21ST CENTURY INSURANCE GROUP
Form 10-Q
October 27, 2005

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

FORM 10-Q

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

For the quarterly period ended September 30, 2005

o 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 0-6964

21ST CENTURY INSURANCE GROUP
(Exact name of registrant as specified in its charter)

Delaware	**95-1935264**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6301 Owensmouth Avenue Woodland Hills, California	**91367**
(Address of principal executive offices)	(Zip Code)
(818) 704-3700	**www.21st.com**
(Registrant's telephone number, including area code)	(Registrant's web site)

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 x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes x No o

The number of shares outstanding of the issuer's common stock as of October 14, 2005 was 85,835,838.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED BALANCE SHEETS
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	**September 30,** 2005	December 31, 2004
Assets		
Fixed maturity investments available-for-sale, at fair value (amortized cost: $1,351,416 and $1,320,592)	**$ 1,350,411**	**$** 1,342,130
Equity securities available-for-sale, at fair value (cost: $47,059 and $41,450)	**46,380**	42,085
Total investments	**1,396,791**	1,384,215
Cash and cash equivalents	**65,264**	34,697
Accrued investment income	**16,183**	16,161
Premiums receivable	**116,980**	105,814
Reinsurance receivables and recoverables	**5,914**	7,160
Prepaid reinsurance premiums	**1,870**	1,787
Deferred income taxes	**53,798**	56,135
Deferred policy acquisition costs	**63,760**	58,759
Leased property under capital lease, net of deferred gain of $1,929 and $3,116 and net of accumulated amortization of $33,802 and $24,794	**25,339**	31,719
Property and equipment, at cost less accumulated depreciation of $83,687 and $68,529	**145,841**	129,372
Other assets	**29,930**	38,495
Total assets	**$ 1,921,670**	$ 1,864,314
Liabilities and stockholders' equity		
Unpaid losses and loss adjustment expenses	**$ 517,614**	$ 495,542
Unearned premiums	**340,055**	331,036
Debt	**131,095**	138,290
Claims checks payable	**40,711**	38,737
Reinsurance payable	**663**	633
Other liabilities	**78,514**	85,675
Total liabilities	**1,108,652**	1,089,913
Commitments and contingencies		
Stockholders' equity:		
Common stock, par value $0.001 per share; 110,000,000 shares authorized; shares issued and outstanding 85,835,038 and 85,489,061	**86**	85
Additional paid-in capital	**423,795**	420,425
Retained earnings	**391,949**	341,196
Accumulated other comprehensive (loss) income:		
Net unrealized (losses) gains on available-for-sale investments, net of deferred income taxes of $(589) and $7,760	**(1,095)**	14,412
Minimum pension liability in excess of unamortized prior service cost, net of deferred income taxes of $(925) and $(925)	**(1,717)**	(1,717)
Total stockholders' equity	**813,018**	774,401

Total liabilities and stockholders’ equity	**$ 1,921,670**	$ 1,864,314

See accompanying Notes to Condensed Consolidated Financial Statements.

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Three Months Ended September 30,* **2005**	2004	*Nine Months Ended September 30,* **2005**	2004
Revenues				
Net premiums earned	**$ 344,102**	$ 333,440	**$ 1,017,311**	$ 978,681
Net investment income	**17,042**	15,118	**51,085**	42,579
Other (loss) income	**(3)**	—	**364**	—
Net realized investment (losses) gains	**(939)**	(162)	**(2,666)**	8,821
Total revenues	**360,202**	348,396	**1,066,094**	1,030,081
Losses and expenses				
Net losses and loss adjustment expenses	**258,105**	252,359	**757,420**	744,429
Policy acquisition costs	**60,852**	55,866	**188,931**	164,338
Other operating expenses	**8,786**	8,942	**24,908**	25,186
Interest and fees expense	**1,988**	2,116	**6,076**	6,527
Total losses and expenses	**329,731**	319,283	**977,335**	940,480
Income before provision for income taxes	**30,471**	29,113	**88,759**	89,601
Provision for income taxes	**9,369**	4,554	**27,725**	23,843
Net income	**$ 21,102**	$ 24,559	**$ 61,034**	$ 65,758
Earnings per share				
Basic	**$ 0.25**	$ 0.29	**$ 0.71**	$ 0.77
Diluted	**$ 0.24**	$ 0.29	**$ 0.71**	$ 0.77
Weighted average shares outstanding ¾ basic	**85,793,904**	85,473,603	**85,672,993**	85,459,383
Weighted average shares outstanding ¾ diluted	**86,205,599**	85,579,863	**85,937,816**	85,603,010

