently filed by Mr. Lockhart against the Company.

**NOTE L INTEGRATION COSTS**

The Company began the integration of Hobbs Group, LLC (Hobbs) with the rest of the Company subsequent to June 30, 2003 with the completion of the Hobbs earn-out. There were no new integration costs for the nine-

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**HILB ROGAL & HOBBS COMPANY AND SUBSIDIARIES**

**September 30, 2006**

**(UNAUDITED)**

month period ended September 30, 2006. The Company recognized integration costs of \$0.8 million and a related income tax benefit of \$0.3 million for the first nine months of 2005. This amount represented facility and lease termination costs. In the 2006 third quarter, the Company reduced the accrual for the previously recognized integration costs by \$0.2 million due to new factors regarding a lease termination. The income tax effect related to the accrual reduction was \$0.1 million.

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**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

*Results of Operations*

*Three Months Ended September 30, 2006*

Revenues for the 2006 third quarter were \$173.2 million, an increase of \$8.7 million, or 5.3%, over prior year performance of \$164.5 million. This increase was primarily driven by acquisitions, improved organic growth, and higher investment income, partially offset by continuing property and casualty premium rate declines and dispositions.

Commissions and fees were \$169.4 million, an increase of \$8.3 million, or 5.1%, over prior year performance of \$161.1 million. The commissions and fees impact from 2006 and 2005 acquisitions, primarily Thilman & Filippini, L.L.C. and Zutz Associates, Inc., was \$6.4 million. The commissions and fees impact from 2006 and 2005 dispositions was \$2.7 million. The remaining increase is primarily attributed to net new business production, partially offset by continuing rate declines and a \$1.0 million reduction in contingent commissions. Commercial property and casualty premium rate declines are believed to approximate 5.3% based upon a 2006 third quarter Council of Insurance Agents and Brokers survey.

Due to a higher interest rate environment and an increase in average cash balances, the Company had \$1.5 million higher investment income, which was partially offset by higher interest expense. Other income decreased primarily due to one-time gains on the sale of insurance accounts in the third quarter of 2005.

The expenses for the third quarter of 2006 were \$142.6 million, a decrease of \$31.6 million, or 18.1%, from the 2005 comparable period of \$174.2 million. This decrease resulted primarily from the Company's 2005 regulatory charge mainly related to the Company's settlement with the Attorney General of the State of Connecticut. Excluding the effect of the 2005 regulatory charge, expenses increased \$10.8 million, or 8.2%, from the prior year third quarter. This increase primarily reflects higher compensation and benefits costs and other operating expenses in 2006.

Compensation and benefits increased \$7.0 million primarily due to acquisitions of insurance agencies, the new accounting treatment for stock-based compensation, and higher revenue production. These increased balances are partially offset by the impact of divestitures. The new accounting treatment for stock-based compensation resulted in \$1.8 million of additional compensation expense for the 2006 third quarter. See *New Accounting Pronouncements* for additional information on the impact of this item.

Other operating expenses increased \$2.5 million primarily due to higher legal, compliance, and claims expenditures and increased travel and meeting expenses for the third quarter. Legal, compliance, and claims expenses increased primarily due to higher legal costs associated with proceedings on the Company's class action suits and an unfavorable development on a contractual dispute from a previous year. Increased travel and meeting expenditures primarily reflect sales and customer related meetings and training.

The 2006 third quarter operating expenses included a \$0.2 million reassessment of prior year lease termination charges related to the integration of Hobbs Group, LLC. In addition, the 2005 third quarter operating expenses included a \$42.3 million regulatory charge primarily related to the Company's settlement with the Attorney General of the State of Connecticut. The settlement provides for a \$30 million national fund for distribution to HRH's clients who elect to participate in the fund. The regulatory charge also included related legal and administrative costs and estimated costs for related pending regulatory matters. For more information on this charge, see *Note G Regulatory Charge and Related Matters of Notes to Consolidated Financial Statements*.

Depreciation expense was relatively comparable to the prior year period. Amortization of intangibles increased approximately \$0.8 million due primarily to intangible assets acquired in 2006 and 2005 acquisitions. Interest

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expense increased \$0.7 million because of the higher interest rate environment. As of September 30, 2006, approximately 44% of the Company's debt is effectively fixed rate.