See accompanying Notes to Condensed Consolidated Financial Statements.

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	*Common Stock $0.001 par value* Shares	Amount	*Additional Paid-in Capital*	*Retained Earnings*	*Accumulated Other Comprehensive Income (Loss)*	*Total*
Balance - January 1, 2005	85,489,061	$ 85	$420,425	$341,196	$ 12,695	$774,401
Comprehensive income (loss)	—	—	—	61,034 (1)	(15,507)(2)	45,527
Cash dividends declared on common stock ($0.12 per share)	—	—	—	(10,281)	—	(10,281)
Other	345,977	1	3,370	—	—	3,371
Balance - September 30, 2005	85,835,038	$ 86	$423,795	$391,949	$ (2,812)	$813,018

(1) Net income.
(2) Net change in accumulated other comprehensive income (loss) for the nine months ended September 30, 2005, is as follows:

AMOUNTS IN THOUSANDS	
Unrealized holding losses arising during the period, net of deferred income taxes of $7,483	$(13,899)
Reclassification adjustment for investment losses included in net income, net of income taxes of $866	(1,608)
Total	$(15,507)

See accompanying Notes to Condensed Consolidated Financial Statements.

21ST CENTURY INSURANCE GROUP
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
Unaudited

AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA				
Nine Months Ended September 30,		**2005**		2004
Operating activities				
Net income	**$**	**61,034**	$	65,758
Adjustments to reconcile net income to net cash				
provided by operating activities:				
Depreciation and amortization		**24,502**		16,182
Net amortization of investment premiums and discounts		**7,205**		4,865
Amortization of restricted stock grants		**238**		297
Provision for deferred income taxes		**10,687**		18,781
Realized losses (gains) on sale of investments		**2,779**		(8,738)
Changes in assets and liabilities:				
Premiums receivable		**(11,166)**		(12,390)
Deferred policy acquisition costs		**(5,001)**		(5,824)
Reinsurance balances		**1,193**		4,009
Federal income taxes		**(1,088)**		697
Other assets		**6,723**		(110)
Unpaid losses and loss adjustment expenses		**22,072**		47,757
Unearned premiums		**9,019**		29,215
Claims checks payable		**1,974**		(5,560)
Other liabilities		**(7,802)**		14,272
Net cash provided by operating activities		**122,369**		169,211
Investing activities				
Investments available-for-sale				
Purchases		**(333,513)**		(809,793)
Calls or maturities		**24,461**		29,847
Sales		**262,827**		623,157
Purchases of property and equipment		**(32,539)**		(29,567)
Net cash used in investing activities		**(78,764)**		(186,356)
Financing activities				
Repayment of debt		**(9,343)**		(8,495)
Dividends paid (per share: $0.08 and $0.06)		**(6,850)**		(5,126)
Proceeds from the exercise of stock options		**3,155**		510
Net cash used in financing activities		**(13,038)**		(13,111)
Net increase (decrease) in cash and cash equivalents		**30,567**		(30,256)
Cash and cash equivalents, beginning of period		**34,697**		65,010
Cash and cash equivalents, end of period	**$**	**65,264**	$	34,754
Supplemental information:				
Income taxes paid (refunded)	**$**	**19,281**	$	(474)
Interest paid		**4,495**		5,072

See accompanying Notes to Condensed Consolidated Financial Statements.