The Company's overall tax rate for the 2006 third quarter was 37.6% compared to 29.2% for the comparable 2005 period. The 2006 rate was higher primarily due to certain non-deductible items in the 2005 regulatory charge, partially offset by reduced taxes from increased tax-exempt investment income and a favorable mix of state tax rates.

Net income for the 2006 third quarter was \$19.1 million, or \$0.53 per share, compared with a net loss of \$(6.8) million, or \$(0.19) per share, for the comparable period last year. Net income for the 2006 quarter included integration costs, net of tax, of \$(0.1) million, or \$(0.01) per share. Net loss for the 2005 quarter included a regulatory charge and related costs, net of tax, of \$26.3 million, or \$0.73 per share.

*Nine Months Ended September 30, 2006*

Revenues for the first nine months of 2006 were \$535.4 million, an increase of \$25.5 million, or 5.0%, over prior year performance of \$509.9 million. This increase was primarily driven by improved organic growth, acquisitions, and increased investment income, partially offset by continuing property and casualty premium rate reductions and dispositions.

Commissions and fees were \$521.7 million, an increase of \$21.9 million, or 4.4%, over prior year performance of \$499.8 million. The commissions and fees impact from 2006 and 2005 acquisitions was \$13.7 million. The commissions and fees impact from 2006 and 2005 dispositions was \$7.4 million. The remaining growth was influenced by the same factors noted in the third quarter, partially offset by a \$4.6 million reduction in contingent commissions for the year-to-date period.

The Company had a \$3.5 million increase in investment income over the prior year period due to the same factors noted in the third quarter.

Expenses for the first nine months of 2006 were \$428.3 million, a decrease of \$18.8 million, or 4.2%, over the 2005 comparable period of \$447.1 million. This decrease resulted primarily from the 2005 regulatory charge previously noted for the 2005 third quarter. Excluding the effect of the 2005 regulatory charge, expenses increased \$23.6 million, or 5.8%, from the prior year period. This increase primarily resulted from higher compensation and benefits costs in 2006.

Compensation and benefits increased \$20.3 million primarily due to the acquisitions of insurance agencies, new accounting treatment for stock-based compensation, increased revenue production, and the impact of continued investment in sales and service talent, partially offset by the impact of divestitures. The new accounting treatment for stock-based compensation resulted in \$5.1 million of additional compensation expense.

Other operating expenses increased \$1.6 million due to higher promotional, travel and meeting expenses, operating expenses from acquired agencies, and other miscellaneous charges. Consistent with the third quarter results, the increase in promotional, travel and meeting expenses primarily reflects sales and customer related meetings and training. Lower legal, compliance and claims expenditures for the first nine months of 2006 period partially offset these increased costs. Legal, compliance and claims expenditures in 2005 include \$4.2 million of insurance recoveries received on contested claims. Excluding the effect of these 2005 insurance recoveries, the 2006 year-to-date decrease in legal, compliance and claims expenditures was \$7.0 million.

The operating expenses in the first nine months of 2006 included a debt extinguishment loss of \$0.9 million and the \$0.2 million reassessment of prior year integration costs noted for the 2006 third quarter. The debt extinguishment loss is associated with the Company's entry into a new credit agreement in April 2006. The charge represents financing costs previously deferred in connection with the financing of the Company's former



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credit agreement and certain lending fees paid in obtaining the Company's new credit facility. See *Liquidity and Capital Resources* for more information on the debt extinguishment loss. As previously noted, the 2005 third quarter operating expenses included a \$42.3 million regulatory charge. The comparable 2005 period operating expenses also included a \$1.3 million severance charge and \$0.8 million of integration costs. The severance charge represented estimated payments due to the Company's former President and Chief Operating Officer under the terms of his employment agreement. Integration costs represented facility and lease termination costs associated with the integration of Hobbs Group, LLC.

Depreciation expense decreased \$0.2 million when compared to the prior year period. Amortization of intangibles increased approximately \$1.2 million due primarily to intangible assets acquired in 2006 and 2005 acquisitions. Interest expense increased \$2.1 million because of the higher interest rate environment.

The Company's overall tax rates for the first nine months of 2006 and 2005 respectively, were 38.7% and 41.6%. The 2006 rate was lower primarily due to higher tax-exempt investment income and a favorable mix of state tax rates.

Net income for the first nine months of 2006 was \$65.6 million, or \$1.81 per share, compared with \$36.7 million, or \$1.01 per share, for the comparable 2005 period. Net income for the 2006 period included integration costs, net of tax, of \$(0.1) million, or \$(0.01) per share, and a loss on extinguishment of debt, net of tax, of \$0.5 million, or \$0.01 per share. Net income for the 2005 period included a regulatory charge, net of tax, of \$26.3 million, or \$0.73 per share, a severance charge, net of tax, of \$0.8 million, or \$0.02 per share, and integration costs, net of tax, of \$0.5 million, or \$0.01 per share.

*Other*

For the three months ended September 30, 2006, net income as a percentage of revenues were relatively consistent with that from the three months ended June 30, 2006. The timing of contingent commissions, policy renewals and acquisitions may cause revenues, expenses and net income to vary significantly from quarter to quarter. As a result of the factors described above, operating results for the nine months ended September 30, 2006 should not be considered indicative of the results that may be expected for the entire year ending December 31, 2006.

*Liquidity and Capital Resources*

Net cash provided by operations totaled \$77.3 million and \$71.4 million for the nine months ended September 30, 2006 and 2005, respectively, and is primarily dependent upon the timing of the collection of insurance premiums from clients and payment of those premiums to the appropriate insurance underwriters.

The Company has historically generated sufficient funds internally to finance capital expenditures. Cash expenditures for the acquisition of property and equipment were \$4.4 million and \$7.4 million for the nine months ended September 30, 2006 and 2005, respectively. The purchase of insurance agencies utilized cash of \$50.8 million and \$19.3 million in the nine months ended September 30, 2006 and 2005, respectively. Cash expenditures for such insurance agency acquisitions have been primarily funded through operations and long-term borrowings. In addition, a portion of the purchase price in such acquisitions may be paid through the Company's Common Stock and/or deferred cash and Common Stock payments. The Company did not have any material capital expenditure commitments as of September 30, 2006.

Financing activities utilized cash of \$28.5 million and \$41.1 million in the nine months ended September 30, 2006 and 2005, respectively, as the Company repurchased Common Stock and made dividend and debt payments. The Company has annually increased its dividend rate and anticipates the continuance of its dividend policy. The Company repurchased 633,300 shares of its Common Stock on the open market for \$25.0 million

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during the nine months ended September 30, 2006. The Company repurchased 612,800 shares of its Common Stock on the open market for \$21.8 million during the nine months ended September 30, 2005. The Company is currently authorized for 2006 and later years to purchase up to \$50.0 million annually of its Common Stock subject to market conditions and other factors.

As of December 31, 2005, the Company had, under its Amended and Restated Credit Agreement (the Amended Credit Agreement), outstanding term loans of \$243.0 million which were due in various amounts through 2011, and no outstanding revolving credit facility borrowings, with \$174.6 million available under the revolving credit facility for future borrowings.

On April 26, 2006, the Company signed a credit agreement (the Credit Agreement) with Bank of America, N.A. and other lenders which provides for a revolving credit facility of \$325.0 million and a term loan facility of \$100.0 million. Upon entry into the Credit Agreement, the Company borrowed \$140.6 million under the revolving credit facility and \$100.0 million under the term loan facility. The Company used these proceeds to repay its \$240.6 million of borrowings under the Amended Credit Agreement outstanding at April 26, 2006. The Credit Agreement replaced the Amended Credit Agreement.

The Credit Agreement permits the Company to request additional facilities in amounts up to \$125.0 million and provides that a portion of the revolving credit facility will be available for the issuance of letters of credit. Borrowings bear interest at variable rates based on LIBOR plus a negotiated spread (1.50% at September 30, 2006). In addition, the Company pays commitment fees (0.3% at September 30, 2006) on the unused portion of the revolving credit facility. The principal payments of the term loan facility are payable quarterly while the principal balance of the revolving credit facility is due and payable upon the maturity date. The revolving credit facility matures on April 26, 2011 and the term loan facility matures on April 26, 2013. Annual payments of the outstanding principal amounts under the term loan facility will total \$0.8 million in 2006, \$1.0 million in 2007, \$1.0 million in 2008, \$1.0 million in 2009, \$1.0 million in 2010, \$1.0 million in 2011, \$1.0 million in 2012, and \$93.2 million in 2013. The Credit Agreement represents senior secured indebtedness and contains, among other provisions, requirements for maintaining certain financial ratios and specific limits or restrictions on acquisitions, indebtedness, investments, payment of dividends and repurchases of Common Stock. In connection with the Credit Agreement, the Company deferred \$1.5 million of debt issuance costs which will be amortized as additional interest expense over the term of the credit facility.