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21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2005
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

NOTE 1. FINANCIAL STATEMENT PRESENTATION

General

21st Century Insurance Group and subsidiaries (the "Company") prepared the accompanying unaudited condensed consolidated financial statements in accordance with the rules and regulations of the Securities and Exchange Commission for interim reporting. As permitted under those rules and regulations, certain notes or other information that are normally required by accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted if they substantially duplicate the disclosures contained in the annual audited consolidated financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

These condensed consolidated financial statements include all adjustments (including normal, recurring accruals) that are considered necessary for the fair presentation of our financial position and results of operations in accordance with GAAP. Intercompany accounts and transactions have been eliminated in consolidation. Operating results for the nine-month period ended September 30, 2005 are not necessarily indicative of results that may be expected for the remaining interim period or the year as a whole.

Earnings Per Share

For each of the quarters and nine months ended September 30, 2005 and 2004, the numerator for the calculation of both basic and diluted earnings per share is equal to net income reported for that period. The difference between basic and diluted earnings per share denominators is due to dilutive stock options. Options to purchase an aggregate of 4,501,547 and 6,395,088 shares of common stock for the three and nine months ended September 30, 2005, respectively, and 6,568,759 and 6,091,424 shares of common stock for the three and nine months ended September 30, 2004, respectively, were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common stock for each respective period. These options expire at various points in time through 2015.

Stock-Based Compensation

Statement of Financial Accounting Standard ("SFAS") No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*, amends the disclosure requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*, to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. As permitted by SFAS No. 123, the Company accounts for its fixed stock options using the intrinsic-value method, prescribed in Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees*, which generally does not result in compensation expense recognition for stock options. Under the intrinsic-value method, compensation cost for stock options is measured at the date of grant as the excess, if any, of the quoted market price of the Company's stock over the exercise price of the options.

In addition to stock options, the Company also grants restricted stock awards to certain officers and employees. Upon issuance of grants under the plan, unearned compensation equivalent to the market value on the date of grant is charged to paid-in capital and subsequently amortized over the vesting period of the grant. The Company becomes entitled to an income tax deduction in an amount equal to the taxable income reported by the holders of the restricted shares when the restrictions are released.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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Restricted shares are forfeited if officers' and employees' employment with the Company is terminated prior to the lapsing of restrictions. The Company records forfeitures of restricted stock as treasury share repurchases and any compensation cost previously recognized with respect to unvested stock awards is reversed in the period of forfeiture. This accounting treatment results in compensation expense being recorded in a manner consistent with that required under SFAS No. 123, and therefore, pro forma net income and earnings per share amounts for the Restricted Share Plan would be unchanged from those reported in the financial statements.

Had compensation cost for the Company's stock-based compensation plans been determined based on the fair-value-based method for all awards, net income would have been reduced by $1.2 million and $3.7 million for the three and nine months ended September 30, 2005, respectively, and reduced by $1.3 million and $4.5 million for the three and nine months ended September 30, 2004, respectively. The pro forma net income and earnings per share amounts follow:

	Three Months Ended September 30,		*Nine Months Ended* September 30,	
AMOUNTS IN THOUSANDS, EXCEPT SHARE DATA	**2005**	2004	**2005**	2004
Net income, as reported	**$21,102**	$24,559	**$61,034**	$65,758
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	**65**	66	**155**	196
Deduct: Total stock-based employee compensation expense determined under fair-value-based method for all awards, net of related tax effects	**(1,278)**	(1,401)	**(3,844)**	(4,681)
Net income, pro forma	**$19,889**	$23,224	**$57,345**	$61,273
Basic earnings per share:				
As reported	**$ 0.25**	$ 0.29	**$ 0.71**	$ 0.77
Pro forma	**$ 0.23**	$ 0.27	**$ 0.67**	$ 0.72
Diluted earnings per share:				
As reported	**$ 0.24**	$ 0.29	**$ 0.71**	$ 0.77
Pro forma	**$ 0.23**	$ 0.27	**$ 0.67**	$ 0.72

For pro forma disclosure purposes, the fair value of stock options was estimated for grants during the nine-month periods ended September 30 using the Black-Scholes valuation model with the following weighted-average assumptions:

	Nine Months Ended September 30,	
	2005	2004
Risk-free interest rate:		
Minimum	**3.74%**	3.43%
Maximum	**4.28%**	4.24%
Dividend yield	**1.13%**	0.56%

Volatility factor of the expected market price of the Company’s common stock:		
Minimum	**0.29**	0.36
Maximum	**0.32**	0.41
Weighted-average expected life of the options	**6 years**	6 years

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21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2005
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

Recent Accounting Standards

In March 2005, the Securities and Exchange Commission (the “SEC”) issued Staff Accounting Bulletin (“SAB”) No. 107, *Share-Based Payment*. SAB No. 107 summarizes the views of the SEC staff regarding the interaction between SFAS No. 123 (Revised 2004), *Share-Based Payment* (“SFAS No. 123R”) and certain SEC rules and regulations, and is intended to assist in the initial implementation of SFAS No. 123R, which for the Company is required beginning in the first quarter of 2006. As a result of SFAS No. 123R, the Company will be required to recognize the cost of its stock options as an expense in the consolidated statement of operations. The Company is currently assessing the impact that the adoption of SFAS No. 123R will have on its consolidated results of operations. Although this assessment is ongoing, management believes that the effect of adopting SFAS No. 123R will be material to the Company’s consolidated results of operations. Had the Company adopted SFAS No. 123R in prior periods, the impact on net income and earnings per share would have been similar to the pro forma net income and earnings per share in accordance with SFAS No. 123 as disclosed earlier in this note.

NOTE 2. PROPERTY AND EQUIPMENT

A summary of property and equipment follows:

	September 30, 2005	December 31, 2004
Land	**$ 2,484**	$ —
Building	**9,722**	—
Furniture and equipment	**40,731**	38,676
Automobiles	**339**	881
Leasehold improvements	**14,494**	14,245
Software currently in service	**152,926**	87,283
Software development projects in progress	**8,832**	56,816
Subtotal	**229,528**	197,901
Less accumulated depreciation, including $38,750 and $25,506 for software currently in service	**(83,687)**	(68,529)
Total	**$ 145,841**	$ 129,372

On September 30, 2005, the Company purchased the land and building that house its 136 thousand square foot service center in Texas. The Company had been leasing this property since June 2004. The operating lease provisions included a rent holiday through June 2005 and a $2.5 million tenant improvement allowance. As of September 29, 2005, the accrued rent obligation and tenant improvement allowance totaled $1.4 million and $2.5 million, respectively. These liabilities were offset against the facility cash purchase price of $17.6 million to arrive at a net cost of $13.7 million. The net cost consists of land, building and building equipment of $2.5 million, $9.7 million, and $1.5 million, respectively. The building and its equipment have been assigned useful lives of 39.5 years and 7 years, respectively, and will be depreciated on a straight-line basis over their respective useful lives.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2005
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

NOTE 3. HOMEOWNER AND EARTHQUAKE LINES IN RUNOFF

More than ninety-eight percent of the claims submitted and litigation brought against the Company as a result of California Senate Bill 1899 ("SB 1899") have been resolved. All of the Company's remaining Northridge earthquake claims are in litigation. No class actions have been certified and the trial court has denied class action status for the two remaining cases seeking class action status. While the reserves established are the Company's current best estimate of the cost of resolving its 1994 Northridge earthquake claims, including claims arising as a result of SB 1899, these reserves continue to be highly uncertain because of the difficulty in predicting how the remaining litigated cases will be resolved. The estimate currently recorded by the Company assumes that relatively few of the remaining cases will require a full trial to resolve, that any trial costs will approximate those encountered by the Company in the past, that most cases will be settled without need for extensive pre-trial preparation, and that the trial court's denial of class action status for those cases seeking such status will be upheld on appeal. Current reserves contain no provisions for extra-contractual or punitive damages, bad faith judgments or similar unpredictable hazards of litigation that possibly could result in the event an adverse verdict were to be sustained against the Company. To the extent these and other underlying assumptions prove to be incorrect, the ultimate amount to resolve these claims could exceed the Company's current reserves, possibly by a material amount. The Company continues to seek reasonable settlements of claims brought under SB 1899 and other Northridge earthquake related theories, but will vigorously defend itself against excessive demands and fraudulent claims. The Company may, however, settle cases in excess of its assessment of its contractual obligations in order to reduce the future cost of litigation.