As of September 30, 2006, the Company had, under its Credit Agreement, outstanding term loans of \$99.5 million which are due in various amounts through 2013, and outstanding revolving credit facility borrowings of \$150.6 million with \$173.5 million available under the revolving credit facility for future borrowings. Borrowings bear interest at variable rates based on LIBOR plus a negotiated spread.

The Company had a current ratio (current assets to current liabilities) of 1.12 to 1.00 as of September 30, 2006. Shareholders' equity of \$608.4 million at September 30, 2006, is improved from \$546.3 million at December 31, 2005. The debt to equity ratio at September 30, 2006 of 0.42 to 1.00 is decreased from the ratio at December 31, 2005 of 0.46 to 1.00 due to net income and the issuance of Common Stock partially offset by Common Stock repurchases.

The Company believes that cash generated from operations, together with proceeds from borrowings, will provide sufficient funds to meet the Company's short- and long-term funding needs.

### *Market Risk*

As of September 30, 2006, approximately 44% of the Company's debt is effectively fixed rate. The Company has variable rate debt, maintains certain investments and utilizes derivative financial instruments (on a limited basis) which are subject to market risk; however, the Company believes that exposure to market risk associated with these instruments is not material.

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*New Accounting Pronouncements*

In 2006, the Company adopted Financial Accounting Standards Board Statement No. 123 (revised 2004), *Share-Based Payment* (Statement 123R). The revised standard requires all companies to recognize compensation costs related to all share-based payments (including stock options) in their financial statements at fair value, thereby, upon adoption, eliminating the use of pro forma disclosures to report such amounts.

Statement 123R permits public companies to account for the adoption of this revised standard using one of two methods: the modified-prospective method or the modified-retrospective method. The modified-prospective method requires a company to recognize compensation cost based upon fair value for only those share-based awards granted or modified with an effective date subsequent to the company's date of adoption and share-based awards issued in prior periods that remain unvested at the date of adoption. The modified-retrospective method allows a company to restate, based upon pro forma amounts previously disclosed under the requirements of Financial Accounting Standards Board Statement No. 123, *Accounting for Stock-Based Compensation*, for either all prior periods presented or prior interim periods included in the year of adoption.

Effective January 1, 2006, the Company adopted Statement 123R and will account for the adoption using the modified-prospective method. For valuation purposes, the Company uses a Black-Scholes option-pricing model to estimate the fair value of stock option awards. As a result of adopting Statement 123R and no longer accounting for stock-based compensation under previous accounting guidance, the Company's income before income taxes and net income for the three months ended September 30, 2006 were reduced by \$1.8 million and \$1.1 million, respectively, and for the nine months ended September 30, 2006 were reduced by \$5.1 million and \$3.1 million, respectively. Basic and diluted net income per share were each lower for the three months and nine months ended September 30, 2006 by \$0.03 and \$0.09, respectively, than if the Company had not adopted Statement 123R. For the 2006 year, the adoption of Statement 123R is expected to result in a decrease to net income of approximately \$4.0 million (\$0.11 per share), net of income taxes of \$2.6 million, although it is not expected to have a significant impact on the Company's overall cash flows or financial position.

At September 30, 2006, there was \$9.1 million of total unrecognized compensation cost related to unvested stock options. This cost is expected to be recognized over a weighted-average period of approximately two years.

For additional information on the adoption of Statement 123R, see *Note B-Accounting for Stock-Based Compensation* of Notes to Consolidated Financial Statements.

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (an Interpretation of SFAS No. 109 (FIN 48)). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a minimum recognition threshold that a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on measurement, derecognition and classification. FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, the Company will adopt FIN 48 as of January 1, 2007, as required. The Company is currently evaluating the impact that the adoption of FIN 48 will have, if any, on its financial position and results of operations.