SB 1899, effective from January 1, 2001 to December 31, 2001, allowed the re-opening of previously closed earthquake claims arising out of the 1994 Northridge earthquake. The discovery stay imposed in early 2002 was lifted in the first quarter of 2003 and the Company obtained more information with which to estimate the ultimate cost of resolving its SB 1899 claims. Based on events occurring during the first quarter of 2003, the Company increased its SB 1899 reserves by $37.0 million, resulting in an after-tax charge of $24.1 million. The revised estimate was based on the pace and cost of settlements reached as of that point, the actual costs incurred during that quarter, and the Company's assessment of the expected length and intensity of the litigation arising out of the remaining claims. The estimate was subsequently increased by $1.0 million during the first quarter of 2004 based on the Company's reassessment of its remaining estimated litigation costs. Based upon information obtained in connection with settlement discussions and mediations conducted during the fourth quarter of 2004, the Company updated its case-by-case review of the remaining cases and reevaluated remaining litigation costs for resolving outstanding matters. As a result of this reassessment, the Company increased its reserve by $1.2 million during the fourth quarter of 2004. The Company's total reserve for SB 1899 claims as of September 30, 2005, was $1.0 million.

The Company has received some Northridge earthquake claims reported after the closing of the window established by SB 1899 which are based upon alternative legal theories. The Company is contesting these claims and the earthquake reserves include only nominal amounts for them. Should the courts ultimately determine that these claims, or additional claims brought in the future, are not barred by the applicable statute of limitations and the provisions of SB 1899, additional reserves may be needed to resolve them. A recent Court of Appeal decision, *Cordova v. 21st Century Insurance Company*, found that SB 1899 does not automatically bar claims brought outside its specified time limitations and that, under certain conditions, a 1994 Northridge earthquake claimant might be able to assert that the Company is equitably estopped to assert a time limitation defense. The California Supreme Court denied the Company's request for review of this decision.

Loss and loss adjustment expenses incurred for the homeowner and earthquake lines in runoff were $0.6 million and $1.0 million for the three and nine months ended September 30, 2005, respectively, compared to $0.4 million and $0.9 million for the same periods in 2004.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2005
DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

NOTE 4. COMMITMENTS AND CONTINGENCIES

Litigation. In the normal course of business, the Company is named as a defendant in lawsuits related to claims and insurance policy issues, both on individual policy files and by class actions seeking to attack the Company's business practices. Many suits seek unspecified extra-contractual and punitive damages as well as contractual damages under the Company's insurance policies in excess of the Company's estimates of its obligations under such policies. The Company cannot estimate the amount or range of loss that could result from an unfavorable outcome on these suits and it denies liability for any such alleged damages. The Company has not established reserves for potential extra-contractual or punitive damages, or for contractual damages in excess of estimates the Company believes are correct and reasonable under its insurance policies. Nevertheless, extra-contractual and punitive damages, if assessed against the Company, could be material in an individual case or in the aggregate. The Company may choose to settle litigated cases for amounts in excess of its own estimate of contractual damages to avoid the expense and risk of litigation. Other than possibly for the contingencies discussed below, the Company does not believe the ultimate outcome of these matters will be material to its results of operations, financial condition, or cash flows. The Company denies liability and has not established a reserve for the matters discussed below. A range of potential losses in the event of a negative outcome is discussed where known.