*Industry Regulatory Matters*

On August 31, 2005, the Company entered into an agreement with the Attorney General of the State of Connecticut (the Attorney General) and the Insurance Commissioner of the State of Connecticut (the Commissioner) to resolve all issues related to investigations conducted by the Attorney General and the Commissioner into certain insurance brokerage and insurance agency practices (the Investigations) and to settle an action commenced on August 31, 2005 by the Attorney General in the Connecticut Superior Court alleging violations of the Connecticut Unfair Trade Practices Act and the Connecticut Unfair Insurance Practices Act. In

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the agreement, the Company agreed to take certain actions including establishing a \$30.0 million national fund for distribution to certain clients, enhancing disclosure practices for agency and broker clients, and to not accept or request contingent compensation on brokerage business. For further information on this agreement, see Note G-Regulatory Charge and Related Matters of Notes to Consolidated Financial Statements.

### *Contingent and National Override Agreements Commissions*

As a result of the industry and regulatory developments, controversy continues to surround the longstanding insurance industry practice of contingent and override commissions paid to agents and brokers by underwriters. The Company has historically entered into contingent and override commission agreements with various underwriters. Contingent commissions are commissions paid by underwriters based on profitability of the business, premium growth, total premium volume or some combination of these factors. Revenue from contingent commissions is heavily weighted in the first and second quarters. Income from the National Override Agreements was typically volume-based and paid quarterly by underwriters in excess of the standard commission rates on specific classes of business. National Override Agreements, as defined in the agreement with the Attorney General, mean corporate-wide compensation agreements negotiated by the Company with certain insurance companies on behalf of all of the Company's offices to receive commissions in lieu of standard contingent compensation arrangements with each office of the Company.

For the nine months ended September 30, 2006 and 2005, the Company recognized contingent and National Override Agreements commissions of \$43.0 million and \$47.6 million, respectively. Of the 2006 nine month amount, 100% was from standard contingency agreements and none were from National Override Agreements. Of the 2005 nine month amount, 93% was from standard contingency agreements and 7% was from National Override Agreements. The standard contingency agreements are entered into and maintained at the local office level. Effective for business written on or after January 1, 2005, these National Override Agreements reverted into standard local contingency arrangements with those underwriters on an office by office basis, which will be paid and recorded, if at all, annually beginning in early 2006. There can be no assurance that the loss of National Override Agreements commissions resulting from the reversion to standard local contingency arrangements will be offset by additional contingent commissions in future periods.

The departments of insurance of various states may adopt new regulations addressing contingent commission arrangements and disclosure of such arrangements with insureds. In addition, the National Association of Insurance Commissioners has proposed model legislation to implement new disclosure requirements relating to agent and broker compensation arrangements. The Company intends to monitor agent and broker compensation practices and, as warranted by market and regulatory developments, will review its compensation arrangements with underwriters. While it is not possible to predict the outcome of the governmental inquiries and investigations into the insurance industry's commission payment practices or the responses by the market and regulators, any material decrease in the Company's contingent commissions is likely to have an adverse effect on its results of operations.

In addition to state regulatory inquiries, the Company has been named as a defendant in four purported class actions brought against a number of brokers in the insurance industry and one purported securities class action. For information on industry and other litigation, see Note H-Commitments and Contingencies of Notes to Consolidated Financial Statements.

### *Forward-Looking Statements*

Forward-looking statements in Form 10-Q or other filings by the Company with the Securities and Exchange Commission, in the Company's press releases or other public or shareholder communications, or in oral statements made with the approval of an authorized Company executive officer, include the words or phrases would be, will allow, expects to, will continue, is anticipated, estimate, project or similar

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expressions and are intended to identify forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