Poss v. 21st Century Insurance Company was filed on June 13, 2003, in Los Angeles Superior Court. The complaint sought injunctive and unspecified restitutionary relief against the Company under Business and Professions Code Sec. 17200 for alleged unfair business practices in violation of California Insurance Code Sec. 1861.02(c) relating to company rating practices. Based on California's Proposition 64, passed in November 2004, the court granted the Company's motion to dismiss the complaint, but allowed the addition of a second plaintiff, Leacy. The court stayed the litigation pending appellate court decisions involving similar issues but other parties. Because this matter is in the pleading stages and no discovery has taken place, no estimate of the range of potential losses in the event of a negative outcome can be made at this time.

Cecelia Encarnacion, individually and as the Guardian Ad Litem for Nubia Cecelia Gonzalez, a Minor, Hilda Cecelia Gonzalez, a Minor, and Ramon Aguilera v. 20th Century Insurance was filed on July 3, 1997, in Los Angeles Superior Court. Plaintiffs allege bad faith, emotional distress, and estoppel involving the Company's (the Company was formerly named 20th Century Insurance) handling of a 1994 homeowner's claim. On March 1, 1994, Ramon Aguilera, a homeowner policyholder, shot and killed Mr. Gonzalez (the minor children's father) and was later sued by Ms. Encarnacion for wrongful death. On August 30, 1996, judgment was entered against Ramon Aguilera for $5.6 million. The Company paid for Aguilera's defense costs through the civil trial; however, the homeowner's policy did not provide indemnity coverage for the incident, and the Company refused to pay the judgment. After the trial, Aguilera assigned a portion of his action against the Company to Encarnacion and the minor children. Aguilera and the Encarnacion family then sued the Company alleging that the Company had promised to pay its bodily injury policy limit if Aguilera pled guilty to involuntary manslaughter. In August 2003, the trial court held a bench trial on the limited issues of promissory and equitable estoppel, and policy forfeiture. On September 26, 2003, the trial court issued a ruling that the Company cannot invoke any policy exclusions as a defense to coverage. On May 14, 2004, the court granted the Encarnacion plaintiffs' motion for summary adjudication, ordering that the Company must pay the full amount of the underlying judgment of $5.6 million, plus interest, for a total of $10.5 million. The Company disagrees with this ruling as it appears inconsistent with the court's simultaneous ruling denying the Company's motion for summary judgment on grounds that there are triable issues of material fact as to whether plaintiffs are precluded from recovering damages as a consequence of Aguilera's inequitable conduct. The Company also believes that the court's decision was not supported by the evidence in the case, demonstrating that no promise to settle was ever made.

The Company has appealed the judgment as to the Encarnacions. The trial as to Aguilera began October 12, 2005 on his claims for bad faith, emotional distress, punitive damages and attorney fees. The Company believes it has meritorious defenses to these claims. The Company's exposure in this case includes the aforementioned $10.5 million judgment, post-judgment interest, plaintiff's attorney fees (which could approach $4 million) and any award for bad faith, emotional distress and punitive damages.

21ST CENTURY INSURANCE GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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DOLLAR AMOUNTS IN THOUSANDS, EXCEPT WHERE NOTED

Insurance Company cases (Ramona Goldenburg) was originally filed as *Bryan Speck, individually, and on behalf of others similarly situated v. 21st Century Insurance Company, 21st Century Casualty Company, and 21st Century Insurance Group*. The original action was filed on June 20, 2002, in Los Angeles Superior Court. Plaintiff seeks California class action certification, injunctive relief, and unspecified actual and punitive damages. The complaint contends that 21st Century uses "biased" software in determining the value of total-loss automobiles. Plaintiff alleges that database providers use improper methodology to establish comparable auto values and populate their databases with biased figures and that the Company and other carriers allegedly subscribe to the programs to unfairly reduce claims costs. This case is consolidated with similar actions against other insurers for discovery and pre-trial motions. The Company intends to vigorously defend the suit with other defendants in the coordinated proceedings. This matter is in the pleading stage of litigation and no reasonable estimate of potential losses in the event of a negative outcome can be made at this time.