While forward-looking statements are provided to assist in the understanding of the Company's anticipated future financial performance, the Company cautions readers not to place undue reliance on any forward-looking statements, which speak only as of the date made. Forward-looking statements are subject to significant risks and uncertainties, many of which are beyond the Company's control. Although the Company believes that the assumptions underlying its forward-looking statements are reasonable, any of the assumptions could prove to be inaccurate. Actual results may differ materially from those contained in or implied by such forward-looking statements for a variety of reasons. Risk factors and uncertainties that might cause such a difference include, but are not limited to, the following: the Company's commission revenues are based on premiums set by insurers and any decreases in these premium rates could result in revenue decreases for the Company; the level of contingent commissions is difficult to predict and any material decrease in the Company's collection of them is likely to have an adverse impact on operating results; the Company has eliminated National Override Agreements commissions effective for business written on or after January 1, 2005, and it is uncertain whether additional contingent commissions payable to the Company will offset the loss of such revenues; the Company's growth has been enhanced through acquisitions, but the Company may not be able to successfully identify and attract suitable acquisition candidates and complete acquisitions; the Company's failure to integrate an acquired insurance agency efficiently may have an adverse effect on the Company; the general level of economic activity can have a substantial impact on revenues that is difficult to predict; a strong economic period may not necessarily result in higher revenues; the Company's success in the future depends, in part, on the Company's ability to attract and retain quality producers; the Company may be subject to increasing costs arising from errors and omissions claims against the Company; the Company is subject to governmental regulation which may impact operating results and/or growth; the business practices and broker compensation arrangements of the Company are subject to uncertainty due to investigations by governmental authorities and related private litigation; the Company is subject to a number of investigations and legal proceedings, which if determined unfavorably for the Company, may adversely affect the Company's results of operations; a decline in the Company's ability to obtain new financing and/or refinance current borrowings may adversely affect the Company; if the Company is unable to respond in a timely and cost-effective manner to rapid technological change in the insurance intermediary industry, there may be a resulting adverse effect on business and operating results; and quarterly and annual variations in the Company's commissions and fees that result from the timing of policy renewals and the net effect of new and lost business production may have unexpected impacts on the Company's results of operations.

The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The Company believes that its exposure to market risk associated with transactions using variable rate debt, certain investments and derivative financial instruments is not material.

### **Item 4. CONTROLS AND PROCEDURES.**

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods required by the Securities and Exchange Commission. As of the end of the period covered by this report on Form 10-Q, the Company's management, including the Chief Executive Officer and the Chief Financial Officer, performed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended). Based on

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that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective as of the end of such period. Management is also responsible for establishing and maintaining adequate internal control over the Company's financial reporting. There have been no changes in the Company's internal control over financial reporting during the three months ended September 30, 2006, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II - OTHER INFORMATION**

**Item 1. LEGAL PROCEEDINGS.**

The information on legal proceedings contained in Note H-Commitments and Contingencies of the Notes to Consolidated Financial Statements filed in Item 1 of Part I of this Form 10-Q is incorporated by reference.

**Item 1A. RISK FACTORS.**

As of the date of this report, there are no material changes to the risk factors previously disclosed in Part I, Item 1A. Risk Factors of the Company's Annual Report on Form 10-K for the year ended December 31, 2005. In evaluating the risks of the Company, readers should carefully consider the risk factors discussed in the Company's Annual Report on Form 10-K, which could materially affect the Company's business, financial condition or operating results, in addition to the other information set forth in this report and in other filings with the Securities and Exchange Commission. The risks described in the Company's Annual Report on Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and/or operating results.

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

- c) No purchases of Common Stock occurred in the third quarter of 2006 under the publicly announced share-repurchase program (the 2004 Program).

The 2004 Program was announced by the Company on March 31, 2004 and provides for the Company to purchase up to \$50.0 million of its Common Stock annually. The repurchases may be made on the open market or in negotiated transactions, with the timing and amount of the transactions to be determined by the Company's management subject to market conditions and other factors.

Not included in the 2004 Program are purchases that were made on behalf of a trust maintained by the Company for the Executive Voluntary Deferral Plan and the Outside Directors Deferral Plan. Total number of shares purchased during the quarter relating to the plans was 3,752 at an average price per share of \$40.56.

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**Item 6. EXHIBITS.**

- a) Exhibits

<b>Exhibit No.</b>	<b>Document</b>
10.1	Form of Hilb Rogal & Hobbs Company Director Non-Qualified Stock Option Agreement (incorporated by reference to Exhibit 10.2 to the Company's Form 10-Q for the quarter ended June 30, 2006, File No. 0-15981)
31.1	Certification Statement of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)
31.2	Certification Statement of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)
32.1	Certification Statement of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.2	Certification Statement of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350



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**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.

Hilb Rogal & Hobbs Company

(Registrant)

Date November 1, 2006

By: /s/ Martin L. Vaughan, III  
**Martin L. Vaughan, III**

**Chairman and Chief Executive Officer**

**(Principal Executive Officer)**

Date November 1, 2006

By: /s/ Michael Dinkins  
**Michael Dinkins**

**Executive Vice President and Chief Financial Officer**

**(Principal Financial Officer)**

Date November 1, 2006

By: /s/ John Hamerski  
**John Hamerski**

**Vice President and Controller**

**(Chief Accounting Officer)**

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**HILB ROGAL & HOBBS COMPANY**

**EXHIBIT INDEX**

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