Thomas Theis, on his own behalf and on behalf of all others similarly situated v. 21st Century Insurance was filed on June 17, 2002, in Los Angeles Superior Court. Plaintiff seeks California class action certification, injunctive relief, and unspecified actual and punitive damages. The complaint contends that after insureds receive medical treatment, the Company used a medical-review program to adjust expenses to reasonable and necessary amounts for a given geographic area. Plaintiff alleges that the adjusted amount is "predetermined" and "biased," creating an unfair pretext for reducing claims costs. This case is consolidated with similar actions against other insurers for discovery and pre-trial motions. The Company intends to vigorously defend the suit with other defendants in the coordinated proceedings. This matter is in the discovery stage of litigation and no reasonable estimate of potential losses in the event of a negative outcome can be made at this time.

NOTE 5. STOCK - BASED COMPENSATION

2004 Stock Option Plan

The stockholders approved the 2004 Stock Option Plan (the "2004 Plan") at the Annual Meeting of Shareholders on May 26, 2004. The 2004 Plan supersedes the 1995 Stock Option Plan, which will remain in effect only as to outstanding awards under it. The 2004 Plan authorizes a committee of the Board of Directors to grant stock options in respect of 4,000,000 shares to eligible employees and nonemployee directors, subject to the terms of the 2004 Plan. Additionally, under the 2004 Plan, the aforementioned committee may grant stock options in respect of shares that were subject to outstanding awards under the 1995 Stock Option Plan to the extent such awards expire, are terminated, are cancelled, or are forfeited for any reason without shares being issued.

At September 30, 2005, 4,170,209 stock options remain available for future grants under the 2004 Plan. Options granted to employees generally have ten-year terms and vest over various periods, generally three years. Options granted to nonemployee directors expire one year after a nonemployee director ceases service with the Company, or ten years from the date of grant, whichever is sooner. Nonemployee director options vest over one year, provided that the nonemployee director is in the service of the Company at that time. Currently, the Company uses the intrinsic-value method to account for stock-based compensation paid to employees and nonemployee directors for their services.

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A summary of securities issuable and issued for the Company’s stock option plans and the Restricted Shares Plan at September 30, 2005, follows:

AMOUNTS IN THOUSANDS	*1995 Stock Option Plan*	*2004 Stock Option Plan*	*Restricted Shares Plan*
Total number of securities authorized	10,000	4,000	1,422
Number of securities issued	(784)	—	(1,144)
Number of securities issuable upon the exercise of all outstanding options	(7,152)	(1,894)	—
Number of securities forfeited	(2,350)	—	—
Number of forfeited securities returned to plan	2,350	—	159
Unused options assumed by 2004 Stock Option Plan	(2,064)	2,064	—
Number of securities remaining available for future grants under each plan	—	4,170	437

Exercise prices for options outstanding at September 30, 2005, ranged from $11.68 to $29.25. The weighted-average remaining contractual life of those options is 6.7 years.

A summary of the Company’s stock option activity for the nine months ended September 30, 2005, and related information follows:

AMOUNTS IN THOUSANDS, EXCEPT PRICE DATA	*Number of* Options	*Weighted*-Average Exercise Price
Options outstanding December 31, 2004	8,109	$ 16.49
Granted in 2005	1,725	14.19
Exercised in 2005	(259)	14.47
Forfeited in 2005	(529)	14.89
Options outstanding September 30, 2005	9,046	16.20

Of the 9,046,092 and 8,108,558 in options outstanding at September 30, 2005 and December 31, 2004, respectively, 5,901,196 and 5,068,493 options were exercisable as of September 30, 2005 and December 31, 2004, respectively. The remaining 3,144,896 and 3,040,065 options outstanding as of September 30, 2005 and December 31, 2004, respectively, were not yet vested.

NOTE 6. EMPLOYEE BENEFIT PLANS

The Company has both funded and unfunded non-contributory defined benefit pension plans, which together cover essentially all employees who have completed at least one year of service. For certain key employees designated by the Board of Directors, the Company sponsors an unfunded non-qualified supplemental executive retirement plan. The supplemental plan benefits are based on years of service and compensation during the three highest of the last ten years of employment prior to retirement and are reduced by the benefit payable from the pension plan and 50% of the social security benefit. For other eligible employees, the pension benefits are based on employees’ compensation during all years of service. The Company’s funding policy is to make annual contributions as required by applicable regulations.

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Components of Net Periodic Cost

Net pension costs for all plans were comprised of the following:

	Three Months Ended September 30,		*Nine Months Ended September 30,*	
	2005	2004	**2005**	2004
Service cost	**$ 1,620**	$ 1,891	**$ 5,145**	$ 4,870
Interest cost	**1,763**	1,758	**5,473**	4,979
Expected return on plan assets	**(1,827)**	(1,608)	**(5,487)**	(4,831)
Amortization of prior service cost	**78**	29	**131**	81
Amortization of net loss	**428**	635	**1,442**	1,624
Total	**$ 2,062**	$ 2,705	**$ 6,704**	$ 6,723

Employer Contributions

The Company previously disclosed in its financial statements for the year ended December 31, 2004, that it did not expect to contribute to its qualified defined benefit pension plan in 2005. As of September 30, 2005, no contributions have been made. After consideration of currently available information, the Company anticipates that it may make a cash contribution between $6.0 million and $14.0 million to its qualified defined benefit pension plan before the end of 2005. The amount and timing of future contributions to the Company's qualified defined benefit pension plan depends on a number of unpredictable factors including the market performance of the plan's assets and future changes in interest rates that affect the actuarial measurement of the plan's obligations.

Contributions to the Company's non-qualified defined benefit pension plan generally are limited to amounts needed to make benefit payments to retirees, which are expected to total approximately $0.9 million in 2005.

NOTE 7. SEGMENT INFORMATION

The Company's "Personal Auto Lines" reportable segment primarily markets and underwrites personal automobile, motorcycle and umbrella insurance. The Company's "Homeowner and Earthquake Lines in Runoff" reportable segment, which is in runoff, manages the wind-down of the Company's homeowner and earthquake programs. The Company has not written any earthquake coverage since 1994 and ceased writing homeowner policies in February 2002.

Insurers offering homeowner insurance in California are required to participate in the California FAIR Plan ("FAIR Plan"). FAIR Plan is a state administered pool of difficult to insure homeowners. Each participating insurer is allocated a percentage of the total premiums written and losses and loss adjustment expense ("LAE") incurred by the pool according to its share of total homeowner direct premiums written in California. Participation in FAIR Plan operations is based on the pool from two years prior. Since the Company ceased writing homeowners business in 2002, the Company no longer receives assignments for plan years beyond 2004, but continues to participate in prior plan year activity, which is in runoff.

The Company evaluates segment performance based on pre-tax underwriting profit (loss). The Company does not allocate assets, net investment income, net realized investment gains (losses), other revenues, nonrecurring items, interest and fees expense, or income taxes to operating segments. The accounting policies of the reportable segments are the same as those described in Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2004. All revenues are generated from external customers and the Company does not rely on any major customer.

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The following table presents net premiums earned, depreciation and amortization expense, and segment profit (loss) for the Company's segments.

	Personal Auto Lines	*Homeowner and Earthquake Lines in Runoff*[1]	*Total*
Three Months Ended September 30, 2005			
Net premiums earned	**$ 344,099**	**$ 3**	**$ 344,102**
Depreciation and amortization expense	**9,504**	**3**	**9,507**
Segment profit (loss)	**16,972**	**(613)**	**16,359**
Three Months Ended September 30, 2004			
Net premiums earned	$ 333,443	$ (3)	$ 333,440
Depreciation and amortization expense	5,493	7	5,500
Segment profit (loss)	16,709	(436)	16,273
Nine Months Ended September 30, 2005			
Net premiums earned	**$ 1,017,302**	**$ 9**	**$ 1,017,311**
Depreciation and amortization expense	**24,495**	**7**	**24,502**
Segment profit (loss)	**47,035**	**(983)**	**46,052**
Nine Months Ended September 30, 2004			
Net premiums earned	$ 978,573	$	